

# FACTOR-BALANCED EQUAL WEIGHTING

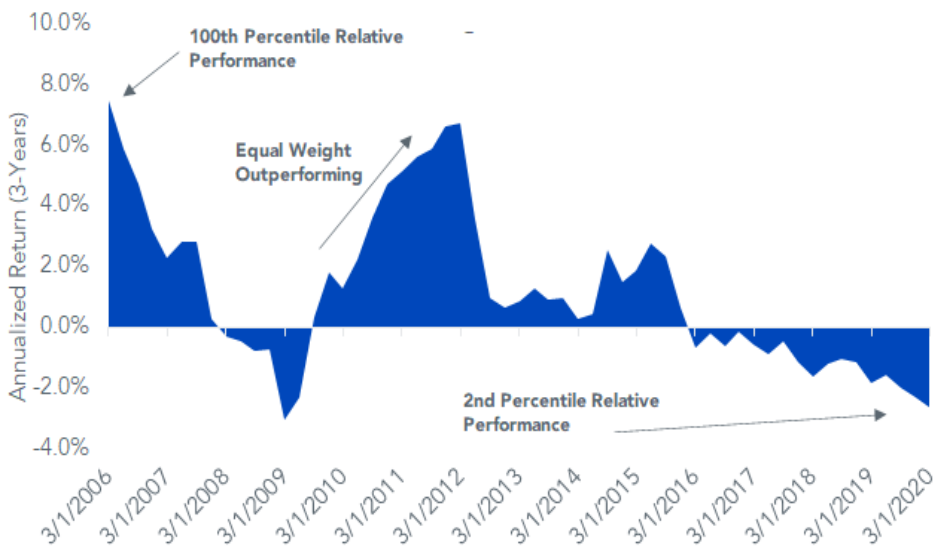
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The [S&P 500 Equal Weight Index \(S&P 500 EW\)](#)—a proxy for the average performance of U.S. stocks—has lagged the [S&P 500](#) by 261 [basis points \(bps\)](#) annualized for the last three years.

This relative performance ranks in the second percentile since inception of the index in 2003.<sup>1</sup>

The equal-weighted Index has outperformed the market cap-weighted Index since inception by 101 bps annualized, with a pattern of significant multi-year outperformance in the years immediately following the early 2000s recession and the financial crisis.

## S&P 500 Equal-Weight Minus S&P 500



Sources: WisdomTree, Zephyr StyleADVISOR. Data from 3/31/03–3/31/20. S&P 500 Equal Weight Index was launched on 1/8/03. Trailing three-year annualized returns using quarterly observations. You cannot invest directly in an index. Past performance is not indicative of future returns.

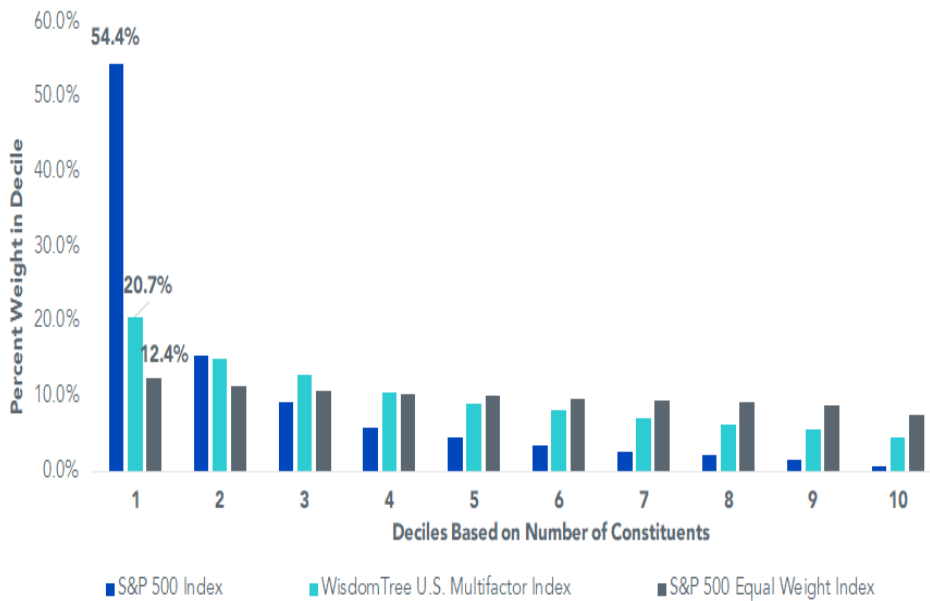
Despite addressing some of the major drawbacks associated with market cap weighting—such as concentration and expensive valuations—the S&P 500 EW does not provide investors with the best tool to improve [diversification](#) at the portfolio level, due to its high [correlation](#) (and high [beta](#)) relative to the S&P 500 Index.

## WisdomTree’s Approach to Equal Weighting

The [WisdomTree U.S. Multifactor Index \(WTUSMF\)](#) invests in [mid-](#) and [large-cap](#) U.S. equities in a way that closely resembles equal weighting. The Index selects 200 securities with a high combined multifactor score for several widely accepted factors: [value](#), [quality](#), [momentum](#) and [low correlation](#).

These 200 constituents are weighted using a normalized factor score. The Index has significantly less weight allocated to its top 10%—or largest 20 constituents—than the S&P 500 Index, and its weighting distribution is closer to the equal-weighted distribution of the S&P 500 Equal Weight Index.

## Percent of Total Weight in Each Market Cap Decile



Sources: WisdomTree, FactSet, as of 5/29/20. You cannot invest directly in an index. Past performance is not indicative of future results. Subject to change.

**Diversification Potential**

One way to measure the diversification potential a strategy can offer to an S&P 500 position is with risk and return characteristics.

