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Elston Insights

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US equities: equal weight proved defensive

- Concentration risk is a choice, not an obligation
- An equal weight approach reduces stock and sector biases
- This has proved defensive in 2022 market stress

Understanding index design

The most common type of equity index has its weights based on the market capitalization of each company within the index. Both the S&P 500 and the FTSE 100 are market-cap-weighted indices. This skews performance towards their largest constituents.

But there are also equally weighted versions of the same indices. So for the S&P500, each company is weighted at 1/500th (0.2%). This entirely removes the "size bias" that cap-weighted indices create. This skews performance away from the largest constituents.

Critics of passive investing are actually critics of market cap weighting, not of indexes, which can be weighted in all sorts of ways. Their argument goes that investors' funds blindly follow the weights of companies in an index in such a way that "the big get bigger" into a self-fulfilling loop.

The reality is that the largest weighted companies are those with 1) highest earnings and 2) highest valuation multiples investors pay for those earnings. Companies drive indices, not the other way round.

But what is true that if and when indices become concentrated, one sector can materially dominate the performance of the overall index.

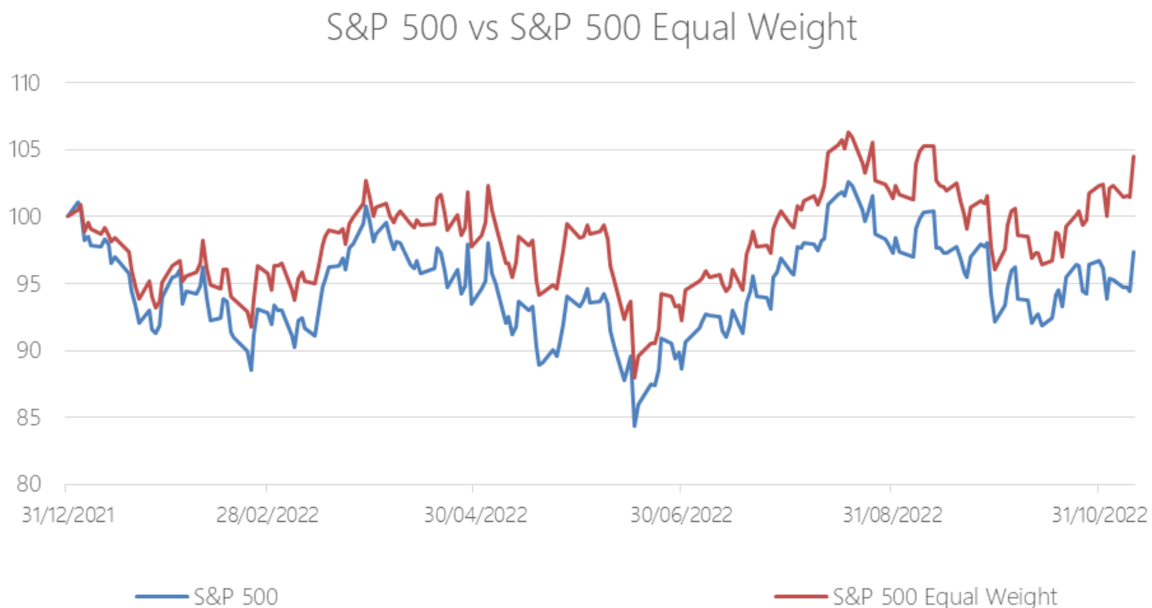
Concentration risk

In the 1980s, the S&P 500 was dominated by Big Oil. In the 2020s – by Big Tech. For investors concerned about the tech sector and tech valuations, traditional passive funds were overly exposed. But accepting concentration risk is a choice, not an obligation.

In 2021, we set out the case for an equal weight approach to provide useful diversification for those wanting to invest in the US equity market yet requiring a more defensive position with lower exposure to tech and reduced concentration risk.

This defensive approach has proved effective in 2022 performance.

Fig.1. S&P500 vs S&P500 Equal Weight Performance YTD



Source: Elston research, Bloomberg data, net total returns in GBP terms

What are the options?

- For the traditional passive approach – with higher concentration risk – there are no shortage of ETFs available. The largest is iShares Core S&P 500 UCITS ETF (LSE:CSP1). The largest holding is Apple (7%) and tech makes up 26.3% of the index. The fund is physical and costs 0.07% TER.
- the Xtrackers S&P 500 Equal Weight UCITS ETF 1C (LSE:XDWE). There is no largest holding – everything has an equal weight of 0.20%! Tech makes up 14.8% of the index. The fund is physical and costs 0.25% TER.

Using an equal weight index means an equal allocation individual stocks, the allocation to specific sectors is based on the number of companies in that sector, not their size.

An equal weight approach eliminates idiosyncratic, company-specific risk and is the ultimate "deconcentration" strategy.

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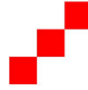

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