Research Insights

October 2020

Choosing Sectors Over Style: Seeking Alpha Within U.S. Equities

Growth and Value style allocation is widely utilized, but, in our view, active sector allocation offers the potential for greater and more consistent excess return.

EXECUTIVE SUMMARY

- While many investors have adopted a Growth/Value style-based framework for allocating among U.S. equities, we find a sector-based approach more useful for making active allocation decisions.
- Sectors provide distinct and granular categories for making allocation decisions, while Growth and Value categories are more diversified and may have significant overlap of exposures, which limits, in our view, the performance dispersion that active allocation seeks to exploit.
- Sectors are closely linked to fundamental economic drivers, which we believe improves investors' potential for successfully generating excess return through active allocation based on forward-looking analysis; in contrast, broad Growth and Value style categories are defined, in significant part, by backward-looking valuation measures.
- In our view, widespread investor familiarity with the concept of style categories makes Growth and Value characteristics a useful lens for *evaluating and discussing the results* of active allocation decisions, but sector categories, combined with relevant macroeconomic analysis, provide a preferable *implementation framework* for investors seeking to add value through active allocation.

INTRODUCTION

There is broad agreement that asset allocation—how an investor weights categories of assets like stocks and bonds within a portfolio—is a primary driver of portfolio returns. Various studies, such as the widely cited "Determinants of Portfolio Performance II: An Update," suggest asset allocation may account for 90% or more of variations in portfolio returns.[1] We believe the same concept applies to sub-categories *within* major asset classes, like U.S. equities, particularly when it comes to active management.

However, for investors seeking to achieve outperformance of broad equity indices, this leaves the question of how one should approach such allocation.

For U.S. equity portfolios, many investors approach allocation from a Growth/Value style framework, either allocating permanently to a particular style that they believe offers superior risk/return characteristics or seeking to actively shift between Growth and Value categories. While we agree that the widely accepted Growth/Value style framework is a useful way to evaluate and discuss U.S. equity allocation, we believe that Growth/Value style factors should be a byproduct of allocation decisions rather than a driver of allocation. As a driver of allocation *decisions*, we find sector classifications to be a powerful *forward-looking* tool for active portfolio management.

DEFINING STYLES VS. SECTORS

A key requisite for making allocation decisions is defining the categories among which to allocate. In our view, clear and discretely defined categories are desirable to allow for evaluating the relative attractiveness of allocation options.

> Growth and Value style categories are inherently backward-looking, as they are defined, in part, by past price movement.

For style-based categories, there are various ways to define "Value" and "Growth." Benjamin Graham, an early advocate of one form of "Value" investing, defined Value stocks as those whose market price was materially below their "intrinsic value," a measure he suggested might be estimated with formulas that approximate a present-value-of-future-earnings calculation as well as consideration of a firm's net assets.[2] Eugene Fama, a Nobel Laureate economist known for work in modern portfolio theory and asset pricing, has defined Value stocks as those with a high book-to-market ratio (effectively the inverse of the more commonly referenced price-to-book ratio).[3] This was essentially the approach initially adopted by major equity index providers to create Growth (high P/B) and Value (low P/B) indices. Subsequently, some index providers changed to yet another approach to defining Growth and Value.[4] Now, major index providers use multi-factor models based on multiple Value factors (including P/B) and Growth factors (e.g. earnings growth rate) to determine inclusion in style indices.[5]

In short, Value and Growth styles can mean different things to different investors at different times. For our analysis, we will focus on major index provider methodologies, which we believe are what most investors reference today when discussing style. However, valuation or price is inherent in essentially all definitions of Value (and typically, by extension, Growth). Thus, any stock might, at one time or another, fall into either category largely because of its historic price movement.

Style categories' definitional reliance on price presents at least two initial hurdles for using Growth and Value for allocation decisions. First, these categories do not necessarily group similar types of companies, for example, a Technology company that has underperformed and a Utilities company that has outperformed could each fall into the Value category. Second, price movement can shift companies from one category to another, even if there has been no change in the fundamentals or character of the company. Thus, Growth and Value style categories are inherently *backward-looking*, as they are driven, in part, by past price movement.

