Understanding equal-weighted investment strategies

- **Equal-weighted indexes and strategies are becoming topical due to their diversification at a time when equity markets have become increasingly concentrated.**
- **By nature, equal-weighted indexes have a higher exposure to small and mid-cap equities.**
- **Investors seeking to choose between equal-weighted and traditional market-weighted indexes must weigh up their advantages and disadvantages.**

When the top 10 stocks in the MSCI World Index, the best-known global stock index, represent more than a fifth of the benchmark as they have for much of 2024, it's natural to revisit the whole topic of whether market capitalization-weighted indexes do the job they were designed for.

They are intended to track the performance of a stock market. Yet do investors really want to have such a skew to just 10 stocks – in this case 10 US technology stocks with a leaning towards generative AI? Or do they want a broader representation of the stock market? These questions have become more pressing over the last 10 years as equity markets have become highly concentrated, reducing diversification.

The obvious solution is to adopt an equal-weighted index. Doing so delivers far greater diversification for investment strategies. It limits the possibility of excessive concentration and the risk of investing in a stock market bubble. However, there are pros and cons to both index approaches – whether the traditional market-weighted or the equal-weighted.

For investors weighing up the two approaches, it's important to understand the differences between the types of indexes, as well as the advantages and disadvantages. While neither approach to indexing is perfect, investors may find that one suits their specific circumstances more than the other.

The differences between the two index approaches

The division between the two types of indexes is described well by their respective names. However, it's also philosophical, depending on whether one believes that the efficient markets hypothesis associated with Eugene Fama, the US economist, is an absolute truth or not.

By way of definition, market-weighted indexes apportion a weighting to each stock in line with its capitalization. This is why the US tech stocks, which have by far the largest stock market capitalizations at the time of writing, also dominate the market-weighted indexes such as the MSCI World Index.

In contrast, an equal-weighted index treats every stock in the same way. Each is assigned the same weight so that the smallest company has as much influence on the index's performance as the largest.[1]

[1] Noonan, Barry, & Adam, n.d.; Bolognesi et al., 2013.

Pros and cons of equal-weighted strategies

Equal-weighted indexes have advantages and disadvantages. Below is a summary of them.

Advantages

1. Greater diversification

As equal-weighted indexes assign the same weight to each stock, regardless of its size, they are naturally more diversified. The index is not dominated by a few huge companies, ensuring that the portfolios tracking it are not liable to becoming excessively concentrated and stabilizing performance during periods of volatility.[2]

Consequently, equal-weighted indexes tend to have greater diversification across stock market sectors. Again, this reduces the risk of excessive portfolio concentration.

In practice, traditional market-weighted indexes are even more concentrated than might at first seem the case. For instance, at the end of September 2024 a measure of equity market concentration called the Herfindahl-Hirschman Index showed that although the MSCI World Index included over 1,400 stocks, in fact what the measure describes as the 'effective' number of stocks was just 104 (see chart 1).

By contrast, the equal-weighted Solactive Sustainable World Equity Index included just 250 actual stocks and the 'effective' number was 246 (the VanEck Sustainable World UCITS ETF follows this index). In other words, the equal-weighted index with the smaller number of holdings delivered far more portfolio diversification than the market-weighted MSCI World Index.

The efficient markets hypothesis

At the heart of differences between the two lies the Capital Asset Pricing Model (CAPM), which provides the theoretical foundation for market-capitalization weighted indexes. With its roots in the efficient markets hypothesis, which states that share prices reflect all available information, the CAPM model infers that market-weighted indexes offer the best possible balance of risk and return.

