Apples to apples: Using the appropriate index is key to evaluating investment performance

Investors are often tracking the performance of their portfolios relative to the performance of "the market" often mentioned in the media. While relative performance is a good way to gauge whether the allocation in a portfolio is performing as expected, comparing an individual's portfolio against the major indices may be an apples-to-oranges comparison.

What is an index?

One of the most commonly used indexes is the S&P 500 Index, but there are many types of indexes that can be used to track a variety of sectors, asset classes, or even countries. An "index" refers to a group of unmanaged securities that represent a specific area of the market. The S&P 500, for example, tracks the 500 largest US publicly traded companies.

Some of the most popular indexes that are used to track equities include the S&P 500, Dow Jones Industrial Average (DJIA), and the Nasdaq Composite Index (Nasdaq). While these are all typically how the market performance is reported by news outlets, there are key differences between them that should be noted:

- Companies are weighted in the S&P 500 based on their market capitalization. The larger a company's market capitalization size, the higher weighting it gets in the S&P 500.
- The DJIA, on the other hand, is price-weighted and only represents 30 of the biggest US blue chip companies.
- The Nasdaq represents companies that trade on the Nasdaq stock exchange. While the Nasdaq is market-weighted, it includes over 3,300 companies, including those outside of the US. Most technology stocks trade on the Nasdaq exchange, so the Nasdaq index is often a good representation of how the technology sector performs.

Since the S&P 500 is market-cap weighted, there is often a heavy concentration in the largest names, meaning that those companies with larger market caps have a significant impact on the overall performance of the index. As of December 31, 2024, for example, the top 10 constituents in the S&P 500 made up 37.4% of the total index .[1] During 2024 the index returned 25.0%, but would have only returned 12.8% if the top ten holdings were removed, compared to the same 25.0% return if the bottom ten holdings were excluded. The performance of those top 10 companies will have a much bigger effect on the return of the index than the bottom.

Why the common indexes are not always the right benchmarks

While using the commonly reported indices' performance relative to your own portfolio is often convenient and easy to understand, it is important to understand why that comparison may not be the best way to benchmark your personal performance. If your portfolio is made up of only 20% US stocks and 80% non-US, using the S&P 500 as a benchmark would not make sense. Similarly, if your portfolio is allocated towards fixed income, gold, and diversified equities, using any benchmark that is 100% equity will show a vast difference in returns.

How to make an apples-to-apples comparison

Understanding what is in your portfolio is the first step in determining what benchmark to use for your portfolio. Comparing your total portfolio performance to a custom weighted benchmark that matches your portfolio's allocation is going to ensure that you are making a reliable comparison. Each asset class in your investment allocation may require a different index. Within each asset class, individual holdings may need their own indexes as well.

The best indexes to benchmark against are your goals

Rather than focusing on outperforming an index, the focus should be on whether your portfolio is allocated to achieve your goals. If you are looking to fund college tuition in the next 3-5 years, your portfolio should reflect that. It is important to understand why you are investing, and whether the investments in your portfolio are on track to get you there. Checking in regularly with your advisor to make sure your goals are up-to-date and your allocation is reflective of your aspirations is key to long term investment success.

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Source: 1. Bloomberg

Important Information: The Standard & Poor's 500 Index, often abbreviated as S&P 500, is an American stock exchange market index based on the market capitalizations of 500 large companies having common stock listed on the NYSE or NASDAQ. The S&P 500 index components and their weightings are determined by S&P Dow Jones Indices.