S&P 500 OR S&P 5? (PART 2) – HOW WOULD A TECH NORMALISATION IMPACT EQUITY PORTFOLIOS?

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A lot has recently been written on the exceptional concentration at the top of the S&P 500 and in technology stocks. In this two-part blog, we want to first dig into the drivers and impact of such concentration before focusing on the potential ramifications on US equity investments for the medium to long term.

In Part 1, we focused on the S&P 500 itself. In this second part, we will look at the impact of this concentration on non-market cap weighted investments in US Equities like income strategies and quality focused strategies.

Looking back at the first 9 months of 2020, we observe that:

•Strategies have not been impacted in the same way by this Technology Run bull market

- Growth and Momentum have strongly benefited from it
- Income strategies, Value oriented strategies and Small Caps have suffered significantly from it
- Quality has managed to navigate the environment relatively unscathed.

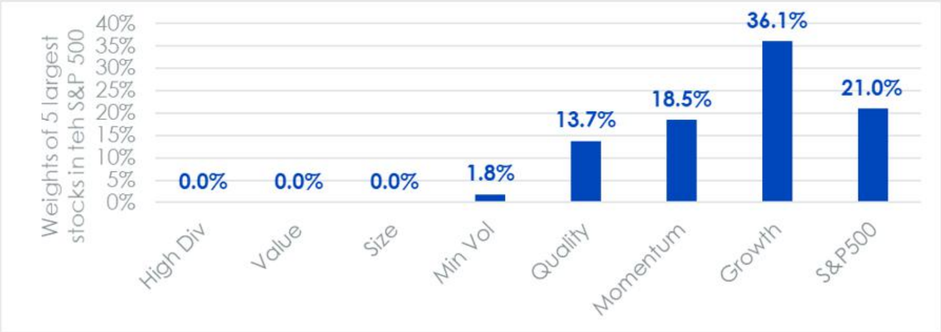
• Companies that do not pay dividends have had a disproportionate impact on the S&P 500 in 2020 and this hurt income strategies almost proportionately to how high was their dividend yield.

Looking forward, if we observe a mean reversion of the concentration of the index, the role could be inverted with Growth suffering the most and Income or value strategies benefitting from the reversal.

Not all equity portfolios are as concentrated as the S&P 500

At the end of September, Apple, Microsoft, Amazon, Facebook and Alphabet represented 21% of the S&P 500. As shown in Figure 1, this concentration is not shared by all equity factors. Momentum and even more so Growth do show a large investment in those 5 stocks. However, on the other side, High Dividend, Value, or Size were not invested in any of those 5 stocks because they have too low dividend yields, are too expensive and are too big respectively. In the middle, Quality showed a decent investment in those stocks without reaching the concentration of the S&P 500.

Figure 1: Weights of Apple, Microsoft, Amazon, Facebook and Alphabet in different US equity factor indices



Source: WisdomTree, Bloomberg. As of 16th October 2020. Definitions of each factor are available at the end.

Historical performance is not an indication of future performance and any investments may go down in value.

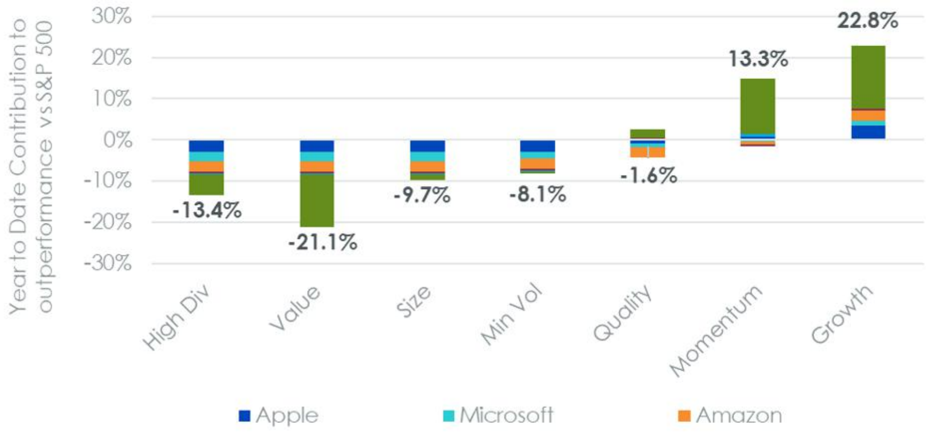
Looking at performance year to date of such equity factors, there appears to be a direct relationship between the weight in the top 5 stocks and such performance. In Figure 2, we show the contribution of the 5 largest stocks in the S&P 500 to the outperformance or underperformance of the equity factors versus the S&P 500.

Without surprise, Momentum and Growth have been the best performers on a year to date basis in 2020, outperforming the S&P 500 Index by 13.3% and 22.8%[1] respectively. Growth, for example, benefitted from a 7.56% contribution to the outperformance of the mega cap stocks that is on top of the 8.35% performance that those stocks contributed to the S&P 500 Index itself.