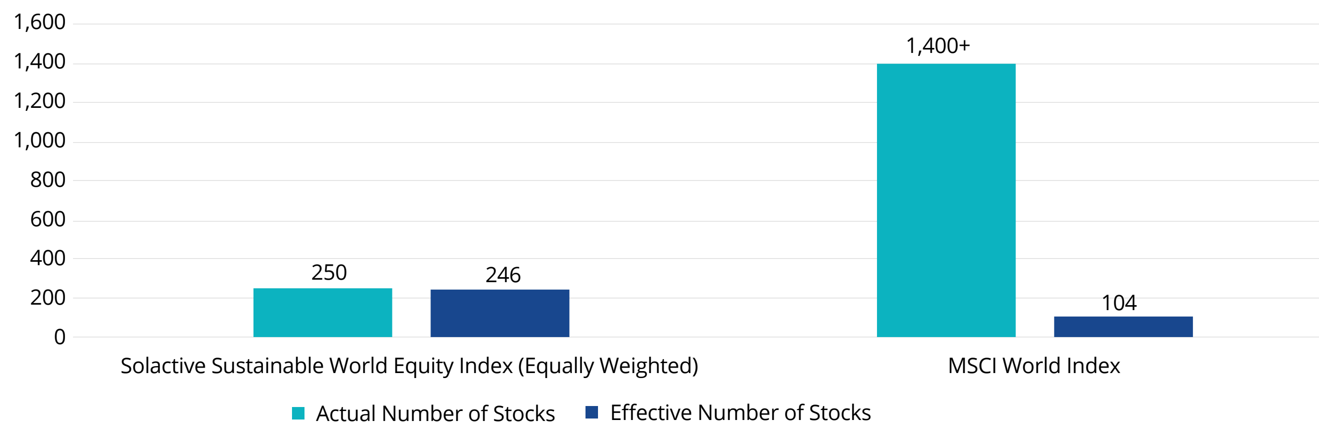
However, some of the most successful active investors (for instance Warren Buffet and George Soros), as well as behavioral economists, have disputed the efficient markets hypothesis. Their criticisms suggest that market-weighted indexes can become overly concentrated from time to time and are susceptible to the risk of bubbles in financial asset prices.

With stock market bubbles a fact of history, this academic theory has not always held in reality.

2. Exposure to smaller and mid-sized companies

Treating each stock in the same way gives equal-weighted indexes a higher allocation to small and mid-sized companies. This provides equal-weighted indexes with greater exposure to the 'small cap effect' that suggests smaller company stocks should outperform over longer periods of time.[3] It also means they perform well in periods when smaller and mid-sized companies outperform for short periods of time, such as during times of economic recovery.

Chart 1: Actual versus effective number of stocks



Source: VanEck. It is not possible to invest directly in an index.

[2] Maillard, Roncalli, & Teïletche, 2010. [3] Fama-French model, developed in 1992. [4] Maillard, Roncalli, & Teïletche, 2008.

3. Naturally contrarian

Equal-weighted indexes are inherently contrarian as they regularly rebalance — buying low and selling high.[4] This goes against herd behavior and momentum investing. In times of great investor optimism, or pessimism, equal-weighted indexes may perform better because they are less influenced by sentiment-driven price movements in a few large stocks.

This contrarian rebalancing process can capitalize on mean reversion, where stocks that have underperformed may experience a rebound, while overperforming stocks may regress to their mean performance levels.

Disadvantages

1. The costs of rebalancing

Equal-weighted indexes are regularly rebalanced to maintain equal weights. This involves selling shares of stocks that have increased in value and buying those that have decreased in value. This trading activity increases the transaction costs of a fund or ETF tracking an equal-weighted index.[5] While market-weighted indexes are also rebalanced, this tends to be less frequent and the trading costs for funds following them are therefore smaller.

2. Lower exposure to the largest companies

By their nature, equal-weighted index performance lags in times when large companies outperform.[6] Strong bull markets for large cap stocks can continue for several years.

3. Smaller company volatility and non-systematic risk

Just as smaller companies tend to outperform when the economy is strong, so they can lag the broader market when interest rates are rising. This may suppress equal-weighted index performance and amplify volatility. What's more, smaller companies bring greater non-systematic risk, which is the risk specific to a company or sector. Examples of this are company-specific events like management changes or profit shortfalls, as well as sector news like a fall in demand for a sector's products or services.

