THE LOVE AFFAIR WITH CAP WEIGHTING IS A RELIC OF A BYGONE ERA

Jeff Weniger — Head of Equity Strategy

07/12/2021

The first index—a price-weighted one—was Charles Dow's eponymous Dow Jones Industrial Average, published in 1896. Your third-grader could have designed it. Yet more than a hundred years later, the index is still widely consulted.

Right now, Dow component UnitedHealth is roughly $400 per share, while 3M is $200, so the former has double the influence on the index. Walgreens is $50, so UnitedHealth has eight times as much influence on the Dow.

It's silly.

But say something similar about market capitalization weighting and you will be run out of town. In an index like the S&P 500, a trillion-dollar company will have 10 times the index weight of a $100 billion company. We all agree the Dow is silly—but *this* is completely fine with the investment gods?

The history of cap weighting may surprise you.

It goes back to the efficient market hypothesis (EMH), which states that all known information is already baked into stock prices. Forget what you just saw with GameStop, forget when the DOT-COM bubble happened before your eyes.

Here is the thing: the EMH was postulated AFTER the modern-day incarnation of the S&P 500 in 1957.

Interestingly, I cannot find an academic paper on EMH until 1965, when Eugene Fama wrote about it. Even Burton Malkiel, founding father of EMH, did not publish *A Random Walk Down Wall Street* until 1973.

Here's what I think happened: fifty years ago, there were only a few indexes floating around. If you owned a mutual fund whose methods consisted of humans picking stocks, the fee may have been 2% a year. You also may have paid a front load, lopping off several percentage points of capital on day one.

And trades were done via floor brokers at the New York Stock Exchange at prohibitively expensive fees. Not only that, the bid/ask on even a big company like IBM may have been $49.50/$49.75. No wonder it was so tough to beat a cap-weighted index.

But instead of correctly attributing the fund shops' frustration to their own huge obstacles, "everyone" instead chalked up the result to excellence *in the benchmark itself*. But maybe we should consider that the funds would have struggled to beat any index.

In 2021, fundamentally weighted indexes are becoming more seasoned with each passing day; track records are getting lengthy. The time is coming when the Street is going to start asking some serious questions about why permanent capital is still being deployed into concepts that make little more sense than Charles Dow's 1896 basket.

Look, I have no bones with the S&P 500. If someone wants to buy a low-cost S&P tracker fund, have at it. But this is not 1975.

The lowest-cost S&P 500 ETF charges 0.03%. We at WisdomTree have a basket of 500 stocks at 0.08%, yet our methodology cares about fundamentals.

How it works: Microsoft alone earns about 4% of all U.S. corporate earnings, so that is its weight in the WisdomTree U.S. LargeCap Fund (EPS). Similarly, Apple also earns about 4% of the total earnings pie in this country, so that is the company's weight in EPS too. By weighting this way, you do not end up with some tiny company at the top of your holdings list. To wit, Google-parent Alphabet, JP Morgan and Facebook are EPS's next three largest holdings.

Naturally, EPS has traded at a lower P/E than the S&P since its inception in early 2007. Today its weighted-average forward multiple is 18, while the S&P's is 22. Again, EPS has an expense ratio of 0.08%.

If Charles Dow were here right now, what would he say?

Important Risks Related to this Article

There are risks associated with investing, including the possible loss of principal. Funds focusing their investments on certain sectors increase their vulnerability to any single economic or regulatory development. This may result in greater share price volatility. Please read the Fund's prospectus for specific details regarding the Fund's risk profile.

References to specific securities and their issuers are for illustrative purposes only and are not intended to be, and should not be interpreted as, recommendations to purchase or sell such securities.

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.

Related Funds

+ WisdomTree U.S. LargeCap Fund

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)

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

Dow Jones Industrial Average : The Dow Jones Industrial Average is a price-weighted average of 30 significant stocks traded on the New York Stock Exchange and the Nasdaq.

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.

S&P 500 Index : Market capitalization-weighted benchmark of 500 stocks selected by the Standard and Poor's Index Committee designed to represent the performance of the leading industries in the United States economy.

Efficient Market Hypothesis : Current share prices correctly reflect all available information about publicly traded firms and continually incorporate the emergence of new information on a nearly instantaneous basis; there are no bubbles, and firms are neither expensive nor inexpensive.

Bid/Ask Spread : This is essentially the difference in price between the highest price that a buyer is willing to pay for an asset and the lowest price for which a seller is willing to sell it.

Fundamental weighting : A type of equity index in which components are chosen based on fundamental criteria as opposed to market capitalization. Fundamentally weighted indexes may be based on fundamental metrics such as revenue, dividend rates, earnings or book value.

Price-to-earnings (P/E) ratio : Share price divided by earnings per share. Lower numbers indicate an ability to access greater amounts of earnings per dollar invested.