Update on MSCI Equal Weighted Indices

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Introduction

Market capitalization weighted benchmarks are used for different purposes in the investment process, such as research, asset allocation, performance benchmarking, and the creation of investment products. Over the course of time, capitalization weighted indices have become the predominant choice for passive investing and the basis for active portfolio construction.

Some investors argue that the risk of a market capitalization weighted benchmark is not limited to volatility, but also includes other dimensions, such as high concentration, and excess volatility due to pricing inefficiency. Some investors suggest that removing the influence of prices from index weighting schemes could address the issues associated with capitalization weighted benchmarks. Historically, equal weighting has been one such approach.

The MSCI Equal Weighted Indices offer an alternative to market capitalization weighted indices. In the MSCI Equal Weighted Indices, each security is weighted equally at the quarterly index rebalancing. Weights may fluctuate between rebalancings based on the performance of each security. This alternative weighting methodology removes the influence of prices from the market capitalization weighting scheme at each index rebalancing. Some investors suggest that equal weighted portfolios may provide a potential way for earning the small cap premium and avoiding the “bubble traps” or pricing inefficiencies in security prices.

In this Research Bulletin we look at the characteristics of equal weighted indices and compare them to market capitalization weighted indices.

Characteristics of an Equal Weighted Index

In an equal weighted index, each security is assigned the same weight on the index rebalancing date. Between index rebalancings the weight of the securities will deviate based on their performance.

Exhibit 1 provides a performance comparison of the MSCI World Equal Weighted Index with the MSCI World Index, which is market capitalization weighted. During the period from December 31, 1998 to October 31, 2010, the MSCI World Equal Weighted Index outperformed the market capitalization weighted MSCI World Index by 4.7% annually. Similar outperformance can be seen in other regional MSCI indices. Exhibit 2 provides the annualized index risk and return for those equal and capitalization-weighted regional MSCI indices. The MSCI Emerging Markets Equal Weighted Index, which outperformed the MSCI Emerging Markets Index during this period, had comparable risk levels to the market capitalization weighted MSCI Emerging Markets Index.

Exhibit 1: USD Cumulative Return - MSCI World and MSCI World Equal Weighted Indices (December 1998 to October 2010).

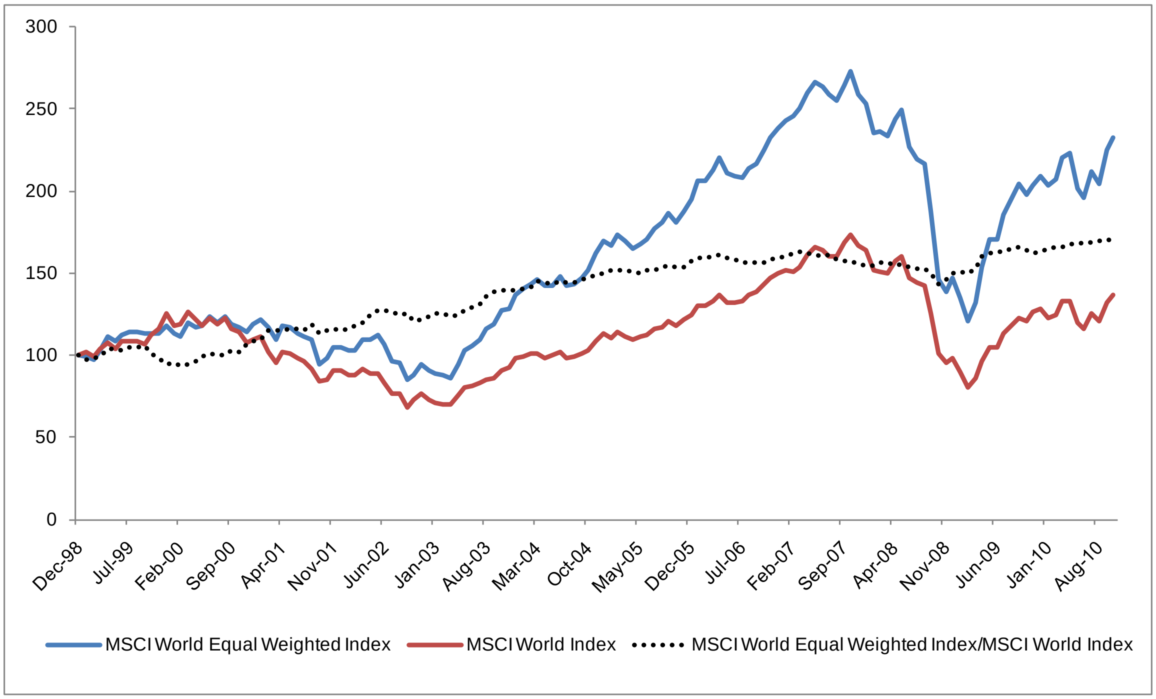


Exhibit 2: Annualized Risk and Return - MSCI Capitalization Weighted and MSCI Equal Weighted Total Return Indices (December 1998 to October 2010).

