VanEck®
Access the opportunities.

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] Examples of equal-weighted indexes include the S&P 500 Equal Weight Index or Solactive Sustainable World Equity Index, underlying VanEck Sustainable World Equal Weight UCITS ETF.

Pros and cons of equal-weighted strategies

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

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

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.

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.

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

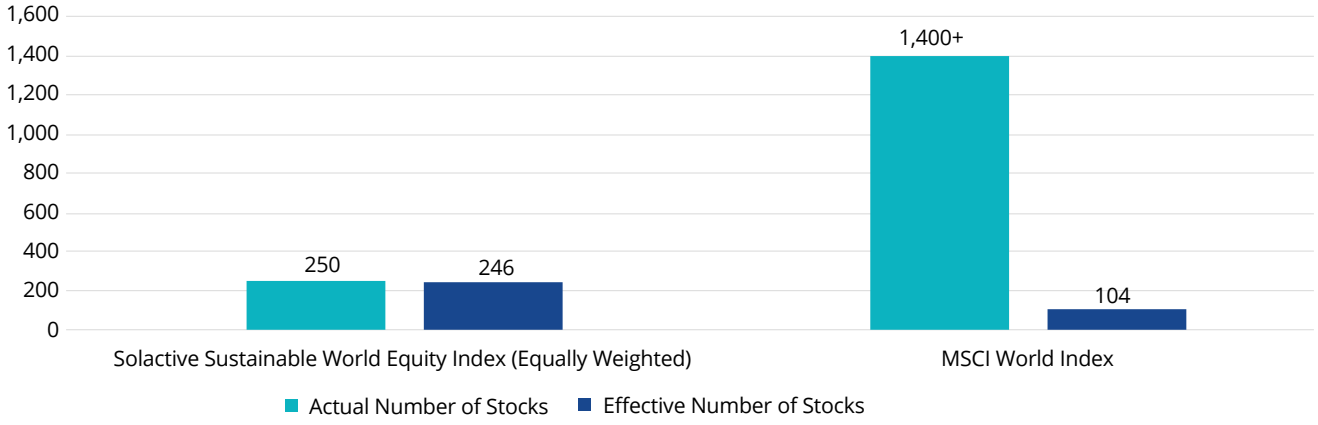
The efficient markets hypothesis

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.

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.

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

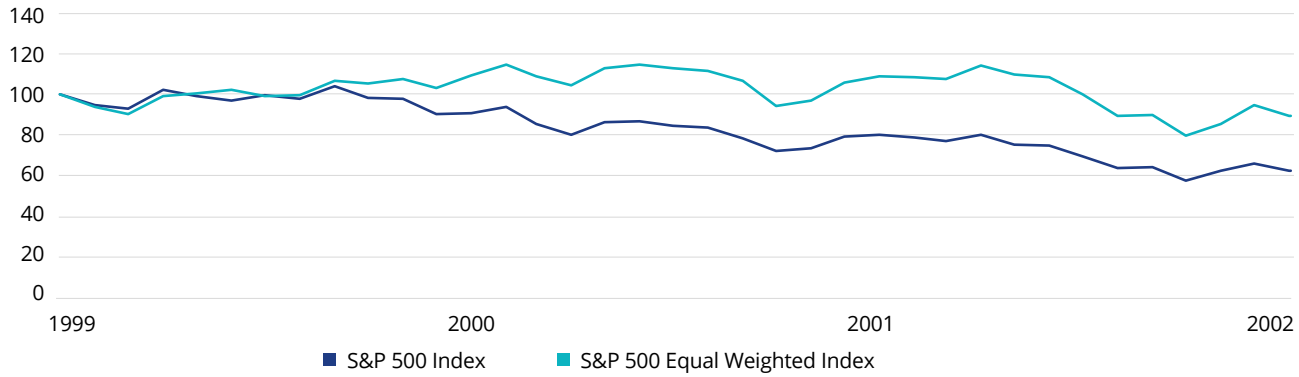
Periods of equal-weighted index outperformance

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 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.

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.

