BUSINESS

Maintenance of S&P; Helps Investors Clean Up

By JON D. MARKMAN

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About two dozen times a year, a small committee in a New York high-rise orders money managers controlling about $500 billion to put a single stock in their portfolios on a specific future date.

Strangely enough, the clique makes its market-moving announcement publicly, allowing just about anyone with access to a financial news wire to join--and profit from--the rush to buy those shares.

For the record:

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Los Angeles Times Wednesday December 25, 1996 Home Edition Business Part D Page 3 Financial Desk 2 inches; 41 words Type of Material: Correction

S&P; 500 Trading--The World Wide Web location of a version of professor Robert E. Whaley's paper on trading stocks as they join the S&P; 500 had incorrect punctuation in the Street Strategies column in Tuesday's Business section. The correct URL: https://www.duke.edu/~whaley/curr_res.htm

The effort is part of the maintenance of the Standard & Poor's 500, the list of 500 large-company stocks that has come to be considered a better proxy for the market than the less diverse Dow Jones industrial average. The S&P; 500 is by far the most common guide for public and institutional index funds--extraordinarily vast pools of money designed to match the performance of the overall market.

Unlike the 30 Dow Jones industrials, whose last set of changes was in 1991, stocks move on and off the S&P; 500 rather frequently. So far this year, 21 stocks, including Dell Computer and Tupperware, have joined the list as 21 others, including First Interstate Bancorp and Cray Research, have been removed. Three more will be switched Dec. 31.

According to recent research by a finance professor in North Carolina, investors can rake in fairly consistent gains with minimal risk by buying a new S&P; stock the day after S&P; makes its announcement that the stock will be added, and selling at the close of the day the stock officially joins the index.

Occasionally the strategy can’t be executed because an index switch must occur overnight. The first example came in February when Disney obtained regulatory approval to acquire Capital Cities/ABC on Feb. 8. Computer communications giant Bay Networks was announced as Cap Cities’ replacement that afternoon and added to the index Feb. 9.

In a study titled “Scorecard for the S&P; 500 Game,” scheduled for the March edition of the Journal of Portfolio Management, professor Robert E. Whaley of Duke University contends that the technique reaped an average of 4% per trade since 1989.

That might not sound like much, but consider this: The strategy returned a whopping compound return of 58.5% in 18 possible trades through Dec. 15 year, turning a hypothetical $10,000 into almost $16,000. (See chart.)

That return does not include commissions or taxes on the short-term gains, which would be levied at the high rate of regular income rather than as capital gains, so the strategy would best be exercised in an IRA or other tax-favored account. The government and brokerage’s takes could drop the return to about 20% for an individual paying 40% in taxes and a discount-level $25 per trade.

On the plus side, however, the figure also does not include any reinvestment of dividends or the likelihood that the money would be earning interest at about a 5% annual rate in a money market account when not invested.

Furthermore, the strategy would have exposed an investor to the market for only 121 days this year. Twelve of the 18 trades were winners, one was flat, five lost. The largest gain was 12.5%, when MGIC Investment was added to the index; the worst loss was 6.5%, when Green Tree Financial was added during a week of bad news for the company.

The tactic was inadvertently born in 1989. In the three previous decades, Standard & Poor's announced additions to the S&P; 500 late in the afternoon the day before they joined the list. The policy left no chance for individual investors to get in ahead of institutional buyers.

Following the explosive proliferation of index funds, the company changed its policy to typically allow for a warning of three to 10 days. A buying frenzy the morning that a stock was added had been causing a chaotic imbalance of orders, according to S&P; Vice President Elliott S. Shurgin, general manager of index services.

Now a few index fund managers buy their new stake little by little over that typically weeklong period, experts say. But most index fund managers postpone their purchase of the new stock until the end of the day on which it's added to the list. The tactic minimizes the chance that their fund's performance will vary from the index's performance because the new stock doesn't actually begin trading in the index until the next morning.

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Regardless of fund managers' exact timing, the S&P; game strategy works because a tremendous amount of buying power is concentrated on a newly added stock in that short period. Shurgin says public mutual funds like the Vanguard Index 500 Trust Portfolio own at least $50 billion in S&P; 500 stocks. But he also estimates that bank trust departments and other institutional managers have invested an additional $450 billion in private index funds.

That means almost 10% of the $5.66 trillion aggregate capitalization of S&P; 500 companies is held in index funds, and thus when a company is added to the S&P;, a huge chunk of its outstanding shares are locked away, often for decades.

In his study, Whaley asserts that 85 stocks added to the list from 1989 to 1995 rose an average of 7% between the date of S&P;'s announcement and the date the stock joined the list.

