Achieve better balance: The case for equal weighting US stocks

ASX: QUS

Betashares S&P 500 Equal Weight 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 (December 2020), Apple has the largest weighting in the S&P 500 Index of over 6%, thanks to its very high market capitalisation of almost US$2 trillion.

Yet it may surprise some investors to know there's an even simpler indexing approach, as this note will outline, which historically has delivered better investment returns over time[2], 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, though each instead has the same equal weight of around 0.2% as at each quarterly index rebalance.

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[1] Source: S&P Annual SPIVA Report, January 2018. 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.

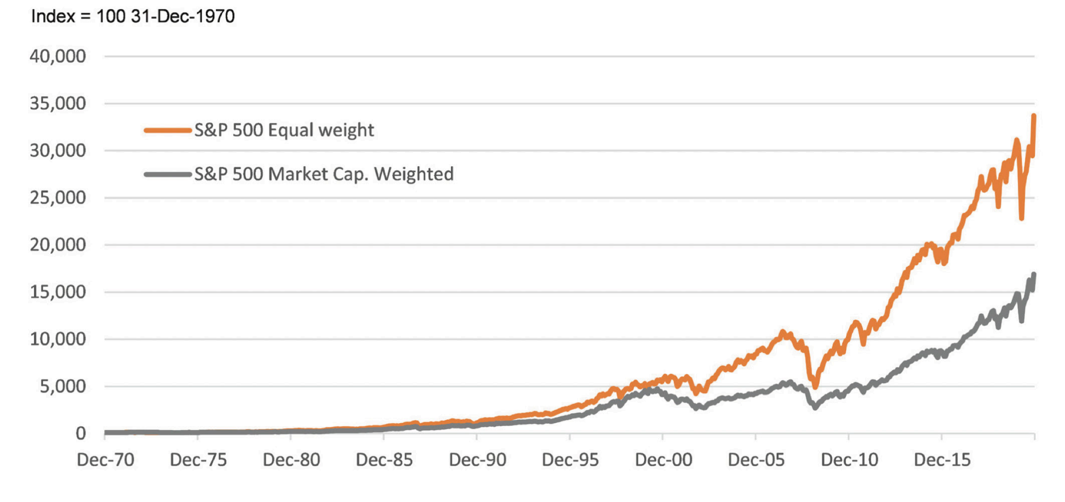
[2] Source: Bloomberg, S&P Dow Jones. Based on performance comparison between S&P 500 Equal Weight Index and the S&P 500 Index over the period December 1970 to November 2020. You cannot invest directly in an index. Past performance is not indicative of future performance of any index or ETF.

Why equal weighting has tended to outperform over time

As seen in the chart over the page, 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 run.[3]

To illustrate, over the past 50 years and 20 years, the S&P 500 Equal Weight Index has returned 12.4% p.a. and 9.5% p.a. versus 10.8% and 7.3% respectively 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 dramatically larger value of one's initial investment compared to that in the market-cap weighted portfolio! That said, over the shorter run, the equal weighted index has gone though periods of underperformance - as over the past 5 and 10 years - when larger cap stocks had periods of outperformance.

S&P 500 Indices: Total return monthly indices



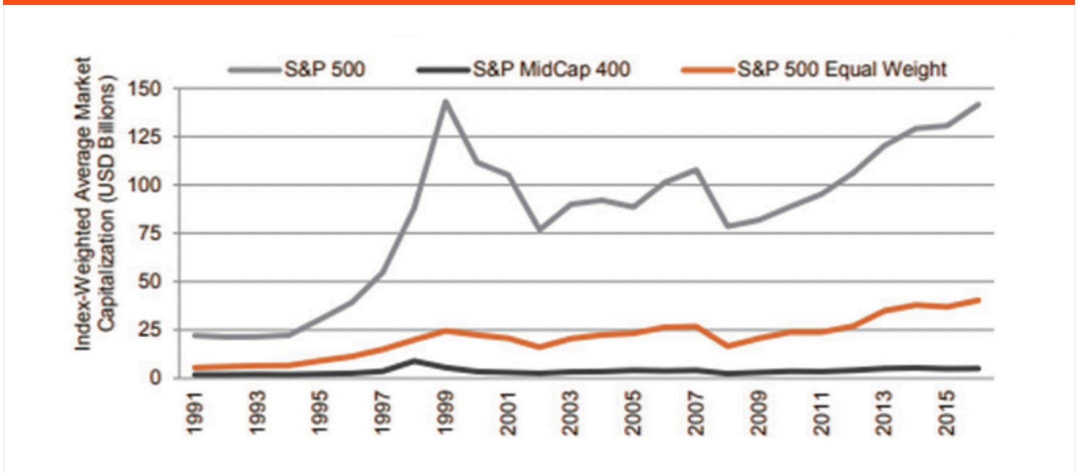
Source: Bloomberg, S&P Dow Jones. Past performance is not indicative of future performance of any index or ETF. You cannot invest directly in an index. Does not take into account ETF fees and costs.

There are two key reasons why equal-weighting has tended to 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 in the chart on the following page, for example, over recent decades the index-weighted average market cap of stocks within the equal-weighted index has been around US$25 billion, or only around one quarter of the approximately $100 billion average market-cap of stocks within the market-cap weighted S&P 500 Index.

[3] 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.

