TABELL'S MARKET LETTER

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Almost as a throwaway last week, we mentioned that we had calculated an unweighted average of the five hundred S & P components and that this average, since mid-1983 at least, had quite decisively underperformed the S & P itself. As any market analyst would, we knew intuitively that such would be the case, but, on reflection, we began to realize that this simple fact raised some fairly profound questions regarding the nature of today's stock market, questions that will probably require more than just today's letter to explore in detail.

To begin with, it may be worthwhile to recall the method of computation used to produce the Standard & Poor's 500 Stock Price Index. That index is often referred to as being capital-weighted and broad-based. The former adjective is factual; the latter description, as we shall see, is open to some argument. At any rate, the method of computation is as follows: The price of each of the 500 stocks is multiplied by the number of shares outstanding, resulting in, for each issue, a total market value. These 500 market values are then added together to produce a market value total, which was, as of a week ago, a fairly impressive figure in the neighborhood of $2.3 trillion. This figure is then divided by a base in order to produce the average itself. This divisor was originally calculated so as to cause the 500 original components, at their 1941-43 average prices, to produce an index of 10. The base, however, is the means used to adjust for changes in capital (Not splits. Multiplication of price by shares eliminates the need to adjust for splits.) and has, therefore, fluctuated widely over the years.

The well-known result, of course, is the fact that larger (in market value) companies have heavier weights in the 500, the largest one, IBM, accounting for 2.694% of the index at recent levels. The 10 largest companies account for 18% of the average, the 20 largest for 29%, the 50 largest for just under half, and the 100 largest for close to two-thirds of the average's weight. Turning this calculation around, it is possible to state that 10% of the average's fluctuation is accounted for by 5 stocks, 50% by 56 stocks, 80% by 185 stocks, 90% by 274, or just over half, of the issues, and 99% by 435. Sixty-five of the components, therefore, do little other than to produce a nice round number such as 500. In other words, while the index is certainly capital-weighted, it is possible to question just how broad-based it is. The thirty companies in the "narrower" Dow Jones wind up accounting for a goodly portion of the weight of the S & P.

Why does Standard & Poor's (along with the proprietors of a whole host of similarly calculated indices) go to all this trouble? There are a number of theoretical answers including the one that the index reflects the changing character of American industrial leadership. General Motors was, for years, the largest component, and now ranks 10th. Number nine, interestingly, is Wal-Mart Stores, well down the list not too long ago. General Electric is, currently, making a run at the top spot. Regardless of theory, however, the S & P 500 has, de facto, become the standard against which portfolio management is judged today. Billions of dollars are shifted about---all too readily, many believe---based on management's performance vs. the 500.

This is not totally unfair for those managers deploying monster amounts of money. The 500 undoubtedly represents a fair measure of the investment universe available to them. The larger-market-value companies obviously tend to be easier to purchase. A good many of the smaller S & P components possess a total market value less than the average single position for some institutional funds. It should be noted, however, that this is not true for the individual investor, who can afford, theoretically, to be indifferent to which of the 500 companies, or a thousand or so others, he owns. (All but eight of the components have total market values of over $100 million.)

The S & P 500 has, therefore, largely become a measure of what is happening to the sorts of stocks that large institutions can buy. The fact that the S & P has performed better than its unweighted cousin may, therefore, be nothing more than a reflection of the growing institutionalization of the market. It is, moreover, no accident that a great many funds, whose horizons must perforce be limited to the upper tier of the S & P, have chosen simply to index, or to use the current, polite phrase, indulge in passive management, maintaining a portfolio which does nothing more than replicate the action of the 500. Thus, it is arguable that the growth of passive management techniques may have itself caused improved relative performance for this kind of management. This apparent paradox will be worth exploring in future issues.

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Dow Jones Industrials (12:00)	2703.60
S & P 500 (12:00)	337.43
Cumulative Index (04/19/90)	4813.89

AWT:ebh