

## Investment INSIGHTS

# Constructing a more dynamic portfolio with equity sector allocation

**This is not your father's stock market, where traditional methods were used to allocate the stock portion of a portfolio. Enter the more refined economic sector approach.**

Employing the traditional style (growth or value) or size (large-, mega-, mid-cap) ways of allocating stocks may be like trying to cut diamonds with a club. Instead, to more precisely access and capitalize on potential market opportunities, we feel it is helpful to use the sharper instrument that is an economic sector lens. Doing so allows us to see not just asset classes overall, but to take a more granular, refined view of the economic forces that *drive* those asset classes.

**I**nvestment managers have long used style (growth or value) and market capitalization (large-cap, mid-cap, or small-cap) criteria to categorize equities in their portfolio construction process. The box below, popularized by Morningstar, has become a familiar icon to managers and investors alike. It provides categorization at a glance to determine whether a particular mutual fund, separately managed account, or other public equity investment vehicle, e.g., individual equities, exchange-traded funds (ETFs), focuses on:



- Growth**  
 Companies expected to grow at an above-average rate relative to the market
- Value**  
 Companies that are trading at a lower price relative to their fundamentals (e.g., dividends, earnings, etc.)

CONTINUED

- **Blend**  
A collection of companies that contains both growth and value companies
- **Large-cap**  
Companies with outstanding shares typically valued at over \$10 billion
- **Mid-cap**  
Companies with outstanding shares typically valued at \$1 billion–\$10 billion
- **Small-cap**  
Companies with outstanding shares typically valued at less than \$1 billion

While style and capitalization have proven useful tools for stock selection, they don't tell the whole story.

Today's growth stock can be tomorrow's value stock, depending on market conditions. And capitalization, while a less ephemeral characteristic, isn't a reliable indicator of how companies might respond to prevailing economic trends.

Sector evaluation has become an integral component of the research methodologies employed at Wilmington Trust. We believe that this analysis can enhance an investor's ability to generate the opportunity for greater risk-adjusted returns over time. Accordingly, we rely heavily on sector analysis in deploying capital in the U.S. public equity space.

### What are economic sectors?

The answer may appear to be self-evident, but in recent years, it's become a bit more complicated. Morningstar has long tracked 12 sectors, while Barron's has followed eight. In an effort to standardize categorization, Standard & Poor's spearheaded an initiative known as the Global Industry Classification Standard (GICS) that categorizes publicly owned U.S. companies by their business activities. It includes 59 industries within 10 sectors and we've grouped them into the following broader "super sector" categories:

**Cyclical** (sensitive to economic shifts, contracting and expanding along with the economy)

- **Materials**—Manufacture chemicals, building materials, and paper products; engaged in commodities exploration/processing
- **Consumer discretionary**—Retailers, auto/auto parts manufacturers, residential construction, lodging facilities, restaurants/entertainment
- **Financials**—Banks, savings and loans, asset management companies, credit services, investment brokerage firms, insurers, mortgagors, property management, and REITs

**Defensive** (reflect essential consumer needs; virtually immune to economic developments)

- **Consumer staples**—Manufacturers of food, beverages, household and personal products, packaging, or tobacco; education and training service providers
- **Healthcare**—Includes biotechnology, pharmaceuticals, research services, home healthcare, hospitals, long-term care facilities, and medical equipment and supplies
- **Telecom services**—Communication services providers (Using fixed-line networks or those that provide wireless access and services); Internet service providers (including access, navigation, and Internet-related software and services)
- **Utilities**—Electric, gas, and water utilities

**Sensitive** (in-between cyclical/defensive; not immune to or acutely affected by economic shifts)

- **Energy**—Oil/gas producers, refineries, services and equipment companies, pipeline operators
- **Industrials**—Manufacturers of machinery, hand-held tools, industrial products; aerospace and defense firms; transportation and logistic services providers

CONTINUED

**“We believe that sector analysis can enhance an investor’s ability to generate the opportunity for greater risk-adjusted returns over time.”**

- **Information technology**—Designers and developers of computer operating systems and applications; computer technology consulting service providers; manufacturers of computer equipment, data storage and networking products, semiconductors, and components

Clearly, the sectors in each super sector react to economic forces differently. For example, a tepid economy would negatively impact new construction and real estate sales, but not utilities, as consumers must continue to use electricity and water. These differences provide portfolio managers with a more precise framework from which to select their investments.

