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Elston Insights

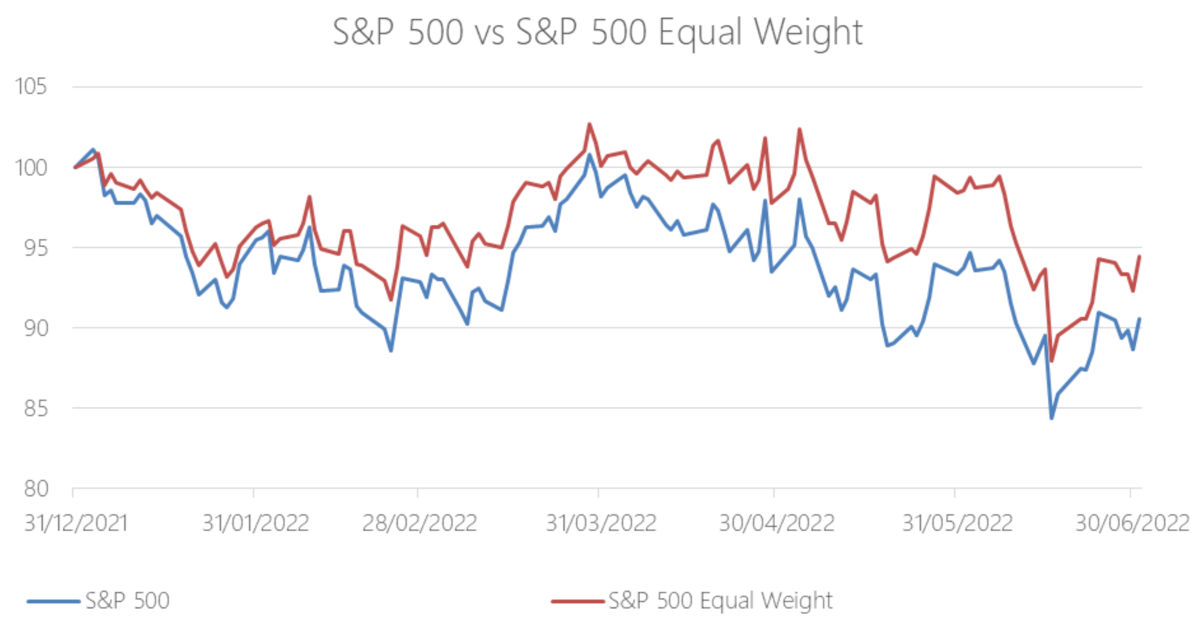
Simple. Effective. Equal-weight.

- A straightforward approach to reduce concentration risk
- Reduces "the big get bigger" effect of cap-weighted "passive" indices
- Scope for outperformance relative to traditional indices

Critics of tracker funds often flagged concentration risk or the "big get bigger" approach of passive investing as a structural flaw to index investing. But concentration risk is a choice, not an obligation for the index investor. As would be expected, an equal weight approach has proved relatively more defensive in the down-market year-to-date.

The S&P500 Equal Weight index has returned -5.2% against the traditional S&P 500's -9.3% YTD, in GBP terms.

Fig.1. S&P 500 vs S&P 500 Equal Weight 1h22 performance



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

Traditional passive vs alternatively-weighted indices

When funds or ETFs track an index, they are known as "passive" and this style is known as "passive investing". We prefer the term "index investing", because investors can be active around asset allocation decisions, and implement using index-tracking funds. Furthermore index selection requires an active choice, as not all indexes are constructed the same way.

Traditional indices are designed such that their constituents are weighted according to respective market capitalisation. This means they will hold ten times more of a company with a market cap of £1m than a company with a market cap of £100,000. This approach is considered to be the truest representation of a market portfolio, assuming markets are efficient: companies are weighted by their market value.

More recently, however, alternative indices (also known as Smart-Beta indices) have been constructed according to different, non-market-cap-weighted premises. For example, for a single equity market, such as US Equities and other markets, there are indices that weight securities based on their factor-style, those that focus on dividend contribution, those that focus on dividend yield ranking, those that focus on volatility ranking, and perhaps most simplistically, there is also the equal-weight index.

Constructing the equal-weight index

The equal-weight index is constructed via the straightforward calculation of one divided by the number of constituents in the index. That's why it's sometimes known as a "1 over N" index. So if an index features 100 companies, then it will hold 1% of each of them. This completely discounts any consideration of profits, dividends, liquidity or market cap.

The problem inherent in a traditional, cap-weighted index is that outperformance is the cap-weighted premise is self-reinforcing. This means that as a company grows it becomes a bigger part of the index which means investors allocate more to it. So the big constituents automatically get bigger.

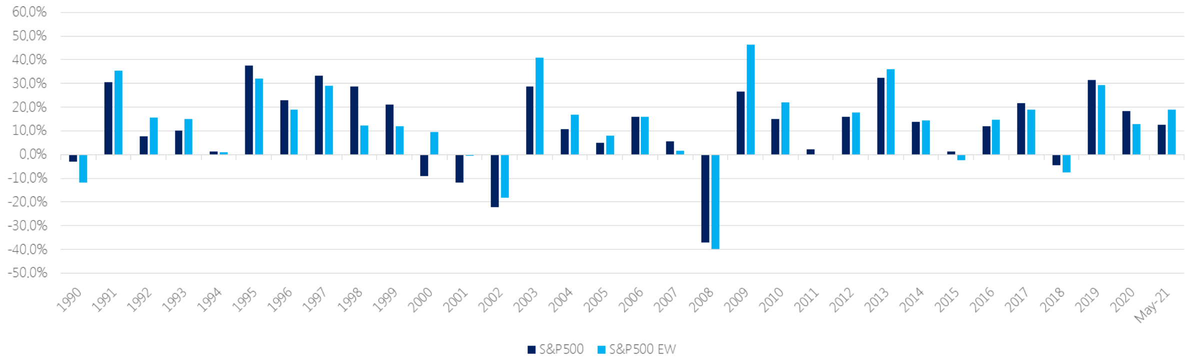
Scope for (relative) outperformance

An equal weight index will always be directionally consistent with its parent index.

In up markets, there will be times when it outperforms. This is most likely in a broad recovery market, where all stocks are being lifted. There will be times when it underperforms. This is most likely in a market characterised by growth that is concentrated in a few names trading on expanding multiples.

In down markets, in a late cycle market where those same over-valued growth stocks are losing more ground than their index counterparts, (like today's environment), an equal-weight index is likely to outperform.

Fig.2. S&P 500 vs S&P 500 Equal Weight: Discrete Returns



Source: Elston research, Bloomberg data. Total Return data in USD terms

Like Value investing, an equal-weight strategy is effective in the current market environment

In terms of investment style, the equal-weight approach has more of a bias towards value than growth and again, owing to its construction. This is reflected in current performance.

Interestingly, over the long-term, risk adjusted returns are generally higher for equal-weight strategies because concentration risk is reduced. The inevitability over a longer period that the market will come to be dominated for a period of time by, for example, big oil (in the 1980s) or big tech (now), is mitigated if holdings are weighted equally.

When investing, it is important to remember that using traditional, more concentrated, indices is a choice, not an obligation and that alternatively-weighted options can offer alternative return patterns for the same asset class exposure.

Henry Cobbe, CFA

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For more on this topic, please see our CISI-endorsed CPD webinar:

[The curious power of equal weight, with guest speaker Tim Edwards, Managing Director, Index Investment Strategy, S&P Dow Jones Indices]

Find out more

For more insights and information on research, portfolios and indices, visit:

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