S&P Dow Jones Indices
A Division of S&P Global

TalkingPoints

U.S. Equities and Sectors in Election Years

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1. Why is the U.S. market relevant to investors worldwide?

The U.S. equity market is the largest in the world, with U.S.-domiciled companies representing 60% of the index market capitalization of S&P Dow Jones Indices' (S&P DJI's) global equity barometer — the S&P Global BMI — at the end of March 2024. The U.S. also accounts for most of the index market capitalization in 10 of the 11 S&P Global BMI GICS® sectors.

Hence, market participants that do not have a U.S. view risk overlooking a sizeable portion of the global equity opportunity set. Not only might this make it more difficult to explain the impact of narratives on global equity returns, but the distinct makeup of the U.S. equity market means that overlooking U.S. equities may impact investors' abilities to gain strategic or tactical exposures.

2. What role can indices play in measuring equity markets?

Since Charles Dow and Edward Jones began publishing the first ever index — the Dow Jones Railroad Average — towards the end of the 19th century, indices have allowed investors to monitor the impact of trends on different market segments and to benchmark the performance of active managers.

While the first indices were equity market measures, transparent, rules-based indices have since been created for a variety of asset classes. Nowadays, indices also measure the performance of more complex strategies previously thought to be solely within the realm of active management.

Accompanying — and to a large extent, driving — the proliferation of index information, indices have come to serve as the basis for investment products, globally. The substantial adoption of index-based investment products has been driven by the increased awareness of the substantial body of evidence that shows that most active managers underperformed on an absolute and risk-adjusted basis most of the time. For example, more than 90% of U.S. Large-Cap funds based in the U.S. underperformed the S&P 500® over a 20-year period ending on Dec. 31, 2023.[1] European Equity funds focused on large-cap U.S. equities posted similar underperformance rates: more than 90% of such active funds underperformed the S&P 500 over the 10-year period ending on Dec. 31, 2023.[2]

This article was first published by ETF Stream.

[1] Source: SPIVA® U.S. Year-End 2023 Scorecard
[2] Source: SPIVA® Europe Year-End 2023 Scorecard

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3. The S&P 500 Equal Weight Index has been a popular strategy recently. What are the drivers behind this?

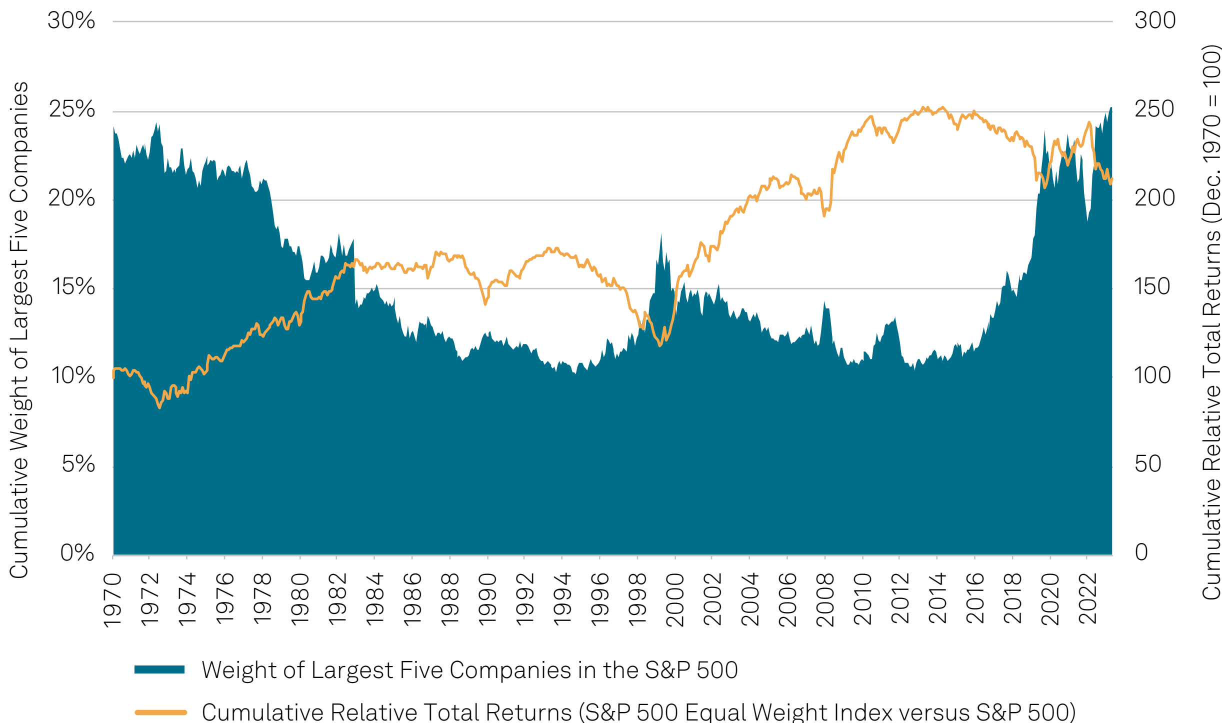
A notable trend in U.S. equities over the past year has been the outperformance of some of the largest companies as investors expressed their views on the potential impact of artificial intelligence on companies' growth prospects. Against this backdrop, the representation of mega-cap companies in the S&P 500 reached multi-decade highs: the cumulative weight of the largest five companies in the S&P 500 was 25.3% at the end of March 2024 — a level that has not been seen since December 1970.