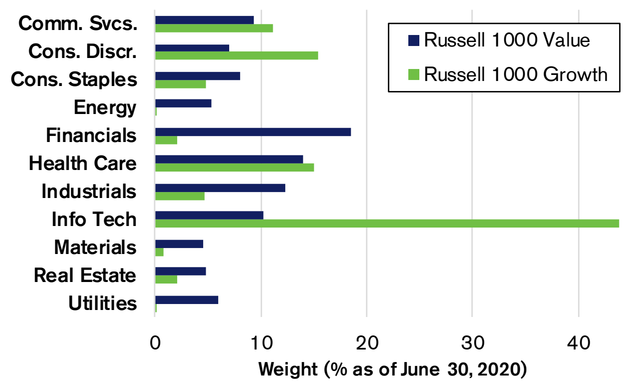
Sector categorization, in contrast, is based on the underlying type of business activity of a company. There are various sets of sector/industry definitions; for example, S&P and MSCI share the Global Industry Classification Standard (GICS®), while FTSE Russell publishes its own Industry Classification Benchmark (ICB).[6] However, given the similar fundamental basis for these classification systems, GICS and ICB tend to align relatively cleanly. Further, given the fundamental economic basis for sector classification, companies tend to remain in a particular sector unless there has been a material fundamental shift in their business model, so the constituency of sector categorizations tends to be more stable than for style categories.

BENEFITS OF DISCRETE CATEGORIES

In our view, discretely defined, stable categories are desirable for evaluating the relative attractiveness of allocation options. Sectors are, by definition, discrete. Style categories are not only more fluid than sectors, as previously noted, but style categories are also more fundamentally diversified (less discrete) than individual sectors, given that a Growth/Value framework essentially spreads the stock universe across just two primary buckets, while a sector framework divides the stock universe into multiple, more granular buckets (e.g. the GICS system has 11 discrete sectors). Greater diversification within a category may be viewed positively from a pure risk-management perspective (all else equal), but it also means there is less distinction between the Growth and Value categories. Further, using the current approach of major index providers, there is actually significant overlap of exposures across Value and Growth indices, as illustrated by comparing sector exposures in Figure 1. In fact, three of the top five GICS sectors in the Russell 1000 Growth and Russell 1000 Value were the same as of June 30, 2020 (Communication Services, Health Care, and Information Technology).

Discrete, stable categories, like sectors, are desirable for making allocation decisions.

FIGURE 1: RUSSELL 1000 STYLE INDICES SECTOR OVERLAP



Sources: Blackrock, WestEnd Advisors. Data as of 6/30/2020.

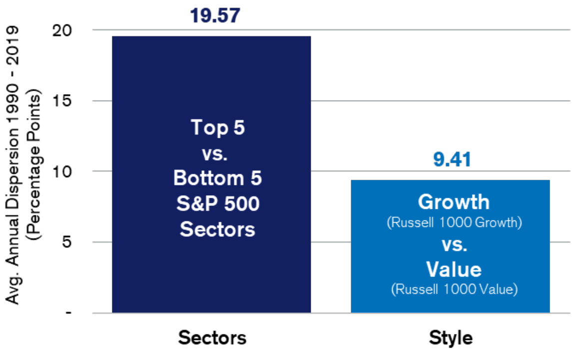
Style indices can also have substantial overlap at the individual company level, as the same stock may be included in *both* Growth and Value indices simultaneously. As of June 30, 2020, over half of Russell 1000 Value Index constituents were also constituents of the Russell 1000 Growth Index. In some cases, overlapping constituents were of similar and material weight in both indices. For example, both Home Depot and Procter & Gamble represent about 1% in each index. Even Alphabet Inc. (the parent of Google), despite being the fourth-largest weight in the Russell 1000 Growth Index, ranked as a top 10 weight in the Russell 1000 Value Index.

