Investment Management

Better together

An all-weather approach to fundamental and market cap weighting

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Executive summary

Investors who believe that the mean reversion we have seen recently is a false start might favor an exclusive allocation to market capitalization weighting. Contrarian investors, on the other hand, might favor an exclusive allocation to fundamental weighting. A combination of market capitalization and fundamental weighting provides an allocation solution in the absence of perfect foresight.

Key takeaways

- Over the long term, equities have oscillated between following trends and reverting to mean valuations.
- During trends where winners seem to gain momentum and valuations on select stocks often soar, market cap-weighted indexes have traditionally performed quite well.
- By comparison, periods of mean reversion tend to reward comparatively undervalued stocks and fundamentally weighted index strategies.
- To give investors the opportunity to potentially experience both market environments—trends and mean reversion—Charles Schwab Investment Management, Inc. (CSIM) offers both market cap-weighted index and Fundamental Index® solutions, enabling a “better together” approach.

Trending markets versus mean reverting markets

Equities tend to follow two general return patterns: trend and mean reversion. A trend is marked by recent winners continuing to outpace recent laggards. In such an environment, stocks with already elevated valuations often become more expensive, and stocks that are comparatively inexpensive become even cheaper. Conversely, mean reversion is marked by recent laggards bouncing back to outpace recent winners. That is, it's a period during which expensive stocks underperform while cheap stocks rebound. There is a natural pattern of oscillation between trending and mean reverting markets.

CSIM offers funds within two groups of index-based strategies. One group may perform well during trending markets. The other may perform well during mean reverting markets.

Market cap-weighted indexes, such as the S&P 500® Index, may perform well during trend-driven markets. By assigning the largest weights to companies with the highest market values, recent winners receive ever-larger allocations at the expense of recent laggards. Fundamentally weighted indexes, such as the Russell RAFI™ US Large Company Index, tend to perform well during periods of mean reversion. By assigning the largest weights to the companies with the largest businesses—as measured by a combination of sales, cash flow, and dividends—the weights to recent winners and laggards are based on metrics unrelated to their prices.

With perfect foresight, investors might be able to precisely time turning points in the market and shift between these indexes at the optimal times. Unfortunately, turning points are difficult to identify in advance. Few investors knew the exact time when expensive stocks would stop outperforming in March 2000. More recent turning points for the peak of cheap stocks in December 2006 or expensive stocks in March 2009 were no easier to precisely identify in advance.

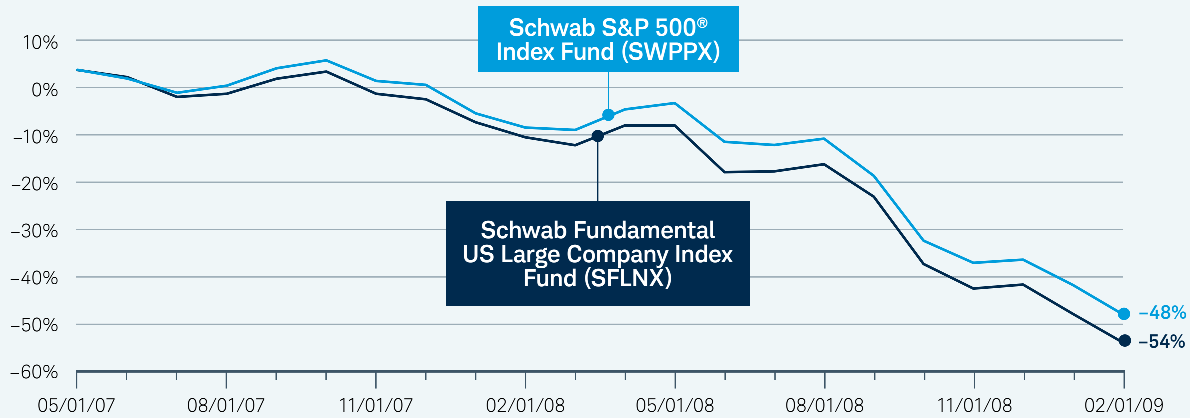
Given the inherent challenges of attempting to time the markets, a combination of market cap-weighted and fundamentally weighted indexes can be used to help create an all-weather portfolio that seeks to smooth out the highs and lows of either index on its own.

