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Achieve better balance: The case for equal weighting US stocks

ASX: QUS

ASX: HQUS

Betashares S&P 500 Equal Weight ETF
Betashares S&P 500 Equal Weight Currency Hedged ETF

Equal-weighted exposure to US stocks has provided both diversification benefits and market-beating returns over time

It's little wonder passive or 'indexed' investing has surged in popularity over recent years, with the majority of actively managed funds having underperformed their benchmark indices over various time periods.[1]

The most popular indexing approach is to track a major market index, such as the US's S&P 500, which essentially involves investing in all stocks within the index, weighted by their market capitalisation. At the time of writing (June 2024), Microsoft has the largest weighting in the S&P 500 Index of over 7%, thanks to its market capitalisation of over US$3 trillion.

Yet it may surprise investors to know there's an even simpler indexing approach, which offers the potential for attractive long term returns, along with generally lower stock-specific risk.

That approach is equal weighting, whereby each stock within an index is simply given the same weight within the portfolio at each index rebalance. In the case of the S&P 500 Index, for example, the Equal Weight Index version provides exposure to the same 500 stocks, but with each stock having the same weight of around 0.2% as at each quarterly index rebalance.

[1] Source: S&P Annual SPIVA Report, December 2023. Report findings show that the majority of active managers failed to beat relevant benchmark indices over 1, 3 and 5-year periods (subject to certain exceptions). Past performance is not indicative of future performance of any index or ETF.

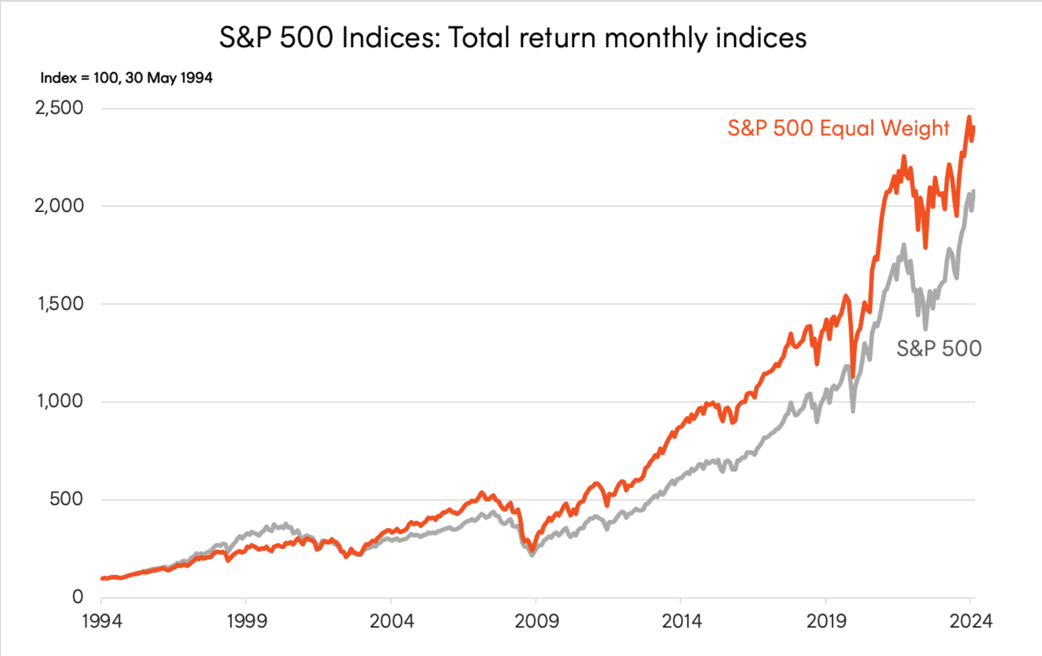
Why equal weighting has tended to outperform over time

As seen in the chart below, and in line with global evidence across many markets, the S&P 500's equal-weighted index has tended to outperform its better-known market-cap weighted counterpart over the long term (on a non AUD hedged basis).[2]

To illustrate, over the past 30 years, the S&P 500 Equal Weight Index has returned 11.14% p.a. versus 10.60%p.a. for the benchmark S&P 500 Index. As evident in the chart below, compounded over the long-term, this degree of outperformance can lead to a significantly larger value of one's initial investment compared to that in the market-cap weighted portfolio.