Growth and Value categories can have substantial overlap of sector exposure *and even* individual constituents.

The diversification and overlap of style categories should be a key consideration for investors seeking to actively allocate among categories, as it contributes to low dispersion of returns between the categories as compared with dispersion among sectors. Figure 2 (next page) shows that the average annual performance dispersion between the Russell 1000 Growth and Russell 1000 Value indices over the past 30 years is less than half the average annual dispersion between the best five and worst five performing S&P 500 GICS sectors.

The wide performance dispersion among economic sectors creates significant opportunity for generating excess return through active sector allocation.

FIGURE 2: AVERAGE ANNUAL PERFORMANCE DISPERSION



Sources: Bloomberg, WestEnd Advisors. Data through 12/31/2019.

In our view, the greater the performance dispersion among categories, the more opportunity that allocating among the categories offers for alpha generation. Of course, no investor is going to capture all of the potential alpha of any allocation approach. Those who allocate among Growth and Value rarely shift fully between one style and another, and even if they did, timing the shifts perfectly is a practical impossibility. Similarly, no investor could expect to allocate to just the top-five performing sectors each year. Still, in our view, by starting with a larger pool of potential alpha (i.e. greater spreads among category performance), the rewards of sector-driven allocation should be proportionally larger for a given level of skill.

THE IMPORTANCE OF BEING FORWARD-LOOKING

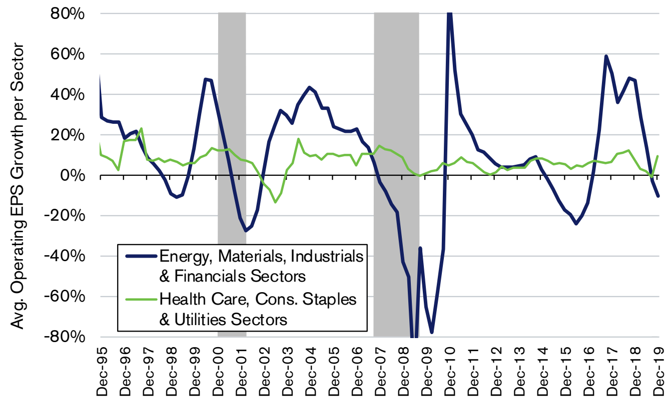
We believe investors should have well-grounded justifications for making allocation decisions. Investment decisions succeed or fail based on future performance, so to be successful over time (absent blind luck), investors need a way to form reasonable expectations about the future. In short, we believe active investors need to be forward-looking.

> We believe patterns of relative sector performance that tend to play out over the economic cycle can be harnessed to *anticipate* likely sector outperformance.

Sectors group together companies that sell similar products and services and, as such, are impacted similarly by certain types of economic developments. Therefore, different sectors naturally respond differently in various economic environments. Thus, we see a clear link between economic analysis and sector analysis, which we believe creates the potential for allocating to sectors that are likely to outperform in a particular economic backdrop. Further, given the cyclical nature of economic activity, we believe that patterns of sector outperformance and underperformance that play out over a full economic cycle can be harnessed with reasonable reliability to *anticipate* which sectors are likely to outperform over the near-to-intermediate term.

For example, as illustrated in Figure 3, economically-sensitive sectors like Energy and Financials typically see sharper changes in earnings during economic contractions and recoveries than defensive sectors like Utilities and Consumer Staples.

FIGURE 3: SECTOR EARNINGS GROWTH BY ECONOMIC SENSITIVITY



Sources: Bloomberg, WestEnd Advisors. Data through 3/31/2020.

These fundamental relationships can translate into significant sector performance dispersion around economic inflection points and in various phases of the economic cycle. Understanding these relationships and the dispersion they can create is one way we believe economic analysis can support capturing potential excess return through sector allocation.

