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THE WEIGHTING IS THE HARDEST PART

As we are barraged on a daily basis by all forms of financial media, it's very easy to take a lot of what is being said at face value. After all, who has the time to fact check or actually research what is being conveyed by the popular media? We are interested in headlines like the daily levels and price movement of the Dow Jones, the S&P, etc. But does the average individual investor really understand the character and make up of these very popular stock market averages? As accepted as these major averages are of being representative of "the stock market" as a whole, almost nothing could be further from the truth. In no way are they truly reflective of the very broad US stock market. This fact is very important for decision making within the context of the current bull market cycle for equities and deserves special attention in terms of what we have been experiencing in 2015.

Let's embark on a bit of background, which necessarily involves looking at how the Dow and the S&P 500 indexes are constructed. Starting with the Dow Jones Industrial Index it is important to understand that this index contains only 30 stocks. Just how is this small sample representative of an entire market that has more than 3,800 public companies? But wait, the story of the Dow gets more interesting as we look a bit deeper...

The Dow is what is termed as a price-weighted index, meaning higher individual stock weightings in the index are assigned to the issues that have the highest prices! Seems hard to believe, but this is exactly how this index is constructed. Individual stock price alone is the determinant. Not revenues, not market capitalization, not earnings, but actual stock price. The table below shows us the current weightings of the top stocks in the Dow Jones Industrial Average:

Company	Weight in Dow	Company	Weight in Dow
Goldman Sachs	7.1%	Nike	5.0%
3M	6.0%	Disney	4.5%
Boeing	5.6%	Apple	4.4%
IBM	5.2%	Travelers	4.3%
Home Depot	5.0%	McDonalds	4.3%

The very simple math tells us that 10 stocks in the Dow account for over 50% of the total weighting in the Dow composite we see flashing on the screen every day. 10 stocks that determine over 50% of the daily price movement of this index are representative of the entire US stock market? Really? Again, what is very important is understanding what we are looking at when we see the Dow Jones stock index quoted incessantly and understanding that its performance is not necessarily indicative of what it happening with other US publicly traded companies.

This may sound wildly facetious, but if Warren Buffet's Berkshire Hathaway was included in the Dow Jones index, at a current price of $203,000 per share, it would most likely account for 99% of the weight of the Dow. It's no wonder Berkshire has never quite made it to the "club" known as the Dow Jones. It can't!

As we delve deeper into the makeup of other stock market indexes the headline stock index "story" only gets more interesting. We will now address the very popular S&P 500. Unlike the Dow, that is weighted by the price an individual stock in the index, the S&P 500 is what is called capitalization weighted. What does that mean? The market capitalization of any security is its price multiplied by the number of shares outstanding. In other words, it is the financial value the market has assigned to the company. As a very simple example, if a company has 100 shares outstanding and the price of the stock is $10, the market has assigned a $1,000 value to that company. Its "market capitalization" is $1,000. The table below shows us the top 15 stocks in the S&P 500 by their respective current market capitalization based weightings.

THE WEIGHTING IS THE HARDEST PART Continued from page 1

TOP S&P 500 STOCKS	WEIGHT IN THE S&P
Apple	3.7%
Google	2.4%
Microsoft	2.3%
Exxon	1.8%
GE	1.6%
Johnson and Johnson	1.5%
Wells Fargo	1.4%
Amazon	1.4%
Berkshire	1.4%
JP Morgan	1.4%
Facebook	1.3%
ATT	1.1%
Proctor and Gamble	1.1%
Pfizer	1.1%
Disney	1.0%
TOTAL	**24.5 %**

Of course what is more than apparent is that the top 6 stocks in the Dow Jones are nowhere to be found in the top 15 S&P weightings. Moreover, of the 500 stocks in the S&P, only 15 stocks account for just under 25% of the total weight of the index with the other 485 stocks accounting for the remainder. Again, it may sound facetious, but the bottom 100 stocks in the S&P 500 are close to a rounding error in terms of weight. The lopsided nature of the S&P weightings means that for every dollar put into an S&P ETF (exchange traded fund) or index fund, 25 cents goes into 15 stocks and the other 75 cents is divided among 485 stocks. Flows into index oriented ETFs or funds disproportionately favor the largest companies. This circumstance is neither right nor wrong, it is simply reality, a reality that may not necessarily be widely recognized by the average investor.

So what are we really looking at when we see the media quote the Dow and S&P every trading day? We are really looking at the movement of about 35 stocks – the top 10 in the Dow and the top 15 in the S&P 500. These 35 stocks are less than 1% of the total number of public companies traded on US financial markets daily. So are the Dow and the S&P really representative of the US stock market broadly? Not even close.

Now that we have dragged you through the exercise of deconstructing the character of the Dow and the S&P, just how do these facts relate to the current market environment and why is this important?

Historically, healthy stock bull markets have been consistently characterized by very broad participation. The stocks that are the top Dow and S&P issues are what are described as being "large capitalization" stocks while their brethren "mid-cap" and "small-cap" stocks must be included when assessing the "broad" or "broader market." Healthy bull markets witness coincident upward movement in large, mid and small capitalization stocks.

