

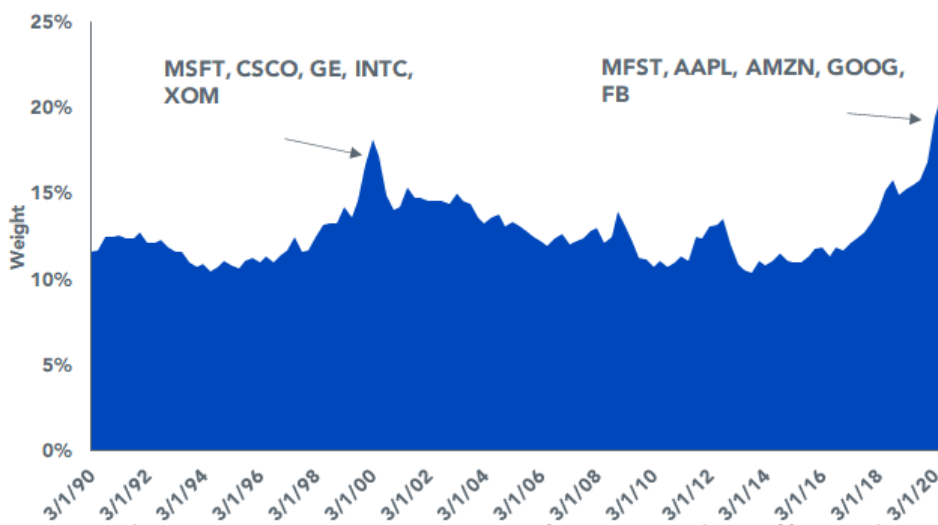
# SECURITY SELECTION REBALANCING

Alejandro Saitiel — Head of Indexes, U.S., Matt Wagner — Associate Director, Research  
05/29/2020

A handful of large companies have come to dominate the weight of the [S&P 500 Index](#). The five largest holdings now account for more weight in the [market cap-weighted](#) index than at any time in the past 30 years.

The growing dominance of a few richly valued companies has elevated [valuations](#)—lowering [future](#) return forecasts—and reduced the [diversification](#) benefits of the index.

## S&P 500 – Top 5 Weights



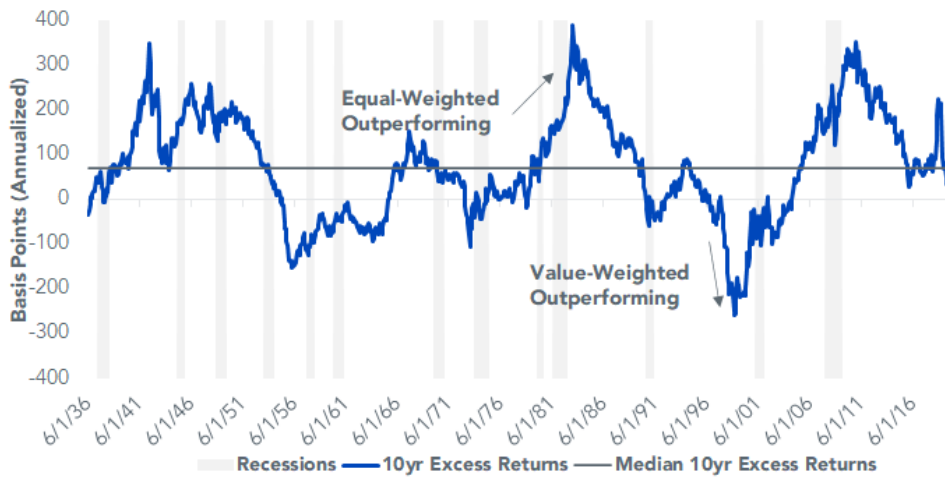
Sources: WisdomTree, FactSet, 3/31/1990–5/27/2020. Past performance is not indicative of future results. You cannot invest directly in an index.

Historic moves in both equity and fixed income markets during the first few months of the year have triggered investors to [rebalance](#) asset class allocations—for example, adjusting portfolios to maintain a 60%/40% equity/bond exposure.

While asset class rebalancing is a necessary condition to maintaining a well-diversified portfolio, we believe now is a critical time for investors to consider *security selection rebalancing* for core U.S. equity allocations. After a run of outperformance by the largest companies, many portfolios are likely dominated by a few names at a scale that has little historical precedent.

