ETF INVESTING

Weighty matters

Equal or market-cap puts different spin on S&P 500

By John Spence, CBS.MarketWatch.com
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SAN FRANCISCO (CBS.MW) -- In the early 1970s the investment management department of San Francisco-based Wells Fargo Bank (now Barclays Global Investors) introduced the first index fund, which was designed to hold an equal weighting of the approximately 1,500 stocks listed on the New York Stock Exchange.

The strategy was deemed the best approximation for obtaining "market" returns, an idea academics had been tinkering with at the time. But as Peter L. Bernstein relates in his classic book "Capital Ideas: The Improbable Origins of Modern Wall Street," the execution of the idea turned out to be a "nightmare" due to the transaction costs and taxes incurred to constantly maintain the equal weighting.

After that first ill-fated index fund, industry practitioners turned to the market-capitalization weighted S&P 500 as a reasonably diversified and more "fund friendly" benchmark. In cap-weighted indexes like the S&P 500, a company's weight is determined by the number of shares outstanding multiplied by the stock's price.

(Note: In a much anticipated move, Standard & Poor's has decided to move all of its indexes, including the S&P 500, to float-adjust market capitalization weights. See related article.)

In 1987 Morgan Stanley revisited the equal-weighting concept with a mutual fund, Morgan Stanley Value-Added Market Equity (VADBX: news, chart, profile) designed to invest in an equal-weighted S&P 500 index. The fund still exists, although it has an extremely high expense ratio at 1.65 percent not to mention a 5 percent deferred load, according to Morningstar.

Now, however, retail investors can access an equal weighted S&P 500 strategy through the relatively new Rydex S&P Equal Weight ETF (RSP: news, chart, profile), which was introduced in April 2003. The ETF holds all companies in the S&P 500 in an equal amount (each component stock is approximately 0.2% of the fund's value) and it is rebalanced quarterly.

Equal weighting vs. market-capitalization weighting

Perhaps the easiest way to understand the difference between market capitalization weighting and equal weighting is to take the simple example of the U.S. legislative branch. Equal weighting could be thought of as the Senate, where all states regardless of population are represented by two senators. Market capitalization weighting is like the House of Representatives, where larger states have more voting power.

The equal-weighted index ends up looking very different from the cap-weighted S&P from a size, style and sector basis.

"In the equal-weighted S&P 500, a company's weighted average capitalization is about $21 billion vs. about $92 billion for the cap-weighted S&P 500," said Steve Sachs, ETF portfolio manager at Rydex.

Aside from more exposure to the smaller companies in the S&P 500, the equal-weighted index also ends up with a lower price-to-earnings ratio.

"There may be a value play there since the bottom of the S&P 500 often includes some slightly fallen angels," said David Blitzer, head of the S&P 500 Index Committee.

Sector	Number of stocks	Equal-weight S&P 500 percent	Rank	Cap-weight S&P 500 percent	Rank
Consumer discretionary	87	17.4%	1	10.6%	5
Consumer staples	37	7.%	6	10.9%	4
Energy	23	4.6%	9	5.8%	7
Financials	83	16.6%	2	21%	1
Health care	47	9.4%	5	13.6%	3

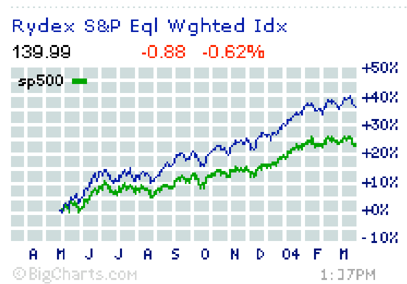
Industrials	59	11.8%	4	10.5%	6
Information technology	83	16.6%	2	18.2%	2
Materials	33	6.6%	8	2.9%	9
Telecommunications services	12	2.4%	10	3.5%	8
Utilities	36	7.2%	7	2.9%	10

Source: Standard & Poor's Indexes, all data as of 1/31/04

"In the equal-weighted S&P 500, the materials sector and the utilities sectors are more heavily weighted, as both of those [sectors] tend to have smaller stocks with a value leaning. Consumer discretionary also gains in rank, health care drops, while information technology is No. 2 in both," said Blitzer.

Probably the most important difference between the two weighting schemes is that equal weighting prevents a few large stocks from dominating the index -- for example a handful of large-cap growth stocks were the main drivers of S&P 500 performance in the late 1990s.

"In the cap-weighted S&P 500, the top 10 companies now comprise about 23 percent of the overall market cap of the index, while the top 100 companies in the index account for around 68 percent," said Sachs, highlighting facts that may surprise many retail investors. By definition, each quarter the Rydex ETF rebalances so that the top 10 companies represent only about 2 percent of assets.



Although the equal-weighted version will by definition have more turnover than the cap-weighted S&P 500, the ETF structure with its "in kind" creation and redemption process helps from a tax-efficiency standpoint. With quarterly rebalancing, the Rydex S&P Equal Weight ETF enforces a "buy low, sell high" discipline that many investors find difficult -- it can be expensive, and there are tax consequences.

"This ETF has benefited from the broad-based market rally of the past 12 months," said Sachs. "It wasn't dominated by mega-cap stocks, so the fund got more of a boost from the smaller companies in the index, relative to the market cap-weighted S&P 500."

As of year-end 2003 the two indexes have a 5-year correlation of 0.90, according to Standard & Poor's.

Returns	S&P 500 equal-weight	S&P 500 cap-weight
1-year	39.6%	28.7%
3-year annualized	4.4%	-4.1%
5-year annualized	6.9%	-0.6%
7-year annualized	10.6%	7.6%

Source: Standard & Poor's Indexes, all data as of 12/31/03

Aside from a core holding, some investors use the Rydex S&P Equal Weight ETF for relative outperformance plays. For example, go long the Spider 500 (SPY: news, chart, profile) and short RSP if you're looking for more of a mega-cap rally. If you expect a broad-based rally you can do the opposite -- go long on RSP and short the Spider.

Although some investors will find RSP a helpful portfolio tool, those seeking a heavier allocation to small-cap or value companies are better off simply buying ETFs that track those market segments.

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