A method we use to gauge the broad health of the stock market as a whole, and to gauge the overall health of a bull market cycle, is to compare the performance of the "unweighted" S&P 500 to the actual capitalization weighted S&P 500 you see quoted every day. In other words, how is the stock market broadly performing relative to the top 15 or 25 stocks in the S&P 500? Are all stocks moving forward on the financial market battlefield, or just a select few? Does the market exhibit broad health, or are only a few the healthy leaders charging ahead while the bulk of the troops are being left behind in sickbay?

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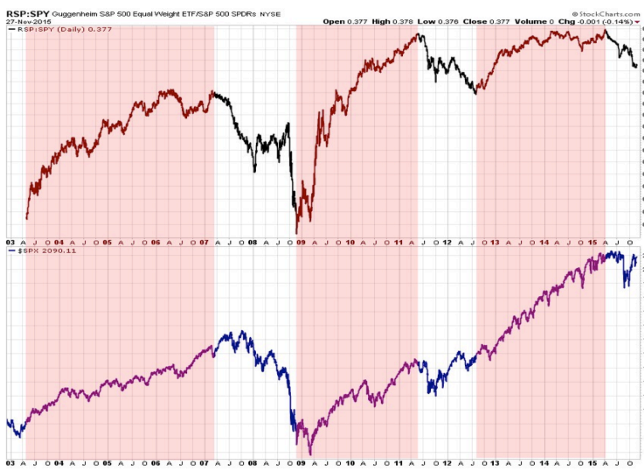
THE WEIGHTING IS THE HARDEST PART Continued from page 2

We are quite grateful there exists an ETF that represents the "unweighted" S&P 500 – an index where all 500 stocks are assigned an equal 0.2% weight (1/500). If we look at the performance of this unweighted index and compare it to the performance of the weighted headline S&P 500, we get a very clear picture of how stocks broadly are performing relative to the few behemoths at the top rung of S&P weightings. This is what you see below.



In the top clip of the chart we are looking at the ratio of the price performance of the unweighted S&P 500 (the RSP ETF) to the "headline" weighted S&P 500 (the ETF SPY). In other words, we are looking at the character of the broader stock market relative to the few very large stocks. When the ratio is headed up, market participation is broad, the very sign of a healthy market. The troops and the generals are marching together in lockstep. When the ratio turns down, it's only the generals who are left alone on the battlefield as the broad stock market troops are "sitting it out." We are seeing exactly this right now, especially since the October 2015 lows.

The bottom clip of the chart is the weighted S&P 500 that we see quoted in the headlines. We've colored with the red bars those periods where the ratio of the unweighted S&P to the weighted S&P has been going up – representing a healthy market showing broad participation. As is clear, the best periods for headline S&P performance have been periods where participation has been broad, not the periods where "narrow" participation has been seen.

Although there are no guarantees in this world and no two market cycles are ever exactly alike, what has characterized "late stage" bull markets in the past has been a narrowing in stock market participation. If you remember back to the late 1990's/early 2000, in the period leading up to the significant market top, it was really only the dotcom and tech stocks that were moving forward into that top. The broad market had peaked in early 1999. In 2007, as you can see in the chart we've prepared, the "broad market" peaked in March of 2007 and began to decline (unweighted versus weighted S&P). The weighted S&P peaked six months later before it started a 50% decline.

So where do we find ourselves now? As we again look at broad market health using our unweighted versus weighted S&P ratio, for now the broad market has peaked in April of 2015. Interestingly, the rally we have seen in the headline stock market averages like the Dow and S&P 500 since the October lows has not been accompanied by broad participation at all, quite the opposite, in fact. Since October, a few large "generals" have led the stock market charge, but they are on the battlefield alone, deserted by the broad troop contingent. Does this circumstance preordain market trouble or some type of bull market peak? Not necessarily, but it is a fingerprint character point well deserving of monitoring ahead. If the current bull market is to continue in a healthy manner into the New Year ahead, reacceleration in broad stock market participation is a must. Continued price divergence between the very large company few and the many small and mid-cap equity issues that trade would be a cause for concern.

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What this current circumstance also tells us is that our thesis on the importance of global flows of capital we have discussed a number of times in the past is playing out. As global capital comes to the US Dollar and Dollar denominated assets, it gravitates toward what it knows and toward what it perceives as quality. In the world of real estate, we have seen significant foreign buying in high-end areas like San Francisco and New York – areas perceived as quality. In the financial markets, global money likewise gravitates toward what it perceives as quality - the top and most well-known US stocks.

As we look ahead, we continue to believe global flows of capital and relative global currency movements will be key investment themes in 2016, but in like manner, we need to be vigilant regarding the broad health of the US stock market. The lack of broad participation over the last eight months is a concern we need to factor into forward decision making and risk management overlays. We form our opinions of "the stock market" as we hear the Dow and S&P results each day, if not each hour. Investors take it on faith, they take it to the heart, but as it turns out the weighting is the hardest part.

On behalf of the entire team at Capital Planning Advisors, we'd like to take this opportunity to wish you and your family our very best for the Holiday Season. Our best wishes for health, happiness and prosperity in the New Year!

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