For style categories, we have noted that the very definitions of Value and Growth are, in part, backward-looking, as they are rooted in valuation, which reflects past price movement. Further, in our view, the analysis that is often used to make style allocation decisions relies too heavily on backward-looking information.

> A permanent bias toward Growth or Value exposes investors to the risk of long and/or sharp periods of underperformance.

For example, some investors believe a permanent "Value Premium" exists, wherein Value stocks are expected to offer higher risk-adjusted performance than Growth stocks. This belief is typically based on very long-term historical data which, depending on the particular period selected, appears to support their conclusion. However, in our analysis, the risk-adjusted outperformance of Value seen over long periods generally results from a few relatively short sub-periods of strong Value outperformance. Thus, investors seeking to capture a premium through a permanent Value bias may suffer long periods of underperformance, as was the case in much of the 1990s and in the 2010s. Similarly, a permanent Growth bias exposes investors to risk of wrenching underperformance when market fundamentals and sentiment do not favor Growth, such as in the period from 2000 to 2002.

Some style allocation investors use an alternate approach of making a long-term strategic allocation to some optimized blend of Growth and Value. In our view, this presents at least two issues for alpha generation. First, such a blended allocation would likely approximate the market's overall exposures and, thus, severely limit the potential for excess returns. Second, "optimizing" such a blended allocation typically involves using a long-term data set to formulate a relatively static allocation which is blind to specific near-to-intermediate-term market conditions (much like investors seeking to capture a Value Premium). Thus, investors using this approach largely abdicate the potential opportunity offered by active, dynamic allocation.

Similarly, even a seemingly straightforward reversion to the mean approach, which assumes Growth and Value will provide similar returns over time and an investor should tilt toward whichever style category had underperformed (expecting it would eventually outperform) provides little guidance on *timing* for asset allocation decisions. Periods of style underperformance can linger long after a material performance lag has been established, and, in our view, the timing of any eventual mean reversion might be driven by sentiment as much or more than discernable fundamental factors.

We see no effective way to determine when Growth or Value styles are likely to outperform.

Given the issues associated with these various approaches to style allocation, we see no effective way to determine when Growth or Value is likely to outperform going forward. We believe the overlap of exposures and broad diversification of the Growth and Value categories dilute their potential ties to fundamental economic drivers. The emphasis on valuation in delineating Growth and Value does tie to investor sentiment, in our view, but we see shifts in investor sentiment (which might drive shifts in style leadership) as notoriously difficult to gauge.

THE POWER OF SECTORS

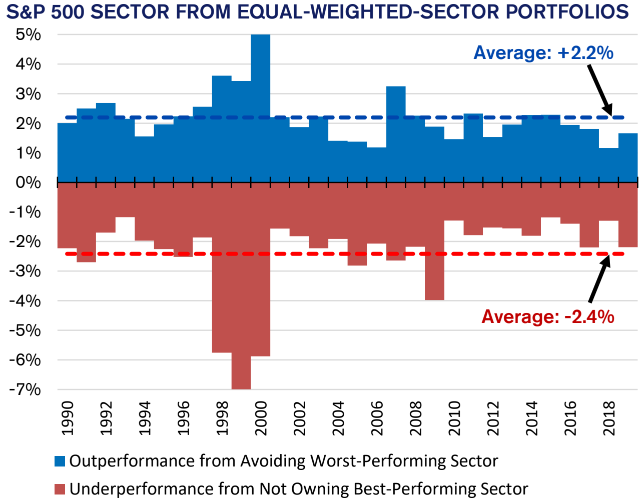
Regardless of an investor's approach to making active allocation decisions, Growth and Value are two overlapping categories which provide a fairly blunt instrument for implementation. Sectors, in contrast, offer a larger number of discrete categories that give a wider range of options for allocation to fit a portfolio to the expected environment. For example, an investor who expects an economic recovery might allocate to a group of sectors that have typically outperformed in the early phase of previous economic cycles, such as Energy, Materials, and Industrials. However, the investor might also choose to avoid any one of those sectors individually, if the sector faced specific headwinds from fundamental factors external to the economic cycle, such as avoiding Energy if there were an oversupply of oil. Alternately, the investor might allocate to additional sectors with other secular tailwinds, such as Health Care (a less economically-sensitive sector) if they expected an easing of regulatory risk for the sector. This allows sector allocations to be aligned with the general economic cycle on a forward-looking basis while also being tailored to the specifics of each cycle.

