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Why Does the S&P 500® Matter to Hong Kong?

The S&P 500 is a renowned benchmark for large-cap, U.S. equities. The index includes 500 leading companies and captures approximately 80% coverage of investable market capitalization in the U.S. equity market. As of year-end 2013, over USD 7 trillion was benchmarked to the S&P 500 alone, with indexed assets making up USD 1.9 trillion of this total.[1] Exchange-traded products of the S&P 500 have been cross-listed in various markets across the globe, but what creates the international appetite for U.S. equities, especially the S&P 500?

In this paper, we will:

- Compare the S&P 500 to the leading large-cap equity benchmark in Hong Kong;
- Explore the significance of the S&P 500 in the global equity market; and
- Compare S&P 500 performance to that of active U.S. large-cap funds.

The S&P 500 and the Hang Seng Index are widely regarded as primary indicators of overall market performance in the U.S. and Hong Kong equity markets.

COMPARISON OF THE S&P 500 AND THE HANG SENG INDEX

The S&P 500 and the Hang Seng Index are widely regarded as primary indicators of overall market performance in the U.S. and Hong Kong equity markets, respectively. Both indices comprise the largest and most-liquid stocks from their respective markets. However, the indices vary significantly due to the different economic landscapes and financial market developments they reflect.

The S&P 500 currently comprises 500 companies and represents around 80% of the market cap of the U.S. equity market, while the Hang Seng Index consists of 50 constituents and captures approximately 60% of the Hong Kong Stock Exchange. Both indices are free-float market capitalization weighted, but the S&P 500 has much greater stock diversification than the Hang Seng Index.

The 10 largest S&P 500 members represent only 18% of the index, and the largest component, Apple, has a weight of just 4%. In contrast, the 10

[1] Each year, S&P Dow Jones Indices conducts a survey to estimate the total assets directly linked to its indices. For the latest report, please see the "S&P DJI Annual Survey of Indexed Assets 2014."

largest stocks in the Hang Seng Index dominate 60% of the index, and the two largest members, HSBC and Tencent, carry stock weights as high as 11% and 10%, respectively.

Exhibit 1: Top 10 Index Members in the S&P 500 and the Hang Seng Index

S&P 500 STOCKS	WEIGHT (%)	HANG SENG INDEX STOCKS	WEIGHT (%)
Apple Inc.	4.0	HSBC Holdings PLC	11.4
Exxon Mobil Corp	1.9	Tencent Holdings Ltd	9.9
Microsoft Corp	1.8	China Mobile Ltd	7.4
Google Inc (A & C)	1.7	AIA Group Ltd	7.0
Johnson & Johnson	1.5	China Construction Bank Corp	6.5
Berkshire Hathaway B	1.4	ICBC	5.0
Wells Fargo & Co	1.4	Bank of China Ltd	4.2
General Electric Co	1.4	China Life Insurance Co Ltd	3.0
JP Morgan Chase & Co	1.2	Ping An Insurance Group	2.9
Procter & Gamble	1.2	Hutchison Whampoa Ltd	2.7
Total weight of top 10 companies	17.6	Total weight of top 10 companies	60.0

Source: S&P Dow Jones Indices LLC, Hang Seng Indexes Company Limited. Data as of March 31, 2015. Table is provided for illustrative purposes.

Both the S&P 500 and the Hang Seng Index capture the largest and most-liquid stocks from their respective markets.

Both the S&P 500 and Hang Seng Index capture the largest and most-liquid stocks from their respective markets. Constituents of these two indices have similar mean and median market capitalizations of approximately USD 40 billion and USD 20 billion, respectively, but the S&P 500 constituents appear to be more liquid. The S&P 500 members have a median and smallest average daily traded value of USD 161 million and USD 22 million, respectively, which are both much higher than the same values for Hang Seng Index members.

Exhibit 2: S&P 500 and Hang Seng Index Size and Liquidity Statistics

INDEX	CONSTITUENT MARKET CAP (USD BILLION)		CONSTITUENT 3-MONTH AVERAGE DAILY TRADED VALUE (USD MILLION)	
	S&P 500	HANG SENG INDEX	S&P 500	HANG SENG INDEX
Mean	37.8	39.7	259.1	66.6
Largest	724.8	267.3	7,341.9	343.6
Median	18.6	22.0	160.7	31.9
Smallest	3.3	4.7	21.6	7.0
Sum of constituents	18,951	1,987	130,071	3,330