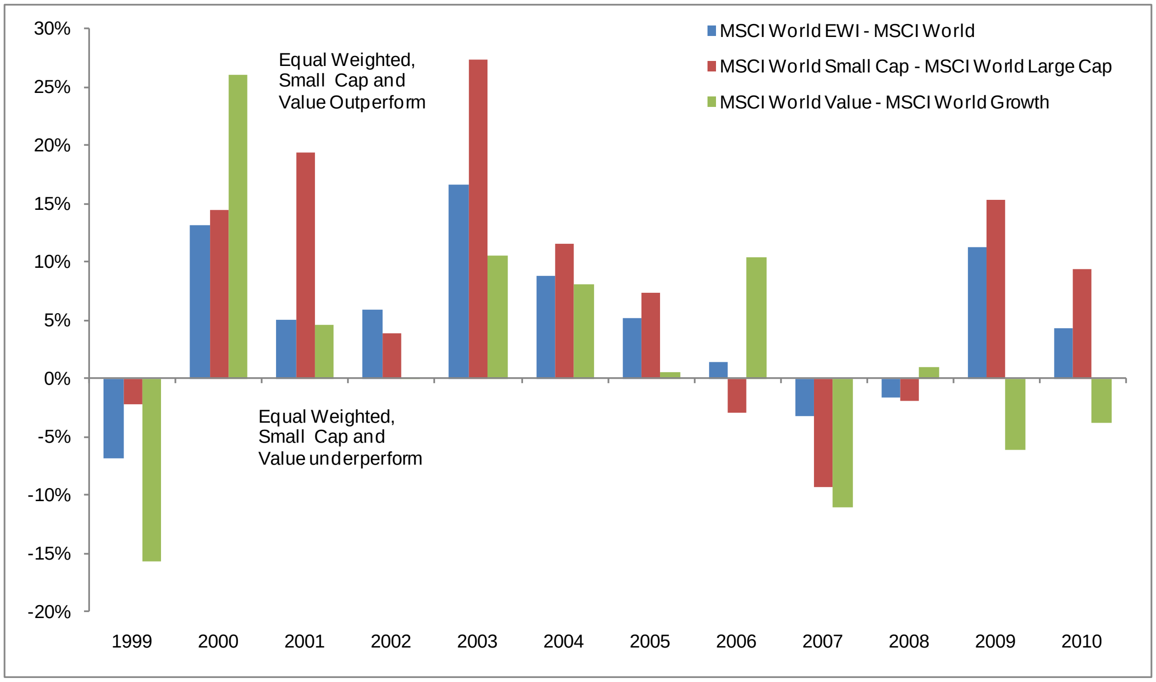
	Return	Risk[1]	Return/Risk
MSCI World	2.7%	16.6%	0.16
MSCI World EWI	7.4%	18.0%	0.41
MSCI EAFE	3.9%	17.8%	0.22
MSCI EAFE EWI	7.7%	18.6%	0.41
MSCI Emerging Markets	14.5%	24.6%	0.59
MSCI Emerging Markets EWI	17.2%	24.6%	0.70
MSCI ACWI	3.5%	17.0%	0.20
MSCI ACWI EWI	10.6%	19.5%	0.54

Note 1: Annualized standard deviation of monthly returns.
Note 2: EAFE stands for Europe, Asia and Far East. ACWI stands for All Country World Index. EWI stands for Equal Weighted Index.

Value and Small Cap Tilt

An equal weighted index provides a tilt towards small cap and value, two prominent sources of equity risk premia that have been well documented in finance literature. As seen from Exhibit 3, during the periods when the MSCI World Small Cap Index and the MSCI World Value Index generally outperformed / underperformed the MSCI World Large Cap Index and the MSCI World Growth Index, respectively, the MSCI World Equal Weighted Index outperformed / underperformed the MSCI World Index.

