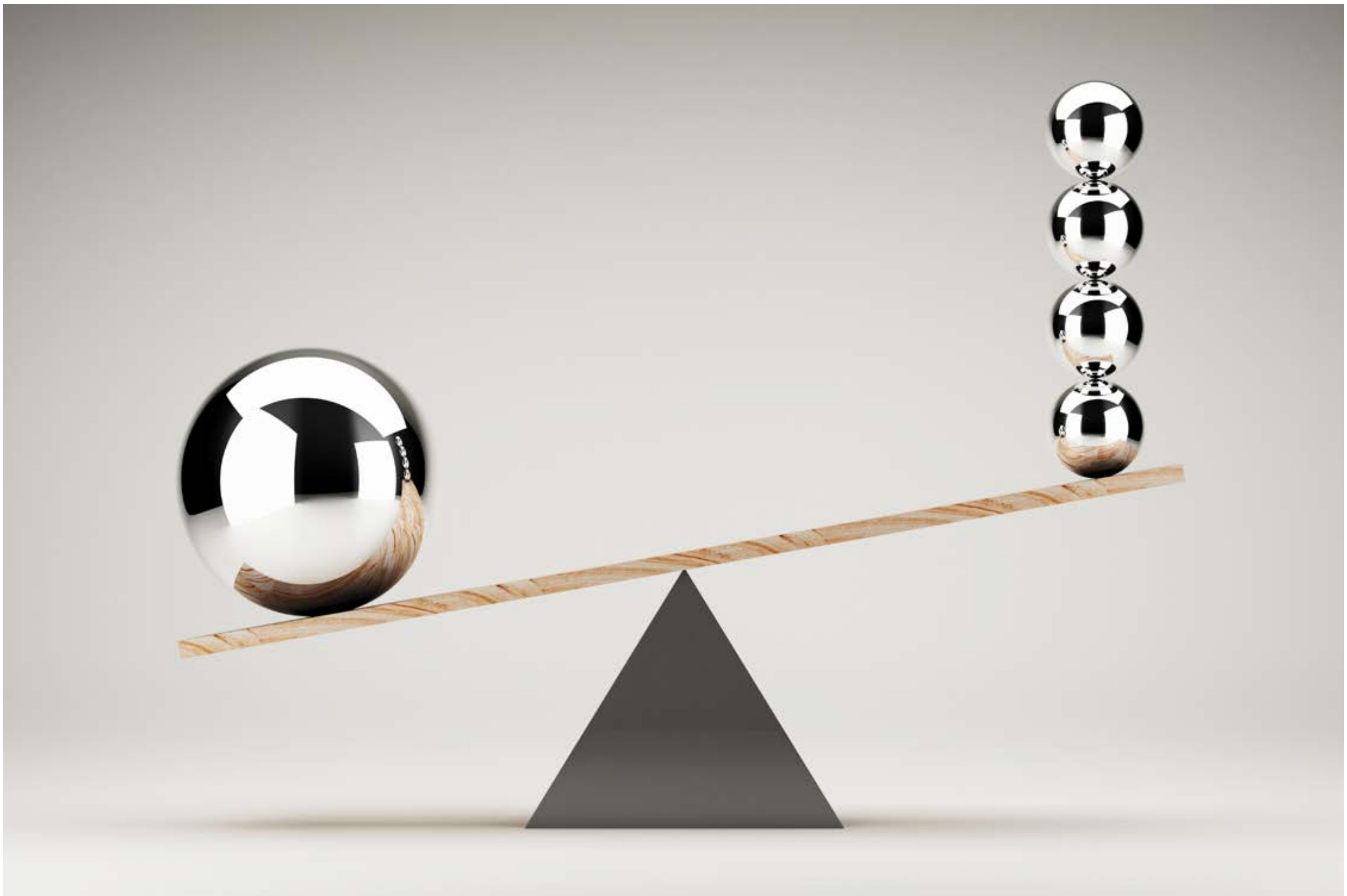
Worth the Weight?

