Elston

Elston Insights

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Sector dispersion creates a potential for alpha

- Equity markets experienced dislocation
- This increases dispersion between sectors
- Higher dispersion increases potential for sector-selection alpha

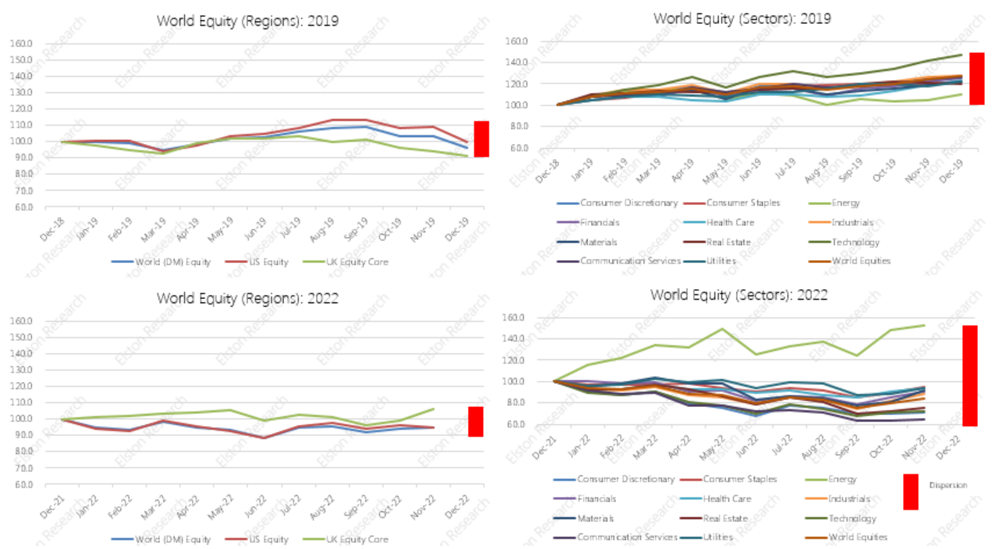
Introducing dispersion

2022 was a year of dislocation. The complex macro and market context is focused on 1) the return of geopolitical risk, 2) near-term vs long-term energy trends; and 3) how companies maintain earnings resilience in a rising interest rate and above-target inflation regime.

In the context of dislocation, different sectors will perform in different ways to adapt to the changing macro and market regime.

The range of variation in returns between different equity market sectors is referred to as sector dispersion. When there is significant sector dispersion, investors have a greater possibility to generate excess returns, or in other words: alpha. They can do so by selecting sectors that are likely to outperform the broader market.

Fig.1. Sector dispersion



The greater the sector dispersion, the more opportunities to generate alpha. As shown in the world equity regions and sectors charts, historically there was a greater opportunity to generate alpha from sectors compared to regions. Dispersion will vary with the market regime, as shown it was greater in 2022 compared to 2019. We believe this trend will continue in 2023 as well. As the charts suggest, dispersion between sectors is more pronounced than dispersion between regions.

By investing in line with market weights, a portfolio would have no variation in the sector allocation of its benchmark.

By actively over- or under-weighting specific sectors, investors have the opportunity of harnessing the specific risk-return characteristics of those sectors, potentially capturing outperforming sectors whilst avoiding underperforming ones.

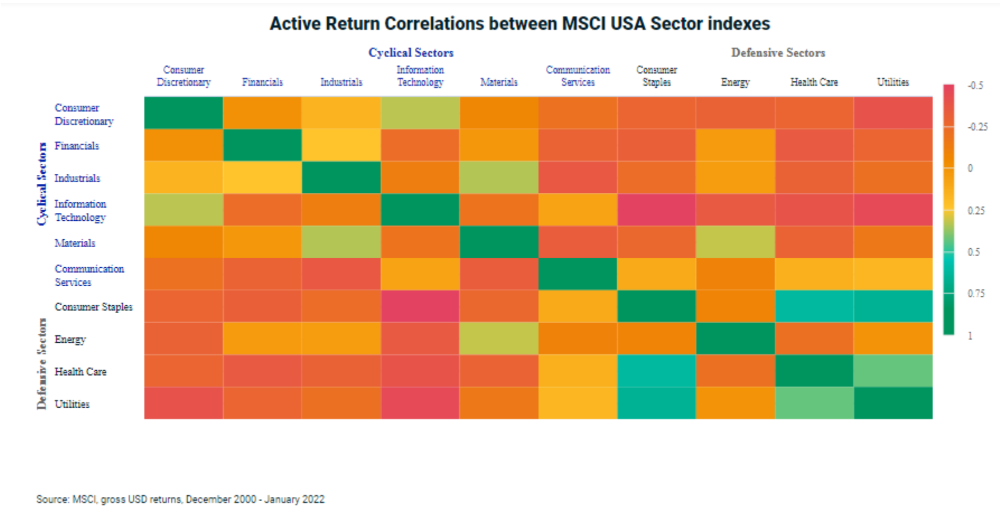
Investors should therefore do extensive study and analysis before making any investment decisions.

