Understanding the Nuances of Sector Fund Exposure

Not all sector ETFs and funds are the same. They can differ substantially in their market-cap break-down, international exposure, style exposure, and weighting. These important factors can have a significant impact on portfolio construction and performance.

Sector investing can be a powerful tool in providing investors with opportunities to fine-tune or manage risk in their portfolios. It is rare for any single sector to be a consistent top or bottom performer year-over-year because different sectors tend to perform differently in various market conditions. Investors may choose to invest in certain sectors that they believe will outperform the market, or choose to avoid certain sectors that they believe will underperform the market. Figure 1 shows how sectors have performed relative to the S&P 500® since 2013.

GICS Sector Performance vs. S&P 500® (2013–12.31.2021)

	Year S&P 500®	
Utilities 17.67%; Consumer Staples 18.63%; Industrials 21.12%; Comm. Services[1] 21.57%; Consumer Discretionary 24.43%; Health Care 26.13%; Materials 27.28%	2021 28.71%	Technology 34.53%; Financials 35.04%; Real Estate 46.19%; Energy 54.64%
Energy -33.68%; Real Estate -2.17%; Financials -1.69%; Utilities 0.48%; Consumer Staples 10.75%; Industrials 11.06%; Health Care 13.45%	2020 18.40%	Materials 20.73%; Comm. Services[1] 23.61%; Consumer Discretionary 33.30%; Technology 43.89%
Energy 11.81%; Health Care 20.82%; Materials 24.58%; Utilities 26.35%; Consumer Staples 27.61%; Consumer Discretionary 27.94%; Real Estate 29.00%; Industrials 29.37%	2019 31.49%	Financials 32.13%; Comm. Services[1] 32.69%; Technology 50.29%
Energy -18.10%; Materials -14.70%; Industrials -13.29%; Financials -13.03%; Comm. Services[1] -12.53%; Consumer Staples -8.38%	2018 -4.38%	Real Estate -2.22%; Technology -0.29%; Consumer Discretionary 0.83%; Utilities 4.11%; Health Care 6.47%
Telecom -1.25%; Energy -1.01%; Real Estate 10.85%; Utilities 12.11%; Consumer Staples 13.49%; Industrials 21.03%	2017 21.83%	Health Care 22.08%; Financials 22.18%; Consumer Discretionary 22.98%; Materials 23.84%; Technology 38.83%
Health Care -2.69%; Consumer Staples 5.38%; Consumer Discretionary 6.03%	2016 11.96%	Technology 13.85%; Utilities 16.29%; Materials 16.69%; Industrials 18.86%; Financials 22.80%; Telecom 23.49%; Energy 27.36%
Energy -21.12%; Materials -8.38%; Utilities -4.85%; Industrials -2.53%; Financials -1.53%	2015 1.38%	Telecom 3.40%; Technology 5.92%; Consumer Staples 6.60%; Health Care 6.89%; Consumer Discretionary 10.11%
Energy -7.78%; Telecom 2.99%; Materials 6.91%; Consumer Discretionary 9.68%; Industrials 9.83%	2014 13.69%	Financials 15.20%; Consumer Staples 15.98%; Technology 20.12%; Health Care 25.34%; Utilities 28.98%
Telecom 11.47%; Utilities 13.21%; Energy 25.07%; Materials 25.60%; Consumer Staples 26.14%; Technology 28.43%	2013 32.39%	Financials 35.63%; Industrials 40.68%; Health Care 41.46%; Consumer Discretionary 43.08%

Source: Bloomberg, 12.31.2021. **Performance displayed is past performance and is no guarantee of future results.** Returns shown are subindex performance of the S&P 500®, representing the GICS sectors. Real estate was added as GICS sector on 8.31.2016. The referenced indices are unmanaged and not available for direct investment.

1 In September 2018, GICS created a new communication services sector, which combined the now defunct telecommunication services sector with parts of the information technology and consumer discretionary sectors.

Understanding sector exposure and construction has perhaps never been more important given the major sector changes that were introduced by the Global Industry Classification Standard (GICS) in September 2018—changes that resulted in thousands of companies being reclassified globally. According to Morningstar, there are approximately 860 available sector funds and ETFs (as of December 31, 2021), so it may be a challenge to choose a sector fund that matches the needs of specific portfolios. Sector fund construction can vary significantly, based on how companies are classified, whether they include global and/or domestic stocks, and which capitalization ranges might be included (large, mid, and/or small). With the emergence of smart beta and alternative weighting approaches, the weighting of stocks within a sector fund can vary significantly. These different sector classifications, inclusion strategies, and weighting approaches may cause performance among sector funds to vary substantially. That is why, before investing in a sector fund, it is important to understand the methodology employed.

