Investment Ideas
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Xtrackers by DWS

# Factor-Based Investment Strategies: Avoid the Market Cap Trap


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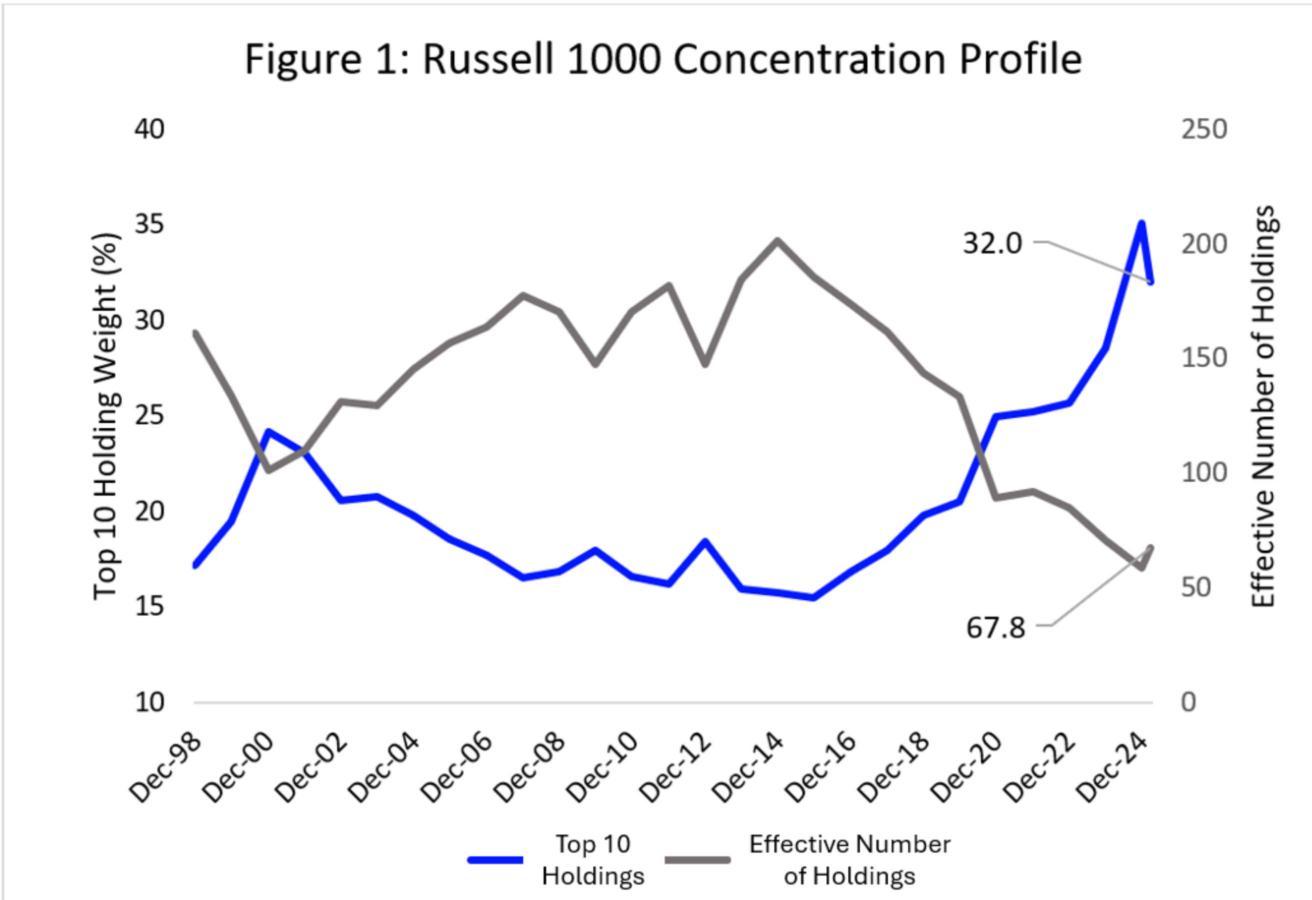
## IN A NUTSHELL

- From a historical perspective, an equal-weight approach to investing may be a sub-optimal method to mitigating portfolio concentration risk.
- Equal-weight strategies have experienced substantial underperformance, generated high transaction costs, and created significant factor under- and overexposures.
- A comprehensive, factor-based investment methodology has the potential to create better risk-adjusted investment outcomes.