4. Less trading liquidity for large investors

Equal-weighted indexes' greater exposure to smaller company stocks reduces the liquidity of the portfolios that follow them, which has implications for large investors. A large fund attempting to rebalance its holdings in line with an index could trigger adverse price movements when it buys or sells significant positions. For this reason, equal-weighted strategies may not scale well for very large funds.

Differences in practice

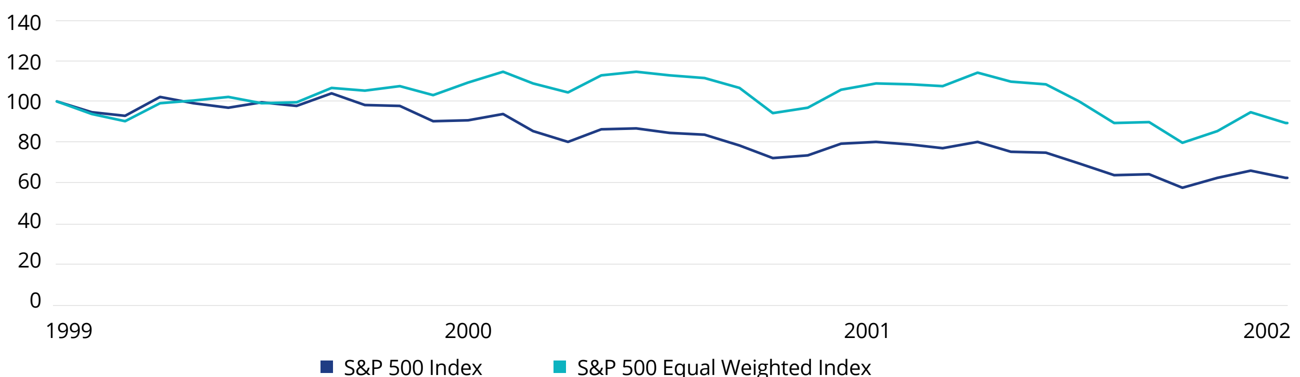
Periods of equal-weighted index outperformance

Below are four periods when equal-weighted indexes outperformed. They have typically been periods when stock market recoveries have boosted small and mid-capitalization stocks.

1. Dot-com bubble bursts (2000-2002)

After the dot-com stock market bubble burst around 2000-2002, and during the recovery period, the equal-weighted version of the S&P 500 Index outperformed

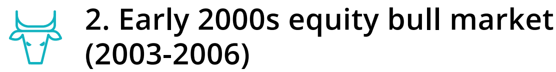
Chart 2: Dotcom Bubble



Source: Bloomberg. Past performance does not predict future returns. It is not possible to invest directly in an index.

[5] Maillard, Roncalli, & Teïletche, 2010.
[6] Fabozzi et al., 2014.

the market-weighted version. The former benefited from its greater exposure to smaller companies with higher growth rates compared to the large-cap technology stocks that dominated the market-weighted index.



