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When Billions Move: The Nasdaq-100® Index Special Rebalance

Stephanie Hill | Head of Index

The Nasdaq-100 methodology stipulates that a "special rebalance" can be conducted to address issues like overconcentration within the index.

- What is a special rebalance?
- What triggered the latest one?
- What does it ultimately mean for investors and the index?

Rebalancing Rules and Index Diversification

The Nasdaq-100 Index is a market-capitalization-weighted index and includes 100 of the largest domestic and international Nasdaq-listed companies, excluding financial companies. This benchmark is utilized in numerous financial products around the world, including exchange-traded funds (ETFs), mutual funds, annuity funds, and futures and options.

It's important to understand that benchmark providers are responsible for making sure the composition of an index adequately reflects its stated methodology, so regular rebalances happen in all benchmarks and are important to ensure proper diversification.

The Nasdaq-100 Index is typically reconstituted annually in December, with additional rebalancing opportunities each quarter. Standard index rebalance changes become effective after the close of trading on the third Friday in March, June, September and December. However, Nasdaq-100 Index rules also include the provision that a special rebalance can be triggered at any time if the cumulative weight of the companies with at least 4.5% weight in the index exceed 48% of the total weight of the index.

A Rare but Appropriate Occurrence

On July 24, the index underwent a special rebalance that redistributed the weights across existing member companies. This rebalance was a rare event for the benchmark, as it is only the third special rebalance in the history of the Nasdaq-100 Index, with the last two occurring in 1998 and 2011.[1] The latest adjustment did not result in the removal or addition of any securities. It was based on the index securities and shares outstanding as of July 3.

One of the underlying reasons behind a special rebalance is the need to re-allocate weights so the index does not trigger US concentration rules for funds or ETFs that track the benchmark.

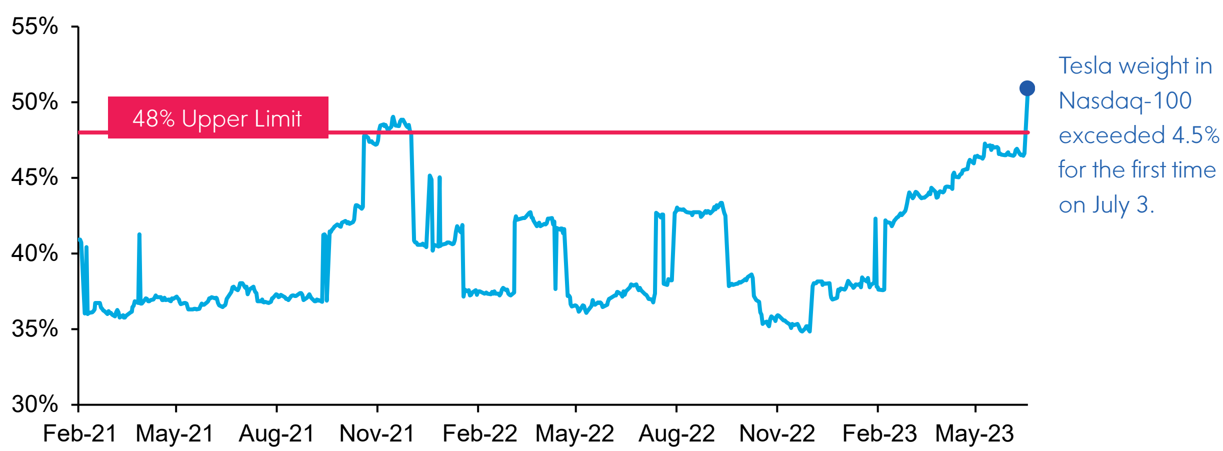
A special rebalance is a rare occurrence, but we consider it appropriate given the increasing concentration of a small number of securities in the Nasdaq-100.

Top Stocks Prompt Adjustment

After Tesla's recent price surge in late June, it joined seven securities ("The Magnificent 7") that each had more than a 4.5% weight in the benchmark in early July. The other securities that exceeded the 4.5% weight are Alphabet (Class A and C), Amazon, Apple, Meta, Microsoft and Nvidia. The addition of Tesla to this group pushed the combined weight of the now "Great 8" over 50%, as shown in the chart below. The sector diversification of the benchmark as of June 30 also highlights the significant weight to Information Technology companies, as shown in the chart on the following page.

