SECURITY SELECTION REBALANCING

Alejandro Saltiel – Head of Indexes, U.S.,Matt Wagner – Associate Director, Research
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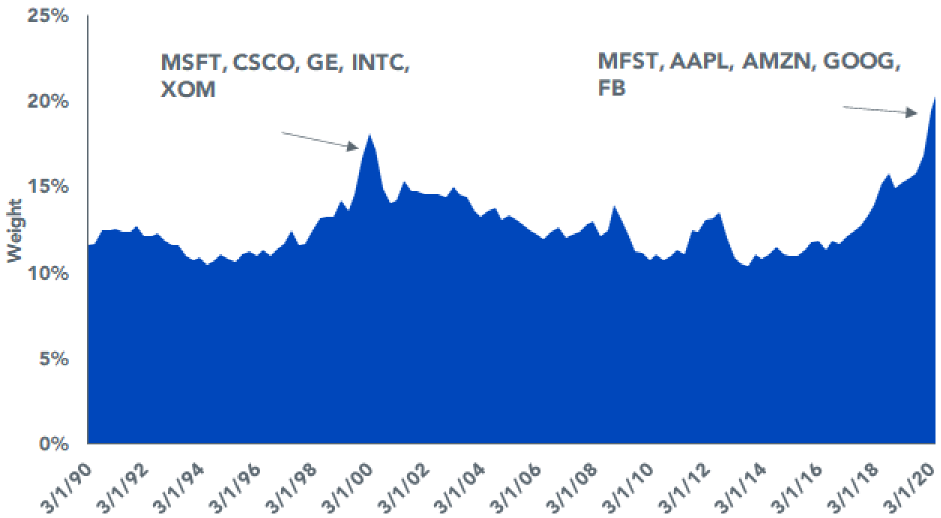
A handful of large companies have come to dominate the weight of the S&P 500 Index. The five largest holdings now account for more weight in the market cap-weighted index than at any time in the past 30 years.

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



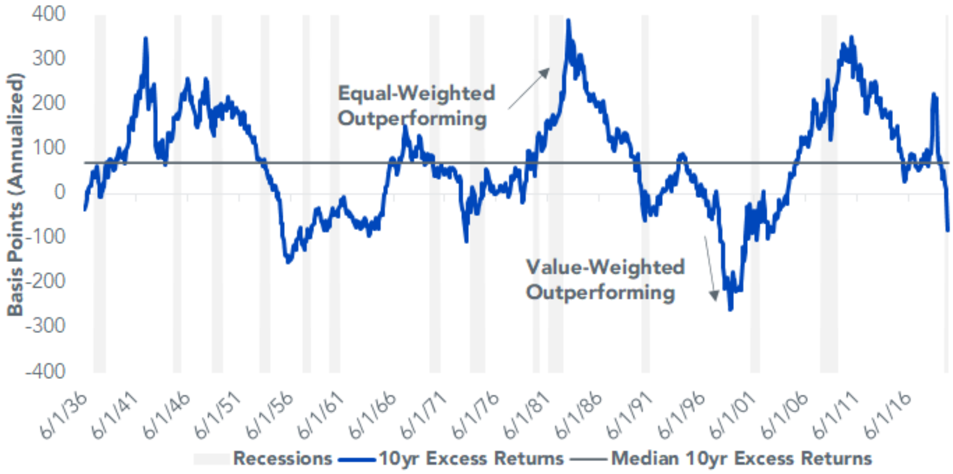
Sources: WisdomTree, FactSet, 3/31/1990–5/27/2020. Past performance is not indicative of future results. You cannot invest directly in an index.

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.[1] 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

Figure 4_tech company growth

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."[2]

Figure 5_sp 500 companies top holding

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

	Factor Loadings					Annualized Statistics	
Portfolio	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

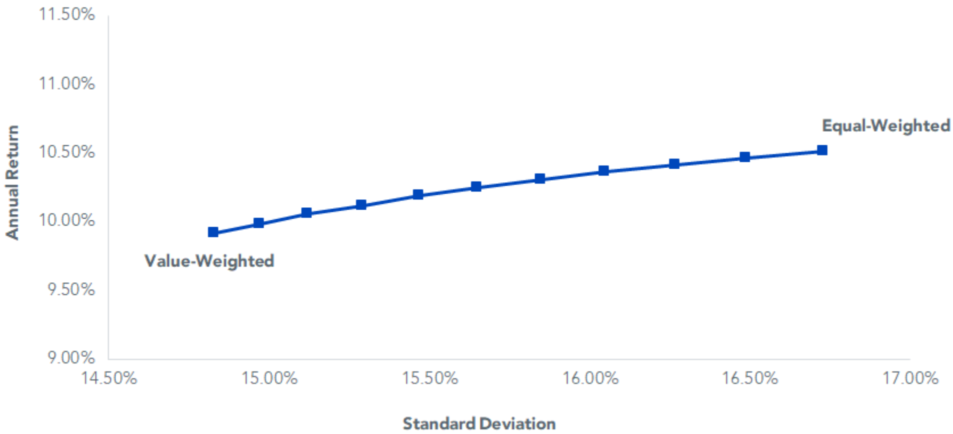
Despite what we see as some positive near-term tailwinds to equal weighting, as well as its attractive factor tilts, there are some drawbacks to a simple equal weighting from a portfolio construction context.

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



Source: 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.

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.

[1]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.

[2]"U.S. Weekly Kickstart," Goldman Sachs Portfolio Strategy Research, 5/1/20.

[3]WisdomTree, FactSet, as of 4/30/20.

[4]WisdomTree, Zephyr Style Advisor, 1/31/03–4/30/20.

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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 tim.

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.