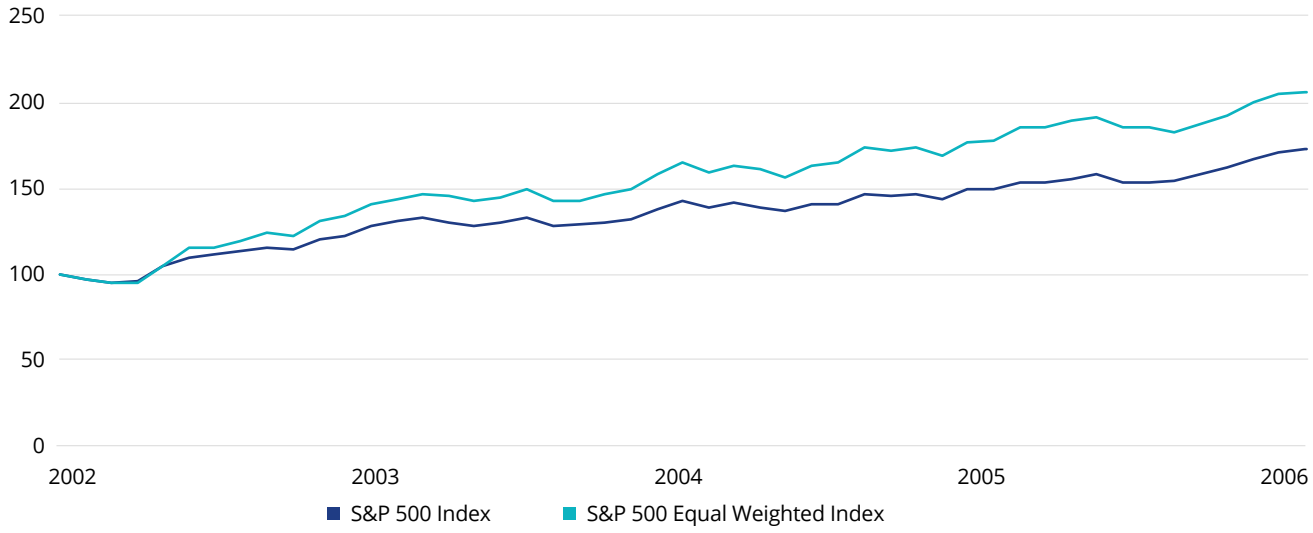
2. Early 2000s equity bull market (2003-2006)

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)

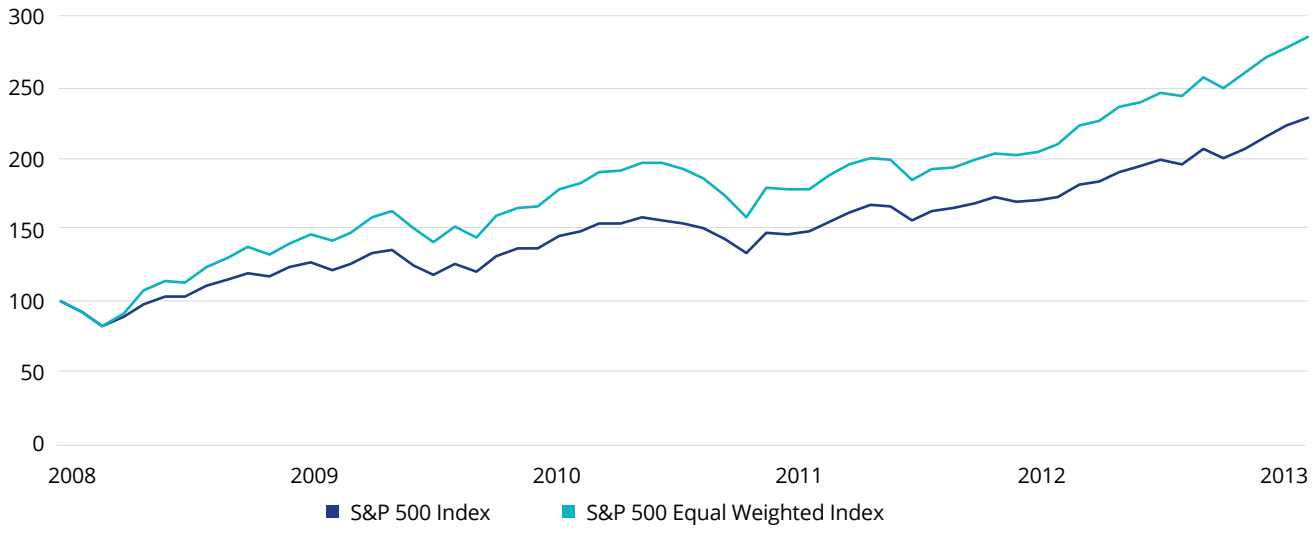
During the recovery from the financial crisis, the equal-weighted S&P 500 index again outperformed the market-weighted S&P 500. While the equal weight index had a more balanced exposure to all sectors, the market cap weighted index had a skew towards the financial sector, which took longer to recover.