Equal Weight Advantages over Cap Weight



Marc Odo, CFA®, CAIA®, CIPM®, CFP® | November 30, 2017 | Swan Blog

As many people know, the Defined Risk Strategy is composed of three primary elements: the long, buy-and-hold position in an equity market, the hedge on that long position, and the premium collection trades. Most people focus on the hedge and premium components because the DRS's willingness to tackle market risk via options makes Swan rather unique. But what about the first element to the DRS, the buy-and-hold position in ETFs? Is there anything unique to discuss there?

With our flagship U.S. Large Cap strategy, we are currently roughly equally weighting[1] the various SPDR Sector ETFs. For the first 15 years of the DRS, we did use the SPY/S&P 500 for our market exposure; however, in 2012 we made a switch to this equal-weighted sector approach.

More Money, More Problems

The rationale for equal weighting the sectors has to do with the underlying problems of a capitalization-weighted index. With a cap-weighted index like the S&P 500 or the Russell 1000, the one and only thing that matters is a company's price. There is no emphasis placed on the valuation of a company, its revenue, its profitability, or any other factor.

The problem with this focus is that the more the price of a stock goes up, the bigger the company gets, and the bigger the company gets, the more of its stock you have to buy in a cap-weighted scheme. This creates a positive feedback loop where the big keep getting bigger; it's a vicious cycle that may result in a perilous bubble.

The table below highlights the top ten names, by size, in the S&P 500. These ten companies represent almost 20% of the S&P 500. A year ago, it was closer to 18%. Half of these names are in technology:

	Holdings	Sector	Weighting
1	Apple Inc	Technology	3.79%
2	Microsoft Corp	Technology	2.90%
3	Amazon.com Inc	Consumer Cyclical	1.97%
4	Facebook Inc A	Technology	1.90%
5	Johnson & Johnson	Healthcare	1.71%
6	Berkshire Hathaway Inc B	Financial Services	1.63%
7	JPMorgan Chase & Co	Financial Services	1.61%
8	Exxon Mobil Corp	Energy	1.59%
9	Alphabet Inc C	Technology	1.38%
10	Alphabet Inc A	Technology	1.38%
	Total		**19.86%**

Source: Morningstar Direct. SPDR S&P 500 ETF (SPY) used as a proxy for the S&P 500 Index. Data as of 10/27/2017.

This trend has been exacerbated by the massive inflows into passive products. The table below shows the top five domestic equity mutual funds and ETFs, in terms of asset flows. The top four are all invested

[1] The allocation isn't exactly equal-weighted sectors, due to S&P's decision in 2016 to carve real estate out of financials. This topic will be discussed in a later blog post.

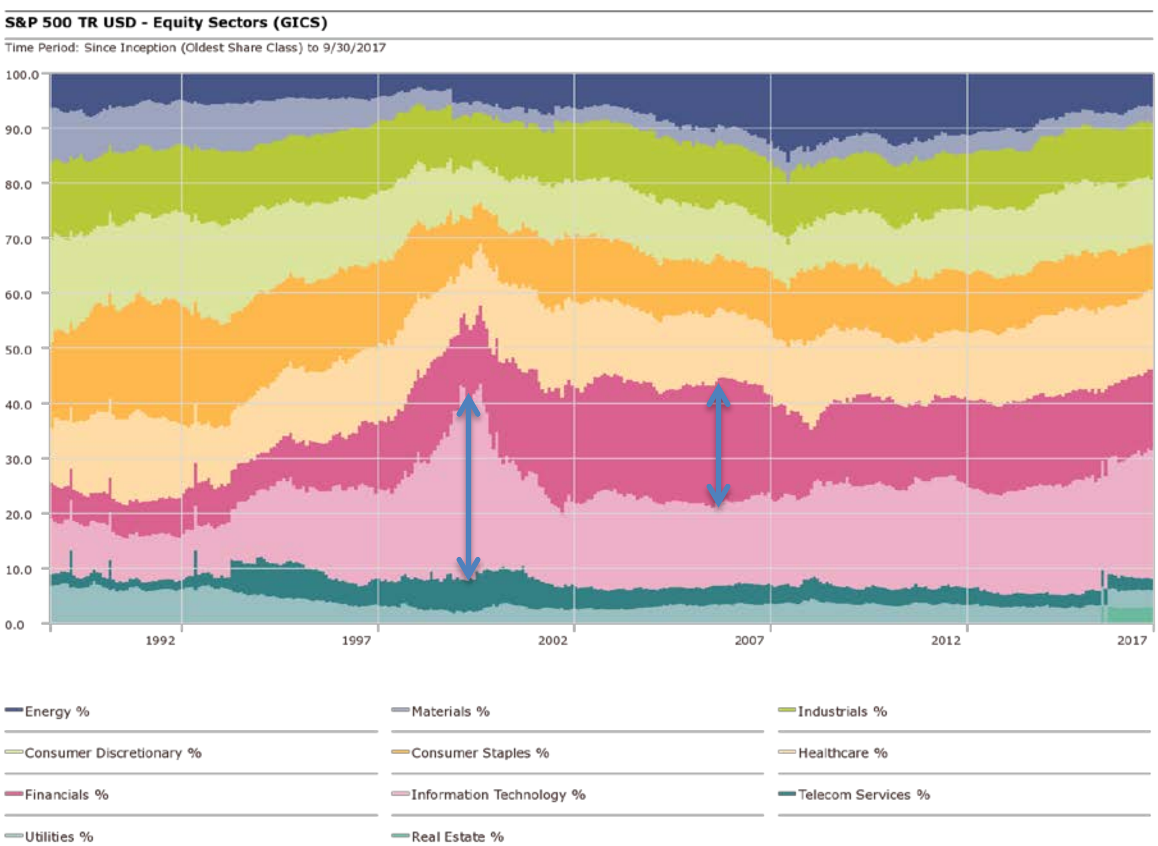
in capitalization-weighted indices. Almost $145 billion has moved into these four over the last 12 months, bringing their aggregate total up to $1.34 trillion invested in just these four index products.

