Nasdaq 100 Rebalance and Your Investments

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A popular and generally effective way to invest in tech growth in the USA is with an ETF that tracks the Nasdaq 100 stock index. The Nasdaq 100 index goes back to 1985 and includes biotech, transportation, retail, health care, telecommunication, media and service, and technology companies. A salient feature of this index is that a handful of stocks dominate in terms of market capitalization. Due to potential problems with the SEC over this degree of dominance, the Nasdaq 100 rebalances the weighting on stocks in the portfolio at least every year and, just this last week, in a special rebalance. We are thinking about the Nasdaq 100 rebalance and your investments.

Nasdaq 100 Is a Modified Weighted Index

The way an ETF that tracks the Nasdaq 100 works is that they need to buy and sell shares of the various stocks in the portfolio to keep it balanced. The goal in a weighted index is to allow each stock representation in the index commensurate with its market capitalization. Thus, stocks like Apple, Amazon, Microsoft, Tesla, Nvidia, and Meta make up more than 40% of the value of the index and any ETF that tracks it. Before the recent special rebalance, Microsoft made up 12.67% of the Nasdaq 100 total market cap and Apple made up 12.31%.

Why Does Nasdaq 100 Rebalance?

The Nasdaq 100 tracks the total market cap for the stocks in the index that account for more than 4.5% individually. Their total may not be more than 48% of the total index market cap. This is because of SEC rules regarding how diversified a registered investment company like an ETF needs to be. By periodically reducing the weight of the most dominant members of the index, the Nasdaq 100 allows the ETFs that track it to stay out of trouble with the SEC. The problem for investors is that this process diminishes the influence of the most profitable members of the index.

What Does Nasdaq 100 Rebalancing Mean for Investors?

Serious long term investors use tools like **intrinsic value** to guide their investments. In the case of an index like the Nasdaq it can be a bit more complicated because there are so many stocks. However, to the degree that a handful dominate the mix, an ETF that tracks the Nasdaq 100 becomes a good proxy for investing in stocks like Apple, Microsoft and Amazon directly. The fact of the matter is that as these big tech stocks grow they come to account for more and more of the Nasdaq 100 index. But periodic rebalancing keeps their representation at a lower level than their market cap and success would imply. In other words, if you invested directly in Microsoft, Apple, Amazon, Tesla, Meta, and Nvidia, your investments would grow faster than if you invested via the Nasdaq 100. When big tech is outperforming everything else in the market the rebalancing has a penalizing effect for those who invest in big tech via this route. Some may say this is a good tradeoff in that they are getting exposure to a wider variety of stocks than by investing in just the top handful. Others will note that a stocks like Amazon and Microsoft offer a great degree of diversification all by themselves due to their ranges of products and services.

Effect of Nasdaq 100 Rebalancing on the Value of the Index

The surge in big tech this year has taken the top stocks in the Nasdaq 100 to more than 50% of the total index market cap. The special rebalancing is meant to bring it down to around 40%. **Big tech's dominance** will be reduced for those who invest via this index by about 20%. On one hand the rebalancing amounts to a forced portfolio rotation. On the other hand it may be a good way to retain some of those tech surge gains if the market corrects a bit. The NASDAQ 100 ETF DR that tracks the Nasdaq 100 is up 40% for the year. In the last week of the month it is trading at the same price as at the start of the month. Meanwhile, Microsoft is up 50% for the year and up 3% since the start of the month. The point is that by diluting the weights of the winners in the Nasdaq 100 index it reduces the gains and forward looking earning potential of those who choose the index instead of investing in a handful of top tech stocks individually.

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