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Don't buy into the market-portfolio hype

Advice for investors: be wary of all the positive publicity surrounding market-weighted indexes or portfolios. They aren't efficient.

May 12, 2016

In the paper, "The Market Portfolio is NOT efficient: Evidences, consequences and easy to avoid errors," IESE professor **Pablo Fernández** works with José Paulo Carelli and Alberto Ortiz to set the record straight regarding what they see as all-too-common errors in portfolio

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management.

They start by debunking the myth that a Market Portfolio — a portfolio consisting of a selection of assets weighted to reflect the market at large — is an efficient portfolio.

In fact, market-value weighted portfolios and indexes have underperformed easy-to-build "equal weighted" portfolios and indexes for many years, they explain. For example, an equal weighted index will give the same weight to each index component, regardless of market capitalization or size. Specifically, in the Standard & Poor's (S&P) 500 equal weighted index, a midcap component like Endo International (ENDP) has the same weight as a giant one like Apple (AAPL). In contrast, in the S&P 500 market-weighted index, because Apple is far bigger than other companies tracked, investors are exposed to much more of the iPhone-maker.

While the S&P 500 market-weighted index remains wildly popular, Fernández and others (dating back to 1973, as cited in the paper) observe that equal weighted indexes help investors find smaller stocks, which have historically outperformed larger ones. They also help investors get into industries and sectors not currently in vogue.

While some financial advisors insist that smaller stocks are riskier, Fernández thinks risk gets confused with volatility too often. If price volatility means a large price upswing for small-stock investors, investors should like this type of "risk." What we want to avoid is putting money in companies that flop or fold.

Down with CAPM

So why do many finance and investment books still recommend diversifying an investment portfolio in the same relative proportions as in a broad market index, such as the S&P500? Fernández thinks blind faith in the Capital Asset Pricing Model (CAPM) should take some blame. CAPM is a model to describe the relationship between "risk" and expected returns in determining prices. But the CAPM formula is based on some iffy assumptions about investors, their liquidity, time horizons, risk tolerance, real market conditions, and more, Fernández and others have argued.

"If you find a formula for expected returns that works well in the real markets, would you publish it?" Fernández asks rhetorically about CAPM. "Before or after becoming a billionaire?"

See also, "**How Much Is a Company Worth?**"

"The CAPM suggests that the value-weighted portfolio should outperform the equal-weighted

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portfolios," Fernandez and his co-authors summarize. And yet, it does not, as their evidence clearly shows.

With this, the co-authors question the myth that market indexes like the oft-praised S&P500 market weighted index "are difficult/impossible to beat."

They also question the conventional wisdom that capturing higher returns requires taking on higher risk (measured as volatility). If "risk" could measure the probability that a company might go bankrupt or default, it would be much more useful to investors — and less misleading — than it currently is.

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