Further evidence of equal-weight's long-term outperformance was presented by **S&P in a special edition of their S&P Indices versus Active (SPIVA) report in 2023**. A comparison of the 20-year live performance of the S&P 500 Equal Weight Index to all large-cap US funds over the same period found that the index outperformed 99.8% of managers.

That said, over the shorter run, the equal weighted index has gone through periods of underperformance – for example, in the past 5 and 10 years - when larger cap stocks had periods of outperformance.



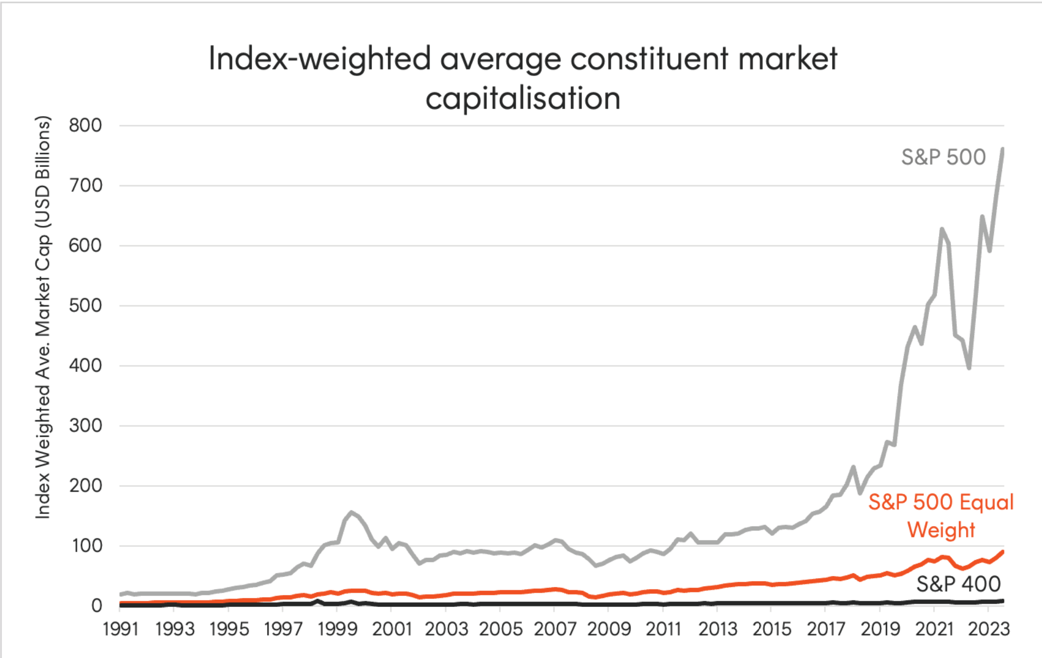
Source: Bloomberg, S&P Dow Jones. Past performance is not indicative of future performance of any index or ETF. You cannot invest directly in an index. Does not take into account ETF fees and costs.

[2] Source: Outperformance of Equal Weighted Indices. S&P Dow Jones. January 2018. Past performance is not indicative of future performance of any index or ETF.

There are two key reasons why equal-weighting can produce superior results to the market-cap weighting approach over the long term.

For starters, an equal-weighting approach provides greater exposure to smaller cap stocks, which on average tend to offer the greatest growth potential. As seen below, for example, the index-weighted average market cap of stocks within the equal-weighted index remains below US$100 billion, which is one eighth of the near $800 billion average market-cap of stocks within the market-cap weighted S&P 500 Index.

The recent strong performance of US mega-cap stocks has pushed the S&P 500's average market-cap to record heights. Considering that only eight listed companies have ever recorded a market capitalisation of greater than US$1 trillion, a figure the average market-cap of stocks in the S&P 500 Index average is approaching, raises the question of the index's future relative growth potential compared to the smaller sized S&P 500 Equal Weight Index.