Although elevated stock-level concentration demonstrates that the S&P 500 continues to meet its stated objective of measuring the performance of large-cap U.S. equities, many investors have turned to an equal weight approach to reduce exposure to the largest names and to express views on mean reversion in equity market concentrations.

The relevance of the S&P 500 Equal Weight Index in these considerations comes from its smaller size exposure: assigning egalitarian allocations to the S&P 500's component companies on a quarterly basis means that the equal weight index has less weight in the largest names. This methodology helped to explain most of the S&P 500 Equal Weight Index's relative performance versus the S&P 500 over the past year, and it provides a tangible link between changes in market concentration and the equal weight index's relative returns.

Typically, when the largest companies (to which equal weight has less sensitivity) outperformed, concentration rose, and equal weight underperformed its cap-weighted benchmark. Conversely, outperformance among smaller companies (to which equal weight has greater exposure) led to reduced concentration and greater likelihood of equal weight outperformance.

Exhibit 1: Weight of Largest Five S&P 500 Companies and Cumulative Relative Total Returns for the S&P 500 Equal Weight Index versus the S&P 500



Source: S&P Dow Jones Indices LLC. Chart shows cumulative relative returns for the S&P 500 Equal Weight Index versus the S&P 500, based on monthly total returns between December 1970 and March 2024. Cumulative weight of largest five S&P 500 companies based on month-end constituents. The S&P 500 Equal Weight Index was launched Jan. 8, 2003. All data prior to index launch date is back-tested hypothetical data. Past performance is no guarantee of future results. Chart is provided for illustrative purposes and reflects hypothetical historical performance. Please see the Performance Disclosure at the end of this document for more information regarding the inherent limitations associated with back-tested performance.