An equal-weight portfolio of [mid-](#) and [large-cap](#) securities—an approach that has historically outperformed [value-](#)weighted over the long-run—can mitigate the concentration that exists in market cap-weighted indexes. For some investors, particularly those more reluctant to have dedicated mid- and small-cap exposures, this may be an approach worth considering.

## Rolling 10-Yr Excess Returns: Hi 30 Equal-Weighted–Hi 30 Value-Weighted



Sources: WisdomTree, Kenneth French Data Library, St. Louis Fed, 5/31/1936–4/30/2020. "Hi 30 Equal-Weighted" represents an equal-weighted portfolio of the largest 30% of companies by market cap in the U.S. "Hi 30 Value-Weighted" represents a value-weighted portfolio of the largest 30% of companies by market cap in the U.S. Past performance is not indicative of future returns.

Many recent headlines suggest equity markets are pricing in an overly rosy recovery scenario. The market cap-weighted S&P 500 Index is down less than 10% from its February all-time high—far off the first-quarter lows. But the picture is less sanguine when assessing the recovery by several other major market gauges.

The [S&P SmallCap 600 Index](#), for example, only after strong performance this week emerged from a technical bear market that began in January.<sup>1</sup> And the equal-weighted S&P 500 and value-tilted S&P 500 both show that market prices still have significant ground to make up during a recovery.

**Cumulative Index Performance Since Feb. 19 (S&P 500 Peak)**



Source: WisdomTree, Bloomberg, 2/19/20-5/27/20. You cannot invest directly in an index. Past performance is not indicative of future returns.

More than ever before, S&P 500 Index performance is being driven by a narrow subset of companies. Just five companies (Microsoft, Apple, Amazon, Alphabet and Facebook) now make up 20% of the weight of the S&P 500, and over one-third of the S&P 500 Growth Index.

**Index Weights**

	Microsoft	Apple	Amazon.com	Alphabet	Facebook	Total
S&P 500 Growth	9.5%	9.1%	6.9%	5.8%	3.8%	35.1%
S&P 500	5.5%	5.3%	4.0%	3.4%	2.2%	20.3%
S&P 500 E/W	0.2%	0.2%	0.2%	0.2%	0.2%	1.0%
S&P 500 Value	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%

Sources: WisdomTree, FactSet, as of 5/27/20. You cannot invest directly in an index. Weights subject to change.

The weight of these companies in the S&P 500 has grown this year, as all have substantially outperformed the broad index returns, exhibiting their resilience during the pandemic.

While it's difficult to argue this concentration should lead to near-term underperformance for this subset, history suggests it eventually will. In a recent note, Goldman Sachs wrote that "(n)arrow breadth is always resolved the same way: The relative outperformance of market leaders eventually gives way to underperformance."<sup>2</sup>

	S&P 500 Index	S&P 500 Top 5 Holdings					
		Average	Microsoft	Apple	Amazon.com	Alphabet	Facebook
Index Weight	100.0%	4.1%	5.5%	5.3%	4.0%	3.4%	2.2%
YTD Total Return	-5.3%	14.6%	15.9%	8.9%	30.4%	6.0%	11.6%
P/E	21.7	33.1	30.4	25.0	114.3	29.7	29.4
P/S	2.2	6.1	10.1	5.3	4.1	5.9	9.0

Sources: WisdomTree, FactSet, as of 5/27/20. You cannot invest directly in an index. Weights subject to change.

### Benefits of Equal Weighting

Given heightened [valuations](#) for the market cap-weighted index, and that it has outperformed equal weighting by about 75 basis points annualized for the last decade, now may be a good time to add a more equally weighted allocation. And there are a few sound arguments that justify equal weighting outperforming market cap weighting over the long run:

- **Size exposure:** U.S. mid-caps tend to outperform large caps in the long run, typically with slightly greater volatility.
- **Value-tilted:** Because equal-weighted indexes must be regularly rebalanced back to equal weight, they have an indirect value process of selling winners and buying losers.

The size exposure and the value tilt can be seen from the factor loadings of a portfolio of equally weighted large-cap securities using returns going back to 1963. Both "Hi 30" portfolios use the Fama-French portfolios of top 30% of securities by market cap.