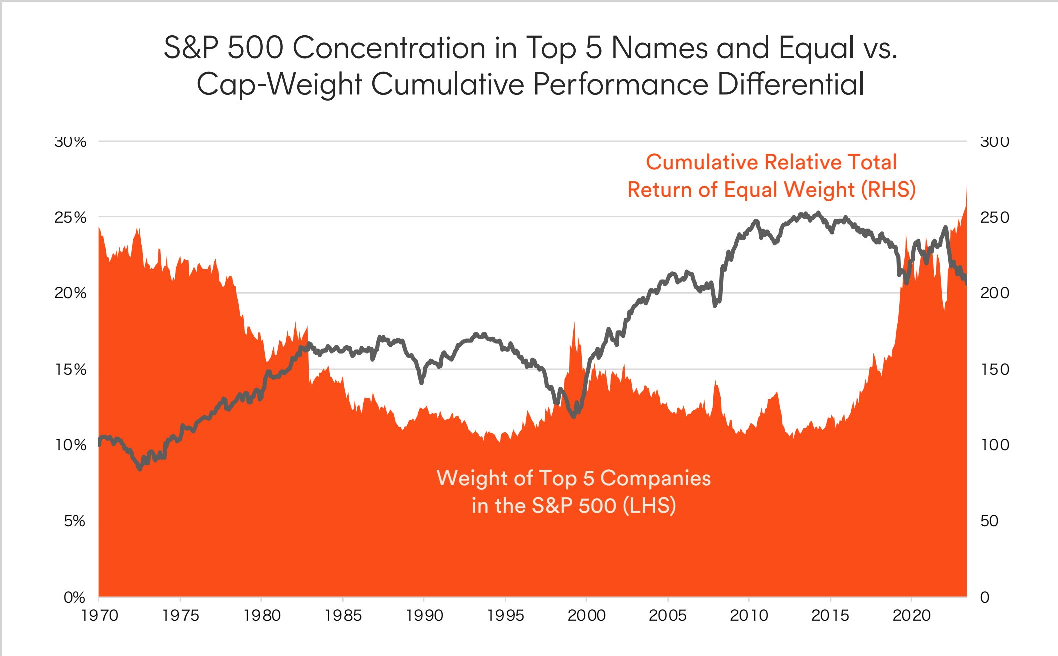


Source: Bloomberg, S&P Dow Jones LLC. Quarterly data from December 1991 to March 2024.

In a similar vein, by maintaining a more diversified exposure across many stocks, equal weighting tends to be better-placed to benefit from the market's positive skew, whereby strong and unexpected price performance among a relatively small number of stocks tends to account for a large degree of overall market performance.

Secondly, equal-weighting benefits by avoiding the susceptibility of market-cap weighting approaches to occasionally become overly concentrated in large stocks and sectors that have enjoyed strong price momentum for some time, and so are at increasing risk of an eventual performance reversal if their valuations get too extreme.

Indeed, as seen in the chart below, while market-cap weighting has tended to outperform equal-weighting in periods of sustained price trends favouring the largest-cap stocks (rising market concentration), the historical evidence suggests equal-weighting has more than made up this lost ground when these price trends have reversed - and the relative performance of these large 'hot' stocks has begun to reverse (market concentration declines).



Source: S&P Dow Jones Indices LLC, Betashares. Chart shows cumulative relative returns for the S&P 500 Equal Weight Index versus the S&P 500, based on monthly total returns between Dec. 1970 and May 2024. Cumulative weight of largest five S&P 500 companies based on month-end constituents. Past performance is no guarantee of future results. Chart is provided for illustrative purposes and reflects hypothetical historical performance.

As evident in the chart above, market concentration is currently at a record high, with the top 5 (or 1% of) stocks in the market-cap weighted S&P 500 Index accounting for over 27% of the Index – a level of large-cap stock concentration even higher than during the 'dotcom' bubble of the late 1990s, and never seen before.

The latest surge in market concentration clearly reflects the strong growth of the US's leading tech stocks in recent years, such as Microsoft, Apple, NVIDIA, Alphabet (Google), Amazon, and Meta (Facebook).

While these companies have strong business models and good underlying profit growth, history nonetheless suggests such an extreme level of market concentration is at growing risk of reversal, in which case the equal-weighted index may once again re-commence its trend of outperformance against its more famous market-cap weighted counterpart. As can be seen in the same chart the Equal Weight Index has tended to have its greatest periods of relative outperformance when concentration is subsiding.

