



FALL 2025

Thoughts From Our Chairman - Alfred B. Van Liew

Equity investors generally seem pleased with the current economic fundamentals here and abroad based upon market performance. While some view equity markets valuations as expensive, others perceive the growth-oriented business friendly policies of both our government and our trading partners justify investor optimism. In our Fall issue of As We See It, my associate James Powell comments on the various methods to gauge investment performance.

The Tyranny of the Index

James M. Powell, CFA, CAIA, CFP®

In 2019, we wrote an essay exploring the relationship between risk and return, asking: “If the market rises 10% in a quarter and your portfolio gains 12%, is that good? Or if it gains only 8%, is that bad?” The answer lies in understanding that risk and return are deeply intertwined. This essay builds on that discussion, examining the risks of using broad equity indexes, like the S&P 500, to measure personal investment performance.

When we use terms like “the market,” we usually mean some type of benchmark or index that reduces that question to one number we can easily compare to another number. The index most often used in the United States to describe the performance of “the market” is the S&P 500 Total Return Index¹ (the “Index”), a broad index used (in one form or another) since 1957 to describe the US large cap equity market. It became so ingrained in financial circles that The Vanguard Group turned the Index into a mutual fund for retail investors in 1976. The financial industry has launched numerous products, derivatives and metrics based on it. The Index shapes much of our modern understanding of equity risk. In this author’s humble opinion, the broad acceptance of the Index democratized equity investing, making it possible for middle-class America to access what had previously been the exclusive domain of institutional and wealthy investors. That does not sound very tyrannical at all, does it?

One of the marketed advantages of Index-related investment products (you cannot invest directly in an index, which does not have transaction costs and does not pay taxes) is instant diversification, a widely accepted technique to reduce a major factor of equity risk. Most professional investors grow wary when a single equity position gets so large that a significant move in the stock can affect the performance of the overall portfolio. Pundits may debate the exact threshold, but most agree that single equity positions over 6% signal concerning concentration risk, warranting close monitoring.

Today’s S&P 500 Index has an exceptional amount of concentration risk. As of August 2025, three companies—Nvidia (7.8%), Microsoft (6.9%), and Apple (6.3%)—exceed 6% of the Index’s total weight. Combined with the other “Magnificent Seven” stocks—Amazon, Meta Platforms, Alphabet, and Tesla—these seven account for roughly 34% of the index, up from 20% in 2020. This concentration creates interdependencies, where a significant event (e.g., a regulatory change affecting tech) could ripple across these stocks, undermining the index’s perceived diversification.

Wealth Management & Trust Services

One Regency Plaza, Suite One, Providence, Rhode Island 02903 401.272.2510

Nine Memorial Boulevard, Newport, Rhode Island 02840 401.846.5550

www.vanliewtrust.com

In fact, this “broadly diversified” Index is so concentrated that, as currently constructed, the Index could not legally be marketed today as a diversified mutual fund!² Under the Investment Company Act of 1940, a diversified mutual fund cannot have more than 5% of its assets in a single stock for 75% of its portfolio. The Index’s current concentration violates this threshold, requiring passive ETFs tracking it to obtain a special SEC exemption³ and specifically disclose in their prospectuses that they are *not diversified*.

There is another significant concern with respect to market indexes: the rise of passive investing. As of August 29, 2025, over 50% of net assets in long-term mutual funds and ETFs reside in index-related funds.⁴ When an investor buys an index-related product (e.g., the SPDR® S&P 500 ETF Trust, ticker: SPY), the manager must invest in the entire index. The index, once used as a metric to *describe* the broad equity market, has now *become* the market to a significant degree. In other words, while stock prices still drive the index, inflows into index funds now influence those stock prices in return. This impairs price discovery, as stock prices may reflect index fund flows rather than fundamental value. For instance, when Tesla was added to the Index in 2020, its stock surged over 12% overnight⁵ following the announcement. Conversely, stocks removed from the index often face sharp declines, highlighting how index mechanics can drive price changes unrelated to company performance.

The “tyranny of the index” describes the risk of oversimplifying investment performance by comparing it to a single number, like the S&P 500 Total Return Index. While the Index’s 10.5% annual return from 1957 to 2024 outpaces bonds (5–6%) and cash (3–4%), its volatility—evidenced by bear market declines of 48% (1973–1974), 49% (2000–2002), and 57% (2007–2009)—is more than many investors can bear. Panic selling during such downturns, as seen in 2007–2009 when investors who sold missed the subsequent doubling by 2012, underscores this challenge. Indexes remain valuable for understanding broad market trends, but investors should align their portfolios with their risk tolerance, financial goals, and time horizon, potentially diversifying into other asset classes and different sectors to mitigate concentrated market risks.

Returning to those initial questions: If your portfolio outperforms the Index by 2% in a quarter, is that truly a win—or does it come at the cost of amplified volatility from chasing the Index’s concentrated bets? Conversely, if your portfolio underperforms the Index by 2% because it has diversified more concentration risk, is that really a bad thing? The tyranny of the index is the notion that that index conveys the “correct” amount of return without considering the inherent risks associated with that return. It tempts us to chase simple benchmarks, but true success lies in constructing portfolios that align with your unique tolerance for risk, not the market’s fleeting highs and punishing lows. By questioning the Index’s grip on our decisions, we reclaim the power to invest on our own terms.

¹ While I do not describe the S&P 500 Total Return Index here, you may learn more about it at <https://www.spglobal.com/>.

² See Section 5(b)(1) of the Investment Company Act of 1940, familiarly known as the 75-5-10 Rule.

³ See Section 6(c) of the Investment Company Act of 1940

⁴ https://www.ici.org/research/stats/combined_active_index

⁵ Tesla closed at \$136 on November 16, 2020 and opened at \$153.39 on November 17, 2020. The press release was after the close on November 16, 2020.

We would be delighted to meet with you to share comments about this article, or to review your portfolio in detail.

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