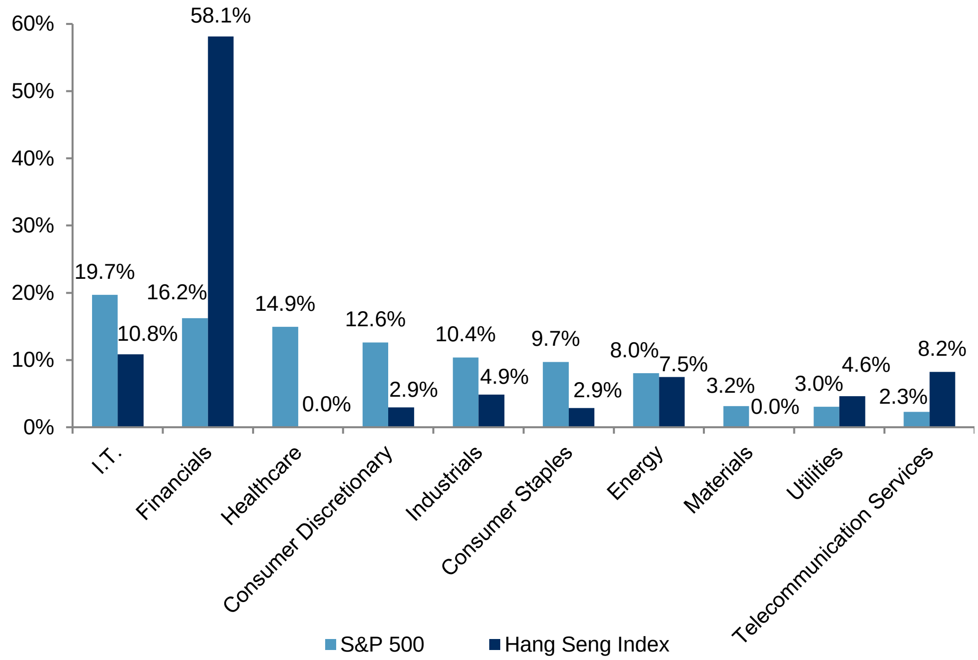
Source: S&P Dow Jones Indices LLC, Hang Seng Indexes Company Limited. Data as of March 31, 2015. Market cap is calculated as the share price multiplied by the number of shares at the security level. Past performance is no guarantee of future results. Table is provided for illustrative purposes.

The Hang Seng Index is highly concentrated in the financials sector, which dominates 58% of the index. Information technology is the second-largest sector, with a weight of 11%. In contrast, the S&P 500 is highly diversified among sectors, with no single sector representing more than 20% of the index. Information technology (I.T.) is the most prominent sector, accounting for 20% of the index. The financials and healthcare sectors are the two next-largest sectors, representing 16% and 15% of the S&P 500, respectively.

The S&P 500 has significantly higher weighting in the I.T. and healthcare sectors compared with the Hang Seng Index. The biggest companies in the I.T. sector, such as Apple, Microsoft, and Google, are global leaders in the tech hardware, software, and internet services industries. These companies represent more than 38% of the S&P 500's I.T. sector and around 22% of the S&P Global BMI's[2] I.T. sector. In the healthcare sector of the S&P 500, the three largest companies are Johnson & Johnson, Pfizer, and Merck, which are worldwide providers of pharmaceutical products. These companies make up more than 24% of the S&P 500's healthcare sector and around 12% of the S&P Global BMI's healthcare sector.

Apart from difference in sector composition, the S&P 500 and Hang Seng Index have also been affected by different economic and political factors historically.