Index-weighted average constituent market capitalisation



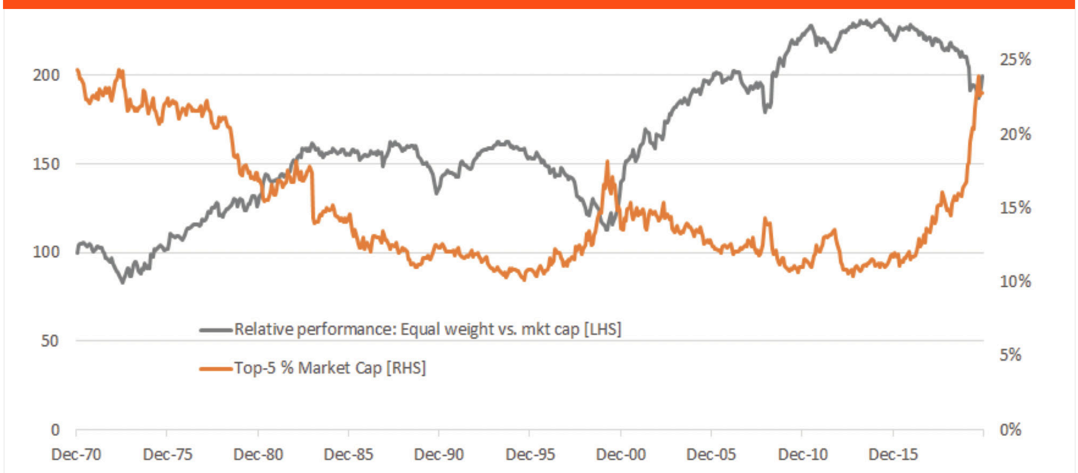
Source: Bloomberg, S&P Dow Jones LLC. Annual data from December 1991 to December 2016. Past performance is no guarantee of future results. Chart is provided for illustrative purposes and reflects hypothetical historical performance. Prospective application of the methodology used to construct the Index may not result in performance commensurate with the back-test returns shown. The back-test period does not necessarily correspond to the entire available history of the Index.

In a similar vein, by maintaining 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 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 have begun to reverse (market concentration declines).

S&P 500 vs Equal Weight: Total return monthly indices



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. Provided for illustrative purposes only. Does not take into account ETF fees and costs.

As evident in the chart on the previous page, moreover, market concentration is currently fairly high by historical standards, with the top 5 (or 1% of) stocks in the market-cap weighted S&P 500 Index accounting for almost 25% of the Index – a level of large-cap stock concentration even higher than during the 'dotcom' bubble of the late 1990s, and not seen since the early 1970s.

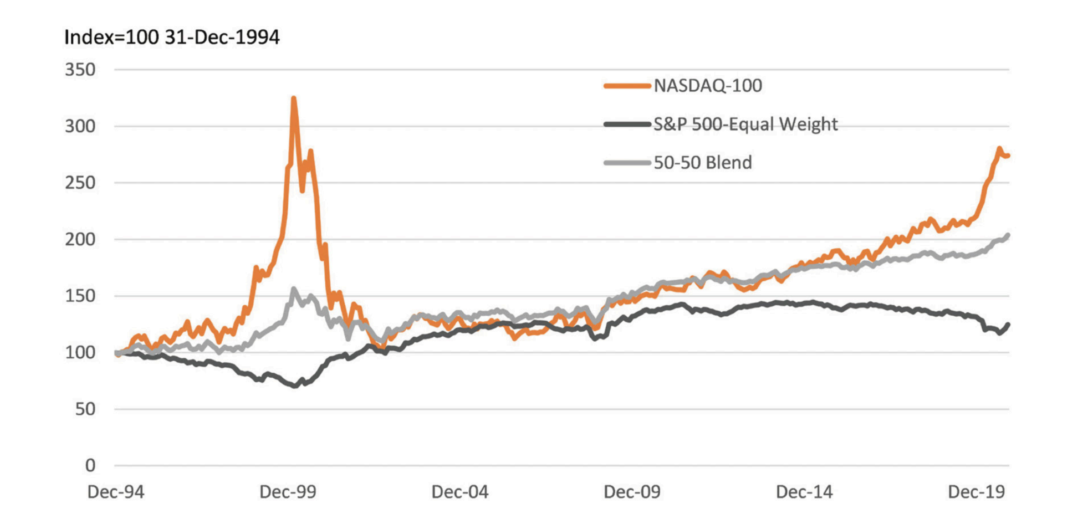
Of course, the latest surge in market concentration clearly reflects the strong growth of the US's leading tech stocks in recent years, such as Apple, Alphabet (Google), Amazon, Facebook and Microsoft. While these companies have strong business models and good underlying profit growth, history nonetheless 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 outperformance against its more famous market-cap weighted counterpart.

A foot in both camps: the case for blending an equal-weighting exposure with more 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. Indeed, 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, such that a blended exposure to both historically has resulted in a 'smoother' trend of outperformance versus the S&P 500 Index over time.

Relative performance vs S&P 500 (Market-cap) Index
Ratio of return performance relative to the S&P 500 (Market-cap) weighted Index



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. 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.

Summary

Given the potential benefits of an equal-weight approach to stocks within the S&P 500 Index, Betashares is pleased to have launched the Betashares S&P 500 Equal Weight ETF (ASX: QUS), which aims to track the S&P 500 Equal Weight Index as described above.

QUS is 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 also offers the potential for a 'smoother path' of outperformance versus the S&P 500 Index over time.

Being an exchange-traded fund (ETF), QUS can be easily accessed on the ASX just like a company share, at a management cost of just 0.29% p.a. or $29 per year for every $10,000 invested.

There are risks associated with investment in QUS, including market risk, index methodology risk, country risk and currency risk. For more information on risks and other features of QUS, please see the Product Disclosure Statement, available at www.betashares.com.au.