Examples of the performance of each index strategy in changing market environments demonstrate the cyclical nature of the shift between trending markets and mean reversion and the subsequent potential benefit of combining these two index-based strategies.

CSIM offers access to market cap-weighted and fundamentally weighted indexes across geographies and in both ETF and mutual fund vehicles. In this analysis, we will walk through the performance of the longest-tenured pair of options: the market cap-weighted Schwab S&P 500 Index Fund and the fundamentally weighted Schwab Fundamental US Large Company Index Fund, represented by tickers SWPPX and SFLNX, respectively.

Figure 1: With mean reversion ending, 2007 was an inopportune time to launch a contrarian strategy

A snapshot showing the lead-up to the financial crisis and the stock market bottom in March 2009



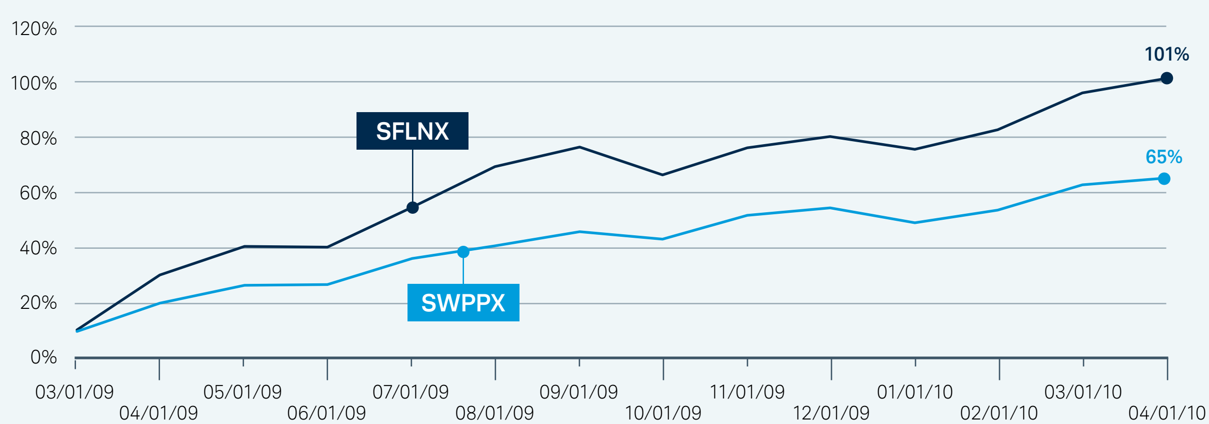
Sources: Charles Schwab Investment Management, Inc.; FactSet. Data from 05/01/07 to 02/01/09.

Our period of common comparison begins with the May 2007 launch of the Schwab Fundamental US Large Company Index Fund (see Figure 1). This was an inopportune time to launch a contrarian strategy because the extended period of mean reversion that had reigned since the peak of the tech bubble more than seven years earlier was ending. The collapse of two Bear Stearns mortgage-focused hedge funds in July 2007 set the stage for the coming global financial crisis.

By the end of February 2009, the Schwab Fundamental US Large Company Index Fund had lost more than half its value, underperforming the Schwab S&P 500 Index Fund by nearly six percentage points. Companies that were cheap in May 2007 had become considerably cheaper by February 2009, creating a sustained trend that served as a tailwind for cap weighting relative to fundamental weight.

Figure 2: 2009 started mean reversion with a vengeance

A recap of the rebound in 2009–2010



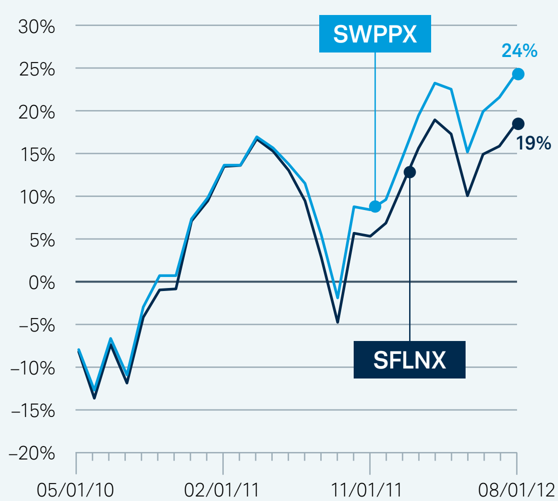
Sources: Charles Schwab Investment Management, Inc.; FactSet. Data from 03/01/09 to 04/01/10.