Chart 3: Bull Market Performance



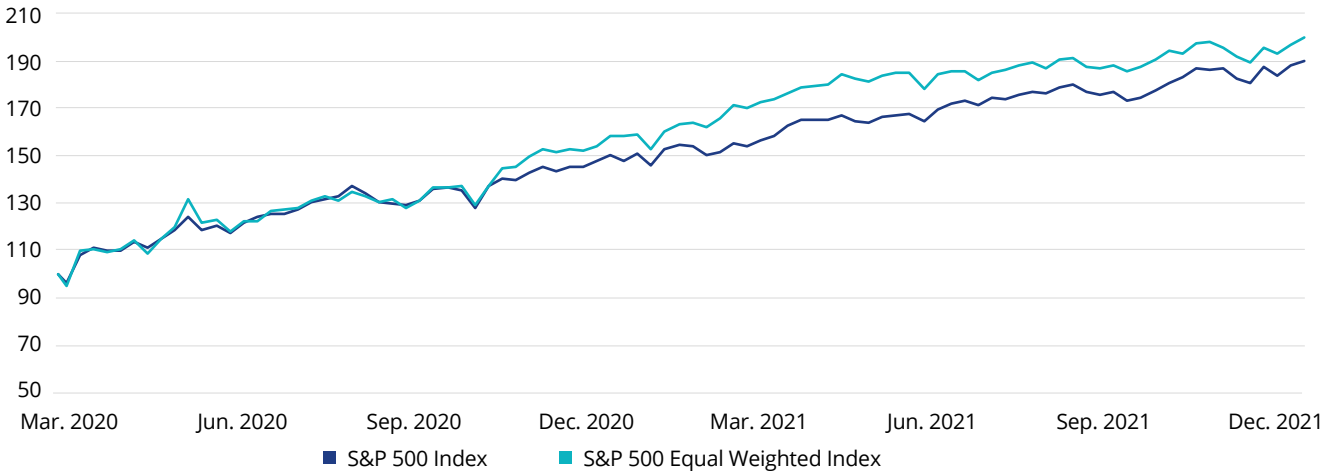
Source: Bloomberg. Past performance does not predict future returns. It is not possible to invest directly in an index.

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.

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.

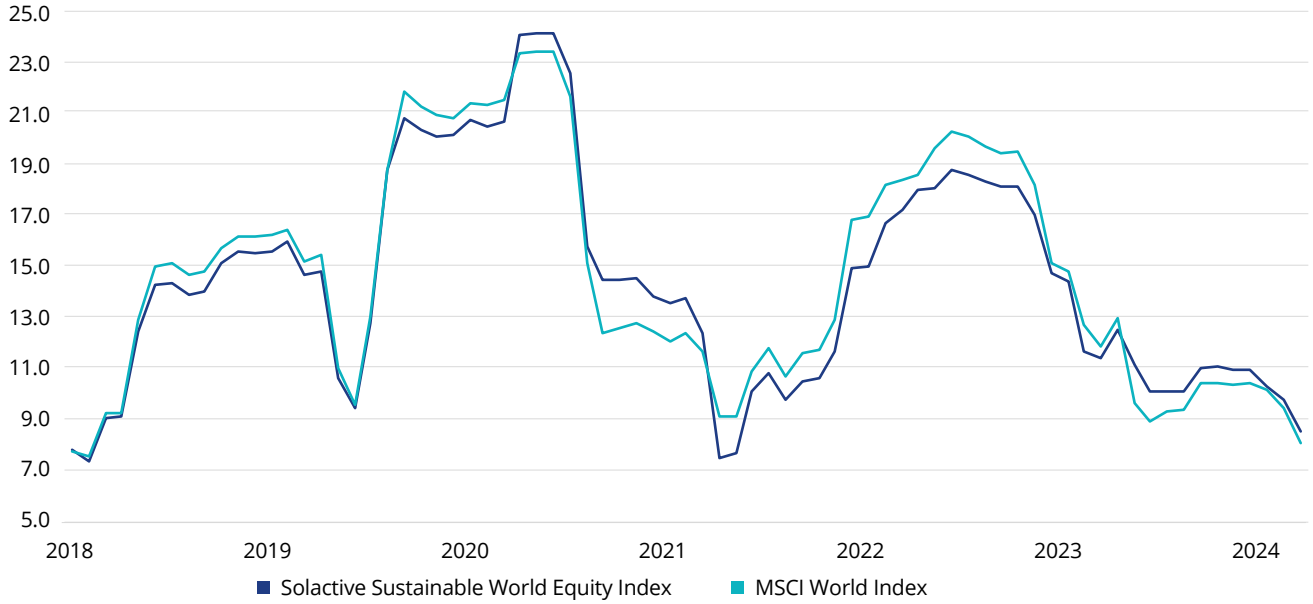
Periods when equal-weighted indexes were less volatile

