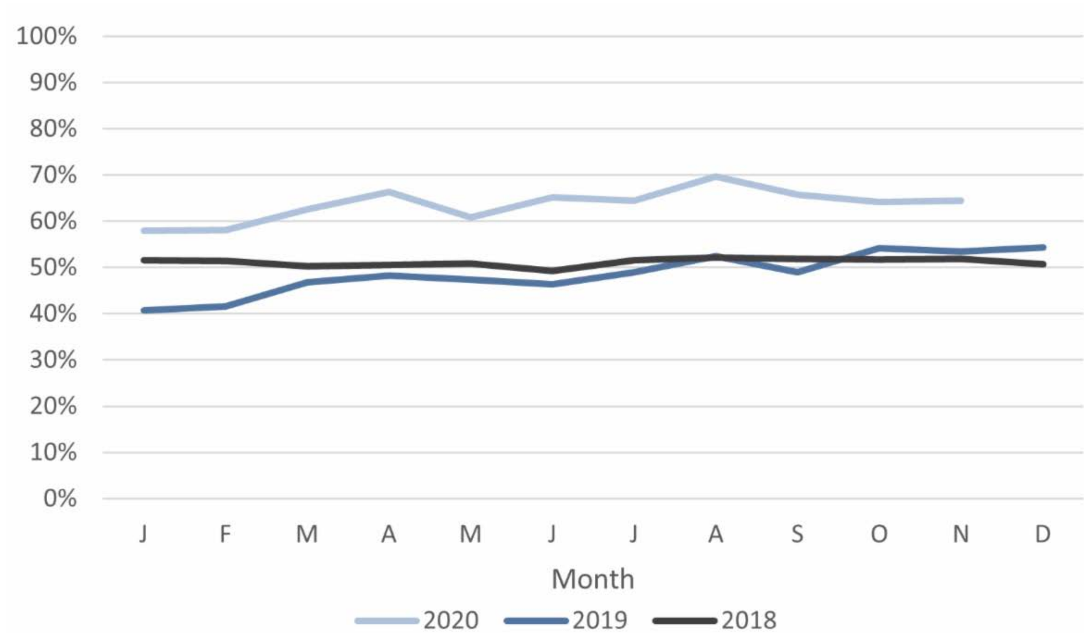
View as Webpage

Market Comment:

Tesla, Benchmarking, and Active Management

Fig. 1: Percentage of constituents underperforming the S&P 500



Source: Bloomberg, Mill Creek

As of today, Tesla Inc. has been added to the S&P 500. There has been and will continue to be plenty of ink spilled around Tesla's prospects from a stock price standpoint, but the publicity around the event also affords an opportunity to discuss equity indices and active management.

To be eligible for inclusion in the S&P 500, a company "should be a U.S. company, have a market capitalization of at least USD 8.2 billion, be highly liquid, have a public float of at least 10% of its shares outstanding, and its most recent quarter's earnings and the sum of its trailing four consecutive quarters' earnings must be positive[1]." Outside of those criteria, a committee at Dow Jones S&P simply tries to allocate to a group of stocks that are representative of the overall US stock market.

Contrast S&P's inclusion criteria to an active equity manager. Active managers select equities based on a perceived gap between market expectations and their expectations for the security in question. One might think such an approach would clearly be superior, but active managers, as a group, have famously struggled to outperform the indices to which they are compared.

One reason: most equities underperform the broad market themselves (Fig. 1). Many investors have a mental model where half of the stocks in the S&P 500 outperform, half underperform, and the index return is right in the middle. The actual returns can be much more skewed. This year, for example, 65% of the companies in the S&P 500 are lagging the S&P 500 index through November (Fig. 1).

Hendrik Bessembinder, a professor at ASU's W. P. Carey School of Business, studies the distribution of wealth creation in US equities. He has found that over decade-long periods, just 37% of equities, on average, outperformed the market average. The skew becomes even more extreme as you extend your time horizon. Over the last 90 years, just 4% of companies were responsible for all of the wealth creation — in excess of Treasury bills — in the US stock market[2].