### **In favor of sector-based investing**

#### **Better identification of earnings drivers**

Oil prices plummeting, the U.S. dollar strengthening, unemployment declining, and consumer confidence increasing—examples of macro trends that would affect different sectors in different ways, driving earnings growth for some and impeding it for others. Style and market capitalization categories, on the other hand, contain companies representing multiple sectors and, as a result, they are not as useful in identifying potential beneficiaries of favorable trends as a sector-based approach.

#### **More differentiated returns**

Because each sector is a grouping that has a more clearly differentiated set of underlying earnings drivers than style and/or market capitalization criteria, it stands to

reason that sectors should also offer more differentiated returns. Over the first six months of 2015, for example, the Standard & Poor’s 500 index was up 1.2% from the beginning of the year. Various style and market capitalization groupings didn’t fare much better.

Sectors, however, offered a wider range of returns during this time period, with six in positive and four in negative territory.

**FIGURE 1**  
**Index ranges for January–June 2015**

Index	YTD return through 6/30/2015
S&P 500	1.2%
Russell 1000 Index	1.7%
Russell 1000 Value	–0.6%
Russell 1000 Growth	4.0%
Russell 2000 Index	4.8%

Sources: Factset, Bloomberg

Over the longer term, the disparity of returns among sectors has held up. As you can see from the S&P 500 returns by sector in Figure 3, performance leaders and laggards have rotated frequently during this

**FIGURE 2**  
**Russell 1000 Index by GICS Sector for January–June 2015**

Sector	YTD return through 6/30/2015
Energy	–4.3%
Materials	0.5%
Industrials	–2.3%
Consumer discretionary	6.2%
Consumer staples	–0.4%
Healthcare	10.7%
Financials	0.2%
Information technology	1.5%
Telecommunications	3.9%
Utilities	–11.0%

Sources: Standard and Poor’s, WTIA

CONTINUED

FIGURE 3

**Disparity = opportunity**  
**Annual performance of various sectors, December 2000–December 2014**

2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014
56.7	3.3	-6.4	46.2	31.2	31.3	35.5	34.5	-16.1	61.7	27.6	19.2	28.9	43.2	28.7
36.7	1.0	-6.8	37.0	24.5	16.8	24.1	21.4	-23.1	46.9	26.8	13.9	24.0	41.1	25.4
24.7	-3.2	-14.2	36.4	19.6	6.6	21.1	19.1	-29.0	41.9	22.9	12.8	17.7	40.8	20.3
16.5	-6.8	-14.9	32.8	18.6	6.3	19.7	16.2	-30.4	21.6	20.5	6.1	17.3	35.3	15.5
5.8	-8.6	-19.2	30.9	13.8	4.7	19.5	13.8	-33.3	20.0	19.3	5.6	15.3	28.7	15.2
4.6	-9.5	-22.9	26.3	10.7	3.9	18.5	11.8	-34.6	19.5	14.3	5.0	14.9	26.2	10.0
-17.1	-11.9	-25.6	24.5	10.2	2.7	14.4	11.6	-40.0	14.9	12.4	2.5	14.6	25.8	9.7
-24.0	-12.6	-26.6	16.2	8.2	-0.5	13.2	7.2	-43.0	13.8	10.3	-0.3	10.4	25.3	7.2
-38.0	-24.8	-33.6	15.4	4.6	-5.3	7.9	-13.0	-44.6	11.7	5.8	-9.5	4.8	12.6	1.9
-38.4	-30.7	-36.8	7.1	1.5	-5.3	7.4	-18.5	-55.1	7.4	3.0	-17.0	1.5	12.4	-7.8
-9.1	-11.9	-22.1	28.7	10.9	4.9	15.8	5.5	-37.0	26.5	15.1	2.1	16.0	32.4	13.7

<span style="display:inline-block; width:15px; height:15px; background-color:grey;"></span> Consumer discretionary	<span style="display:inline-block; width:15px; height:15px; background-color:green;"></span> Healthcare	<span style="display:inline-block; width:15px; height:15px; background-color:purple;"></span> Telecommunication services
<span style="display:inline-block; width:15px; height:15px; background-color:orange;"></span> Consumer staples	<span style="display:inline-block; width:15px; height:15px; background-color:blue;"></span> Industrials	<span style="display:inline-block; width:15px; height:15px; background-color:lightgreen;"></span> Utilities
<span style="display:inline-block; width:15px; height:15px; background-color:lightblue;"></span> Energy	<span style="display:inline-block; width:15px; height:15px; background-color:lightgrey;"></span> Information technology	<span style="display:inline-block; width:15px; height:15px; background-color:white;"></span> S&P 500 Index
<span style="display:inline-block; width:15px; height:15px; background-color:yellow;"></span> Financials	<span style="display:inline-block; width:15px; height:15px; background-color:lightyellow;"></span> Materials	