Focus on correlation

The term "sector correlation" describes the closeness of fit between the performance of different equity sectors. When sectors perform in a similar pattern, there is a positive correlation, which suggests that both sectors behave similarly.

For example, as shown in the "Active Return Correlations between MSCI USA Sector Indexes" chart below, shows varied correlations between different sectors. Understanding the correlation structure of sectors enables true diversification within equities and the potential for alpha.

Fig.2. Correlation between US Equity Sectors.



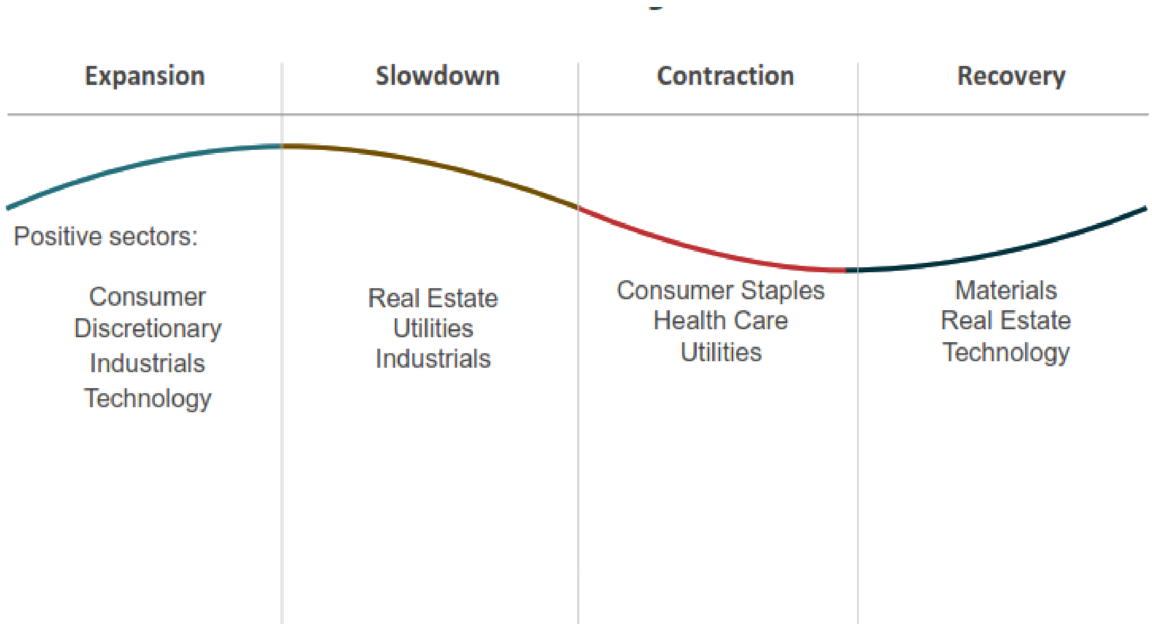
Source: https://www.msci.com/www/quick-take/changing-sectors-changing/03526045714

Sector rotation

A strategy that investors can apply as an alternative approach to traditional equity diversification is a sector rotation strategy. It involves adjusting portfolios' sector positioning based on the macroeconomic context.

This strategy seeks to increase returns by investing in industries that are anticipated to perform well in the current phase of the economic cycle and avoiding those that are believed to underperform.