## The Market Cap Problem

Even with the recent market pullback of the Magnificent Seven's historical weighting in large-cap indices, concentration risk remains a leading concern for investors. While only representing 0.7% of the names in the Russell 1000, these stocks account for nearly 27.1% of the Index's total market capitalization and 34.4% of its total risk as of April 30th, 2025. This presents a dilemma for investors seeking to diversify their portfolio exposure away from a narrow sleeve of primarily technology-oriented companies (Figure 1).




Source: FTSE Russell Data, timeseries through 3/31/2025.

Historically, some Russell 1000 investors have chosen an equal-weighted strategy to mitigate large cap portfolio concentration risk, where each name in the Index is assigned a 0.1% weighting. As of April 30th, 2025, this methodology translates into the largest company by market cap in the Index (Apple at approximately 6.13%) having the same weighting as the smallest company (Seaport Entertainment Group at 0.0003%) despite the 20,000-fold differential in size.

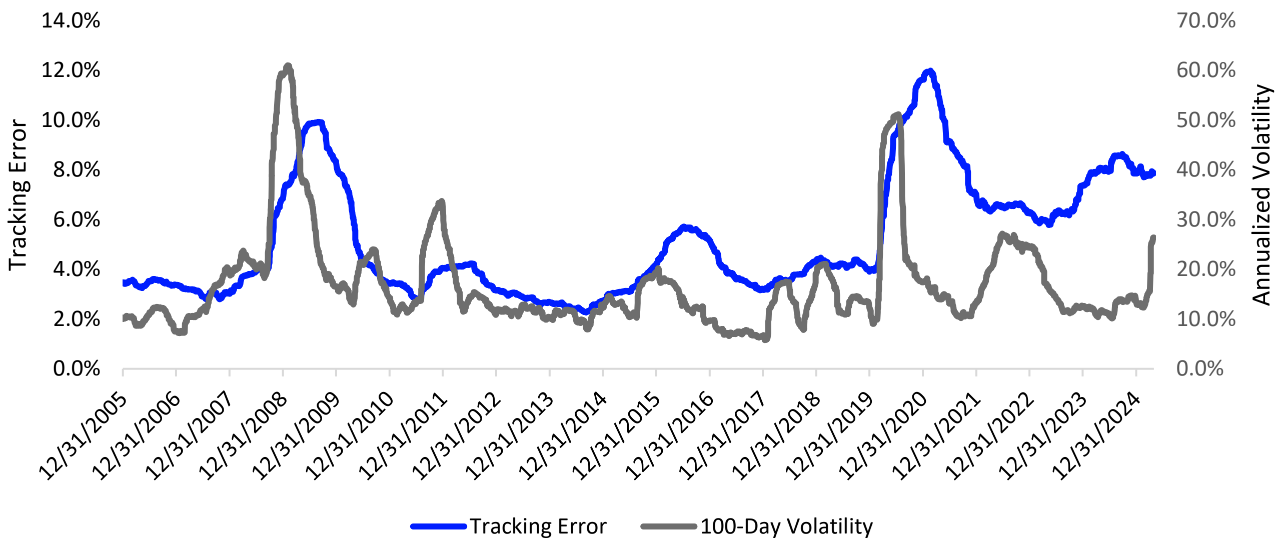
While this strategy reduces the concentration risk that investors have been increasingly concerned about, this default alternative has the potential to create extreme and undesirable results.

**An equal-weight approach to solve for the portfolio concentration problem no longer serves as a substitute benchmark for a cap-weighted strategy, but it in fact becomes an aggressively active strategy.**