Over this almost three-year period, the Equal Weight Index had roughly 90 bps of greater risk (or standard deviation) than the S&P 500 and a beta of 1.02.

WTUSMF had less risk than the S&P 500, contributing to its lower beta of 0.92. It also had a modestly higher [tracking error](#) than the S&P 500 EW.

**Annualized Risk/Return Statistics**

	WT U.S. Multifactor Index	S&P 500 Equal Weight	S&P 500
Return	7.76%	5.80%	10.42%
Standard Dev.	20.88%	22.97%	22.06%
Correlation	0.97	0.98	1.00
Beta	0.92	1.02	1.00
Tracking Error	5.02%	4.94%	0.00%
Active Share*	78.5%	50.60%	N/A

Sources: WisdomTree, Bloomberg, FactSet. Returns from 6/9/17–6/2/20. Inception date of the WisdomTree U.S. Multifactor Index was 6/9/17. You cannot invest directly in an index. Past performance is not indicative of future returns.

Another measure of diversification is in the common holdings, or active share. In the below tables, we show the number of holdings that are common to each Index, as well as a common holdings score/active share to show how common/different the weights are between the two Indexes.

The S&P 500 EW has an active share of 51% to the S&P 500, which is quite a bit lower than the 78% for WTUSMF. Part of the explanation is that each Index holds the same 505 securities. WTUSMF, on the other hand, selects just 200 securities from a starting universe of 800 of the largest U.S. companies by market cap. Only 123 securities in WTUSMF are also in the S&P 500 Index.

	WTUSMF	S&P 500
Total Stock Holdings	200	505
Common Holdings	124	
Common Holdings Score / Active Share	21.5% / 78.5%	

	S&P 500 E/W	S&P 500
Total Stock Holdings	505	505
Common Holdings	505	
Common Holdings Score / Active Share	49.4% / 50.6%	

Sources: WisdomTree, FactSet, as of 5/29/20. You cannot invest directly in an index.

## Blending Value and Quality

As expected, the equal-weighted S&P 500 has better value characteristics across the board relative to the S&P 500. The trade-off is lower profitability, or exposure to the quality factor.

The stock selection model for WTUSMF balances exposure to value and quality. By selecting on both of these characteristics, it aims to own securities that have above-average scores on both factors. It offers lower valuations than the S&P 500 and higher profitability, as measured by return on assets and return on equity.

Index	Valuation			Profitability	
	Price to Earnings	Price to Cash Flow	Price to Book	Return on Assets	Return on Equity
WT U.S. Multifactor	16.85	9.52	3.01	5.21%	17.45%
S&P 500 Equal Weight	18.98	8.01	2.08	2.30%	11.24%
S&P 500	21.77	12.31	3.44	3.24%	14.99%

Sources: WisdomTree, FactSet, as of 5/29/20. Past performance is not indicative of future results. You cannot invest directly in an index.

For definitions of terms in the table, please visit our [glossary](#).

From a return on equity (ROE) [quintile](#) attribution on since inception performance, WTUSMF was over-weight in the highest ROE quintile relative to the S&P 500 EW and under-weight in the lowest ROE quintile. The total attribution from these two quintiles contributed about 225 bps of annualized outperformance.

WisdomTree U.S. Multifactor Index (WTUSMF) vs S&P 500 Equal-Weighted Index ROE Quintile Attribution (06/30/2017 - 05/31/2020)						
Category	Total Attribution	Average Category Weights			Category Performance	
		WTUSMF	S&P 500 Equal-Weight	+/- Wgt	WTUSMF	S&P 500 Equal-Weight
1st Quintile (Highest ROE)	1.23%	30.64%	19.74%	10.89%	11.85%	10.26%
5th Quintile (Lowest ROE)	1.03%	6.60%	16.84%	-10.24%	4.15%	-0.34%
<b>Total</b>	<b>2.52%</b>				<b>7.55%</b>	<b>5.03%</b>

Sources: WisdomTree, FactSet. performance is not indicative of future results. You cannot invest directly in an index.

## A More Diversified Equal Weighting

There are many tactical and strategic tailwinds that may favor equal weighting versus market cap weighting U.S. equities. For most strategic asset allocators, allocation decisions need to be made from a portfolio construction context, making the consideration of things that we have discussed—like active share, tracking error and beta to existing positions—important.

The WisdomTree U.S. Multifactor Index aims to offer a diversified investment to traditional core positions while balancing its exposure to factors associated with outperformance over the long run.

<sup>1</sup>Sources: WisdomTree, Zephyr StyleADVISOR, 3/31/03–3/31/20. Rolling three-year annualized returns using quarterly observations. Inception of the S&P 500 Equal Weight Index was January 8, 2003.

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](#).

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**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.**

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You cannot invest directly in an index.

## DEFINITIONS

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

**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.

**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.

**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.

**Quality** : Characterized by higher efficiency and profitability. Typical measures include earnings, return on equity, return on assets, operating profitability as well as others. This term is also related to the Quality Factor, which associates these stock characteristics with excess returns vs the market over time.

**Momentum** : Characterized by assets with recent price increase trends over time. This term is also associated with the Momentum Factor which associates these stock characteristics with excess return vs the market over time.

**Low Correlation** : Characterized by assets that have a relatively lower correlation vs the market over time. This term is also associated with the Low Correlation Factor which associates these stock characteristics with excess returns vs the market over time.

**Tracking Error** : Can be discussed as both the standard deviation of excess return relative to a specific benchmark, or absolute excess return relative to a specific benchmark.

**Quintile** : One of the class of values of a variate which divides the members of and batch or sample into equal-sized subgroups of adjacent values or a probability distribution into distributions of equal probability.