In the second half of what we will show to be a recurring pattern, mean reversion followed the trend, returning with a vengeance after the market bottomed in early March 2009. The rebound from the depths of 2009 was led by many of the firms that experienced the worst performance during the preceding drawdown. As a result, the Fundamental Index strategy more than doubled between the beginning of March 2009 and the end of April 2010, outpacing the market cap strategy by more than 35 percentage points in a little more than a year (see Figure 2).

Figure 3: A recurring pattern

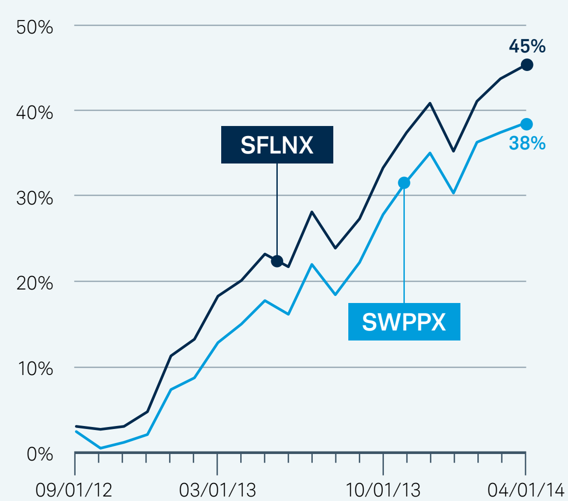
Reverting to the mean after market downturns

Figure 3A: A sharp rebound in 2012



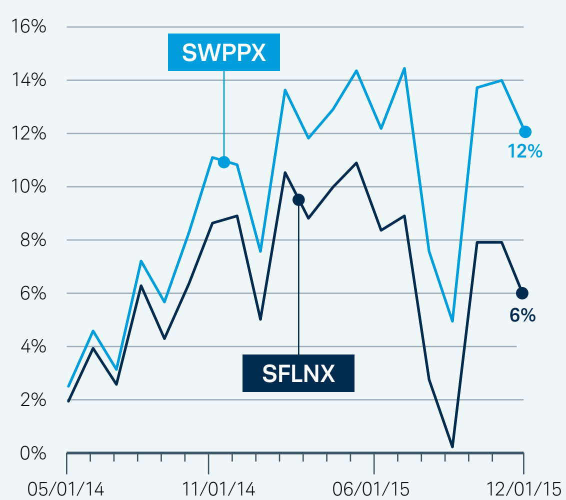
Sources: Charles Schwab Investment Management, Inc.; FactSet. Data from 05/01/10 to 08/01/12.

Figure 3B: Resuming the climb in 2014



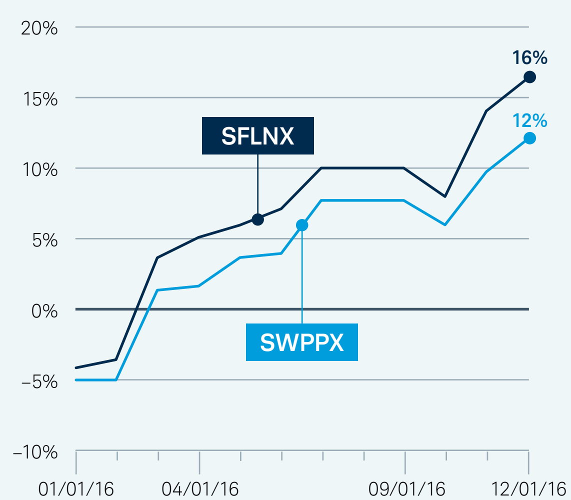
Sources: Charles Schwab Investment Management, Inc.; FactSet. Data from 09/01/12 to 04/01/14.

Figure 3C: Market capitalization weighting's outperformance



Sources: Charles Schwab Investment Management, Inc.; FactSet. Data from 05/01/14 to 12/01/15.

Figure 3D: Rising from the dip in 2016



Sources: Charles Schwab Investment Management, Inc.; FactSet. Data from 01/01/16 to 12/01/16.