This skewed distribution of stock returns is a double-edged sword. On one hand it gives the indexes an advantage since concentrated portfolios can easily miss one of the few equities that produce outsized results, whereas broad-based passive benchmarks have a high probability of holding at least a small allocation to the eventual winners. On the other hand, and as we've seen in our actively managed equity portfolios this year, a skilled stock selector with a concentrated portfolio can produce returns that far exceed the market. Many investors will find that a prudent combination of active and passive — offering broad market exposure with the potential for outperformance — to be the best of both worlds.

[1] https://www.spglobal.com/spdji/en/indices/equity/sp-500/#overview
[2] Bessembinder, Hendrik (Hank), Do Stocks Outperform Treasury Bills? (May 28, 2018). Journal of Financial Economics (JFE), Forthcoming, Available at SSRN: https://ssrn.com/abstract=2900447 or http://dx.doi.org/10.2139/ssrn.2900447

Updated Benchmark Performance:

Benchmark Performance by Asset Class	Week-to-Date	Month-to-Date	Year-to-Date
U.S. Large Cap Equities	1.65%	3.14%	19.70%
U.S. Small Cap Equities	3.09%	8.33%	19.60%
International Developed Equities	2.01%	3.83%	6.98%
Emerging Markets Equities	0.89%	5.31%	16.06%
Global Equities	1.61%	3.55%	15.04%
U.S. Bonds	-0.08%	-0.22%	7.12%
Intermediate Municipal Bonds	7.83%	0.31%	4.15%
High Yield Bonds	0.33%	1.30%	6.50%
Oil	4.73%	8.99%	-30.94%
Gold	2.46%	6.07%	20.55%
Key Rates	**12/18/2020**	**12/31/2019**	**12/18/2019**
U.S. 2 Year Treasury Note	0.13	1.58	1.63
U.S. 10 Year Treasury Note	0.95	1.92	1.92

Week in Review:

Optimism around a fiscal stimulus and the continued rollout of vaccines drove all major US indexes to all-time highs last week. Weak economic data highlighted a difficult near-term environment despite the improving long-term outlook. Retail sales for November declined 1.1% while weekly jobless claims numbered 885,000 – both weaker than expected by economists. On Sunday night Congress announced an agreement on a fiscal stimulus bill which includes $600 checks to many Americans and $300 per week in enhanced Federal unemployment benefits. The bill will also provide aid for schools, vaccine distribution, and small businesses.

The price of Bitcoin eclipsed $23,000 for the first time last week after rallying 25% on the week. Bitcoin is now up over 200% year-to-date as institutional investors have begun embracing the cryptocurrency. Coinbase, the largest cryptocurrency exchange in the US, is taking advantage of the simultaneous Bitcoin rally and IPO frenzy by filing to go public early next year. Coinbase will be the first major bitcoin-focused company to test the public markets. The San Francisco-based company's most recent financing in October 2018 valued it at $8 billion.

Economic Calendar:

- Third Quarter GDP Estimate – Tuesday, December 22nd
- Consumer Confidence Index – Tuesday, December 22nd
- Existing Home Sales – Tuesday, December 22nd
- New Home Sales – Wednesday, December 23rd

This week's contributors: Michael Crook, CAIA and Dusko Jankovic, CFA, CAIA

Indices Used: U.S. Large Cap equities: Russell 1000 Index, U.S. Small Cap Equities: Russell 2000 Index, International Developed Equities: MSCI EAFE Index, Emerging Market Equities: MSCI Emerging Markets Index, U.S. Bonds: Barclays Aggregate Bond Index, U.S. 10 Year Treasury Note: Bloomberg 10 Yr. Treasury Note, Municipal Bonds: Barclays Intermediate Municipal Bond Total Return Index, High Yield Bonds: Barclays U.S. High Yield Total Return Index, Oil: Bloomberg WTI Crude Sub-Index Total Return Index, Gold: Bloomberg Gold Sub-Index Total Return Index