

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

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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?

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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.