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Understanding exchange-traded fund weightings

Not all ETFs are the same

While investors understand that exchange-traded funds (ETFs) track indices, many are unfamiliar with the specific ways in which indices can be built. Because the index is a key component in performance, investors should understand the index weighting of any ETFs they consider in order for acquisitions to fit portfolio goals.

The most popular weighting method is market capitalization which creates an index where the largest companies have the highest percentage weighting in the index, essentially creating a product that favors companies considered the most valuable by the market. An example is SPDR S&P 500 (SPY), the world's largest ETF, whose current top holdings are Apple Inc and Exxon Mobil Corporation.

Opponents argue that market capitalization results in heavy concentration, ultimately decreasing diversification and increasing risk because inclines or declines in the top holdings will have a greater impact on the ETF. Opponents also argue market capitalization can generate sector overconcentration if top holdings occupy the same space; Information Technology currently represents more than 17% of SPY.

However, market capitalization weighting is easy for investors to understand and easy for ETF managers to administer. The strategy lends itself to lower turnover and therefore tax efficiency and lower operating expenses.

Another method is equal weighting. The rationale behind this approach is to avoid the overconcentration risks associated with market capitalization. As the name denotes, these ETFs assign the same weighting to each constituent in the index. An index containing 100 holdings will assign a weight of 1% to each. ETFs using this approach require more frequent rebalancing, which can result in higher costs and potential capital gains distributions.

Although equal weighting increases diversification, it has the potential to increase volatility because the index will have a higher proportion of its assets in smaller companies. A study by Skirant Dash and Keith Loggie of Standard & Poor's analyzed the performance of an equal weighted version of the S&P 500 index and found that while it outperformed the regular index by 1.5% a year, it did so with significant volatility.

The fundamental indexing method attempts to resolve these issues. ETFs using this approach overlay such factors as dividends, cash flow, and book value to create an index that better reflects the constituents' intrinsic value. Of course, the success of fundamental indexing is ultimately based on the success of the particular fundamental thesis applied.

Low volatility or minimum volatility weighting is another strategy that has been gaining momentum. These ETFs are comprised of stocks that move around less than the broader indices. They have

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gained popularity in recent years with investors seeking ways to reduce portfolio risk in unsettled markets.

The various weighting strategies offer flexibility. ETF investors might opt for a blend of weightings, such as opting for equal weighted and low volatility products for bear markets and market capitalization weighted for bull markets. As with

any investing, choices must fit personal goals and it's important to do the homework. Those who take time to learn about weighting strategies can gain a significant edge.

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