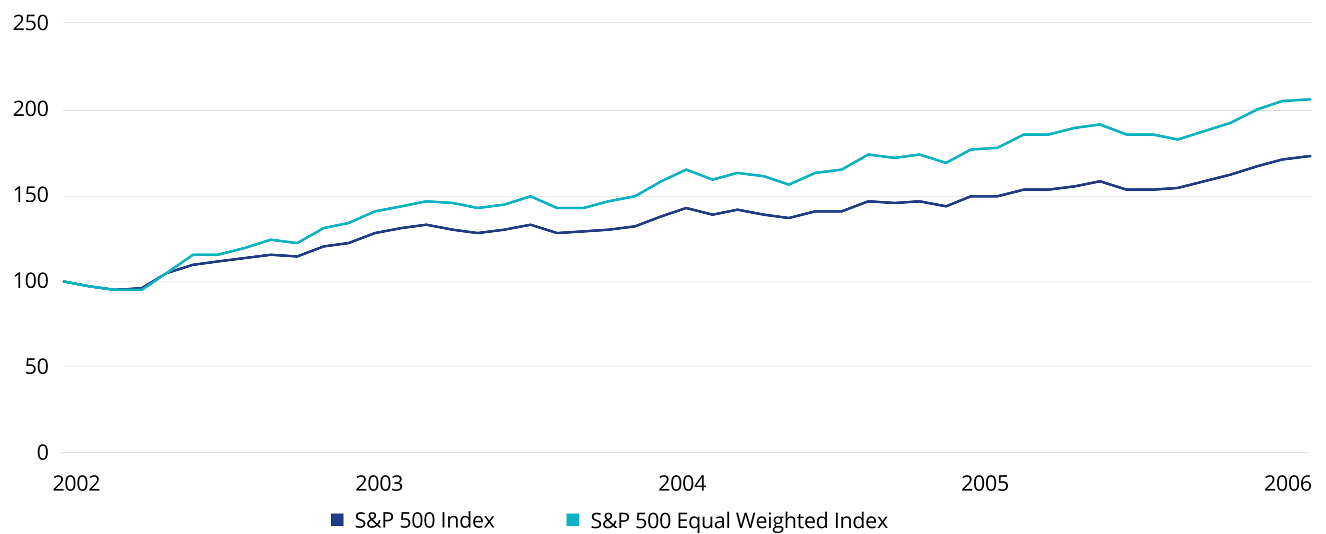
2. Early 2000s equity bull market (2003-2006)

In this period, the equal-weighted strategy outperformed as smaller and mid-sized companies, which were more represented in the equal-weighted index, experienced significant growth compared to the large caps that dominated the market-weighted indexes.

3. Recovery from Global Financial Crisis (2009-2013)

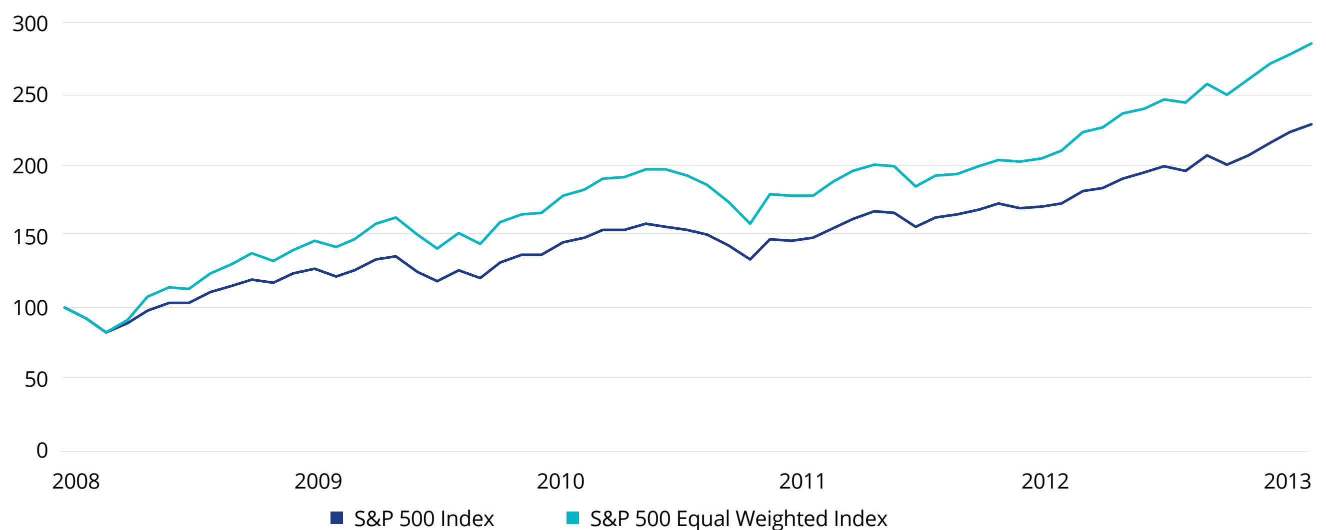
During the recovery from the financial crisis, the equal-weighted S&P 500 index again outperformed the market-weighted S&P 500. While the equal weight index had