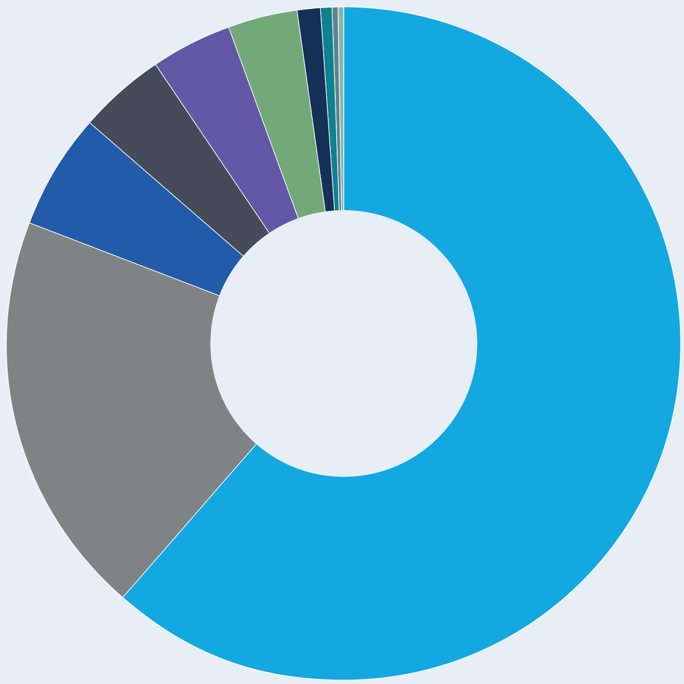
While a combined-weight breach also happened for a brief time in late 2021, Nasdaq did not choose to hold a special rebalance at that time, and a short while later, the combined weights trended downward. The July 24 rebalance was different, most likely triggered because the collective combined weight went over the 50% mark.

Cumulative Weight in the Nasdaq-100 of Names with Total Weight Greater than 4.5%



Source: Instinet, Nasdaq.

Nasdaq-100 Sector Allocation



Sector	Allocation
Information Technology	61.65%
Consumer Discretionary	19.32%
Health Care	5.67%
Communication Services	4.03%
Industrials	3.86%
Consumer Staples	3.50%
Utilities	0.98%
Energy	0.52%
Real Estate	0.24%
Materials	0.22%

Source: Nasdaq, as of June 30, 2023.

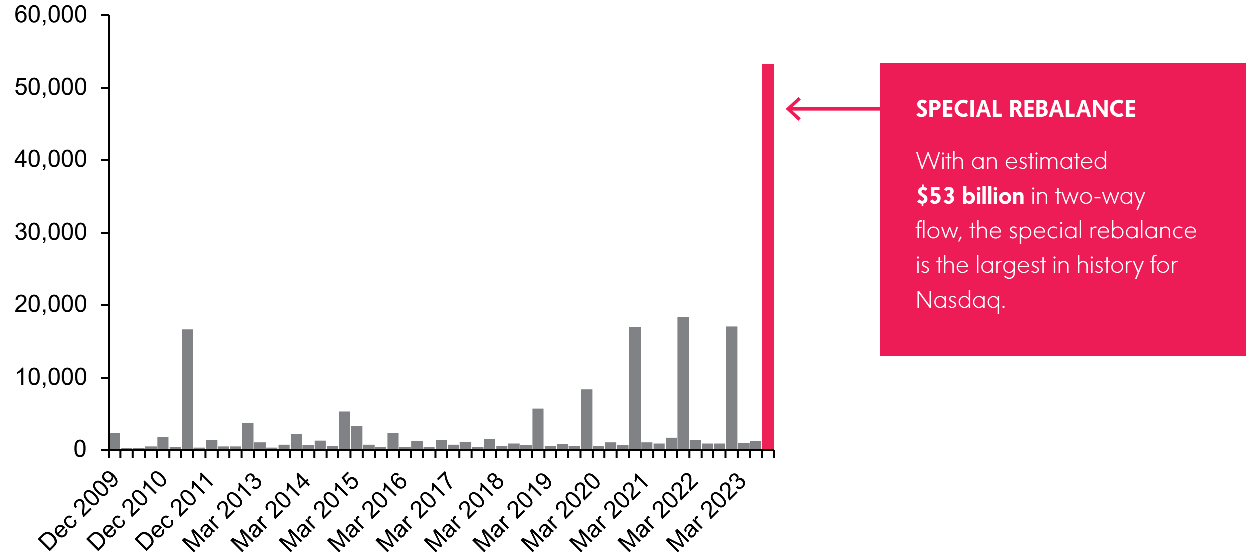
We think the crowding into the largest US mega-cap companies could be driven by investors seeking equity exposure but still nervous about the broader US economy or, alternatively, buying companies they believe are more exposed to growth or even artificial intelligence as a theme. As a result, investors have chosen to invest in mega-cap companies that could provide perceived less-risky equity returns or exposure to a growth theme. This has led to "The Great 8" driving most of the returns thus far in 2023 for large-cap indices like the S&P 500 and for mega-cap benchmarks such as the Nasdaq-100 specifically addressed in this report.

