

# Avoiding Too Much of a Good Thing

A stock index's degree of diversification may depend on how the index is weighted. Indexes that are equal weighted avoid the potential for returns being influenced by a small number of stocks with the largest market capitalizations.

Equal-weighted indexes historically have generated higher returns along with higher risk.

When the S&P 500 surges in value by 25.1%, as it did between October 1, 2011, and April 30, 2012, it may be beneficial to consider whether the largest components within the index have skewed returns.<sup>1</sup> As of April 30, 2012, the top 10 stocks as determined by market capitalization comprised 20.3% of the value of the S&P 500.<sup>1</sup> This scenario presents the risk that the value of the index, and investments benchmarked to it, are overly dependent on a few big names.

## Equal-Weighted Versus Capitalization-Weighted Indexes

In certain instances, investors can construct portfolios benchmarked to equal-weighted indexes in which the constituents have a fixed weight that is rebalanced periodically. These indexes are an alternative to capitalization-weighted indexes in which the largest constituents as determined by market capitalization have the greatest influence on returns. According to S&P Capital IQ, during the five-year and ten-year periods ending April 30, 2012, the S&P 500® Equal Weight Index (EWI) generated higher returns along with greater risk than the S&P 500, which is capitalization weighted.<sup>2</sup> The combination of higher return and greater risk for the EWI may stem from its greater exposure to both midcap and small-cap stocks, which have outperformed large-cap stocks and also generated greater volatility during the time periods presented.<sup>3</sup>



Source: S&P Capital IQ Financial Communications. Returns compare the S&P 500 with the S&P 500 Equal Weight Index for the five-year and ten-year periods ending April 30, 2012, and also for the period beginning January 1, 1990, and ending April 30, 2012. You cannot invest directly in an index. Past performance does not guarantee future results.

### What Investors Can Do

There are investments benchmarked to both equal-weighted versions and capitalization-weighted versions of the S&P 500 Index, the S&P MidCap 400 Index, the S&P SmallCap 600 Index, the MSCI EAFE Index, and the MSCI Emerging Markets Index.<sup>4</sup> When evaluating these investments and their benchmarks, consider the following:

- For a broad market index such as the S&P 500, the difference in sector weightings between capitalization-weighted and equal-weighted indices can be significant. As of April 30, 2012, Information Technology comprised 20.3% of the S&P 500, compared with 14.2% of the S&P 500 EWI. The differential for the Consumer Discretionary Sector was 11.2% for the S&P 500 versus 16.2% for the EWI.<sup>5</sup>
- Sector weightings are likely to change more slowly in an equal-weighted index, potentially shielding investors from sudden run-ups or sell-offs in certain sectors.<sup>6</sup>
- An equal-weighted index does not guarantee against losses during a stock market decline. Between October 31, 2007, and February 28, 2009, the S&P 500 EWI declined by 41.4% compared with a decline of 38.8% for the S&P 500.<sup>1</sup>
- A market cap-weighted index more accurately reflects current market valuations, helping an investor to gauge the performance of an actively managed fund versus a market index.

When the market capitalization of a security grows, so does its influence on the returns of a capitalization-weighted index. An equal-weighted index may present an opportunity to level the playing field as long as investors understand that there may be corresponding risks.

<sup>1</sup>Source: Standard & Poor's.

<sup>2</sup>Source: S&P Capital IQ. Risk is measured by standard deviation.

<sup>3</sup>Source: S&P Capital IQ *Sector Watch*, "Don't Get Mad, Get Even!" April 16, 2012. Small-cap stocks are represented by the total return of S&P SmallCap 600 Index; midcap stocks by the S&P MidCap 400 Index. Securities of smaller companies may be more volatile than those of larger companies. The illiquidity of the small-cap market may adversely affect the value of these investments.

<sup>4</sup>Foreign investments involve greater risks than U.S. investments, including political and economic risks and the risk of currency fluctuations, and may not be suitable for all investors. Emerging markets are generally more volatile than the markets of more developed foreign nations, and therefore you should consider this increased market risk carefully before investing.

<sup>5</sup>Source: S&P Capital IQ. Sector funds may be more volatile than funds that diversify across many sectors or industries.

<sup>6</sup>Source: S&P Indices *Indexing 101*, "What Makes Indices Tick?" February 2012.