Exhibit 3: Annual Performance Difference - MSCI World Equal Weighted Index vs. MSCI World Index, MSCI World Small Cap Index vs. MSCI World Large Cap Index, and MSCI Value Index vs. MSCI Growth Index (except for 2010, which is year-to-date difference).



Stable Sector Weights

In an equal weighted index, the capitalization of the firms does not affect the sector weights. Instead, the number of firms in each sector will determine the sector weights in the index. Sectors that are well diversified will be overweighted and sectors that are concentrated will lose weight. Figure 4 provides the average historical difference of sector weights in the MSCI World Equal Weighted Index relative to the capitalization weighted MSCI World Index. During the observed period, Industrials, Consumer Discretionary, and Materials sectors were overweighted in the MSCI World Equal Weighted Index, and Health Care, Energy and Financials sectors were underweighted. Exhibit 5 also shows that during the observed period the MSCI World Equal Weighted Index shows low variability in sector weights.

Exhibit 4: Average of Sector Weights Difference - MSCI World Equal Weighted Index vs. MSCI World Index (December 1998 to October 2010).

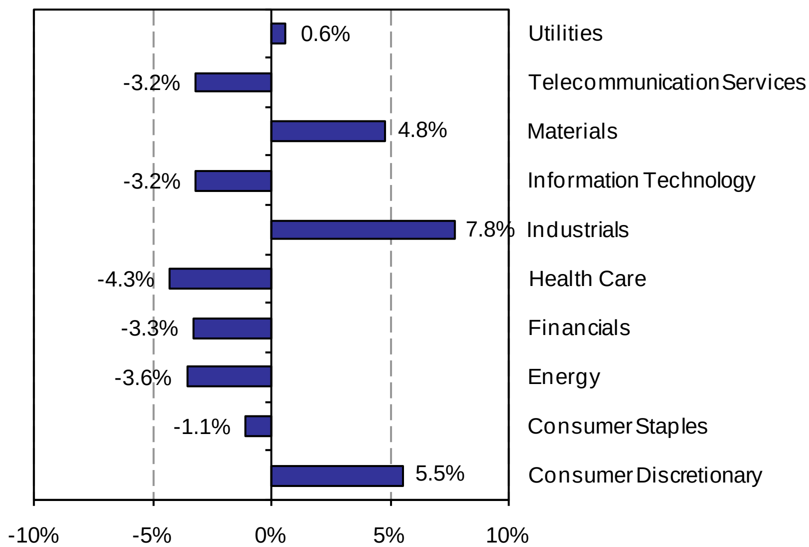
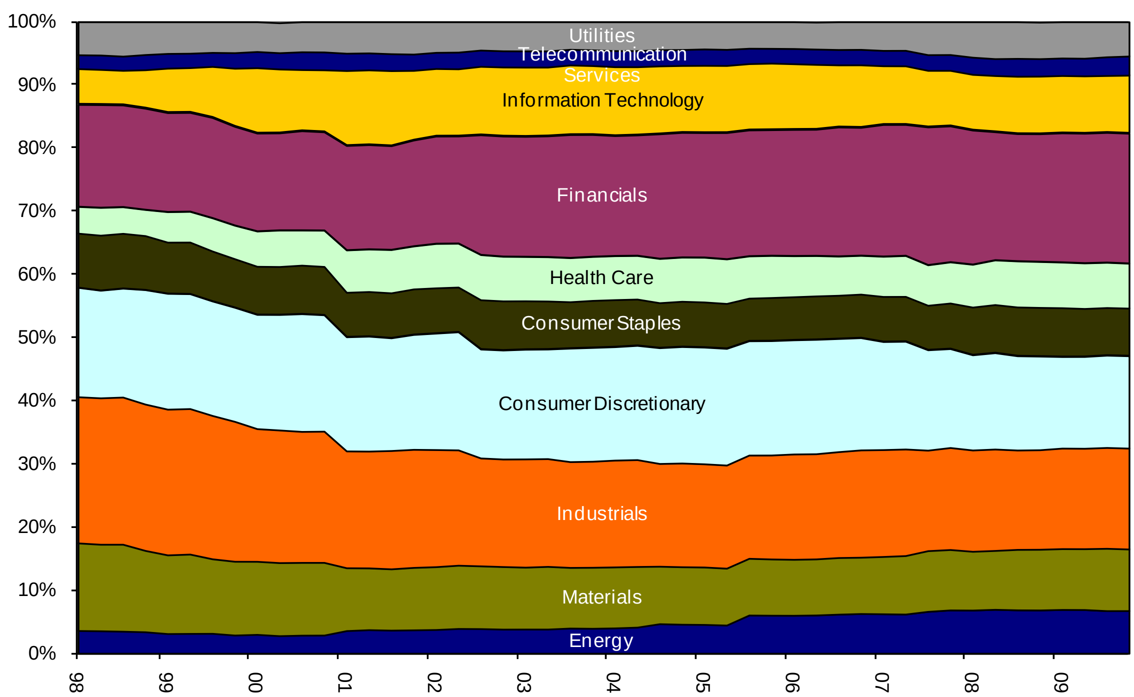


Exhibit 5: Sector Weights - MSCI World Equal Weighted Index (December 1998 to October 2010).