	Fund	Estimated Net Flow - Year to Date	Estimated Net Flow - 12 months	Total Net Assets
1	Vanguard Total Stock Market Index Fund	50,812,721,510	61,423,096,634	620,505,798,379
2	Vanguard S&P 500 ETF Index Fund	27,233,129,966	39,512,852,618	350,318,481,732
3	iShares Core S&P 500 ETF	23,341,666,500	31,617,050,500	126,492,385,434
4	SPDR® S&P 500 ETF	(9,344,707,133)	12,213,801,149	241,411,771,369
5	Financial Select Sector SPDR® Fund	2,561,895,222	10,028,777,765	27,347,268,425

Source: Morningstar Direct. All data as of 9/30/17.

The Bigger the Rise, the Bigger the Fall

This can lead to bubbles in individual stocks or broad sectors. Obviously, the best example of this was the dot-com boom and bust in the late 1990s. We also saw it in financials prior to the subprime crisis. When the correction came in those sectors, it was not pretty. The graph below shows the relative weights in the GICS sectors of the S&P 500 over the last several decades.



Source: Morningstar Direct

Scenario	Sector	Peak Max Weight	Peak Max Date	Post-Correction Min Weight	Post-Correction Min Date	Current Weight
Dot Com Bubble	Tech	31.42%	Aug 2000	12.85%	Sep 2002	23.23%
Financial Crisis	Finance	22.56%	Sep 2006	9.90%	Feb 2009	14.61%
“The Passive Push”	Tech	23.51%	Aug 2017	???	???	23.23%

Source: Morningstar Direct

Following the bear markets of 2000-02 and 2007-09, technology and finance were reduced to well less than half of their peak weight in the S&P 500. Today, years later, they have yet to fully recover to their peak levels. While it’s anybody’s guess as to how much longer technology’s current run will go on, it is accurate to say that technology’s current weight is greater than it’s been since January 2001.

The Value of Equal Weight

Equally weighting the sectors is a way to reduce the impact the positive feedback loop from the cap weighted approach. As certain sectors run, the equal weight approach systematically reallocates to undervalued sectors. Such an approach is not making tactical calls on the relative strength or weakness of a given sector. Instead, it is a way of systematically “selling high, buying low.”

Also, equal weighting the sectors is more of a value, long term investing approach. One way to think about a cap-weighted strategy is as a “momentum” strategy. The stocks or sectors that go up continue to attract assets until the tipping point is hit and the momentum reverses itself. With the equal-weighted sector approach being more of a “value” strategy, it shuns momentum and trends and focuses more on the long-term value of a company.