The equal-weight portfolio has higher risk—as measured by its market [beta](#) and [standard deviation](#)—which is consistent with its small but positive size loading, as well as a clear value tilt.

### Fama-French Factor Loadings and Returns

Portfolio	Factor Loadings					Annualized Statistics	
	Market	Size	Value	Operating Profitability	Investment	Total Return	Standard Deviation
Hi 30 - Value-Weighted	0.99	-0.17	0.01	0.02	0.00	9.92%	14.83%
Hi 30 - Equal-Weighted	1.07	0.02	0.13	-0.02	-0.07	10.52%	16.73%

Sources: WisdomTree, Kenneth French Data Library, 6/30/1963–4/30/2020. "Hi 30 Equal-Weighted" represents an equal-weighted portfolio of the largest 30% of companies by market cap in the U.S. "Hi 30 Value-Weighted" represents a value-weighted portfolio of the largest 30% of companies by market cap in the U.S. Past performance is not indicative of future returns.

### Portfolio Construction Drawback to Equal Weighting

Despite what we see as some positive near-term tailwinds to equal weighting, as well as its attractive factor tilts, there are some drawbacks to a simple equal weighting from a portfolio construction context.

For example, the S&P 500 Equal-Weight Index only has a modest active share (51%)<sup>3</sup> and a high [correlation](#) (.97)<sup>4</sup> to the S&P 500 Index.

The intention of adding a diversifying allocation to a portfolio would be some reduction in risk for each incremental unit of return—an improvement in the portfolio's [Sharpe ratio](#).

However, this isn't what occurs with a historical blend of equal-weighted and value-weighted portfolio returns. While returns have been better over the long run for equal weighting, there is no risk reduction benefit that you would typically see from blending two portfolios with lower correlations.

## Efficient Frontier

### Enhancing Equal Weighting

Equal weighting has outperformed market cap-weighting over the long run. While “timing” when that outperformance will occur is a difficult task, we think now is a favorable backdrop given the concentration and heightened valuations of the market cap-weighted benchmark.

However, some of the characteristics of a traditional equal-weighting approach make such an allocation unattractive when paring it with an investor’s core market cap-weighted approach. In a nod to some of the benefits of equal weighting—namely size exposure and diversification—WisdomTree elected for a “modified” equal-weighting approach for [its high-active share multifactor model](#).

In a future post, we’ll highlight how this model aims to improve on some of the drawbacks of simple equal weighting, and how it fills the role of a true portfolio diversifier to a traditional core exposure.

<sup>1</sup>Source: Bloomberg. Recent peak for the S&P SmallCap 600 Index was set on 1/16/2020. On a price return basis the index was down over 20%--a technical bear market-- until 5/27/20.

<sup>2</sup>“U.S. Weekly Kickstart,” Goldman Sachs Portfolio Strategy Research, 5/1/20.

<sup>3</sup>WisdomTree, FactSet, as of 4/30/20.

<sup>4</sup>WisdomTree, Zephyr Style Advisor, 1/31/03–4/30/20.

For standardized performance and the most recent month-end performance click [here](#) NOTE, this material is intended for electronic use only. Individuals who intend to print and physically deliver to an investor must print the monthly performance report to accompany this blog.

For more investing insights, check out our [Economic & Market Outlook](#)

View the online version of this article [here](#).

## **IMPORTANT INFORMATION**

**U.S. investors only: Click [here](#) to obtain a WisdomTree ETF prospectus which contains investment objectives, risks, charges, expenses, and other information; read and consider carefully before investing.**

There are risks involved with investing, including possible loss of principal. Foreign investing involves currency, political and economic risk. Funds focusing on a single country, sector and/or funds that emphasize investments in smaller companies may experience greater price volatility. Investments in emerging markets, currency, fixed income and alternative investments include additional risks. Please see prospectus for discussion of risks.