4. How important is sector selection in U.S. election years?

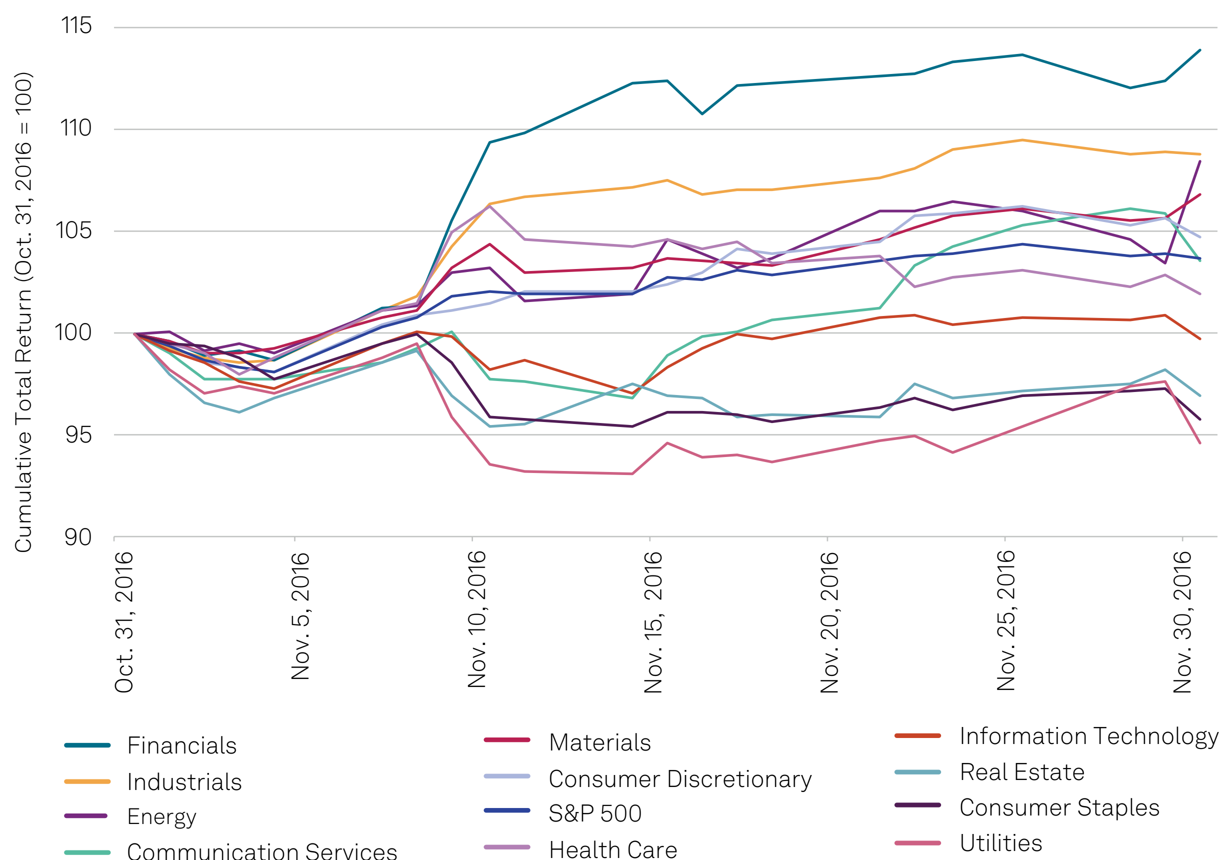
Sectors group companies according to common characteristics, and so companies within the same sector typically have shared sensitivities to common drivers of returns. Hence, many market participants use sector-based perspectives to express views while mitigating idiosyncratic risks from picking individual stocks.

Dispersion provides a way to assess the potential value of correct selection: higher dispersion indicates a greater difference between the outperformers and laggards, and so greater reward for skillful (or lucky) choices. Market dispersion can also be viewed as a combination of dispersion across (inter) and within (intra) sectors. In fact, the square of market dispersion is approximated by the sum of squares of inter- and intra-sector dispersion.

On average, sector effects — as measured by the ratio of the squares of inter-sector and total effects — accounted for 22% of the S&P 500's monthly dispersion since 1989. However, in U.S. presidential election years, sector effects were elevated in the November months, contributing a greater-than-average proportion in 75% of instances. For example, while the S&P 500 was little changed after the November 2016 election result, sector effects accounted for over 40% of the S&P 500's monthly dispersion, as the market priced in the anticipated impact of the then-incoming administration's policies on different market segments.

Of course, we will have to wait and see which narratives emerge in the 2024 U.S. presidential election, but history points to sector effects playing an elevated role, amplifying the importance of sector choices.

Exhibit 2: S&P 500 and S&P 500 Sector Performance



Source: S&P Dow Jones Indices LLC. Data based on total monthly returns between Oct. 31, 2016 and Nov. 30, 2016. Past performance is no guarantee of future results. Chart is provided for illustrative purposes.

5. Why has interest in U.S. mid- and small-cap segments grown?

Smaller U.S. size segments represent a significant portion of the global opportunity set, meaning they could be relevant for investors, globally. Indeed, the S&P MidCap 400® and S&P SmallCap 600®'s market capitalizations are larger than the Canadian and South Korean equity markets, respectively. We've seen continued interest in the S&P MidCap 400 and S&P SmallCap 600 amid increased familiarity with the potential benefits of incorporating index-based approaches for smaller U.S. size segments to gain tactical and strategic exposures.

For example, U.S. mid- and small-cap segments have been relevant for investors looking to express views on the health of the U.S. economy: the performance of the S&P 400® and S&P 600® over the past three decades has been more highly correlated with U.S. GDP growth than the S&P 500, in part explained by the fact that smaller companies typically have more domestically focused revenue exposures. More broadly, the S&P 400 and S&P 600's distinct sector exposures and historical outperformance versus the S&P 500 are also relevant for investors looking to diversify large-cap U.S. equity exposures.