About 3 percentage points of that gain was inaccessible to new investors because it was already reflected in the first trade on the day after the announcement, according to Whaley. But the remaining 4% average gain is still a superb return on a week's investment. (An easy-to-read Adobe Acrobat version of Whaley's paper can be accessed at his page on the World Wide Web at https://www.duke.edu/whaley/curr--res.htm)

To execute the strategy, keep an ear out for each change to the S&P; 500 index either by asking your broker or monitoring the Dow Jones news wire. For reference, you can check S&P;'s index Web page:
https://www.stockinfo.standardpoor.com/indexes/idxnews.htm

Enter a market-on-open order to purchase the stock on the day after the announcement. Then enter a market-on-close order to sell the stock on the day that the stock is actually added to the index.

You'll essentially be selling your short-term stake to the highest bidder in one of the most frantic hours of trading the market ever sees in individual stocks.

This year's average gain for added stocks was 2.8%, easily beating the cumulative 0.22% loss in the S&P; 500 during the periods in which all stocks were added. Held steadily, the index is up about 21% this year.

Of course, the gain for the S&P; 500 game would be much greater if you could determine which stock would be added, but that's a separate guessing game.

Whaley, whose specialty is derivatives, said investors who are willing to pursue the strategy aggressively could amplify the value of their investment by buying options rather than shares.

Street Strategies explores investment tactics. Jon D. Markman is a Times staff writer. He can be reached at jon.markman@latimes.com

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The S&P; 500 Game

Through Dec. 15 of this year, buying stocks immediately after the announcement that they would be added to the S&P; 500 index, then selling them at the end of the day they were officially added, would have provided a handsome 58.5% compound return (before any commissions and taxes). Below are additions to the S&P; 500 index, with each opening price on the morning after the announcement and at the end of trading on the effective date. Most stocks rose during those periods. Final column shows how $10,000 would have fared through the year following this buy-and-sell strategy.

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Annc Next market Effective Company Ticker date day open date Close Case Corp. CSE 1/10/96 $41.38 1/19/96 $44.13 Bay Networks BAY 2/8/96 47.38 2/9/96 47.88 Fifth Third FITB 3/1/96 53.50 3/7/96 58.63 Bancorp Green Tree GNT 3/5/96 36.25 3/12/96

33.99 Financial Chase CMB 3/25/96 73.00 3/29/96 73.50 Manhattan General GIC 3/25/96 27.25 3/29/96 27.38 Instrument WorldCom WCOM 3/25/96 23.25 3/29/96 23.00 EMC Corp. EMC 3/26/96 21.25 3/27/96 21.75 Aon Corp. AOC 4/17/96 53.38 4/22/96 54.50 Tupperware TUP 5/21/96 42.75 5/30/96 45.88 Corp. MGIC MTG 7/15/96 56.00 7/18/96 63.00 Investment Battle BMG 7/16/96 7.88 7/19/96 8.50 Mtn Gold Seagate SEG 8/6/96 25.50 8/15/96 26.25 Technology HFS Inc. HFS 8/6/96 66.00 8/15/96 66.00 Allegheny ALT 8/8/96 20.38 8/15/96 20.88 Teledyne Dell DELL 8/29/96 34.50 9/5/96 33.88 Computer Lucent LU 9/17/96 40.88 9/30/96 45.88 Technology Union Pacific UPR 10/7/96 29.25 10/15/96 28.63 Resources Cognizant CZT 10/25/96 32.88 11/1/96 31.50 Corp. MBIA MBI 11/25/96 102.00 12/2/96 103.63 Total Average Compound

Company % change $10,000 Case Corp. 6.65% $10,665 Bay Networks 1.06 * Fifth Third 9.58 11,687 Bancorp Green Tree -6.55 10,921 Financial Chase 0.68 ** Manhattan General 0.46 ** Instrument WorldCom -1.08 10,923 EMC Corp. 2.35 * Aon Corp. 2.10 11,153 Tupperware 7.32 11,969 Corp. MGIC 12.50 13,465 Investment Battle 7.87 14,525 Mtn Gold Seagate 2.94 ** Technology HFS Inc. 0.00 14,739 Allegheny 2.45 15,100 Teledyne Dell -1.80 14,828 Computer Lucent 12.23 16,641 Technology Union Pacific -2.12 16,288 Resources Cognizant -4.20 15,604 Corp. MBIA 1.60 15,554 Total 2.8 58.5

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Sources: Robert Whaley, Duke University, and Nelson Freeburg, Formula Research newsletter

* Trades could not be executed because the stocks were added to the S&P; 500 overnight.

** Trading account is split to buy stocks announced and added to the S&P; 500 on the same day. Figure represents total of the trades.

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