Research suggests that an equal-weighted strategy can stabilize performance in volatile markets.[7] The Chart 6 shows that the VanEck Sustainable Equal Weight UCITS ETF, which follows 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

Dmitrii Ponomarev

Product Manager,
VanEck

Important Information
This is marketing communication. Please refer to the prospectus of the UCITS and to the KID/KIID before making any final investment decisions. These documents are available in English and the KIDs in local languages and can be obtained free of charge at www.vaneck.com, from VanEck Asset Management B.V. (the "Management Company") or, where applicable, from the relevant appointed facility agent for your country.

For investors in Switzerland: VanEck Switzerland AG, with registered office in Genferstrasse 21, 8002 Zurich, Switzerland, has been appointed as distributor of VanEck´s products in Switzerland by the Management Company. A copy of the latest prospectus, the Articles, the Key Information Document, the annual report and semi-annual report can be found on our website www.vaneck.com or can be obtained free of charge from the representative in Switzerland: Zeidler Regulatory Services (Switzerland) AG, Neudtadtgasse 1a, 8400 Winterthur, Switzerland. Swiss paying agent: Helvetische Bank AG, Seefeldstrasse 215, CH-8008 Zürich.

For investors in the UK: This is a marketing communication for professional investors only. Retail clients should not rely on any of the information provided and should seek assistance from an IFA for all investment guidance and advice. VanEck Securities UK Limited (FRN: 1002854) is an Appointed Representative of Sturgeon Ventures LLP (FRN: 452811), who is authorised and regulated by the Financial Conduct Authority (FCA) in the UK, to distribute VanEck´s products to FCA regulated firms such as Independent Financial Advisors (IFAs) and Wealth Managers.

This information originates from VanEck (Europe) GmbH, which is authorized as an EEA investment firm under MiFID under the Markets in Financial Instruments Directive ("MiFiD). VanEck (Europe) GmbH has its registered address at Kreuznacher Str. 30, 60486 Frankfurt, Germany, and has been appointed as distributor of VanEck products in Europe by the Management Company. The Management Company is incorporated under Dutch law and registered with the Dutch Authority for the Financial Markets (AFM).

This material is only intended for general and preliminary information and shall not be construed as investment, legal or tax advice. VanEck (Europe) GmbH and its associated and affiliated companies (together "VanEck") assume no liability with regards to any investment, divestment or retention decision on the basis of this information. The views and opinions expressed are those of the author(s) but not necessarily those of VanEck. Opinions are current as of the publication date and are subject to change with market conditions. Information provided by third party sources is believed to be reliable and have not been independently verified for accuracy or completeness and cannot be guaranteed.

VanEck Sustainable World Equal Weight UCITS ETF (the "ETF") is a sub-fund of VanEck ETFs N.V., an investment company with variable capital under the laws of the Netherlands. The ETF is registered with the AFM, passively managed and tracks an equity index. Investing in the ETF should be interpreted as acquiring shares of the ETF and not the underlying assets.