Fig.3. Sectors and the economic cycle



Source: State Street Global Advisors, Based on "Asset Performance and the Business Cycle" published September 2019. Asset Performance and the Business Cycle A European Case Study published January 2021. Economic activity is determined by Conference Board's Leading Economic Index. Best-performing sectors in each regime since January 1990 based on level of excess return and consistency. The information contained above is for illustrative purposes only. It should not be construed as investment advice.

Sector selection

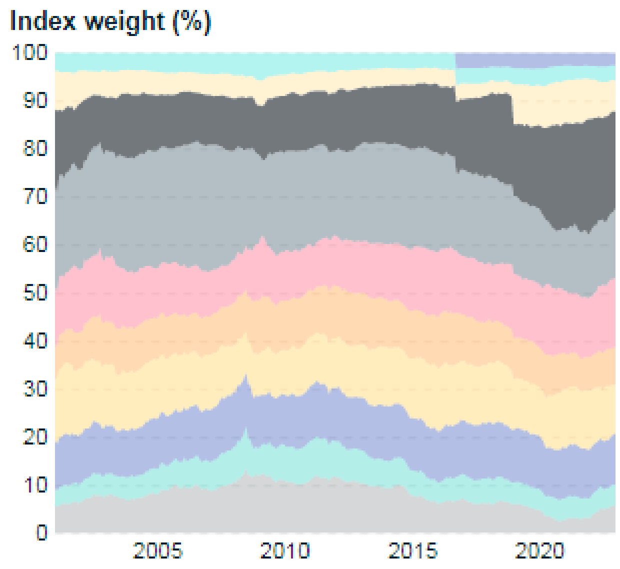
Sector selection can be accomplished using a range of criteria including price momentum strategies, macroeconomic indicators, and also by looking for improving fundamentals and through business cycles analysis. Once the analysis is done, investors can then allocate a larger share of their portfolio to the outperforming sectors and decrease their exposure to the underperforming sectors.

A sector rotation strategy is a constant process that must be reviewed and modified continuously based on investment objectives and market conditions. Moreover, a good understanding of the macro and market context is a requirement to understand the appropriate sectors for the context.

Sector concentrations

When one sector gains considerable traction (in terms of market capitalisation), there is a risk of increased sector concentration. The chart below shows the concentration of world equity sectors over time. Sector concentrations can create idiosyncratic risks, if valuations become over-extended. This was the risk facing the technology sector as highlighted in our [September 2020] and [January 2021] Insights.

Fig.4. Sector concentration over time



Information technology sector is largest by market capitalisation

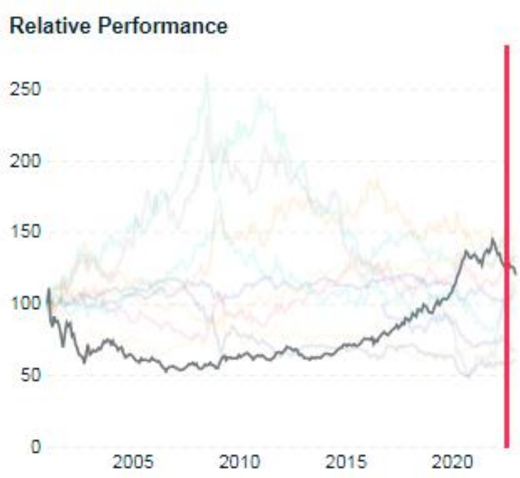
Source: https://www.msci.com/research-and-insights/insights-gallery/sector-performance-and-concentra

The charts below show the relative performance of different sectors over time relative to world equity. The first observation is the range of return patterns (dispersion) between sectors.

Also, to note how Information Technology had outperformed world equity from 2015 to 2021. Conversely, Energy had structurally underperformed since 2008, but outperformed since 2021 relative to world equities.

Fig.5. Relative performance of world equity sectors

Information Technology



Energy

Source: https://www.msci.com/research-and-insights/insights-gallery/sector-performance-and-concentra

Conclusion

All investors are sector investors, but oftentimes a portfolio's sector positioning is not immediately obvious: particularly for a portfolio constructed with regional funds.

So for investors looking to navigate sector allocations, the first step is to understand current sector exposures, secondly to consider sector positioning relative to the economic cycle and finally decide on how best to implement a portfolio closer to target allocations.

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