The chart above illustrates the dispersion of returns across economic sectors within the S&P 500 index, as identified in their Global Industry Classification Standards (GICS). The weighting of each sector within the broader index varies, from one another and over time. You'll see wide swings among sectors, most noticeably in 2000, with utilities returning 56.7%, while information technology reaped a dismal -38.4% and the S&P fell in-between the two extremes at -9.1%.

Past performance is no guarantee of future results.

Sources: Standard and Poor's, Wilmington Trust Investment Advisors

timeframe. You'll notice wide swings among sectors, most noticeably in 2000, with utilities returning 56.7%, while information technology reaped a dismal -38.4%, and the S&P was in-between the two extremes at -9.1%.

**More effective diversification**

Investors allocate their assets among various asset classes like stocks, bonds, cash, and alternatives in an effort to diversify their portfolios and achieve the maximum return at a chosen level of market risk. Equity investors generally go one step further by diversifying their equity holdings among various investment categories that typically have been based on style, market capitalization, or sectors.

The effectiveness of a diversification strategy, however, depends on whether the returns generated by the various components of a portfolio are correlated or uncorrelated. Correlated returns among various

investment categories mean they are more or less moving in lockstep. Uncorrelated returns mean that the various asset classes in which funds are invested are reacting differently to prevailing trends and performing with a greater degree of independence from one another. Investments with a greater degree of independence are less volatile when combined.

Figure 4 measures correlation among returns generated by various style and capitalization-based categories from December 31, 1991–July 31, 2015. A coefficient of 1.0 means that categories moved in perfect lockstep. The lower the coefficient, the less similarly two categories performed. As you can see, all style and capitalization categories had a coefficient of at least 0.75; in other words, they tended to perform similarly.

Now look at Figure 5, which tracks correlation among returns provided by economic sectors over the same

CONTINUED

**FIGURE 4**
**A comparison of varying market capitalization and style indices' performance** (from 12/31/1991–7/31/2015)

	Russell 1000 Large Cap	Russell 1000 Large Cap Growth	Russell 1000 Large Cap Value	Russell Mid Cap	Russell 2000 Small Cap
Russell 1000 Large Cap	1.00				
Russell 1000 Large Cap Growth	0.96	1.00			
Russell 1000 Large Cap Value	0.94	0.79	1.00		
Russell Mid Cap	0.95	0.89	0.90	1.00	
Russell 2000 Small Cap	0.82	0.79	0.75	0.92	1.00

Sources: Factset, WTIA.

**FIGURE 5**
**Correlation among returns of economic sectors** (from 12/31/1991–7/31/2015)

	Energy	Materials	Industrials	Consumer discretionary	Consumer staples	Healthcare	Financials	Information Technology	Telecommunication Services	Utilities
Energy	1.00									
Materials	0.64	1.00								
Industrials	0.58	0.83	1.00							
Consumer discretionary	0.44	0.73	0.83	1.00						
Consumer staples	0.36	0.52	0.62	0.55	1.00					
Healthcare	0.34	0.43	0.56	0.50	0.68	1.00				
Financials	0.47	0.68	0.81	0.77	0.63	0.58	1.00			
Information Technology	0.38	0.53	0.65	0.74	0.34	0.43	0.52	1.00		
Telecommunication Services	0.31	0.40	0.48	0.55	0.43	0.40	0.47	0.51	1.00	
Utilities	0.51	0.32	0.40	0.27	0.41	0.40	0.41	0.16	0.32	1.00

Sources: Factset, WTIA.