Exhibit 3: Sector Weighting of the S&P 500 Versus the Hang Seng Index



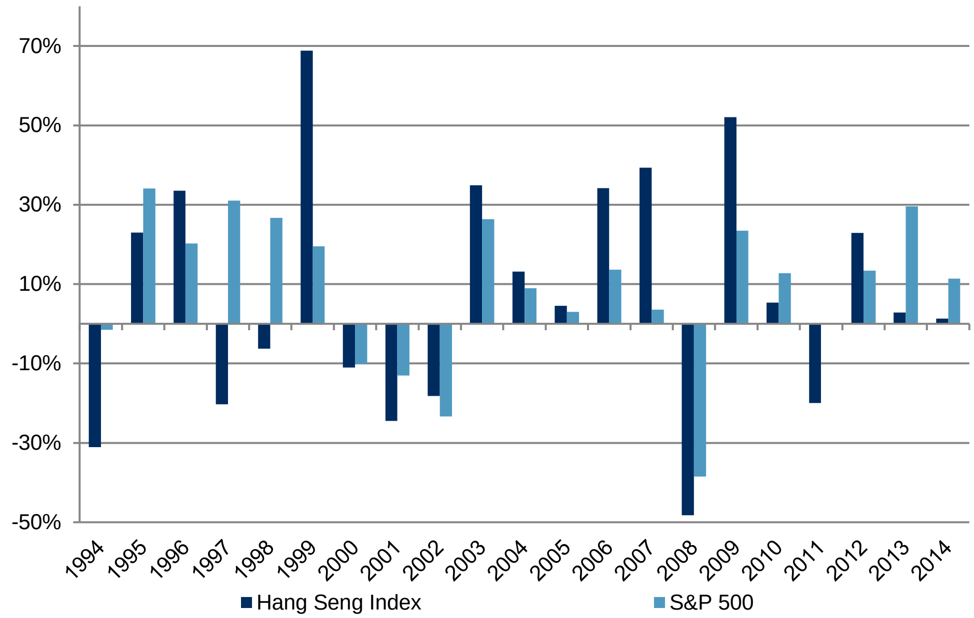
Source: S&P Dow Jones Indices LLC, Hang Seng Indexes Company Limited. Data as of March. 31, 2015. Chart is provided for illustrative purposes.

Apart from difference in sector composition, the S&P 500 and Hang Seng Index have also been affected by different economic and political factors historically. The S&P 500 measures the equity market performance of the world's largest economy, the U.S., while the Hang Seng Index's performance is highly sensitive to the world's second-largest economy, China. Currently, 40% of Hang Seng Index members are Hong Kong-listed, Chinese enterprises. As a result, the historical risk/return profiles of these two indices differ significantly.

[2] The S&P Global BMI (Broad Market Index), which includes more than 11,000 global investable stocks, is designed to measure the performance of the global equity market.

In the past 20 years, S&P 500 performance has been less volatile than that of the Hang Seng Index, so one might expect it to have recorded lower returns than the Hang Seng Index. However, because the S&P 500 has historically experienced smaller market downdowns than the Hang Seng Index, the S&P 500 has recorded higher absolute returns over the past 20 years and higher risk-adjusted returns over short- and long-term horizons.

Exhibit 4: Annual Price Performance of the S&P 500 Versus the Hang Seng Index



Source: S&P Dow Jones Indices LLC, Hang Seng Indexes Company Limited. Data as of year-end 2014. Index performance based local currency price performance. Past performance is no guarantee of future results. Chart is provided for illustrative purposes.

Companies in the S&P 500 represent 37% of the total market capitalization of the S&P Global BMI.

Exhibit 5: Risk/Return Profile of the S&P 500 and Hang Seng Index

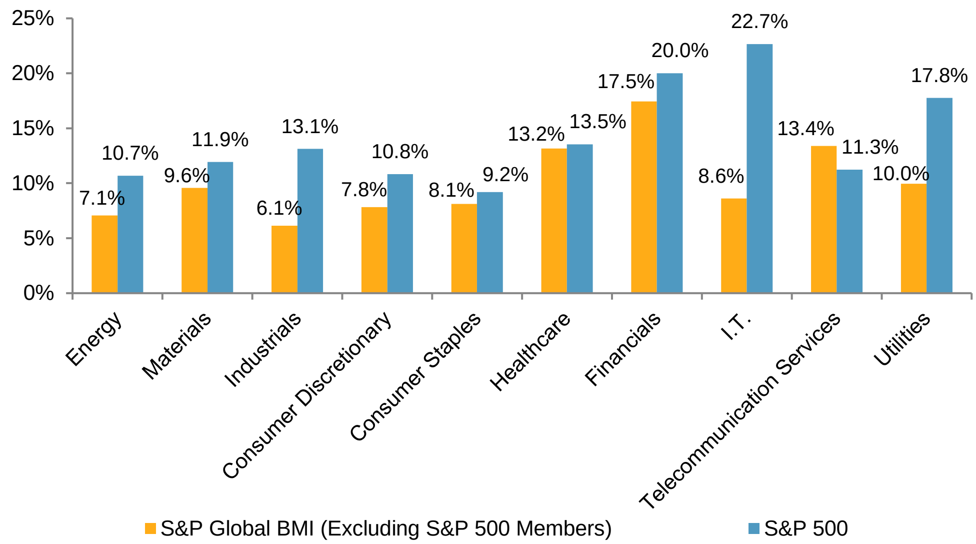
PERIOD	S&P 500	HANG SENG INDEX	S&P 500	HANG SENG INDEX
	ANNUALIZED RETURN (%)		ANNUALIZED VOLATILITY (%)	
1-Year	10.4	12.4	8.9	12.6
5-Year	12.1	3.2	13.0	17.6
10-Year	5.8	6.3	14.8	21.6
20-Year	7.3	5.5	15.2	24.8
PERIOD	RISK-ADJUSTED RETURN		12-MONTH MAXIMUM DRAWDOWN (%)	
1-Year	1.17	0.99	-3.5	-7.4
5-Year	0.93	0.18	-17.0	-25.8
10-Year	0.39	0.29	-47.5	-55.4
20-Year	0.48	0.22	-47.5	-55.4

