Why Do Investors Use the S&P 500 as a Benchmark?

The Standard & Poor's 500 Index (S&P 500) is one of the most commonly used benchmarks for determining the state of the overall economy. Investors also use the S&P 500 as a benchmark for their individual portfolios.

The Dow Jones Industrial Average (DJIA) is another popular benchmark, and while it serves its purpose, it is much more limited in scope as it only contains 30 companies while the S&P 500 contains 500.

The S&P 500 has generally become the leading stock index due to its broader scope, and investors and analysts use its performance to judge the overall economy. Additionally, many hedge funds compare their annual performance to the S&P 500, seeking to realize alpha in excess of the index's returns. Below are some of the advantages and disadvantages of using the S&P 500 as a benchmark.

KEY TAKEAWAYS

- The S&P 500 is largely considered an essential benchmark index for the U.S. stock market.
- Composed of 500 large-cap companies across a breadth of industry sectors, the index captures the pulse of the American corporate economy.
- Limited to just large-caps, however, the index misses the much larger swath of mid- and small-cap stocks that make up most of the economy.
- As a market-cap-weighted index, this benchmark also gives disproportionate weight to the largest companies, which thus make up the bulk of the index.

Advantages of Using the S&P 500 as a Benchmark

The key advantage of using the S&P 500 as a benchmark is the wide market breadth of the large-cap companies included in the index. The index can provide a broad view of the economic health of the U.S. because it covers so many companies in so many different sectors.

In addition to its broad scope, another advantage of the S&P 500 is that the components of the index are updated on a quarterly basis. A committee determines which companies to include in the index.
The factors considered include a market capitalization of $14.5 billion, a public float of at least 50%, and headquarters in the U.S.

Companies must have traded for at least 12 months after their initial public offerings (IPO) before being considered for inclusion in the index. By updating the index components, the index can accurately reflect the state of the large-cap market.

There are many other indexes that investors can look to in addition to the S&P 500, such as the NASDAQ 100, the Russell 2000, the NYSE Composite, and the FTSE 100.

Disadvantages of Using the S&P 500 as a Benchmark

There are also some disadvantages to using the S&P 500 as a benchmark for individual portfolio performance. Most investors are widely diversified in assets other than stocks, such as bonds, precious metals, and cash; values of which are not reflected in the S&P 500.

Also, the index contains only larger market-cap companies from the U.S. In contrast, investors may own small-cap or foreign companies in their portfolios. Using the S&P 500 as a benchmark may be an inaccurate measure of portfolio return for individual investors.

Another drawback to using the S&P 500 for benchmark purposes is that the index is disproportionately weighted toward larger companies. The top 10 holdings, which include some of the largest companies in the world—Apple (AAPL), Microsoft (MSFT), Amazon.com (AMZN), etc.—make up 30.6% of the S&P 500.

The S&P 500 uses a weighted market capitalization for its construction. The index takes the number of shares multiplied by the current market share price to determine the market capitalization for each company. All the market capitalizations are then added together and then divided by a number known as the index divisor. The result of that calculation is the index value.

What Is the S&P 500 10-Year Return?

As of July 2023, the 10-year return for the S&P 500 is 172.2%.

Is the S&P 500 Always a Good Investment?

Whether or not the S&P 500 is a good investment will depend on the individual investor, their risk tolerance, and their investment goals. Generally, yes, the S&P 500 is a good investment because over time the index always has a positive performance so investors would see a return on their investment; however, as with all investments, timing matters. Investing in the S&P 500 is a better investment if you are investing for the long term.

Can You Invest in the S&P 500?

You cannot directly invest in the S&P 500 because it is a market index. The easiest way to invest in the S&P 500 is by investing in an exchange-traded fund (ETF) that tracks the index, such as the SPDR S&P 500 ETF Trust.

The Bottom Line

The S&P 500 works well as a benchmark for the broader economy because it includes 500 companies in the U.S. across all sectors. The performance of the index is an indicator of the performance of the overall economy. Though not perfect, because it is made up of only large-cap companies, and limited to just stocks in the U.S. and no other asset or foreign entities, the index is still used by investors to gauge the performance of their portfolios.

This material was prepared by: Investopedia.com

Written By: Brian Beers

Reviewed by: Thomas J. Catalano

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