## Equal Weight is Expensive

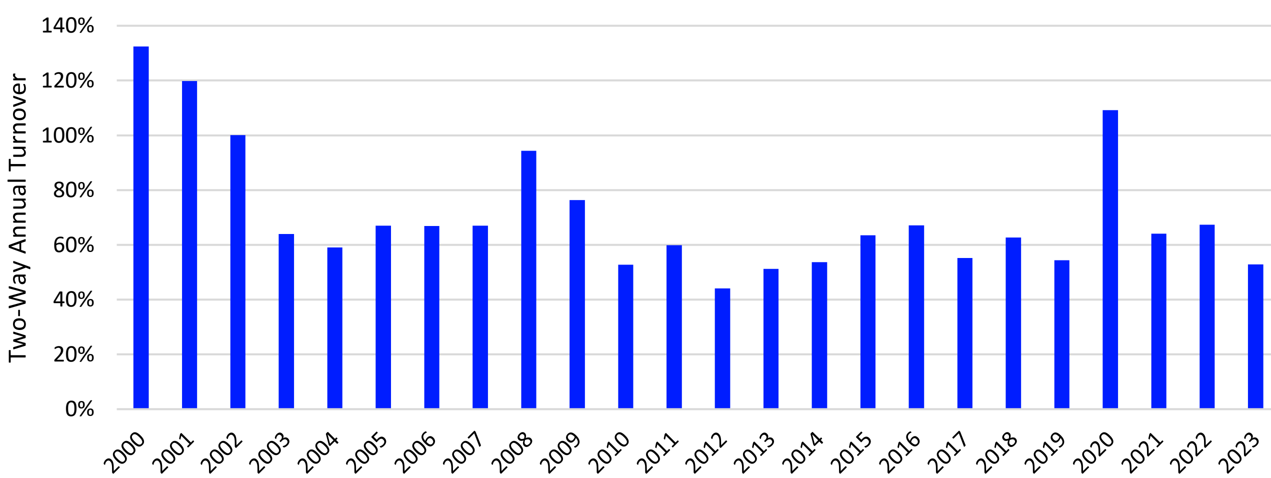
As market concentration heightens, tracking error and trading costs become increasingly substantial in maintaining equalized holdings. The trading costs of maintaining an equal-weight strategy are very high (and variable), with two-way turnover averaging 71.0% per year since 2000 (Figure 2 and 3).

Figure 2: Russell 1000 Equal Weight Tracking Error




Source: FTSE Russell Data, timeseries through 4/30/2025.

