Weighting For The Sun (W)

Buying index funds is sort of like eating spinach: It may be good for you, but with the notable exception of Popeye, whoever did either with true enthusiasm? And those John Bogle "keep the costs down, boys" posters haven't exactly been flying off of E-bay onto teenagers' walls lately, have they?

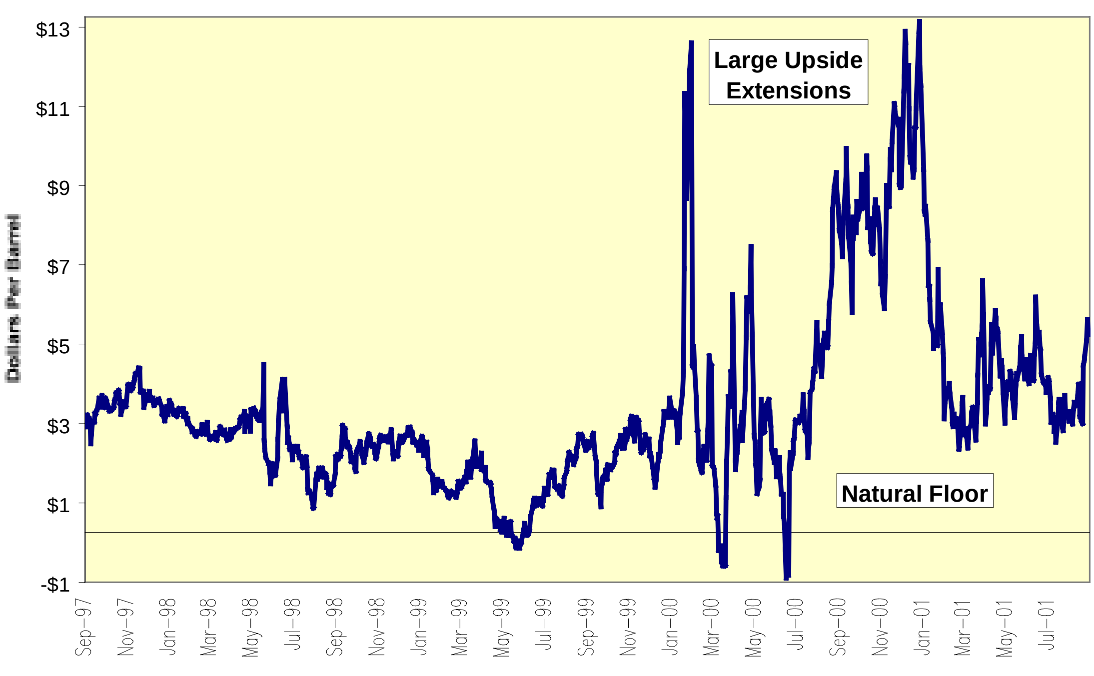
Students of indexation – and aren't we all – were aware for years of one of the strategy's inevitable consequences, the need to buy more and more of ever higher-priced stocks in a rising market. As a stock's price rose, its weight within various indices rose as well, which required the indexers to buy more and more in a virtuous cycle. By 1998, the ever-higher weights of giants like Microsoft, General Electric, Cisco, etc. led to increasingly narrow rallies. A secondary consequence of this strategy was the inability of most active managers, many of whom blanched at the stratospheric multiples associated with the big index components, to keep pace with the indices themselves.

Well, what's sauce for the goose is sauce for the gander, even though I don't like goose and wouldn't know a gander from a plastic pink flamingo. A falling market requires indexers to sell shares of index components in accordance with their weight, once again in disregard of whether they deserve such termination with extreme prejudice.

Vive Le Difference

Take two strips of different metals, soak them in an acid, and the flow of electric energy produces a battery. Take two different indices, soak them in money, and the flow of financial energy creates either an embedded option or a natural trend. Briefly, embedded options are financial instruments with asymmetric returns. These are quite common in the world of commodities; some, such as the heating oil "crack spread" or the natural gas "spark spread" have been described in this space (see "Is The Heat On?" November 1999, or "California Power: Sparking Some Interest," Jan. 2001 on TheStreetPros). They can increase in value quickly and sharply, but seldom fall below a floor level. As a result, they have the profit profile of a call option, as seen in the chart below of the heating oil refining margin.

