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TRENDS & IDEAS

NOT ALL SECTOR PORTFOLIOS ARE THE SAME

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During the recent market expansion, investors and advisors put roughly $3 billion of fresh money each month into U.S. sector ETFs regularly and that trend has continued into this year. We believe they are using sector products to make tactical decisions on what areas of the market they think will be the leaders.

S&P Capital IQ provides research and rankings on approximately 800 equity ETFs, based on a combination of proprietary holdings-based research and relevant performance and cost factor metrics. ETFs that earn a top ranking of Overweight have a number of favorable attributes in our opinion. In recent months, S&P Capital IQ has profiled a number of strategies run by ETF Asset Managers, some whom at first glance that seem like peers of one another and hold ETFs that rank favorably to us, but in reality construct quite different portfolios.

TAKEAWAY: Main Management and Wilbanks, Smith & Thomas offer different approaches to sector ETF investing.

POSITIVE IMPLICATIONS:

Financial Select Sector SPDR Fund	Overweight	[XLF]
Guggenheim S&P 500 Equal Weight Consumer Discretionary ETF	Marketweight	[RCD]
Guggenheim S&P 500 Equal Weight Financials ETF	Overweight	[RYF]
Guggenheim S&P 500 Equal Weight Technology ETF	Marketweight	[RYT]
iShares US Broker-Dealers ETF	Marketweight	[IAI]
Technology Select Sector SPDR Fund	Overweight	[XLK]

The recommendations contained in this Takeaway box are current, and may have changed since the original story was published. For full S&P Research Reports on these securities (when available), please click on the ticker and download the report.

In February 2014, we profiled Main Management's U.S. Large Cap Sector Rotation Strategy. Main starts with a top-down view on macroeconomic factors, including GDP, inflation, etc. in an effort to provide a view on where the U.S. is in the economic cycle. Next, the team focuses on increasing exposure to U.S. sectors where it sees appealing valuations key fundamental drivers. At the same time, the team limits exposure to other areas.

Kim Arthur, Main's CEO and CIO, told S&P Capital IQ in January that the strategy allowed for a 0 to 2.5X weighting in a sector relative to the S&P 500 Index. When Main chooses to favor one sector, it begins by investing in a broad sector ETF before adding specific industry exposure. Main tends to hold an ETF for 12-18 months. Main's primary focus is on a market-cap weighted ETF's top-10 holdings and then establishes price targets, which are rolled up to the ETF level.

Information Technology was one of Main's favored sectors for Main, with Technology Select Sector SPDR (XLK 44 Overweight) complemented by Market Vectors Semiconductor (SMH 35 Overweight). While well diversified and incurring a modest expense ratio in our opinion, XLK offers the most exposure to Computer Hardware and Internet Software & Services sub-industries, which provided Main and its clients with direct exposure to capital spending and increased productivity from the cloud.

Another favored sector by Main was Financials, where Arthur noted in January that M&A activity was picking up, headline risk was largely in the past and dividend increases seemed likely. (Since then most large banks have received regulatory approval for such increases.) The core position was in Financials Select Sector (XLF 21 Overweight), which is most concentrated in Other Diversified Financial Services and Diversified Banks. iShares US Broker Dealers (IAI 35 Marketweight), which has most of its assets in Investment Banking & Brokerage stocks, enhanced the strategy.

Health Care was a third favored sector, but there was little to no exposure within Main's US Large Cap Sector Rotation Strategy to Consumer Discretionary, Consumer Staples, Energy and Materials sectors. The strategy is rebalanced on a quarterly basis or when sectors achieve their internally derived target prices.

In contrast, Wilbanks, Smith & Thomas (WST) is an ETF asset manager we profiled in January 2014 that offers a sector portfolio using Guggenheim ETFs tied to S&P 500 Equal Weight Sector Indices; S&P Capital IQ operates independently from S&P Dow Jones Indices. Unlike traditional sector focused ETFs, like XLK and XLF mentioned above that are weighted based on the market capitalization of its constituents and can be concentrated in certain top-10 holdings (as we discuss below), equal weight ETFs hold a roughly identical stake in all constituents and are rebalanced quarterly. The benefit is that it reduces exposure to the sectors' prior best performers that might not be able to repeat its success and limits the mega-cap exposure, but naturally the performance and risk profile is different too.

Rather than hold all nine Guggenheim S&P 500 sector ETFs, WST uses a proprietary, optimized momentum model and technical analysis to select securities. Assets are primarily focused on just five sector ETFs, with zero exposure to four others. The most favored one sector ETF makes up nearly half of the portfolio's assets and four other sector ETFs make up 10% each. The remaining 12% of the portfolio is in investment-grade corporate bond ETFs, which helps to reduce risk.

At the end of 2013, the most favored sector was Consumer Discretionary, with a 48% weighting for the WST Sector portfolio in Guggenheim S&P 500 Equal Weighted Consumer Discretionary (RCD 76 Marketweight). There are 83 holdings in RCD, none comprising more than 1.5% of the assets, unlike the Consumer Discretionary Sector SPDR (XLY 62 Overweight), which recently had a 6.5% stake in Comcast (CMCSA 48 ****). Relative to XLY, RCD's sub-industry is quite different due to the equal weighting of all stocks. RCD had more exposure to Specialty Retail than Media stocks, which is the largest industry for XLY.

Changes to the strategy can occur monthly. For example, in October 2013, WST added a 10% position in the Guggenheim S&P 500 Equal Weighted Information Technology ETF (RYT 77 Marketweight) and eliminated exposure to Consumer Staples. Unlike its peer XLK, RYT is a pure play on tech stocks and has no telecom services exposure. Other sector ETFs inside at year end included Guggenheim S&P 500 Equal Weighted Financials (RYF 39 Overweight) and Guggenheim S&P 500 Equal Weighted Industrials (RGI 81 Marketweight).

In 2013, XLK, which was recently in Main's portfolio, rose 26% compared to the 41% gain for RYT, which was recently in Wilbanks, Smith & Thomas' RYT. However, XLK's beta of 0.9 is much lower than RYT's 1.30. Before looking closely at either of these sector focused strategies, investors should determine if a market-cap weighted or equal-weighted approach best suits their risk profile. To learn more about Main's US Large Cap Sector Rotation visit www.mainmgt.com. To learn about Wilbanks Smith & Thomas's offerings, visit www.wstam.com

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