Source: S&P Dow Jones Indices LLC, Hang Seng Indexes Company Limited. Data as of March 31, 2015. Index performance based on local currency price performance. Past performance is no guarantee of future results. Table is provided for illustrative purposes.

SIGNIFICANCE OF THE S&P 500 IN THE GLOBAL EQUITY MARKET

Because many stocks in the S&P 500 are leading global companies, they represent a significant part of global equity market capitalization, revenue, and earnings. Companies in the S&P 500 represent 37% of the total market capitalization of the S&P Global BMI. Among the 100 largest stocks in the S&P Global BMI, 61 of them are S&P 500 members. In 2014, the S&P 500 generated more than 25% of corporate revenue and 31% of corporate earnings for the S&P Global BMI. We have also observed that in most sectors, S&P 500 companies have delivered higher operating margins than their global sector peers, especially in the I.T. sector, with a spread of 14%.

Exhibit 6: Operating Margin of S&P 500 Sectors



Source: S&P Dow Jones Indices LLC, Worldscope. Data as of March 31, 2015. Figures based on company-reported operating income and revenue in FY2014. Past performance is no guarantee of future results. Chart is provided for illustrative purposes.

Based on the Best Global Brand 2014 report, 52 out of the top 100 global brands are members or are owned by members of the S&P 500.

Because many S&P 500 members are global industry leaders and produce in large quantities, they usually have higher negotiation power with suppliers, which can lower their operating costs. On the other hand, the brand power of these companies helps them to sell their products at premium prices and maintain higher margins.[3] Based on the Best Global Brand 2014 report published by the worldwide brand consultant Interbrand, 52 of the top 100 global brands are members or are owned by members of the S&P 500.[4] These brands scored well on the valuation-based competitive strength of the brand, the role the brand plays in the purchase decisions, and the financial performance of the branded products or services. Apple, Google, Coca-Cola, IBM, Microsoft, GE, and McDonald's are 7 of the top 10 global brands.

[3] For more details, please see the article "America's Most Profitable Products" by Thomas C. Frohlich and Alexander E.M. Hess.

[4] For methodology and complete list of the 100 best global brands, please see http://www.bestglobalbrands.com/2014/methodology/.

Exhibit 7: Global Brands in the S&P 500

GLOBAL RANKING	BRAND	COMPANY/ PARENT COMPANY IN THE S&P 500	GLOBAL RANKING	BRAND	COMPANY/ PARENT COMPANY IN THE S&P 500
1	Apple	Apple Inc.	48	Citi	Citigroup Inc
2	Google	Google Inc	50	Colgate	Colgate-Palmolive Co
3	Coca-Cola	Coca-Cola Co	61	Caterpillar	Caterpillar Inc
4	IBM	Intl Business Machines Corp	62	Xerox	Xerox Corp
5	Microsoft	Microsoft Corp	63	Morgan Stanley	Morgan Stanley
6	GE	General Electric Co	66	3M	3M Co
9	McDonald’s	McDonald's Corp	67	Discovery	Discovery Communications Inc
12	Intel	Intel Corp	68	KFC	Yum! Brands Inc
13	Disney	Walt Disney Co	69	VISA	Visa Inc
14	Cisco	Cisco Systems Inc	71	Tiffany	Tiffany & Co
15	Amazon	Amazon.com Inc	72	Sprite	Coca-Cola Co
16	Oracle	Oracle Corp	76	Starbucks	Starbucks Corp
17	HP	Hewlett-Packard Co	77	Adobe	Adobe Systems Inc
18	Gillette	Procter & Gamble	78	Johnson & Johnson	Johnson & Johnson
22	Nike	NIKE Inc B	79	John Deere	Deere & Co
23	American Express	American Express Co	80	MTV	Viacom Inc
24	Pepsi	PepsiCo Inc	82	Chevrolet	General Motors Company
27	UPS	United Parcel Service Inc B	83	Ralph Lauren	Ralph Lauren Corp
28	eBay	eBay Inc.	84	Duracell	Procter & Gamble
29	Facebook	Facebook Inc	85	Jack Daniel’s	Brown-Forman Corp
30	Pampers	Procter & Gamble	87	Harley-Davidson	Harley-Davidson Inc
32	Kellogg	Kellogg Co	88	Mastercard	Mastercard Inc
35	J.P. Morgan	JP Morgan Chase & Co	89	Kleenex	Kimberly-Clark
39	Ford	Ford Motor Co	92	FedEx Corp	FedEx Corp
44	Accenture	Accenture plc	96	Pizza Hut	Yum! Brands Inc
47	Goldman Sachs	Goldman Sachs Group Inc	99	GAP	Gap Inc