Lower Index Concentration

Exhibit 6 shows the concentration level of select equal and capitalization weighted regional indices by aggregating the weights of the ten largest index constituents, highlighting the top-heavy characteristic of a capitalization weighted scheme.

Exhibit 6: Concentration in the Top Ten Securities of Select MSCI Capitalization Weighted and MSCI Equal Weighted Indices.

Index	Sum of Largest 10 Weights
MSCI World	9.0%
MSCI World EWI	0.6%
MSCI EAFE	12.6%
MSCI EAFE EWI	1.0%
MSCI Emerging Markets	15.6%
MSCI Emerging Markets EWI	1.3%
MSCI ACWI	7.8%
MSCI ACWI EWI	0.4%

Data as of October 31, 2010

Additionally, exhibit 7 highlights the decrease in country weights for larger weight countries achieved in the MSCI World Equal Weighted Index relative to the capitalization weighted MSCI World Index.

Exhibit 7: Country Weight Difference - MSCI World Index vs. MSCI World Equal Weighted Index.

Country	Weight in MSCI World Index	Weight in MSCI World Equal Weighted Index	Difference (EWI- MC)
USA	48.6%	35.8%	-12.8%
UNITED KINGDOM	10.0%	6.3%	-3.7%
JAPAN	9.6%	20.5%	10.9%
CANADA	5.0%	5.9%	0.9%
FRANCE	4.8%	4.7%	-0.1%
AUSTRALIA	4.0%	4.4%	0.4%
GERMANY	3.8%	3.0%	-0.8%
SWITZERLAND	3.6%	2.2%	-1.4%
SPAIN	1.8%	1.7%	-0.1%
SWEDEN	1.4%	2.0%	0.6%
ITALY	1.4%	1.8%	0.4%
HONG KONG	1.2%	2.4%	1.2%
NETHERLANDS	1.2%	1.3%	0.1%
SINGAPORE	0.8%	1.8%	1.0%
FINLAND	0.5%	1.0%	0.5%
DENMARK	0.5%	0.7%	0.2%
BELGIUM	0.5%	0.8%	0.3%
NORWAY	0.4%	0.5%	0.2%
ISRAEL	0.4%	1.0%	0.6%
AUSTRIA	0.2%	0.5%	0.3%
GREECE	0.2%	0.5%	0.4%
PORTUGAL	0.1%	0.5%	0.4%
IRELAND	0.1%	0.3%	0.2%
NEW ZEALAND	0.0%	0.3%	0.3%

Data as of October 31, 2010

Other Considerations

Relative to a market capitalization weighted index, an equal weighted index will have lower investment capacity for institutional investors due to its small cap bias and higher turnover (the index will be rebalanced back to equal weighting at every index rebalancing cycle[1]). Additionally, the largest companies (by free-float adjusted market capitalization) in the capitalization weighted index will have considerably smaller weights in the equal weighted index[2].

[1] Over the period from 2001 to 2009, the average annual one-way index turnover for the MSCI World Equal Weighted Index was 31.8% compared to an average annual one-way index turnover of 4.6% for the MSCI World Index.
[2] For example, the weight of Exxon Mobil Corp. in the MSCI World Equal Weighted Index is around 0.06% compared to its weight of 1.54% in the MSCI World Index, as of November 30, 2010.

Conclusion

This paper illustrates the effect of equal weighting an index relative to a capitalization weighted index. An equal weighted index exhibits a small cap and value tilt, lower index concentration, and more stable sector weights. However, an equal weighted index has higher index turnover and lower investment capacity relative to a capitalization weighted index. Over the last twelve years (December 1998 to October 2010) the MSCI Equal Weighted Indices outperformed their capitalization weighted counterparts in the major countries and regions analyzed. This outperformance appears to be mainly driven by the small cap and value tilt, which are well-documented sources of excess return in financial literature.

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