Chart 3: Bull Market Performance



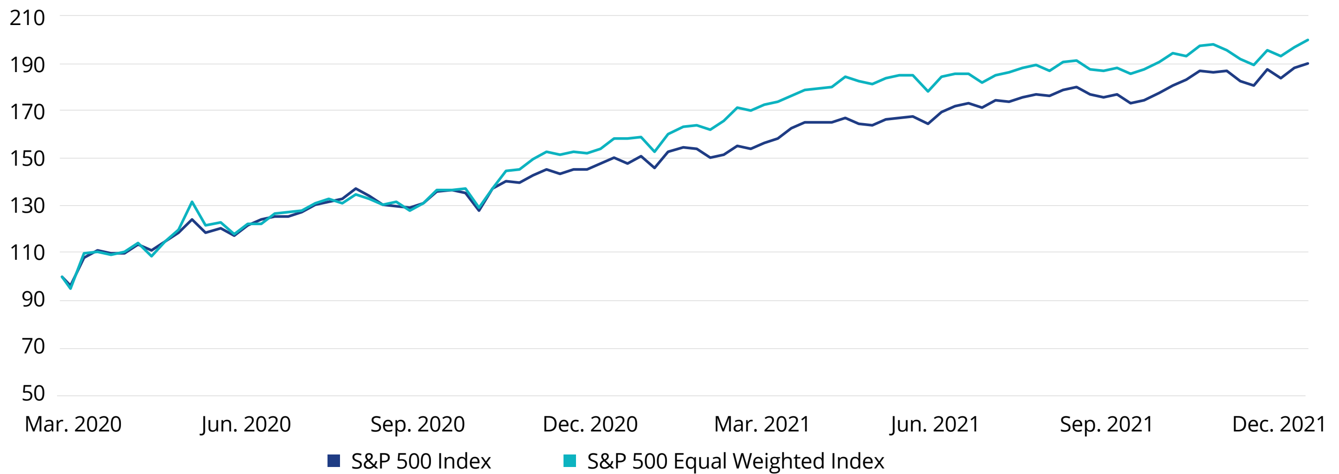
Source: Bloomberg. Past performance does not predict future returns. It is not possible to invest directly in an index.

Chart 4: Post Global Financial Crisis recovery



Source: Bloomberg. Past performance does not predict future returns. It is not possible to invest directly in an index.

Chart 5: Covid Recovery



Source: Bloomberg. Past performance does not predict future returns. It is not possible to invest directly in an index.

a more balanced exposure to all sectors, the market cap weighted index had a skew towards the financial sector, which took longer to recover.

4. Recovery from COVID-19 crash (2020-2021)

Equal-weighted indexes benefited from the recovery in smaller and mid-cap stocks, which rebounded faster than large-cap stocks as the market recovered. This allowed the equal-weighted strategies to outperform their market-weighted peers.