Not All Sectors Are the Same

Market sectors are a way to classify different stocks into common groups that may perform similarly in certain economic conditions. There are a number of different sector classification systems, which classify companies based on different criteria such as the markets served, revenue sources, or the products/services offered. GICS is one of the most well-known sector classifications, but a few other popular ones include the Industry Classification Benchmark, Bloomberg, and FactSet Revere Business Industry Classification System.

As **Table 1** illustrates, a company's classification can vary depending on the sector methodology used.

Table 1: Sector Classification Variations

	Target	Walmart	Amazon	CVS Health	Netflix	Tesla	Alphabet
GICS Sector	Consumer Discretionary	Consumer Staples	Consumer Discretionary	Health Care	Communication Services	Consumer Discretionary	Communication Services
ICB Industry	Consumer Discretionary	Consumer Discretionary	Consumer Discretionary	Consumer Staples	Consumer Discretionary	Consumer Discretionary	Technology
Bloomberg	Consumer Staples	Consumer Staples	Consumer Discretionary	Health Care	Communications	Consumer Discretionary	Communications
FactSet RBICS	Consumer Non-Cyclicals	Consumer Non-Cyclicals	Consumer Non-Cyclicals	Healthcare	Technology	Consumer Cyclicals	Technology
Guggenheim/Rydex Proprietary Classification	Retailing	Retailing	Retailing, Internet	Health Care	Leisure, Internet	Transportation	Technology, Internet

Source: Guggenheim, FactSet, Bloomberg, ICB, GICS 12.31.2021

While sector classifications typically remain constant, recently there have been two significant changes in the popular GICS classifications. In 2016, real estate was carved out of the financials sector to reflect its increased importance. In September 2018, GICS made more substantial changes by creating a new communication services sector, which combined the now-defunct telecommunication services sector with parts of the information technology and consumer discretionary sectors. The new sector was created to demonstrate the changes in the way consumers communicate and access entertainment content and other information. Among the more notable changes:

- Facebook and Alphabet moved to communication services from information technology.
- Netflix and Walt Disney moved to communication services from consumer discretionary.
- EBay moved to consumer discretionary from information technology.

These sector changes underscore the need to understand how a sector strategy classifies companies. Certain companies, particularly ones with well-diversified lines of business or ones in emerging technologies or industries, can be difficult to pin down.

Guggenheim's philosophy on classification is that sector portfolios should be reflective of the broad economic performance of specific sectors. If a company is integral to the economic performance of more than one sector, then it should be included in all of the relevant sectors.

For example, Amazon has a significant impact on retail, a strong online presence, and offers internet hosting services and web-based data and services. The case can be made for including Amazon in both retailing and internet sector funds, as Guggenheim does.

GICS classifies Walmart and Target in different sectors (Walmart in consumer staples and Target in consumer discretionary). However, both of these companies compete directly in retail, and, accordingly, Guggenheim includes both Walmart and Target in the Rydex Retailing Fund.

A new GICS consultation just got underway that involves potential changes within many of the sectors, most notable in shifting some well known companies from the information sector to either financials or industrials. These changes are expected in 2022.

Domestic or Global?

Sector categorization is the broadest way to deconstruct sectors, but there are many other considerations, such as geographic exposure (global, domestic, region-specific) or capitalization factors (large-, mid-, small-cap stocks).

In today's globalized economy, as firms grow larger, it's not uncommon for them to become more and more exposed to markets outside of the United States. A case in point is the S&P 500® Index, one of the most common benchmarks for U.S. equities. The average stock in this index generates 32% of its revenues from outside the U.S. (as of December 31, 2021), according to FactSet. FactSet also reports that more than a quarter of index members earn less than 50% of their revenue domestically, demonstrating that even this well-known benchmark composed of U.S. stocks has a considerable global footprint and exposes investors to international markets. Guggenheim believes it makes sense to look at sectors in holistic terms and include global exposures through international stocks that trade on U.S. stock market exchanges, such as American Depositary Receipts. For example, including Unilever in the consumer products sector and Novartis in the health care sector may provide a truer sector exposure than excluding them.

