PERSONAL FINANCE

The ABCs of ETFs

By Joseph Caplan

The ability for investors to easily diversify an equity or bond portfolio has been increasingly simplified over the years. In the 1970s and 1980s, the emergence of mutual funds helped investors gain access to professional management and diversified investment vehicles in one transaction. But over time, "active" mutual funds on average began to be widely perceived as lagging in performance, which led to the launch of "passive" index mutual funds. A variant of this concept came in the form of a new product called an "ETF" or an "exchange traded fund." These funds have become popular with many investors because of their liquidity (they trade in the open market like stocks), tax efficiency and low management fees.

When investors buy an ETF based on a broad market index such as the S&P 500, they in essence own a broad swath of stocks (in this case 500 stocks) in just one transaction. They have achieved a significant level of diversification. But should one consider an investment portfolio with one ETF as well diversified?

To answer this question, I would like to explore one of the potential drawbacks in the construction of certain indices. It is true that the S&P 500 index is composed of 500 stocks. My concern is that the index has become heavily concentrated in a narrower group of companies and industries.

According to Yahoo Finance, the top 10 companies by weighting in the S&P 500 index represent over one quarter of the entire index. This is due to the fact that the index is "market-capitalization weighted" or based on the relative size of each company in the index. The company with the largest weighting in the index is currently Apple, with a weighting of about 6.5%. Thus, if you purchase the oldest and most popular index ETF (SPDR S&P 500 ETF Trust—Symbol: SPY), approximately 6.5% of your overall return will reflect the performance of Apple stock.

Why Does This Matter?

Historically, the sector and individual stock weightings were more disparate. While there have always been gaps in size between largest and smallest stocks in the index, those gaps appear to have increased in recent years. The result is that an investor's ability to achieve sector and individual stock diversification has been attenuated. In years like 2020, when the heavily weighted technology sector performed exceedingly well, this was good news for S&P 500 index investors. The question is whether it makes sense going forward to leave that investment as is, or whether to gravitate to more diversified ETFs.

To answer this question, let us look at an ETF with a slight variation from the SPDR ETF. There is an ETF that invests in all 500 companies in the S&P 500, but with equal weightings in each stock making up the index. It is called the Invesco S&P 500 Equal Weight ETF (Symbol: RSP). Every time the ETF is rebalanced, the weightings for each stock in the fund are adjusted to 0.2% of the portfolio. This makes sense as 500 stocks times 0.2% equals 100%. The result is that one effectively owns 500 stocks, albeit with substantially more balanced weightings. The risk and potential returns of the RSP are notably different from those of the SPY.

2020 as a Test Case

One could safely say that at the outset of 2020 one could not be certain which of the two ETFs was the better choice. But there turned out to be a clear difference. After the COVID-19 pandemic spread to the United States, SPY began to outperform RSP by a fairly wide margin. By mid-July, SPY was already generating positive returns for the year while RSP returns were still down about 8%. While the performance gap narrowed somewhat late in the year, the divergence was noteworthy.

A Deeper Dive

So how did this divergence take place? I believe that the primary reason for this divergence is that RSP has a much lower exposure to technology stocks than SPY. In addition, the RSP has a higher allocation to many of the underperforming sectors of the stock market.

Recently, I was listening to a webcast hosted by famed investor and market pundit Jeff Gundlach, who noted that the dispersion in returns between the various S&P 500 sectors was one of the highest in history in 2020. The leading sector (Information Technology) delivered returns of 43.89%, while the lagging sector (Energy) delivered negative returns (-33.68%). I believe this phenomenon was largely due to the effects of the pandemic. The "stay-at-home" effect was a tonic for technology companies, as global investment in remote technology surged. At the same time, leisure travel and commuting ground to a near halt, adversely impacting the performance of energy companies.

Looking Ahead

With 2020 in the rearview mirror and a post-pandemic economic recovery in sight as vaccines become more widely available, how should one plan to invest in 2021 and beyond? Should one stay with the 2020 winners, maintaining a heavy exposure to the technology sector? Or should one bet on a broader economic recovery that will help benefit the many lagging sectors most adversely impacted by COVID-19? One's view of how rapidly and smoothly the expected economic recovery unfolds should be a key consideration in positioning one's equity portfolio for the coming year.

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