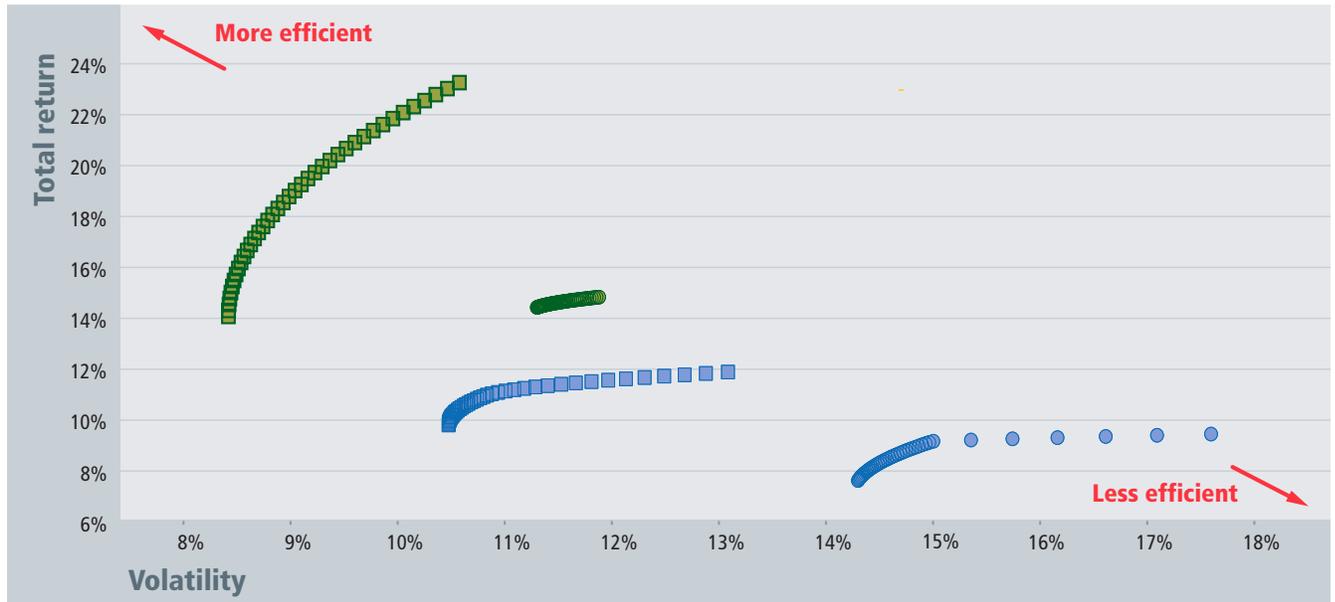
time period. With some exceptions, sector correlation coefficients were generally lower. In fact, each of the 10 sectors showed a performance correlation of below 0.50 with at least one other sector, and the overall average correlation of sectors versus one another was 0.51—

considerably lower than the 0.87 exhibited using style or capitalization criteria.

As we've seen, sectors have less correlated returns than traditional style indexes. By using a sector-based approach,

CONTINUED

**FIGURE 6**  
**Efficient frontier: U.S. equity sectors and styleboxes**



- Sectors: past 4 years
- Styles: past 4 years
- Sectors: past 10 years
- Styles: past 10 years

For periods ending 6/30/2015

Investing involves risks and you may incur a profit or a loss. Past performance is no guarantee of future results.

Sources: Factset, WTIA

an investor may be able to construct a portfolio with a better risk/return profile than can be achieved by using only style or market capitalization. In portfolio management parlance, this makes for a more “efficient” portfolio, i.e., greater return potential for a given level of risk. Figure 6 illustrates this point. We have constructed a series of efficient frontiers using historic data going back four years, covering the recent rally, and also going back 10 years. In both instances, the sector-based results produced a more efficient frontier, offering better return and lower risk versus portfolios based purely on style criteria.

**No overlap**

As mentioned above, today’s growth stock can be tomorrow’s value stock, depending on market conditions. In fact, many stocks can be found in both the growth and value indexes at the same time. For example, as of June 30th, 2015, Microsoft was listed

on both the Russell 1000 Value Index and the Russell 1000 Growth Index.

With a sector-based approach, however, distinctions among companies are far more specific. A utility, for example, will never be found in the healthcare sector, or an information technology company will not drift into materials as a result of fluctuating market conditions. This level of precision enables investment managers to construct portfolios that more accurately reflect their expectations for future returns.

**More stable volatility characteristics**

Figure 3 shows that sector returns vary widely from year to year. At first glance, this would suggest that it is futile to attempt to predict sector performance. However, as the economy cycles through periods of growth and contraction, many sectors react with a characteristic pattern. For example, the beginning of an economic cycle

CONTINUED

is often marked by increasing consumer confidence and strengthening demand for goods and credit. This creates a favorable environment for the consumer discretionary, materials, and financials sectors as the earnings of companies in these sectors benefit. In contrast, defensive sectors such as utilities and consumer staples often gain favor with investors during periods of economic contraction due to their reliable cash flows and steady dividends. In addition, some sectors have other earnings drivers that make their volatility less tightly linked to the domestic economic cycle, but these drivers are still useful in forecasting trends. For example, energy has particular sensitivity to oil prices, industrials to global growth, and information technology to sector-specific innovation and corporate capital-spending decisions.