Guggenheim includes international stocks in its sector classifications because it believes that a global frame of reference can be beneficial to help create a purer sector definition.

Does Company Size—Large, Mid, Or Small—Matter?

A sector index's starting universe can have a significant effect on composition and performance. For example, if the sector is solely selected from the S&P 500, it will be dominated by large-cap stocks and may miss opportunities in smaller stocks or international stocks. Guggenheim believes a more inclusive approach is appropriate and includes companies from various cap ranges in its sector strategies. **Table 2** shows the market capitalization and international exposure composition of the Rydex Health Care Fund compared to two popular health care indices (percentages indicate the relative composition of stocks from each category).

Table 2: Health Care Capitalization and International Exposure Comparison

	Rydex Health Care Fund	S&P 500® Health Care Select Sector Index	MSCI US IMI Health Care 25-50 Index
S&P 500®	54%	100%	14%
S&P MidCap 400	14%	0%	8%
S&P SmallCap 600	1%	0%	17%
Other U.S.	23%	0%	57%
International	9%	0%	3%

Source: Guggenheim, Bloomberg. 12.31.2021

Watch Your Weight

In traditional sector portfolios, stocks are weighted by market capitalization, which can result in overweighting or dominance by the largest stocks. In the past decade, smart beta has become a popular way to create investment strategies for many areas of the market, including sectors. Smart beta generally refers to any strategy that differs from a conventional market-cap-based weighting. Some sector funds use equal weighting to limit the size bias. Others may use factor weighting techniques, such as dividend yield or momentum scores, to weight stocks.

Cap-weighting provides a representation from a business landscape perspective, with larger stocks getting larger weights, whereas equal weighting provides a good representation of an investor's opportunity set with all stocks equally able to contribute to performance. Guggenheim's modified cap-weighted approach, which, in general, takes the square root of each company's market capitalization, acts as a midpoint between these two perspectives, allowing the market leaders to retain the most influence without unduly dominating the sector and negatively impacting diversification. For more than 20 years, Guggenheim has used this approach as a basis for its Rydex sector funds because we believe it reduces stock-specific risk and broadens sector exposure.

Table 3 shows a hypothetical example of the differences in weights between the top 10 S&P 500 Energy Index allocations, based on market capitalization, equal weight, and modified market-capitalization methodologies.

Table 3: Energy Sector Weighting Comparison

	Weighting Scheme		
Stock	**Market Cap**	**Modified Cap**	**Equal**
Exxon Mobil Corp	23.61%	12.04%	4.76%
Chevron Corp	20.61%	11.25%	4.76%
ConocoPhillips	8.68%	7.30%	4.76%
EOG Resources Inc.	4.74%	5.39%	4.76%
Schlumberger NV	3.83%	4.85%	4.76%
Pioneer Natural Resources Co	4.05%	4.81%	4.76%
Marathon Petroleum Corp	3.59%	4.70%	4.76%
Phillips 66	2.89%	4.22%	4.76%
Williams Cos Inc.	2.88%	4.21%	4.76%
Kinder Morgan Inc.	3.28%	4.16%	4.76%
Weight in the Top 10 Stocks	**78.15%**	**62.93%**	**47.62%**
Weight in Remaining 11 Stocks	**21.85%**	**37.07%**	**52.38%**

Source: Guggenheim, Bloomberg. 12.31.2021

Bottom Line: No Two Sector Funds Are Alike

Not all sector ETFs and funds are the same and they can differ substantially in their market-cap breakdown, international exposure, style exposure, and weighting. All of these factors impact performance and how the sector strategy will be integrated into the overall client portfolio. Understanding the nuances of a sector fund's security selection process can result in a better outcome for meeting portfolio risk-return objectives.

Portfolio Managers

Ryan Harder, CFA, is a Managing Director and Portfolio Manager at Guggenheim Investments. He leads a team of portfolio managers responsible for managing tradable Rydex funds, as well as select alternative funds. He is a member of the investment leadership team and sits on the credit review committee.

Adrian Bachman, CFA, is a Portfolio Manager at Guggenheim Investments. In addition to managing portfolios, Mr. Bachman conducts research on various quantitative equity strategies.

The GICS® is an industry taxonomy developed by MSCI and Standard & (S&P) in 1999 for use by the global financial community. The GICS structure consists of 11 sectors, 24 industry groups, 68 industries, and 157 sub-industries into which S&P has categorized all major public companies, according to the definition of the principal business activity.

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