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Investment Advisory

Indices: Market Cap or Equal Weighted?

It is no secret that active managers have been getting a bit of a beating lately as many alpha driven portfolio managers have considerably underperformed their respective indices in recent years. In response to their shortfall, the industry has seen a shift in interest from alpha to beta and now to smart beta. The question then becomes, what does this mean? Is this sustainable? Will this apparent indifference to fundamentals continue? If the answer is yes and investors remain invested in beta strategies, the next reasonable question might be, are all index funds created equal? The answer of course is no, for a variety of reasons: market selected, fees, fund liquidity, leverage, exposure, etc. For purposes of this paper, let's focus on the U.S. market, and more specifically, exclusively discuss the S&P 500 index. For those index funds focused solely on the S&P 500 market, there exist two different investment approaches: The first is market weighted, while the second is a fund designed to equally weight exposures. An index that is market cap weighted would have the largest underlying company's stock as its highest allocation, which in the case of the S&P 500, is Apple at 3.9% of the index. An index that is equally weighted weights each underlying holding equally, with no preference to a company's size. In this case, the equally weighted index holds Apple stock at a 0.22% weight. Table 1 provides the difference by sector between the two investment strategies. As is evident, while there are considerable differences in the weights across all sectors, the most glaring difference is in the technology sector, 23.32% versus 14.40%.

Table 1

S&P 500 GICS Sector Weights

	Cap weighted	Equal weighted
Information Technology	23.32%	14.40%
Financials	13.95%	12.54%
Healthcare	13.92%	12.32%
Consumer Discretionary	12.29%	15.81%
Consumer Staples	9.31%	7.41%
Industrials	10.13%	13.48%
Energy	5.92%	6.02%
Utilities	3.21%	5.73%
Real Estate	2.88%	6.25%
Materials	2.82%	5.09%
Telecom Services	2.19%	0.80%

As of June 8, 2017

Let's explore the weights of the so-called FANG (Facebook, Amazon, Netflix and Google) stocks. Table 2 provides the weights of the FANG stocks for a both a market cap and equally weighted index. For the market cap weighted index these stocks account for 6.79%, while the equal weighted index holds them at 0.80%.

Table 2

FANG % of S&P 500 Cap Weight:	6.79%
FANG % of Equal Weight:	0.80%

As of June 8, 2017

As you can imagine, performance will vary considerable depending on the index approach. Table 3 puts this discussion into historical context. During the 1990s, the market weighted index outperformed the equal weighted index, while the following decade equal weighted outperformed and finally, from 2010 through last month, equal weight outperformed but not by as wide of a margin. It is not surprising market cap weighted outperformed in the 1990s given the strength of technology stocks, which was then followed by a sharp reversal in the sector in the early 2000s, leading to superior performance from an equally weighted index. The question of the moment is, how will the rest of this decade play out? The answer lies in an investor's expectations for technology stocks, since they are the biggest difference in the two indices. Also, important to consider is which company size, large or mid and small, will outperform. If the bias is towards small and mid, an equally weighted index might make more sense given that they tend to have a higher allocation to companies on mid and smaller side. Will this trend continue? It's hard to predict with any certainty, but what is important to keep in mind when investing in an equally weighted benchmark is transaction costs and possible increased taxable gains (if you are a taxable investor) driven by the higher degree of rebalancing required to keep the portfolio correctly weighted. Also, be aware that the mandatory rebalancing tends to lead to a higher expense ratio. Conversely, rebalancing mitigates performance chasing and inefficiencies that tend to occur in the cap weighted index.

Table 3

	1990 to 1999	2000 to 2009	2010 to 5-2017
Annualized Returns Divs Reinvested			
S&P 500 Index	18.14%	-0.95%	13.31%
S&P 500 Equal Weighted Index	12.47%	3.38%	14.34%

Source: Bloomberg

As we've outlined, there are positives and negatives to each approach, as well as periods of outperformance of one strategy over the other. As previously mentioned, market cap weighted tends to lead to inefficiencies and the need to use other indexes to help balance exposures, while equal weighted has automatic rebalancing and mitigates performance chasing, typically at the expense of a higher turnover and fund fees. We believe, an advantages way to capture the S&P 500 market weighted index is through the ETF SPY, while the ETF RSP is ideal for obtaining equal weighted exposure.

Source: all data from Bloomberg