

Let's talk weighting...

As in, how much importance do you give a particular investment within your portfolio? How do you decide on a distribution of funds between the various stocks and asset classes?

There's no single right way to make that decision. As with everything else about investing, there is no "one size fits all" and that's a good thing. Your allocation should always reflect your financial goals, and those goals can certainly change over time. But regardless of what they might be, finding the right mix of assets is essential to your long-term success and that's where some smart strategies can help.

In this article, we'll discuss one of those strategies - let's talk about **equal weight investing**.

What is Equal Weight Investing?

Equal weight is exactly what it sounds like: each investment is given equal importance (in the form of dollars invested), relative to the other investments in the group. There are really two different methods of equal-weight investing - one is within your portfolio and the other is achieved by using an index fund - so let's start there.

In an equal-weighted portfolio, all the different asset classes are given the same weight, meaning that each class receives the same amount of investing dollars. If you're going to invest \$10,000 for example, across five asset classes, each asset class would receive a 20% weight and a \$2,000 investment.

Equal-weight index funds work in a similar manner, but here we're talking about weight between individual stocks, rather than weighting at the asset level.

In both instances, each "investment" - be it a class or an individual stock - receives an equal share of the total amount invested. If a particular stock or class falls in price, more is purchased to rebalance and restore the equal-weighting system. Likewise, if a stock or class gains in value, the excess is sold off.

This is in contrast to the more traditional **market capitalization** method of weighting where greater importance is given to large-cap companies. This grouping typically includes the well-established blue chip stocks - such as **Amazon** (NASDAQ: AMZN), **Facebook** (NASDAQ: FB) and **Costco** (NASDAQ: COST) - that many investors see as the stable and steadfast foundation to a portfolio.

The S&P 500 is a good example of market cap weighting; this index tracks the 500 largest assets by market capitalization, and is often used as a benchmark for overall performance of the market.

So, if market capitalization is the more conventional way to weight a portfolio or index fund, then why consider an equal-weighting strategy instead?

Benefits of an Equal Weight Investing Strategy

One of the biggest advantages to using an equal-weighted strategy is **diversification**. Looking at the **SPDR S&P 500 Trust ETF** (NYSEMKT: SPY) for example, the top 25 stocks represent a little more than 40% of the total portfolio. That means the remaining 60% is comprised of over 450 stocks. Equal-weighting ensures that each asset class is balanced against the others, meaning that one doesn't have more influence (or impact) on your portfolio than another.

Small-cap stocks get the same weight as large-cap stocks for instance, and large-cap stocks have the same weight as bonds and real estate and commodities. As stock prices rise and fall, the equal-weighted portfolio is rebalanced so that this broad diversification is maintained.

Another benefit is that equal-weighting ensures a **value-based approach to buying and selling**. Essentially, you're only selling when the prices go up and you're only buying when the prices go down. Buy low, sell high - what could be more foolish than that? You're also reducing exposure to overvalued stocks and instead, favoring undervalued stocks, effectively diminishing the impact on your portfolio when those overpriced stocks finally come back down.

And then there's performance...

Historically, equal-weighted indices have performed slightly better than their cap-weighted counterparts. This is due to that lower exposure to overpriced stocks we mentioned above, as well as the extensive diversification that equal-weighting produces. It's also the result of allowing smaller, growth-oriented companies to have a larger influence than is typically seen in indices weighted by market capitalization.

Is there a downside?

Unfortunately, yes.

There's always going to be some risk with investing - that's just a given - and while an equal-weight strategy does offer some nice benefits, there are a few disadvantages as well.

Those smaller, growth-oriented companies that help drive returns also bring more volatility to your portfolio for instance, and because this type of strategy requires regular rebalancing, you'll need to have a more hands-on approach. You'll also likely see more fees from the higher volume of transactions. Ditto for funds that follow this strategy - equal-weighted index funds usually have a higher *stock turnover* - that is, these funds will tend to sell a larger percentage of the portfolio on a regular basis - and that means more fees to manage the fund.

Also keep in mind that because of this constant rebalancing, you're essentially selling off potential winners and buying more shares of companies that have dropped in value. Now, we're no strangers to the second half of that equation - buying more in a downturn is a very Foolish thing to do! - but selling off your winners is in contrast to our *buy well, hold long* philosophy. It also actively works against a particular stock or group of stocks building any real momentum and we believe those outperforming companies are essential if you want to see 10X returns!

Is equal-weight investing right for you?

Again, only you can make that call, and we strongly recommend that you explore all of your options before choosing an allocation strategy. Our Allocator tool is

always a good place to start, and of course, we think our *Essential Investing Principles* are powerful words to live by.

But that doesn't mean you can't branch out. And if you're curious (but not quite ready to go *all-in*), you could consider investing in an equal-weight index fund; it's an easy way to add this strategy to your portfolio without undoing everything you've built so far.