Source: S&P Dow Jones Indices LLC, Interbrand (http://www.bestglobalbrands.com/2014/ranking/). Table is provided for illustrative purposes.

Twice a year, S&P Dow Jones Indices releases the SPIVA® Scorecard, which tracks the number of actively managed mutual funds that beat their comparable benchmarks over different timeframes.

PERFORMANCE OF THE S&P 500 VERSUS ACTIVE U.S. LARGE-CAP FUNDS

Investing in the U.S. equity market can be done via the use of active fund managers or index-linked products, which track the returns of the underlying index. Twice a year, S&P Dow Jones Indices releases the

SPIVA® Scorecard, which tracks the number of actively managed mutual funds that beat their comparable benchmarks over different timeframes.[5]

The year-end 2014 SPIVA U.S. Scorecard showed that the S&P 500 outperformed more than 86% of active U.S. large-cap funds in 2014. Performance of active U.S. large-cap funds looks equally unfavorable for longer investment periods, as 89% and 82% of them underperformed the S&P 500 over the 5- and 10-year periods, respectively. The returns of the S&P 500 also exceed the average returns of active U.S. large-cap funds on both an equal- and asset-weighted basis. This result indicates that index-based investing may be a viable complement or substitute to actively managed investments in the U.S. equity market.

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Exhibit 9: Annualized Performance of Active U.S. Large-Cap Funds and the S&P 500

INDEX/FUND CATEGORY	1-YEAR (%)	3-YEAR (%)	5-YEAR (%)	10-YEAR (%)
S&P 500	13.69	20.41	15.45	7.67
Active U.S. Large-Cap Funds (Equal-Weighted Average)	10.27	18.43	13.37	6.81
Active U.S. Large-Cap Funds (Asset-Weighted Average)	10.65	18.99	13.71	7.03
% of Active U.S. Large-Cap Funds Outperformed by S&P 500	86.44	76.25	88.65	82.07

Source: S&P Dow Jones Indices LLC. Data as of December 2014, as reported in the SPIVA U.S. Scorecard Year-End 2014. Past performance is no guarantee of future results. Table is provided for illustrative purposes.

CONCLUSION

The S&P 500 and the Hang Seng Index are considered primary indicators of overall market performance in the U.S. and Hong Kong equity markets, respectively. Both indices comprise the largest and most-liquid stocks from their respective markets, but the S&P 500 has much greater stock diversification and its members are significantly more liquid compared with those of the Hang Seng index.

Due to the differences in sector composition and exposure to different economic landscapes, the historical risk/return profiles for the two indices are significantly different. In the past 20 years, performance of the S&P 500 has been less volatile and had smaller market drawdowns than the Hang Seng Index, and the S&P 500 recorded higher absolute and risk-adjusted returns for the same period.

The members of the S&P 500 are not only the largest companies in the U.S., but many of them are leading global companies that represent a significant share of global equity market capitalization, revenue, and earnings. These companies delivered higher operating margins than their global peers in most sectors in 2014, and more than one-half of the top

[5] It is not possible to invest directly in an index, and index returns do not reflect expenses a fund would pay to replicate an index. For the complete analysis on U.S. active funds versus S&P DJI U.S. benchmark returns, please see the most recent SPIVA U.S. Scorecard.

brands across the globe are members or are owned by members of the S&P 500.

Additionally, the majority of active U.S. large-cap funds were outperformed by the S&P 500 over 1-, 3-, 5- and 10-year periods, indicating that index-based investing may be a viable complement or substitute to actively managed investments in the U.S. equity market.

All of these factors drive international appetite for the S&P 500, and as a result, there has been an increasing number of S&P 500 exchange-traded products listed in various markets across the globe.

Index-based investing may be a viable complement or substitute to actively managed investments in the U.S. equity market.

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