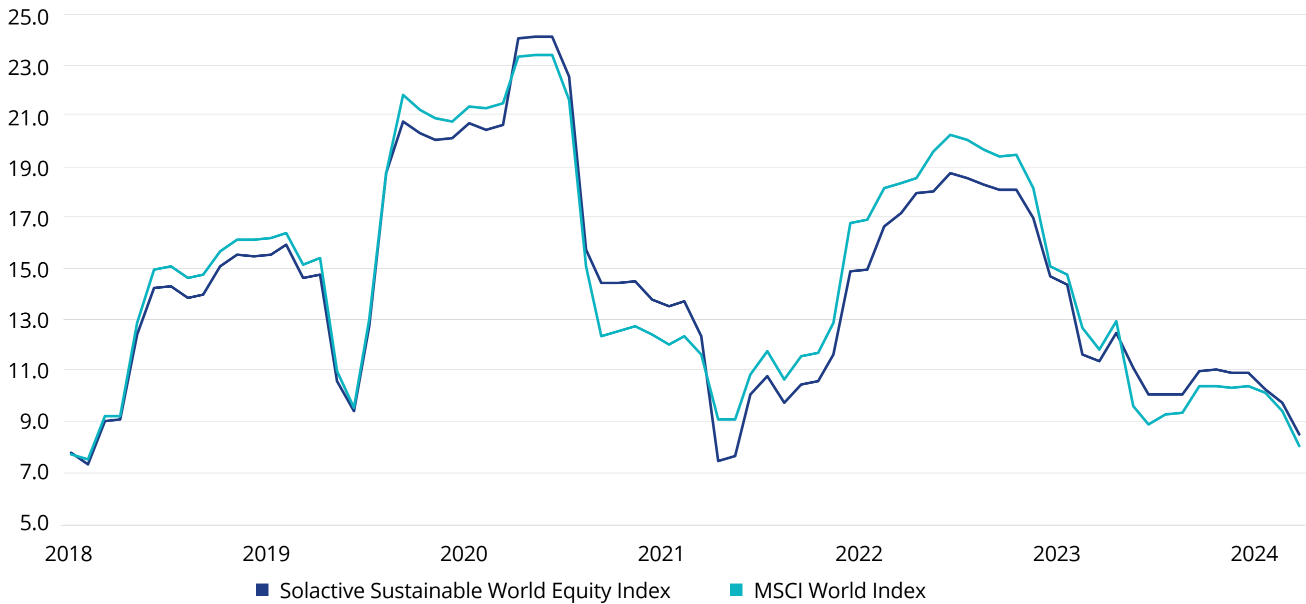
Periods when equal-weighted indexes were less volatile

Research suggests that an equal-weighted strategy can stabilize performance in volatile markets.[7] Chart 6 shows that the Solactive Sustainable World Equity Index, was less volatile than the MSCI World market-weighted strategy during both the 2020 Covid-19 market crash and during the 2022 market fall that followed a spike in inflation, rising interest rates and the invasion of Ukraine. The chart on the next page uses 12-month rolling standard deviation to measure volatility.

Please note that the periods presented here represent selected excerpts from the full performance history of equally-weighted indices. It is important to highlight that there have been periods where equally-weighted indices have underperformed the broader market or exhibited higher levels of volatility compared to other strategies. Past performance is not indicative of future results, and potential investors should carefully consider the associated risks before making investment decisions. For complete information on the risks, please refer to the KID and the Prospectus.

[7] Maillard, Roncalli, & Teïletche, 2010 – sample period from 1973 to 2008

Chart 6: Twelve-month rolling standard deviation



Source: Morningstar Direct. Past performance does not predict future returns. It is not possible to invest directly in an index.

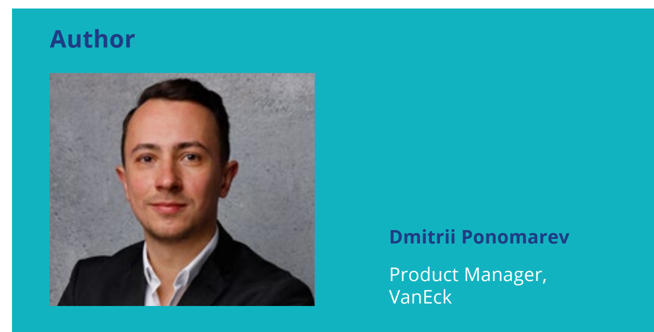
Conclusion

The first market-weighted index, the S&P 500 Index, was introduced in 1957, long before equity markets became as concentrated as they are today. Arguably, if indexes were introduced in current times they might be designed differently to deal with the concentration problem.

At the heart of the matter is the efficient market hypothesis and the CAPM that gives market-weighted indexes their theoretical justification. Yet even some proponents of efficient markets tend to concede that they do not perfectly discount all known information all of the time, leaving them susceptible to bubble risk.

That means equal-weighted indexes have a valuable role to play for some investors. However, they are not perfect either. At the end of the day, investors should weigh up the advantages and disadvantages when deciding which index option is most suitable for them. Please remember that equally weighted strategies are also affected by the equity market risk and your investment is at risk of capital loss. Please refer to the KID and the Prospectus for other important information before investing.

Author



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