Shifting Weights to Fix Imbalances

The July 24 special rebalance sold down the eight securities with weights greater than 4.5% of the benchmark's weight so they were no longer more than 48% of the index in total and redistributed their weights across the remaining member securities of the benchmark. The estimated combined weight of these eight securities was 55%; after the rebalance, their combined weight dropped to 43%.

The latest rebalance is significant. For portfolios that track an index, the rebalance meant portfolio managers had to sell shares of companies that reduced their weight in the index and buy the weights of the stocks that have been upweighted. Overall, Nasdaq-100 Index managers traded approximately $53 billion[2] to rebalance their portfolios, for a two-way turnover of 23.6%. This appears to be the largest rebalance in the history of the Nasdaq-100.[1]

Nasdaq-100 Rebalances: Two-Way Turnover (US Dollar, Millions)



Source: Instinet, Nasdaq.

As usual for index rebalancing events, Mellon's portfolio managers and trading team worked seamlessly with the objective to trade this rebalancing in a cost-efficient manner for clients.

Marching Forward

The Nasdaq-100 Index has outperformed the S&P 500® in 2023 by more than 22% as of June 30. Most of that outperformance was driven by the eight stocks that have just been downweighted. However, as these names are pushed up, it becomes more difficult for the fundamentals of the company to match the market sentiment, so potentially a greater proportion of the performance going forward will come from the rest of the securities in the index. How this benchmark performs post-rebalance will depend on the combined performance of all the securities held.

Stephanie Hill
Head of Index

As Head of the Index business, Stephanie is responsible for managing all aspects of the index business including portfolio management, asset retention and growth, business strategy and profitability. In her role, she oversees the heads of equity and fixed income index portfolio management, working closely with them to develop index investment staff into roles of increasing responsibility.

Previously at the firm, Stephanie was responsible for co-heading the index division, focusing on business development as well as articulating Mellon's index strategies to clients and prospects. Prior to joining the firm, she was a strategic product innovator within the iShares division at BlackRock, working to design and develop new ETF products and business solutions. Prior to joining iShares, Stephanie worked as a senior institutional strategist responsible for equity index and active quantitative investments within BlackRock in San Francisco and New York. Before joining BlackRock, she held investment-focused roles of increasing responsibility at Merrill Lynch Investment Managers. Stephanie has been in the investment industry since 1999.

Stephanie earned an MFA from New York University and a BA from the University of California at Berkeley. She is a member of Women in ETFs, Renaissance Entrepreneurship Center Women's Leadership Council and FTSE Russell Global Advisory Committee. She serves on the editorial board of The Journal of Beta Investment Strategies.

Endnotes

1. Source: Nasdaq

2. Excludes leveraged strategies.

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