Value and High Dividend, with their non-exposure in the Tech mega stocks, were the worst performers with -21.1% and -13.4%[1] underperformance to the S&P 500 Index, respectively. Having a zero exposure to those stocks means that, like Size, they did not benefit at all from the 8.35% contribution of those stocks to the S&P 500 Index and basically started the year with a -8.35% handicap.

Quality is in the middle once again with a slight underperformance of -1.6%[1] (i.e. it is up 7.8% year to date vs 9.5% for the S&P 500). Looking at the contribution to the underperformance of the Top 5, we observe that quality suffered a -3.57% negative contribution which means that on the rest of the Quality Portfolio outperformed the S&P 500 Index by 2%.

Figure 2: Year to Date contributions to outperformance vs the S&P 500 of the five biggest stocks in different US equity factors



Source: WisdomTree, Bloomberg. 31st December 2019 to 16 October 2020. Using Gross TR Index in USD. Definitions of each factor are available at the end.

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So looking forward to a potential mean reversion of US stocks and of their impact on the S&P 500 as discussed last week, it stands to reason that roles could be inverted with Momentum and especially Growth suffering from the correction while High Dividend, Size or Value would benefit from it. We have already discussed extensively of Quality in other blogs and publications, highlighting its capacity to behave in a stable manner across market environment. In this instance, it would appear that once again Quality is the middle of the road factor which did not benefit nor suffer much due to the recent Tech run and which therefore would probably resist well to both a continuation or reversion of that trend.

In a way, Quality is the ‘all-weather’ type of play, where High Dividend, Size or Value would be a more overt expression of an expectation of a mean reversion of the Growth versus Value unbalance.

The disproportionate impact of Companies that have not paid dividends on the S&P 500

Another interesting angle to look at the impact of Technology on the performance of US equities year to date is dividend payers versus non dividend payers. Historically, since the launch of the S&P 500 Index in 1957, non-dividend payers were relatively rare and had the tendency to underperform the rest of the stocks. This trend has been fading. Year to Date, non-dividend payers contributed 6% of the 9.45%[1] performance of the S&P 500 Index i.e. 63% when the average weight of companies which have not paid any dividends in the last 12 months in the index was 20.5%. Looking at the companies that did not pay a dividend and that contributed the most to the performance of the S&P 500 Index, we find familiar names: Amazon (+2.4%) Facebook (+0.55%), PayPal (+0.51%), Netflix (+0.4%), Salesforce (+0.35), Adobe (+0.32%), Alphabet (+0.49% across its 2 listings)...

As discussed above this translated into a difficult year for all income-oriented strategies in US Equities. In Figure 3, we look at a range of such strategies and we observe that they all consistently underperformed the S&P 500 Index in 2020. What is even more striking is that there is an almost linear relationship between the Dividend Yield of the index and the performance year to date: The higher the dividend yield, the worse the performance. This clearly illustrates the strong impact of the divide between dividend payers and non-dividend payers this year.

Figure 3: Year to Date Performance of different income-oriented strategies in US equities

Source: WisdomTree, Bloomberg. 31st December 2019 to 16 October 2020. Using Net TR Index in USD. The dividend yield is calculated as the gross dividend amount paid by each stock in the index divided by the price of the index as of 16th October 2020.

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Looking at WisdomTree US Quality Dividend Growth Index

WisdomTree's own approach to quality, the WisdomTree US Quality Dividend Growth Index, focuses on dividend paying companies with a high return on equity and low debt – attributes that are commonly considered to be fundamental in quality investing - while maintaining a strong valuation discipline.

We observe that similarly to more classic approaches to quality, the current weight of the 5 mega stocks in the strategy is 12.5% i.e significantly lower than their weight in the S&P 500 but not as low as in other strategies.

Year to date, the index has been doing well despite its focus on dividend paying companies and is up 7.84%3 meaning that it underperformed the S&P 500 by 1.6%. Looking at the contribution of those 5 mega stocks, they contributed negatively -3.34% to the performance of the strategy versus the S&P 500 i.e. by more than twice the underperformance of the strategy to the benchmark.

Looking at WisdomTree US Equity Income UCITS Index

The WisdomTree's approach to income and High Dividend, revolved around a fundamentally weighted portfolio of risk-filtered high dividend paying companies.

In this strategy, we observe that like for other classic high-income strategies the current weight to the 5 mega stocks is zero. Apple or Microsoft are indeed low dividend yield stocks and Facebook or Amazon do not even pay any dividend.

Year to date, the index is down -13.8%3 meaning that it significantly underperformed the S&P 500 (by 23.2%). Looking at the contribution of those 5 mega stocks, they contributed negatively -8.35% to the performance of the strategy versus the S&P 500 already.

Min Vol is proxied by MSCI USA Min Volatility total return index. **Quality** is proxied by MSCI USA Quality Sector Neutral total return index. **High Dividend** is proxied by MSCI USA High Dividend total return index. Value is proxied by MSCI USA Enhanced Value total return index. Momentum is proxied by MSCI USA Momentum total return index. Growth is proxied by MSCI USA Growth total return index. Size is proxied by MSCI USA Small Cap total return index.

Source

[1] WisdomTree, Bloomberg. As of 16 October 2020. Using Gross Total Return Indices in USD.

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