An Embedded Option: Heating Oil Refining Margin



A naturally trending spread occurs far more often in the world of stocks, particularly for matched-pair trades, such as Intel-AMD, or for index spreads, such as the Nasdaq Composite-Nasdaq 100 (NDX). These trends are produced, in part, by the different weights individual stocks and related sectors have in each index. Let's take a look at Sun Microsystems, a great company with a great product; a Sun server probably is handling the data transmission for this page as you're reading it. Sun had a bad, bad week last week, losing 23.5% of its value. Sun has a 1.415% weight in the Composite and a 1.637% weight in the NDX. Last week, Sun and others large-capitalization tech stocks pushed the NDX to a 6.96% loss against a smaller 5.81% loss for the Composite. By virtue of their different weights in the two indices, the major tech stocks have contributed to a very tradable long-term trend between the Composite and the NDX.

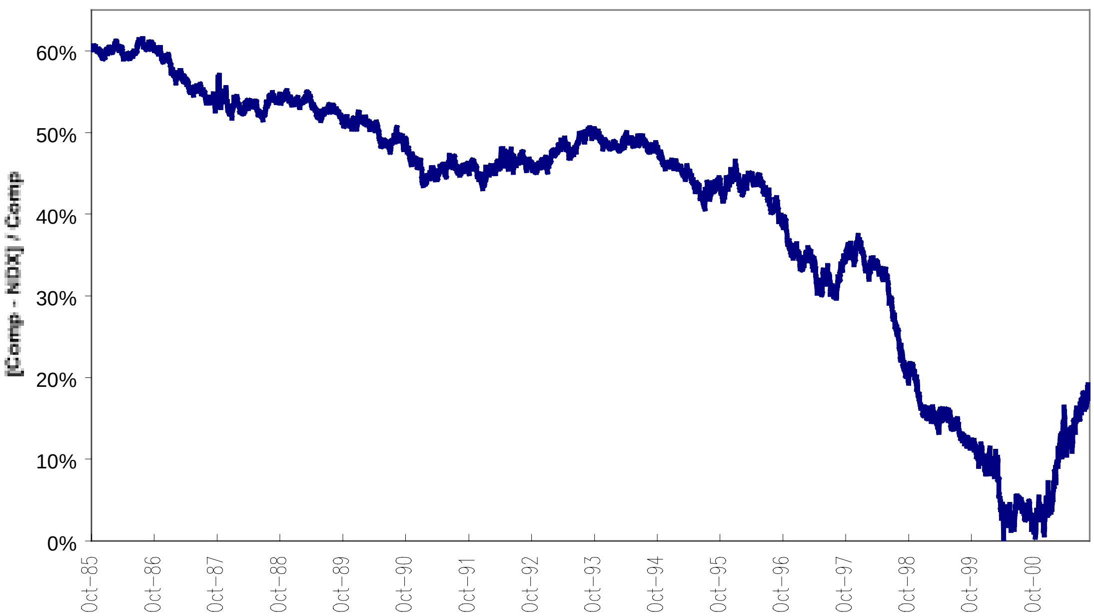
The weights of the top 20 stocks in the NDX and their comparative weights in the Composite are listed below. The same stocks that constitute 55.8% of the NDX are only 41.8% of the Composite, and this alone will produce a trending spread between the two indices. If we add an overwhelming market direction to the picture, the mechanics of indexation will push the trend even further.

	Weight In Index	
	NDX	**Composite**
Microsoft	10.66%	11.65%
Intel	6.64%	7.13%
Qualcomm	5.42%	1.70%
Cisco	4.31%	4.53%
Amgen	3.15%	2.55%
Oracle	2.88%	2.60%
Maxim	2.15%	0.58%
Dell	2.07%	2.11%
Applied Materials	1.82%	1.33%
Linear Technologies	1.76%	0.50%
Xilinx	1.72%	0.49%
Comcast	1.66%	1.27%
Sun	1.64%	1.42%
Altera	1.56%	0.42%
Genzyme	1.49%	0.41%
Concord EFS	1.45%	0.48%
Peoplesoft	1.45%	0.39%
Worldcom	1.35%	1.41%
Paychex	1.33%	0.53%
Immunex	1.30%	0.36%
Subtotal:	55.80%	41.84%

The Trend Is Your Friend - Except For The Bend In The End

The long bull market in technology stocks made the spread trade of being long the NDX against the Composite a winner since the mid-1980s. Once the spread between the Composite and the NDX was more than 60% of the Composite's value; this advantage nearly disappeared by December 2000. It's now back to 18.6%, and the trend trade of being long the Composite against being short the NDX shows no signs of slowing down.

The Composite - NDX Spread
A Very Trendy Affair



So long as Sun and its tech brethren remain under pressure and constitute a disproportionately large share of the NDX as opposed to the Composite, this spread will be one to watch. All you need to trade is an opinion on the market in general and the tech sector in particular. I don't suspect this is a problem for most TSC readers.