Figure 3: Russell 1000 Equal Weight Turnover

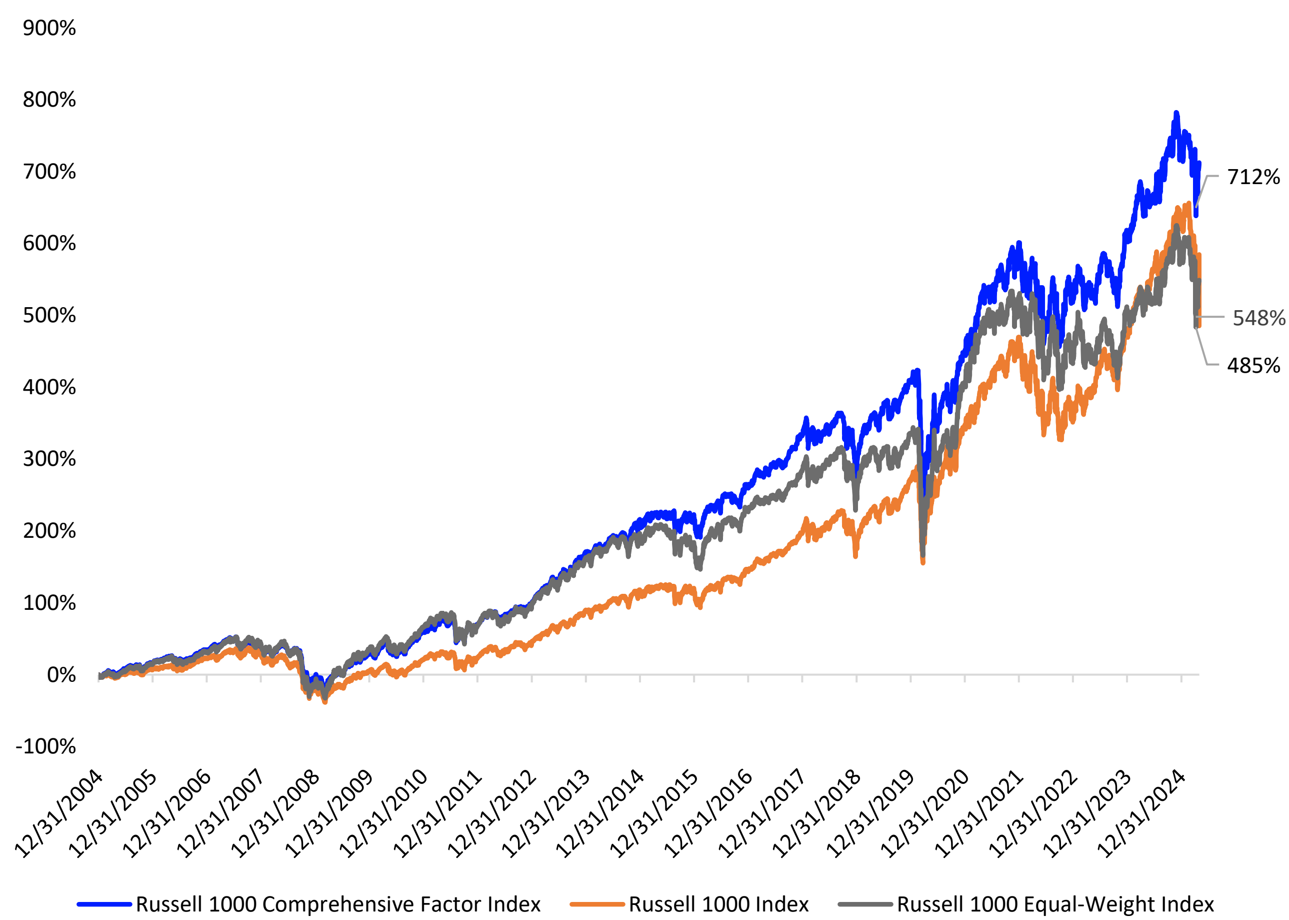



Source: FTSE Russell Data, May 2025.

## Equal Weight Has Underperformed

The mega-cap stocks did not grow stratospherically by performing poorly. Equal weighted returns have suffered tremendously when compared to both cap-weighted and factor-based strategies. Between Q4 2014 and Q1 2025, the Russell 1000 Equal Weight Index underperformed the cap-weighted Russell 1000 Index by over 3.89% annually, and this underperformance has occurred in nearly every market condition.  Meanwhile, the Russell 1000 Comprehensive Factor Index outperformed the former benchmark by 1.91% annualized over the same period (Figure 4).

Figure 4: Long-Term Cummulative Returns: 2004-2025




Source: FTSE Russell Data, timeseries through 4/30/2025. Past performance is no guarantee of future returns. One cannot invest directly in an index.

## Equal Weight Can Create Distorted Exposures

Holding stocks in equal measure seems appealing at first glance, but this company agnosticism leads to very uneven portfolio construction, creating risk profiles notoriously subject to fluctuations. While an equal weighting produces a moderate skew towards value and away from momentum, it also significantly underweights quality and low volatility. Additionally, an equal weight strategy produces such a large allocation to the small size factor that it drowns out all other portfolio risk characteristics. While equal weighting would suggest a steady blend of equity exposures, it actually presents a convoluted – and unstable – assortment of risk factors.

## Why a Factor-Based Approach?

The U.S. large cap ecosystems can pose a problematic exposure for investors from a risk, diversification and even a regulatory perspective. From 2015 through the end of Q1 2025, the weight of the Top 10 names in the Russell 1000 exploded over 106%, to 32.0%. Portfolio breadth has decreased, with the whole Russell 1000 Index offering an effective diversification of only 68 stocks.

# The Xtrackers Russell US Multifactor ETF (DEUS): A Balanced Large Cap Exposure Approach for an Unbalanced Market

Since 2019, Xtrackers has partnered with FTSE Russell to apply the powerful and robust Comprehensive Factor methodology to one of the most recognized U.S. indices. The Russell 1000 accounts for about 93% of the Russell 3000, creating a comprehensive representation of the U.S. equity market.[1]

## Factor Investing Basics

Factor investing is a strategy that forecasts future returns based on their exposure to macroeconomic or other factors, and the prediction of those factor variables. Many investors are familiar with factors on some level, with the most well-known being beta, or exposure to systematic equity market risk. DEUS seeks investment results that correspond to the **Russell 1000 Comprehensive Factor Index**, which is designed to capture exposure to the five well-established investment factors – *Quality, Value, Momentum, Low Volatility, and Size.*

- **Quality:** Companies that exhibit low debt, stable earnings, and consistent growth.
- **Value:** The belief that relatively undervalued companies will outperform overvalued companies.
- **Momentum:** The concept that stocks that have had a recent history of appreciation will continue on this trajectory.
- **Low Volatility:** The evidence shows that the stocks with the lowest volatility can also exhibit the highest risk-adjusted returns.
- **Size:** Small-cap companies have tended to have greater returns than large-cap stocks.

The FTSE Russell factor construction methodology defines each of these factors with multiple inputs, ensuring that measurements remain robust throughout the market cycle. Quality, for example, is defined by debt coverage and profitability, which in turn is defined as a composite of three sub-factors (Accruals, Return on Assets and Change in Turnover).