Past performance is not indicative of future results. This material contains the opinions of the author, which are subject to change, and should not to be considered or interpreted as a recommendation to participate in any particular trading strategy, or deemed to be an offer or sale of any investment product and it should not be relied on as such. There is no guarantee that any strategies discussed will work under all market conditions. This material represents an assessment of the market environment at a specific time and is not intended to be a forecast of future events or a guarantee of future results. This material should not be relied upon as research or investment advice regarding any security in particular. The user of this information assumes the entire risk of any use made of the information provided herein. Neither WisdomTree nor its affiliates, nor Foreside Fund Services, LLC, or its affiliates provide tax or legal advice. Investors seeking tax or legal advice should consult their tax or legal advisor. Unless expressly stated otherwise the opinions, interpretations or findings expressed herein do not necessarily represent the views of WisdomTree or any of its affiliates.

The MSCI information may only be used for your internal use, may not be reproduced or re-disseminated in any form and may not be used as a basis for or component of any financial instruments or products or indexes. None of the MSCI information is intended to constitute investment advice or a recommendation to make (or refrain from making) any kind of investment decision and may not be relied on as such. Historical data and analysis should not be taken as an indication or guarantee of any future performance analysis, forecast or prediction. The MSCI information is provided on an "as is" basis and the user of this information assumes the entire risk of any use made of this information. MSCI, each of its affiliates and each entity involved in compiling, computing or creating any MSCI information (collectively, the "MSCI Parties") expressly disclaims all warranties. With respect to this information, in no event shall any MSCI Party have any liability for any direct, indirect, special, incidental, punitive, consequential (including loss profits) or any other damages ([www.msci.com](http://www.msci.com))

Jonathan Steinberg, Jeremy Schwartz, Rick Harper, Christopher Gannatti, Bradley Krom, Tripp Zimmerman, Michael Barrer, Anita Rausch, Kevin Flanagan, Brendan Loftus, Joseph Tenaglia, Jeff Weniger, Matt Wagner, Alejandro Saltiel, Ryan Krystopowicz, Jianing Wu, and Brian Manby are registered representatives of Foreside Fund Services, LLC.

WisdomTree Funds are distributed by Foreside Fund Services, LLC, in the U.S. only.

You cannot invest directly in an index.

## DEFINITIONS

**Market capitalization-weighting** : Market cap = share prices x number of shares outstanding. Firms with the highest values receive the highest weights in approaches designed to weight firms by market cap.

**Valuation** : Refers to metrics that relate financial statistics for equities to their price levels to determine if certain attributes, such as earnings or dividends, are cheap or expensive.

**Futures/Futures Contract** : Reflects the expected future value of a commodity, currency or Treasury security.

**Diversification** : A risk management strategy that mixes a wide variety of investments within a portfolio.

**Rebalance** : An index is created by applying a certain set of selection and weighting rules at a certain frequency. WisdomTree rebalances, or re-applies its rules based selection and weighting process on an annual basis.

**Mid-Cap** : Characterized by exposure to the next 20% of market capitalization (after the top 70% have been removed) within the Value, Blend or Growth style zones with the majority of the fund's weight.

**Large-Capitalization (Large-Cap)** : A term used by the investment community to refer to companies with a market capitalization value of more than \$10 billion. Large cap is an abbreviation of the term "large market capitalization". Market capitalization is calculated by multiplying the number of a company's shares outstanding by its stock price per share.

**Value** : Characterized by lower price levels relative to fundamentals, such as earnings or dividends. Prices are lower because investors are less certain of the performance of these fundamentals in the future. This term is also related to the Value Factor, which associates these stock characteristics with excess returns vs the market over time.

**S&P SmallCap 600 Index** : Market capitalization-weighted measure of the performance of small cap equities within the United States, with constituents required to demonstrate profitability prior to gaining initial inclusion.

**Beta** : A measure of the volatility of a security or a portfolio in comparison to a benchmark. In general, a beta less than 1 indicates that the investment is less volatile than the benchmark, while a beta more than 1 indicates that the investment is more volatile than the benchmark.

**Standard deviation** : measure of how widely an investment or investment strategy's returns move relative to its average returns for an observed period. A higher value implies more "risk", in that there is more of a chance the actual return observed is farther away from the average return.

**Correlation** : Statistical measure of how two sets of returns move in relation to each other. Correlation coefficients range from -1 to 1. A correlation of 1 means the two subjects of analysis move in lockstep with each other. A correlation of -1 means the two subjects of analysis have moved in exactly the opposite direction.

**Sharpe ratio** : Measure of risk-adjusted return. Higher values indicate greater return per unit of risk, specifically standard deviation, which is viewed as being desirable.