### **More efficient portfolios**

Taking advantage of the diversified returns and uncorrelated results, we believe we can construct more efficient portfolios using sectors than we can by using growth or value style-based criteria.

### **A powerful addition to portfolio management**

The characteristics outlined above highlight sectors' enhanced suitability (relative to style and capitalization criteria) to implementation of investment insights through active management. Sectors have the right characteristics for active management because they are differentiated groups with stable characteristics and relatively low correlations.

Style and capitalization may still play a role in our investment analysis, but sectors give us an additional dimension with which to explore the investment universe and structure portfolios to better express our preferences. The specificity of sector categorization also offers the ability to diversify portfolios more effectively and manage risk while pursuing returns. Finally, the introduction of exchange-traded funds based on particular indexes has greatly enhanced investors' ability to implement sector-based strategies and alter strategies as conditions warrant. Your Investment Advisor can provide you with more information on how to incorporate our sector-based approach into your investment program.

**Disclosures**

*Wilmington Trust® is a registered service mark. Wilmington Trust Corporation is a wholly owned subsidiary of M&T Bank Corporation. Investment management and fiduciary services are provided by Wilmington Trust Company, operating in Delaware only; Wilmington Trust, N.A., a national bank; and Manufacturers and Traders Trust Company (M&T Bank), member FDIC. Wilmington Trust Investment Advisers, Inc., a subsidiary of M&T Bank, is a SEC-registered investment adviser providing investment management services to Wilmington Trust and M&T affiliates and clients.*

*The information in this commentary has been obtained from sources believed to be reliable, but its accuracy and completeness are not guaranteed. The opinions, estimates and projections constitute the judgment of Wilmington Trust and are subject to change without notice. This commentary is for information purposes only and is not intended as an offer, recommendation or solicitation for the sale of any financial product or service or as a determination that any investment strategy is suitable for a specific investor. Investors should seek financial advice regarding the suitability of any investment strategy based on the investor's objectives, financial situation and particular needs. The investments or investment strategies discussed herein may not be suitable for every investor. There is no assurance that any investment strategy will be successful. Diversification does not ensure a profit or guarantee against a loss. Past performance is no guarantee of future results.*

***Investment products are not insured by the FDIC or any other governmental agency, are not deposits of or other obligations of or guaranteed by Wilmington Trust, M&T, or any other bank or entity, and are subject to risks, including a possible loss of the principal amount invested. Some investment products may be available only to certain "qualified investors"—that is, investors who meet certain income and/or investable assets thresholds. Investing involves risk and you may incur a profit or a loss.***

**Efficient Frontier:**

*Plots the asset mixes, ranging from conservative to aggressive, that provide the best trade-off of risk and return. These "efficient" asset mixes provide (1) the maximum available assumed return for a given level of risk and (2) the minimum available level of risk for a given level of assumed return.*

**GICS, the Global Industry Classification Standard:**

*Developed in 1999 by Standard & Poor's and MSCI Barra in response to the global financial community's need for a complete, consistent set of global sector and industry definitions.*

**Russell 1000 Index:**

*Measures the performance of the 1,000 largest companies in the Russell 3000 Index, representing approximately 90% of U.S. equity market capitalization.*

**Russell 1000 Growth Index:**

*Measures the performance of those Russell 1000 Index companies with higher price-to-book ratios and higher forecasted growth values.*

**Russell 1000 Value Index:**

*Measures the performance of those Russell 1000 Index companies with lower price-to-book ratios and lower forecasted growth values.*

**Russell 2000 Index:**

*Measures the performance of the 2,000 smallest companies in the Russell 3000 Index, representing approximately 8% of U.S. equity market capitalization.*

**Russell 3000 Index:**

*Measures the performance of the 3,000 largest U.S. companies based on total market capitalization, representing approximately 98% of the investable U.S. equity market.*

**S&P 500 index:**

*Measures the performance of approximately 500 widely held, typically large-cap, common stocks listed on U.S. exchanges, as selected by Standard and Poor's.*

*Third-party trademarks and brands are the property of their respective owners.*