The VanEck's ETF is not sponsored, promoted, sold or supported in any other manner by Solactive AG nor does Solactive AG offer any express or implicit guarantee or assurance either with regard to the results of using the Index and/or Index trade mark or the Index Price at any time or in any other respect. The Index is calculated and published by Solactive AG. Solactive AG uses its best efforts to ensure that the Index is calculated correctly. Irrespective of its obligations towards the Issuer, Solactive AG has no obligation to point out errors in the Index to third parties including but not limited to investors and/or financial intermediaries of the financial instrument. Neither publication of the Index by Solactive AG nor the licensing of the Index or Index trade mark for the purpose of use in connection with the financial instrument constitutes a recommendation by Solactive AG to invest capital in said financial instrument nor does it in any way represent an assurance or opinion of Solactive AG with regard to any investment in VanEck's ETF.

The S&P 500 Index ("Index") is a product of S&P Dow Jones Indices LLC and/or its affiliates and has been licensed for use by Van Eck Associates Corporation. Copyright © 2020 S&P Dow Jones Indices LLC, a division of S&P Global, Inc., and/or its affiliates. All rights reserved. Redistribution or reproduction in whole or in part are prohibited without written permission of S&P Dow Jones Indices LLC. For more information on any of S&P Dow Jones Indices LLC's indices please visit www.spdji.com. S&P® is a registered trademark of S&P Global and Dow Jones® is a registered trademark of Dow Jones Trademark Holdings LLC. Neither S&P Dow Jones Indices LLC, Dow Jones Trademark Holdings LLC, their affiliates nor their third party licensors make any representation or warranty, express or implied, as to the ability of any index to accurately represent the asset class or market sector that it purports to represent and neither S&P Dow Jones Indices LLC, Dow Jones Trademark Holdings LLC, their affiliates nor their third party licensors shall have any liability for any errors, omissions, or interruptions of any index or the data included therein.

The MSCI information may only be used for your internal use, may not be reproduced or redisseminated in any form and may not be used as a basis for or a component of any financial instruments or products or indices. 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 for any use made of this information. MSCI, each of its affiliates and each other person involved in or related to compiling, computing or creating any MSCI information (collectively, the "MSCI Parties"), expressly disclaims all warranties (including, without limitation, any warranties of originality, accuracy, completeness, timeliness, noninfringement, merchantability and fitness for a particular purpose) with respect to this information. Without limiting any of the foregoing, in no event shall any MSCI Party have any liability for any direct, indirect, special, incidental, punitive, consequential (including, without limitation, lost profits) or any other damages.
It is not possible to invest directly in an index.

Performance quoted represents past performance. Current performance may be lower or higher than average annual returns shown.
The Dutch domiciled ETFs use a gross reinvestment index as opposed to many other ETFs and investment funds that use a net reinvestment index. Comparing with a gross reinvestment index is the purest form since it considers that Dutch investors can reclaim the dividend tax withheld. Please note that the performance includes income distributions gross of Dutch withholding tax because Dutch investors receive a refund of the 15% Dutch withholding tax levied. Different investor types and investors from other jurisdictions may not be able to achieve the same level of performance due to their tax status and local tax rules. Returns may increase or decrease as a result of currency fluctuations. Investors must be aware that, due to market fluctuations and other factors, the performance of the ETFs may vary over time and should consider a medium/long-term perspective when evaluating the performance of ETFs.

Investing is subject to risk, including the possible loss of principal. Investors must buy and sell units of the UCITS on the secondary market via a an intermediary (e.g. a broker) and cannot usually be sold directly back to the UCITS. Brokerage fees may incur. The buying price may exceed, or the selling price may be lower than the current net asset value. The indicative net asset value (iNAV) of the UCITS is available on Bloomberg. The Management Company may terminate the marketing of the UCITS in one or more jurisdictions. The summary of the investor rights is available in English at: complaints-procedure.pdf (vaneck.com). For any unfamiliar technical terms, please refer to ETF Glossary | VanEck.

No part of this material may be reproduced in any form, or referred to in any other publication, without express written permission of VanEck.

© VanEck (Europe) GmbH ©VanEck Switzerland AG © VanEck Securities UK Limited