Source: FTSE Russell as of 12/31/2024

## The DEUS Approach

The **Xtrackers Russell Multifactor ETF (DEUS)** combines all five factors with the objective of improving risk-adjusted returns over the long term. The prevailing academic evidence suggests that these are some of the most relevant drivers of equity returns. The Russell methodology as utilized in DEUS uses these five factors to capture those potential extra returns, utilizing a straightforward approach.  Each company's factor scores (which represent a company's exposure to the five previously mentioned factors) are a direct multiplier to their market cap weights— resulting in stocks that can be over- or underweighted by the model.  Moreover, the strategy selects companies that have high scores across the five factors, rather than blending together separate factor portfolios. This combined factor integration sees holdings with high scores increased up to 20 times in weight, or subject to elimination if their scores are sufficiently low.

This multifactor approach also recognizes that, despite all of them historically having boosted returns over the very long run, there will be periods when individual factors underperform. Factors, like stocks, are difficult to time: not every factor always works all the time, in all market environments. There will be periods when some, or all, underperform – that's to be expected. What is important to remember is that over time, they all have been long-term drivers of risk-adjusted returns, and their low inter-correlation makes combining them a potentially attractive strategy.

## An Alternative to Equal-Weight Investing

**The Xtrackers Russell US Multifactor ETF (DEUS)** seeks to address all of the previously addressed shortcomings inherent in an equal-weight investment approach. Indeed, when investors are considering equal-weight as an alternative market cap exposure, equal-factor may be a more data-driven choice.

Since its inception in 2019, DEUS has offered investors a quantitative, rules-based approach designed to mitigate portfolio concentration risk.

## Conclusion

The **Xtrackers Russell US Multifactor ETF (DEUS)** is a comprehensive, rules-based strategy designed to capture exposure to five factors – Quality, Value, Momentum, Low Volatility and Size, designed to offer diversified exposure to U.S. large cap equities. Many of the largest companies dominating equity risk exposure have shockingly poor factor characteristics, and DEUS may serve as a corrective to these lopsided portfolio constructions. If looking to go beyond the inherent concentration to market cap strategies, DEUS with its 6-year live track record may offer a compelling option for informed diversification.

## Glossary

Beta: A measure of how a stock's price moves with the market.

Concentration risk: The potential for financial loss due to an overexposure to a single counterparty, sector, or geographic region.

Equal weight investing: A strategy that allocates the same amount of capital to each asset within a portfolio, regardless of the asset's market capitalization.

Factor Investing: A strategy that involves targeting specific drivers of investment return across asset classes.

Low Volatility: The evidence shows that the stocks with the lowest volatility can also exhibit the highest risk-adjusted returns.

Magnificent Seven: Refers to a group of seven dominant companies, primarily in the tech sector, that play a significant role in shaping the stock market. The companies are Alphabet, Amazon, Apple, Meta Platforms, Microsoft, Nvidia, and Tesla.

Mega Cap Stocks: The largest companies in the investment universe as measured by market capitalization, usually over $200 billion.

Momentum: The concept that stocks that have had a recent history of appreciation will continue on this trajectory.

Quality: Companies that exhibit low debt, stable earnings, and consistent growth.

Risk adjusted return: The calculation of the profit or potential profit from an investment that considers the degree of risk that must be accepted to achieve it.

Russell 1000 Index: A key market benchmark representing the largest 1000 U.S. companies by market capitalization.

Russell 1000 Comprehensive Factor Index: A benchmark designed to capture exposure to five factors: Quality, Momentum, Value, Low Volatility, and Size, of the largest 1000 U.S. companies by market capitalization.

Russell 1000 Equal Weight Index: Composed of securities in the Russell 1000 Index and is equally weighted across nine sector groups, with each security within the sector receiving equal weight.

Russell 3000 Index: A capitalization-weighted stock market index that serves as a benchmark for the entire U.S. stock market. It measures the performance of the 3,000 largest publicly held companies in America.

Size: Small-cap companies have tended to have greater returns than large-cap stocks.

Tracking error: The difference in performance between a portfolio and its corresponding benchmark.

Trading costs: Various expenses incurred when buying and selling securities.

Value: The belief that relatively undervalued companies will outperform overvalued companies.

fund may diverge from that of an underlying index due to operating expenses, transaction costs, cash flows, use of sampling strategies or operational inefficiencies. There are additional risks associated with investing in high-yield bonds, aggressive growth stocks, non-diversified/concentrated funds and small- and mid-cap stocks which are more fully explained in the prospectuses, as applicable. An investment in any fund should be considered only as a supplement to a complete investment program for those investors willing to accept the risks associated with that fund. Please read the applicable prospectus for more information.

DEUS: Because the fund seeks to provide exposure to stocks based on the following multifactors – value, momentum, quality, low volatility and size – it is expected exposure to such investment factors will detract from performance in some market environments, as more fully explained in the fund's prospectus.

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