MARKET OBSERVATIONS
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Popular

Be it restaurants, movies, sports teams or common stocks, to be popular is to be regarded with favor. The popularity of a common stock is reflected in the breadth of its ownership and its relative price movement. As the favor shown certain stocks is transmitted through meaningful changes in their prices, market indexes including such stocks are impacted. In turn, the dynamics of exchange-traded funds ("ETFs") tracking such indexes can shift as well. These shifts then shape the return and risk behaviors of portfolios with particular ETF holdings. A review of the consequences of stock popularity can provide perspective for investing yet ahead.

PERSPECTIVE

Popular or average? Stock indexes and respective ETFs convey these themes by either weighting holdings by market value ("popular") or equally weighting ("average") them. The current resulting individual stock allocations for a measure of the largest companies in the U.S., the S&P 100 index, is shown in Table I. The allocation variances among just the top five holdings is quite pronounced. The popular approach leads to much more stock-specific risk and much less risk reduction through diversification. The potential for return and risk variances between popular and average schemes is high.

An index, ETF or portfolio constructed of popular (market-value weighted) stocks can lead to sector weightings with similar popular tilts. When market-value weighted, the S&P 100 index of the largest U.S. companies currently has a 26% allocation to the popular technology sector. The average (equally weighted) construction of the index has a much lower 13% allocation. This variance likely would generate different return and risk patterns. Sector popularity comes and goes. Stocks in the overall market generally are assigned to one of eleven sectors. Chart I shows the relative sector relationships among three sectors – energy, financial, technology – and their trends over time. The trends for these sectors are quite disparate. The energy sector rose steadily and then declined to a de minimus level. The financial sector has declined as well but remains a sizable component. The technology sector has moved irregularly higher to a dominant level.

Index, ETF or portfolio performance can vary widely if the construction methodology is either popular (market-value weighted) or average (equally weighted). Chart II displays the rolling 12-month return advantage of popular over average for the largest U.S. companies as measured by the S&P 100 index. The variance has been notable from a high of +15.7% to a low of -16.7%. Most recently the advantage has turned from positive to average. The statistical advantage for the total period shown here goes to the average portfolio with a median 12-month return of +12.5% versus +11.3% for popular. In addition, average 12-month returns were higher than popular returns 58% of the time.

INVESTMENT IMPLICATIONS

"Popular", "average" and a host of other methodologies are employed today in the construction of indexes, ETFs and portfolios. Each approach can bring different return and risk outcomes. Pursuing investment goals is not a popularity contest. Rather, it is the application of proven investment principles to clearly identified goals, horizons and tolerance for risk. Improving the odds of achieving investment goals is a popular outcome for all investors.

TABLE I

"POPULAR" VS. "AVERAGE" BIG STOCK ALLOCATIONS

	"POPULAR" PORTFOLIO (MARKET-VALUE WEIGHTED)	"AVERAGE" PORTFOLIO (EQUALLY WEIGHTED)
APPLE	8.4%	1.0%
MICROSOFT	8.0%	1.0%
AMAZON	5.8%	1.0%
FACEBOOK	3.3%	1.1%
ALPHABET (GOOGLE)	3.5%	0.6%
% TOP 10 STOCKS	39.7%	11.8%

CHART I

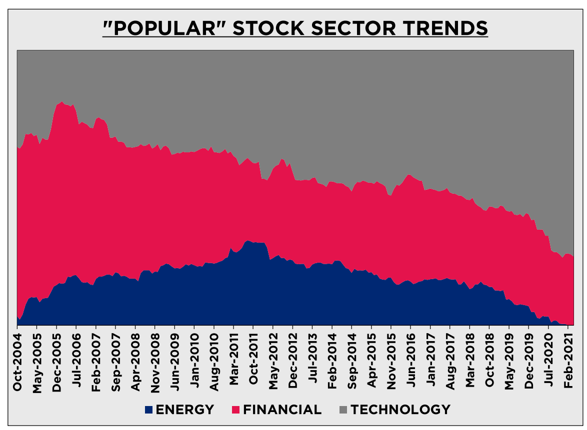

CHART II