The underperformance of active managers has further supported the growing adoption of index-based approaches. Contrary to the perception that smaller size segments offer greater opportunities for active managers to succeed, most mid- and small-cap active U.S. equity funds have underperformed the S&P 400 and S&P 600 most of the time, historically. In fact, S&P DJI's SPIVA® U.S. Year-End 2023 Scorecard showed that more than 90% of mid- and small-cap active equity managers underperformed over the 20-year horizon ending December 2023.

6. There are many different shades of green. How does S&P DJI approach sustainability from an indexing perspective?

For more than two decades, S&P Dow Jones Indices has offered indices that incorporate sustainability criteria in their index construction, starting with the launch of the Dow Jones Sustainability World Index in 1999. In recognition of the evolution of the sustainability market and growing demand for index-based sustainability solutions, S&P DJI has since launched a variety of indices to bring transparency and choice to market participants that wish to monitor sustainability performance and incorporate sustainability considerations into index-based strategies.

For example, S&P DJI provides broad-based equity indices, such as the S&P 500 ESG Index, that measure the performance of securities meeting sustainability criteria while maintaining similar overall industry group weights as their parent index. S&P DJI also produces indices with more targeted exposures to align with regulation or thematic trends, including the S&P PACT™ Indices (S&P Paris-Aligned & Climate Transition Indices) and the S&P Clean Energy Indices, as well as offering fixed income indices — such as the iBoxx ESG and iBoxx SRI Screened Indices — that incorporate sustainability criteria in constituent selection.

Performance Disclosure/Back-Tested Data

S&P 500 Equal Weight Index was launched January 2003. All information presented prior to an index's Launch Date is hypothetical (back-tested), not actual performance, and is based on the index methodology in effect on the index launch date. However, when creating back-tested history for periods of market anomalies or other periods that do not reflect the general current market environment, index methodology rules may be relaxed to capture a large enough universe of securities to simulate the target market the index is designed to measure or strategy the index is designed to capture. For example, market capitalization and liquidity thresholds may be reduced. In addition, forks have not been factored into the back-test data with respect to the S&P Cryptocurrency Indices. For the S&P Cryptocurrency Top 5 & 10 Equal Weight Indices, the custody element of the methodology was not considered; the back-test history is based on the index constituents that meet the custody element as of the Launch Date. Complete index methodology details are available at www.spdji.com. Back-tested performance reflects application of an index methodology and selection of index constituents with the benefit of hindsight and knowledge of factors that may have positively affected its performance, cannot account for all financial risk that may affect results and may be considered to reflect survivor/look ahead bias. Actual returns may differ significantly from, and be lower than, back-tested returns. Past performance is not an indication or guarantee of future results.

S&P Dow Jones Indices defines various dates to assist our clients in providing transparency. The First Value Date is the first day for which there is a calculated value (either live or back-tested) for a given index. The Base Date is the date at which the index is set to a fixed value for calculation purposes. The Launch Date designates the date when the values of an index are first considered live: index values provided for any date or time period prior to the index's Launch Date are considered back-tested. S&P Dow Jones Indices defines the Launch Date as the date by which the values of an index are known to have been released to the public, for example via the company's public website or its data feed to external parties. For Dow Jones-branded indices introduced prior to May 31, 2013, the Launch Date (which prior to May 31, 2013, was termed "Date of introduction") is set at a date upon which no further changes were permitted to be made to the index methodology, but that may have been prior to the Index's public release date.

Index returns shown do not represent the results of actual trading of investable assets/securities. S&P Dow Jones Indices maintains the index and calculates the index levels and performance shown or discussed but does not manage actual assets. Index returns do not reflect payment of any sales charges or fees an investor may pay to purchase the securities underlying the Index or investment funds that are intended to track the performance of the Index. The imposition of these fees and charges would cause actual and back-tested performance of the securities/fund to be lower than the Index performance shown. As a simple example, if an index returned 10% on a US $100,000 investment for a 12-month period (or US $10,000) and an actual asset-based fee of 1.5% was imposed at the end of the period on the investment plus accrued interest (or US $1,650), the net return would be 8.35% (or US $8,350) for the year. Over a three-year period, an annual 1.5% fee taken at year end with an assumed 10% return per year would result in a cumulative gross return of 33.10%, a total fee of US $5,375, and a cumulative net return of 27.2% (or US $27,200).

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