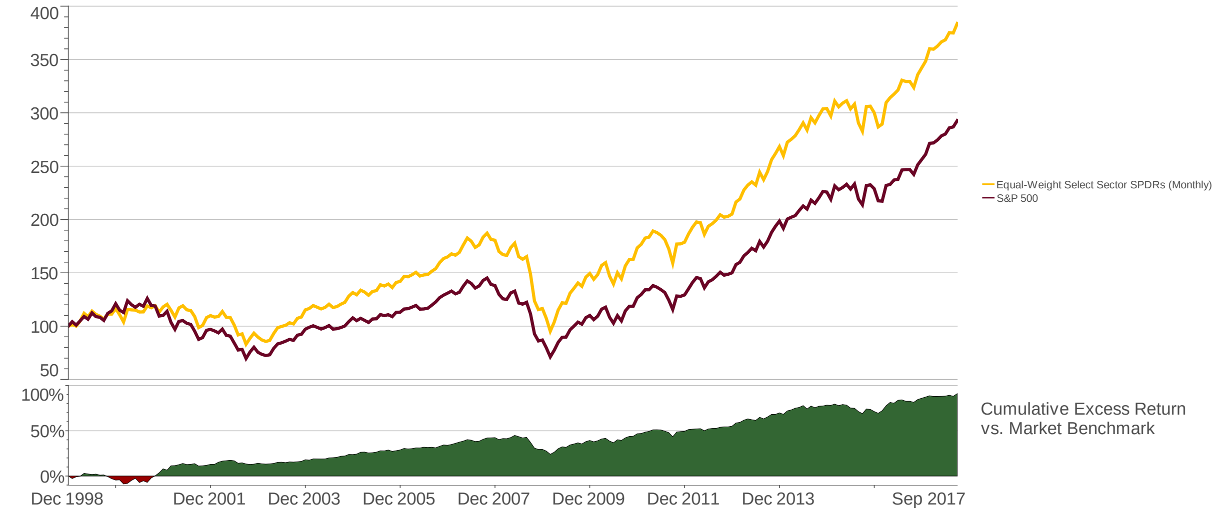
The aggregate impact on the portfolio is that you have more of a value tilt and less of an emphasis on the megacap names. Sometimes this works, sometimes it doesn’t. In 2015, when the “FANG” stocks delivered almost all of the S&P 500’s returns, the equal-weight strategy lagged. However, in 2016 equal weight was a positive driver to performance, as sectors like energy rallied. In 2017, the equal weight approach has trailed the S&P 500 as growth stocks have run circles around value stocks, again led by “FANG”. Long-term, however, the equal weight strategy still appears to be superior.

Zephyr StyleADVISOR

Zephyr StyleADVISOR: Informa Investment Solutions

Manager Performance

January 1999 - September 2017 (Single Computation)



Multi-Statistic (Custom Table)

January 1999 - September 2017: Summary Statistics

	Return	Cumulative Return	Standard Deviation (Population)	Beta vs. Market	Excess Return vs. Market	Sharpe Ratio	Cumulative Excess Return	Batting Average
Equal-Weight Select Sector SPDRs (Monthly)	7.44%	283.77%	14.09%	0.94	1.54%	0.40	91.07%	55.11%
S&P 500	5.90%	192.70%	14.49%	1.00	0.00%	0.28	0.00%	0.00%

Source: Zephyr StyleADVISOR

The DRS is in It for the Long Haul

Since the DRS is meant to be a long-term investment, the equal weight approach is aligned with our purpose. It has always been Swan's philosophy that it is worth giving up some of the upside in order to potentially protect more on the downside. Minimizing losses is more important that maximizing gains. Obviously, the hedge is the most direct way we manage downside risk, but the equal weighted sector approach is another defensive aspect of the Defined Risk Strategy.

About the Author:

Marc Odo, CFA®, CAIA®, CIPM®, CFP®, Director of Investment Solutions, is responsible for helping clients and prospects gain a detailed understanding of Swan's Defined Risk Strategy, including how it fits into an overall investment strategy. Formerly, Marc was the Director of Research for 11 years at Zephyr Associates.

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