Sectors offer a large number of discrete allocation options for tailoring a portfolio to the economic backdrop.

The power of owning or avoiding individual sectors can be illustrated both anecdotally and quantifiably. Consider the Information Technology sector in the late 1990s. By 1998 and 1999, it had become the largest sector in the S&P 500 and, in those years, outperformed the next-best performing S&P 500 sector by over 25 percentage points in 1998 and over 50 percentage points in 1999. Clearly, in our view, having a material allocation to Technology in that period would be critical to relative performance. Conversely, in the past five years, the Energy sector has been one of the smallest and typically worst-performing sectors in the S&P 500, but having the flexibility to avoid that sector also represents a significant potential contributor to excess return. From 2015 through 2019, simply avoiding the Energy sector could have contributed nearly a full percentage point of relative performance per year, on average, to an S&P 500-benchmarked portfolio.

More broadly, the difference between the best-performing and worst-performing S&P 500 sectors each year has averaged more than 41 percentage points over the past three decades. Thus, excluding even a single sector from a portfolio can have a dramatic impact on annual returns. For a portfolio of equally-weighted S&P 500 sectors, as illustrated in Figure 4, excluding the worst-performing sector or missing out on the best-performing sector might each shift performance by more than two percentage points per year, on average.

FIGURE 4: IMPACT OF EXCLUDING BEST- OR WORST-PERFORMING S&P 500 SECTOR FROM EQUAL-WEIGHTED-SECTOR PORTFOLIOS



Sources: Blackrock, WestEnd Advisors. Data through 12/31/2019.

THEORY VERSUS PRACTICE

On the surface, both style allocation and sector allocation may seem like simple concepts. We have already explored, however, some hurdles to achieving consistent excess return through Growth/Value allocation. Sector allocation, though a more useful approach for alpha generation in our view, is also complex when it comes to real-world implementation.

> To exploit the potential of active sector allocation, we believe investors must have a foundational understanding of how sectors relate to the economic cycle, skill in analyzing the economic backdrop, and sound judgment for integrating idiosyncratic factors unique to each cycle.

As we have noted, the link between sector composition and economic fundamentals provides a roadmap for making active sector allocations. Again, it sounds simple: allocate to more economically-sensitive sectors early in an economic recovery or expansion, and shift to increasingly less cyclical sectors as an economic expansion matures and moves into recession. In practice, however, no two economic cycles are identical, either in length or in the relative importance of specific economic drivers. Most economic cycles also have unique political or geopolitical factors that we believe can enhance or reduce some sectors' expected relative performance in a particular phase of the economic cycle. We do not believe mechanical or formulaic approaches to sector allocation can appropriately account for these variables on a forward-looking basis. To successfully exploit the potential of active sector allocation through a particular economic cycle, we believe investors must have a foundational understanding of how sectors relate to the economic cycle, skill in analyzing the economic backdrop, and sound judgment for integrating idiosyncratic factors unique to each cycle. These are traits that we believe require dedicated focus and can be honed through studied analysis and experience.

In practice, we recognize there may be potential benefits of using a style-based framework as a lens for examining and discussing the *results* of active allocation decisions. Investor familiarity with the concepts of Growth and Value can facilitate communication by providing a broad picture of how more granular, sector-driven decisions have impacted a portfolio's positioning. Style categories also can be used in risk analysis and risk management, such as for evaluating how extremely portfolio positioning has tilted from a valuation standpoint or setting long-term strategic allocation ranges within which managers might use non-style approaches to make active decisions. As such, we do not believe investors need to abandon the concepts of Growth and Value. Instead, we see the potential for practical integration of a style-based framework into the analysis and communication of the results of sector-driven allocation decisions.