This pattern of a trend followed by mean reversion repeated itself multiple times. From May 2010 through August 2012 (see Figure 3A), market capitalization weighting outpaced fundamental weighting by roughly five percentage points. Fundamental weighting then beat market capitalization weighting by roughly seven percentage points from September 2012 through April 2014 (see Figure 3B). Market capitalization weighting won by six percentage points from May 2014 through December 2015 (see Figure 3C). In calendar year 2016, fundamental weighting won by four percentage points (see Figure 3D).

Figure 4: Market cap strategies reign through the end of the decade

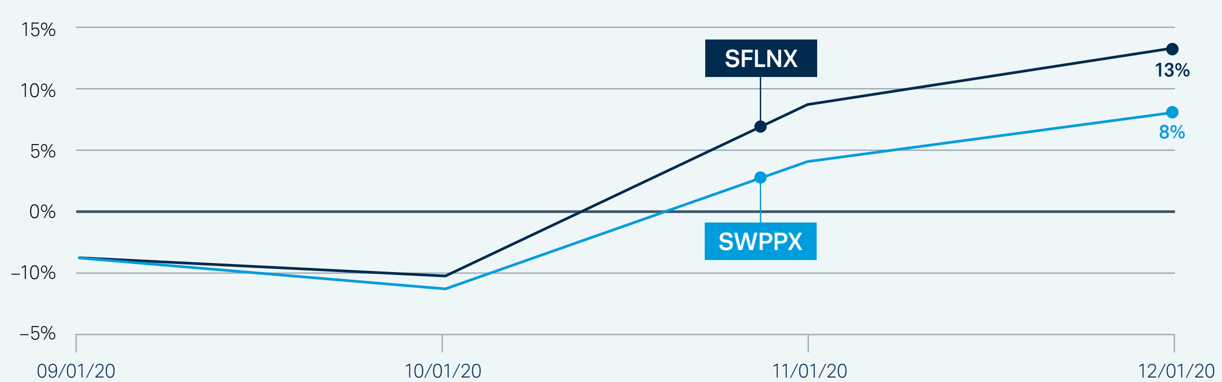
A three-year look at mean reversion

Sources: Charles Schwab Investment Management, Inc.; FactSet. Data from 01/01/17 to 07/01/20.

This brings us to the recent performance. We experienced an unprecedented trend from the beginning of 2017 through July 2020 (see Figure 4). As expensive companies such as the "FANG" stocks (Facebook, Amazon, Netflix, and Google) dominated the U.S. market, so too did the market cap-weighted index dominate the fundamentally weighted index, outperforming by 33 percentage points.

Figure 5: Mean reversion is back and accelerating with hopes for an end to the pandemic

How long will fundamental weighting outpace cap weighting?



Sources: Charles Schwab Investment Management, Inc.; FactSet. Data from 09/01/20 to 12/01/20.

Mean reversion returned for the first time in years in September 2020 and accelerated in November, largely due to optimism that COVID-19 vaccines would herald a return to some semblance of normalcy and a rebound in the fortunes of the companies whose businesses have been hardest hit by the various iterations of social distancing (see Figure 5). Fundamental weighting outpaced cap weighting by five percentage points in the last four months of the year as a result.

In the absence of perfect foresight, consider a "better together" approach

Investors who believe the mean reversion we have seen over the last few months is a false start—whether due to low interest rates, concentration in profitability growth, the continued effects of COVID-19, or some combination of these and other factors—might favor an exclusive allocation to market capitalization weighting. Contrarian investors, who believe stretched valuations for recent winners signal that the trend has run its course, might favor an exclusive allocation to fundamental weighting. Given the challenge in forecasting future markets, a combination of the two may be the optimal approach.

Catalysts for turning points are often challenging to identify even after they have occurred. Tech stocks were expensive well before March 2000. Why did that specific month become the peak? The housing market was inflated well before July 2007. Who knew in advance that mortgages would show meaningful signs of problems that month and that the subsequent downturn in equity markets would not meaningfully accelerate until September 2008 before bottoming in March 2009? Was September 2020 the end of another trend, or was the mean reversion we experienced at the end of the year just a pause before the most recent trend continues?

While we know the trend that began in 2017 will eventually end, just as all trends before it have ended, we don't know why and we don't know when. A combination of market capitalization and fundamental weighting provides a potential allocation solution in the absence of perfect foresight.

Charles Schwab Investment Management

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