Seeking Alpha α

Just One ETF: Riding Mid Caps (and Beating SPY) Through Equal Weighting

by: Christian Wagner

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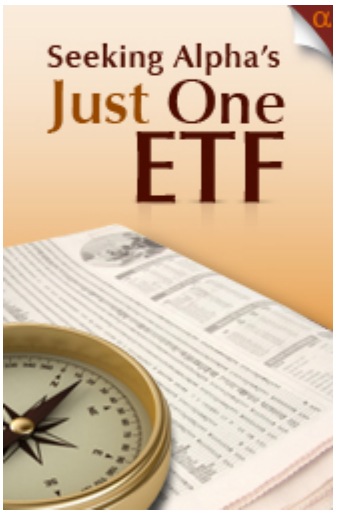


Several times a week, Seeking Alpha's Jason Aycock asks money managers about their single highest-conviction position - what they would own (or short) if they could choose just one stock or ETF.

Christian Wagner is the founder of Longview Capital Management, a Wilmington, Del.-based RIA specializing in personal asset management for individuals, families, institutions and retirement plans. Prior to founding Longview, he worked as director of investment services at Commerce Bancorp in Philadelphia.

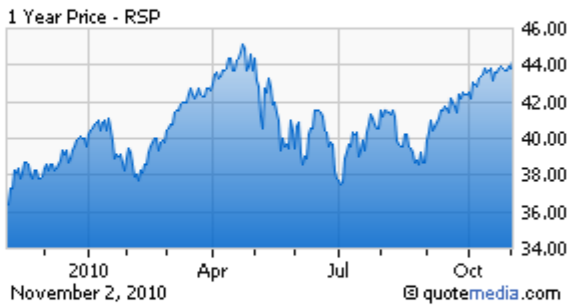
Which single asset class are you most bullish about in the coming year? Which ETF position would you choose to best capture that?

In the U.S. we are bullish on the mid-cap space. The ETF that we would choose to best capture that would be the **Rydex S&P Equal Weight Index Fund (RSP).**

How does RSP fit into your overall investment approach? Tell us a bit about your strategy and goals.

Longview is an active, all-asset manager; through the use of relative strength analysis we look for the greatest opportunity across the asset classes that we follow. We continue to see strength in international equities - specifically emerging and frontier markets - as well as domestic equities - specifically, the small and mid-cap sectors with an emphasis on commodities, energy and transportation.

The Rydex Equal Weight Index fits perfectly into our overall investment approach; it allows us to be invested in the S&P 500 Index with a twist: Instead of directly investing in the S&P 500 Index, which is capital-weighted, RSP is equal-weighted.



Think of the House of Representatives vs. the Senate. In the House of Representatives, the number of representatives depends on the population of your state. This is how a capital-weighted index works. The larger capital stocks get a greater share of the overall allocation. Now compare that to the Senate, where no matter the population of your State, every State has two senators, therefore, the same amount of votes. That is the same as an equal-weighted index. Every stock gets the same vote, or weight, in this case.

We believe that capital weighting tends to overweight slower-growing and overpriced stocks; equal weighting does the exact opposite.

Year-to-date, the S&P 500 Index is up 7.71%, the Rydex S&P Equal Weighted Index Fund is up 11.97% (as of Oct. 27). In 2009 the S&P 500 Index was up over 26%; RSP was up over 44%. Over the 10 years ended in 2009, the S&P 500 was down 24.1% while the equal-weighted version of the S&P 500 was up 39.5%.

RSP also allows the investor who is looking for S&P 500 exposure to beat the index by being the index. By also analyzing the delta of RSP vs. the S&P 500, one can reduce their allocation to RSP during certain market cycles and get the same performance as the S&P 500. Last year the number was as much as a 30% reduction to RSP.

And it's got the same holdings as SPY - just with 0.20% weights for each stock?

Correct; 0.20% per holding, rebalanced quarterly.

Tell us a little more about the area of U.S. stocks; what makes it your top pick?

We are seeing continued strength in U.S. equities, specifically the small- to mid-cap growth stocks. RSP allows us to capture the S&P 500 Index on an equal-weight basis; it is our belief that equal weighting allows you to capture more of the undervalued stocks in the S&P that have room to grow.

Are there alternative ETFs that could be used to capture the same theme? What makes this specific ETF your first choice?

There seems to be a new ETF every day; however, as far as equal weighting is concerned, there are less than 100 to choose from and they are normally very sector-specific, such as the Rydex S&P Equal Weight Utilities ETF (RYU).

RSP is our first choice because it is currently the only equal weighted S&P 500 Index ETF.

Since we're talking about mid-caps, Russell Investments is rolling out a bunch of new indexes with equal weighting (and Rydex is planning 19 new ETFs based on them). Do you think this means that equal weighting is getting more of a foothold (though Russell still says the market-cap approach is the "best way to truly reflect market segments")?

Equal weighting has outperformed the capital-weighted indices in times of recovery. The true advantage to the investor is by equal weighting they also avoid specific sector concentration and get a broader approach to the entire economy. On a capital-weighted basis, Energy and Technology dominate the top 10 holdings in the S&P 500. One sector, Technology, has done very well, as evidenced by the performance of Apple (AAPL), while Energy has been a laggard, as evidenced by Exxon (XOM). Guggenheim also announced they were going to bring out an equal-weighted Wilshire 5000, although we have not seen it yet.

Could the outsized returns be what could draw in investors from SPY, considering that RSP's expense ratio is more than four times SPY's (0.40% vs. 0.09%)?

I dont think enough people recognize that it can even be done. I would venture to say that 95% of the so-called financial advisers don't know that there is a way to invest in the equal-weighted S&P 500.

If an investor wants to do it themselves, they can also easily do it via FolioFN. Pay the annual fee and rebalance commission-free.

How does your view on equities fit with the consensus?

The domestic equity market has not been a top performer in 2010, however, we believe that more investors/managers are now starting to invest a little heavier in the U.S. We were invested heavily in emerging/frontier markets and commodities in the first two quarters of 2010; in the third quarter we have begun to overweight domestic equities. We see continued growth in the asset class throughout the remainder of the year.

What catalysts, near-term or long-term, do you think could move the sector significantly?

We believe that QE2 and the Republican “Tidal Wave” in the House and Senate have been priced into the market. However, if a surprise is announced, we could see a significant pickup in the fourth quarter of 2010.

What could go wrong with your pick?

A stimulus backfire, a spike in unemployment or another geopolitical nightmare as we had at the beginning of this year.

And conversely, if large-caps outperform, then we could expect equal-weight ETFs to underperform market-cap-weighted issues like SPY? And if so, what's your take on how long into a recovery smaller-cap stocks could be expected to lead the way?

During the last decade the only time that SPY was favored on a relative-strength basis over RSP was during the period of October 2007 thru April 2009. We choose to use this relationship change as a cautionary indicator as investors begin to flock to the larger, more defensive positions in the index. During that time frame, the maximum drawdown in RSP was a little over 45%, while SPY was slightly over 40%.

Thank you, Christian, for sharing your impressions with us.

Disclosure: Long RSP.

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