CONCLUSION

Based on our decades of experience making allocation decisions within the U.S. equity market, we are strong advocates of sector-based allocation. We see the wide dispersion of sector returns as providing opportunity for generating alpha through sector allocation; and we believe the linkage of sectors to economic fundamentals provides an avenue for capturing that opportunity through analysis of both cyclical patterns and the unique characteristics of each cycle. Thus, we see sector allocation as a core tool for aligning portfolios with the economic backdrop, while style-based analysis can still be used to evaluate and communicate portfolio characteristics. Whether used as a stand-alone approach, paired with other active approaches that seek to exploit different sources of alpha generation, or as a dynamic complement to longer-term strategic models, we believe sector allocation can enhance the opportunity to generate alpha and help manage risk through portfolio construction.

WestEnd Advisors Investment Team | October 2020

Disclosures

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The Standard and Poor's 500 Stock Index includes 500 stocks and is a common measure of the performance of the overall U.S. stock market. The Russell 1000® Growth Index is an index composed of large- and mid-capitalization U.S. equities that are deemed to exhibit growth style characteristics. The Russell 1000® Value Index is an index composed of large- and mid-capitalization U.S. equities that are deemed to exhibit value style characteristics. An index is unmanaged and is not available for direct investment.

Any portfolio characteristics, including position sizes and sector allocations, among others, are generally averages and are for illustrative purposes only and do not reflect the investments of an actual portfolio unless otherwise noted. The investment guidelines of an actual portfolio may permit or restrict investments that are materially different in size, nature, and risk from those shown. The investment processes, research processes, or risk processes shown herein are for informational purposes to demonstrate an overview of the process. Such processes may differ by product, client mandate, or market conditions. Portfolios that are concentrated in a specific sector or industry may be subject to a higher degree of market risk than a portfolio whose investments are more diversified.

DISCLOSURE UPDATE: On December 31, 2021, Victory Capital Holdings, Inc. ("Victory Capital") acquired WestEnd Advisors, LLC ("WestEnd"). WestEnd, an SEC-registered investment adviser, operates as an autonomous Victory Capital Investment Franchise. WestEnd's active principals continue to be responsible for managing the firm and its day-to-day operations.

[1] Gary P. Brinson, Brian D. Singer & Gilbert L. Beebower (1991) "Determinants of Portfolio Performance II: An Update" (Financial Analysts Journal, 47:3), 40-48, DOI: 10.2469/faj.v47.n3.40.

[2] Benjamin Graham and David L Dodd, *Security Analysis,* Sixth Edition (New York, McGraw-Hill Companies, Inc., 2009), 708, DOI: 10.1036/0071592539; Benjamin Graham, *The Intelligent Investor, Revised Edition* (New York, HarperCollins, 2003), Chapter 11 under "Capitalization Rates for Growth Stocks", Kindle.

[3] Eugene F. Fama and Kenneth R. French, "The Cross-Section of Expected Stock Returns" (The Journal of Finance, Vol XLVII, No. 2, June 1992), 427-465.

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[5] "Russell U.S. Equity Indexes Construction and Methodology v4.8," ftserussell.com, FTSE Russell, 2020, 25, https://research.ftserussell.com/products/downloads/Russell-US-indexes.pdf?_ga=2.205809238.454568144.1599585549-692004331.1599224591; "MSCI Global Value and Growth Index Series Methodology Book," MSCI, msci.com, 2007, accessed September 8, 2020, 2, https://www.msci.com/eqb/vg/MSCI_Dec07_GVGMethod.pdf.

[6] "The Global Industry Classification System (GICS®)," msci.com, MSCI, accessed September 8, 2020, https://www.msci.com/gics; "Industry Classification Benchmark," ftserussell.com, FTSE Russell, accessed September 8, 2020, https://www.ftserussell.com/data/industry-classification-benchmark-icb.