A foot in both camps: the case for blending an equal-weighting exposure with momentum-based approaches

Given equal weighting has tended to perform especially well when strong share price trends have reversed, there is also diversification potential in blending this indexing approach with strategies that tend to benefit from price momentum, such as a focus on 'growth' stocks. If both approaches tend to produce relatively good returns over time, but at different points in the cycle, a blended exposure could help to reduce the overall volatility of portfolio returns without overly sacrificing returns.

As an example, the Nasdaq-100 Index has tended to outperform the S&P 500 Index over time, and could benefit from strong price momentum effects as successive generations of new dynamic companies succeed and grow. As evident in the chart below, there has tended to be a negative correlation between the relative performance of the Nasdaq-100 Index and the S&P 500 Equal Weight Index versus the S&P 500 (market- cap weighted) Index respectively.

Source: Bloomberg Betashares. You cannot invest directly in an index. Provided for illustrative purposes only. Not a recommendation to make any investment decision or adopt any investment strategy. Does not take into account ETF fees and costs. Past performance is not indicative of future performance of any index or ETF

Over the examined 30-year time period this relationship meant that a blended exposure to the Nasdaq-100 and S&P 500 Equal Weight Index would have provided investors with better risk adjusted returns than the individual indexes themselves.[3] Professional investors often look for these types of relationships when constructing portfolios to benefit from diversification and to balance their desired risk and return characteristics.

	S&P 500 EW	Nasdaq 100	S&P EW & Nasdaq Blend
Return (p.a)	10.09%	14.55%	12.52%
Volatility (p.a.)	16.81%	24.03%	18.98%
Sharpe ratio	0.36	0.44	0.45

Source: Bloomberg, Betashares. S&P EW & Nasdaq Blend is a portfolio comprising a 50:50 allocation between the S&P 500 Equal Weight Index and Nasdaq 100 Index, rebalanced monthly. For the calculation of the Sharpe Ratios an average risk-free rate of 3.99% was used. Not a recommendation to invest or adopt any investment strategy. You cannot invest directly in an index. Past performance is not indicative of future performance of any index or ETF.

[3] Source: Bloomberg, Betashares. May 1994 to May 2024. Sharpe ratio: S&P 500 0.43, S&P 500 EW and Nasdaq 100 blend 0.45. Average risk-free rate over period of 3.99% used. You cannot invest directly in an index. Past performance is not an indicator of future performance.

A currency-hedged approach

Australian investors who want to invest in the S&P 500's equal weighted index may also want to minimise the impact of the currency variable on the investment equation.

Currency fluctuations can have a significant impact on the returns from an unhedged investment. In periods when the Australian Dollar is rising, an unhedged approach will underperform an equivalent currency-hedged approach. Equally, in periods when the Australian Dollar is falling, unhedged exposures will outperform equivalent hedged exposures.

The main aim of currency hedging is not so much to take a position that the Australian Dollar will strengthen (although investors who are of this view can use currency-hedged investments to express that view), but rather to achieve a 'purer' exposure to the performance of the companies in the portfolio, minimising the influence of exchange rate movements, and substantially reducing a source of uncertainty.

Summary

Given the potential benefits of an equal-weight approach to stocks within the S&P 500 Index, Betashares is pleased to offer investors the Betashares S&P 500 Equal Weight ETF (ASX: QUS), which aims to track the S&P 500 Equal Weight Index as described above, alongside a currency hedged alternative (ASX: HQUS).

QUS and HQUS are designed to provide a simple-to-access, transparent and cost-effective way for Australian investors to gain exposure to a highly diversified portfolio of large-cap US stocks. As noted above, QUS offers the potential to outperform the S&P 500 (market-cap weighted) Index over the long term, whilst reducing the investment risk associated with an overly concentrated stock exposure.

Blended with a strategy that benefits from price momentum, QUS and HQUS also offer the potential for a 'smoother path' of outperformance versus the S&P 500 Index over time.

QUS and HQUS can be easily accessed on the ASX, at a management cost of just 0.29% p.a. or $29 per year for every $10,000 invested (0.32% p.a. and $32 per year for HQUS).*

*Other costs, such as transaction costs, may apply. Refer to PDS for more information.

There are risks associated with an investment in the Funds, including market risk, index methodology risk and in the case of QUS currency risk. Investment value can go up and down and returns are not guaranteed. For more information on risks and other features of QUS and HQUS, please see the Product Disclosure Statement available at www.betashares.com.au.