

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) methods of allocating to stocks doesn't take full advantage of return differences and lower correlations. To more precisely access and capitalize on potential market opportunities we feel it is helpful to use economic sectors. 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.

Investment 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:

Morningstar Style Box™

			Large
			Medium
			Small
Value	Blend	Growth	

Style

- 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.)
- Blend**—A collection of companies that contains both growth and value companies

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Market Capitalization

(price per share multiplied by total number of shares)

- **Large-cap**—Companies with outstanding shares typically valued at over \$26 billion
- **Mid-cap**—Companies with outstanding shares typically valued at \$3 billion–\$26 billion
- **Small-cap**—Companies with outstanding shares typically valued at less than \$3 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 eleven sectors, while Bloomberg follows 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 68 industries within 11 sectors and we've grouped them into the following broader categories that range according to degree of economic sensitivity:

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, and mortgagors
- **Real estate**—Property management, and Real Estate Investment Trusts (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
- **Telecommunication 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
- **Information technology**—Designers and developers of computer operating systems and applications; computer technology consulting service

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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 last three months of 2016, for example, the Standard & Poor’s 500 index was at 10.12%. Various style and market capitalization groupings didn’t fare much better or much worse.

FIGURE 1
Index ranges (9/30/2016 – 3/31/2017)

Index		
Russell 2000 Index	11.52%	 <p>High</p> <p>Difference: 1.51%</p> <p>Low</p>
Russell 1000 Value	10.16%	
S&P 500	10.12%	
Russell 1000 Index	10.09%	
Russell 1000 Growth	10.01%	

Sources: Factset, Bloomberg

FIGURE 2
Russell 1000 Index by GICS Sector (9/30/2016 – 3/31/2017)

Sector		
Financials	24.16%	 <p>High</p> <p>Difference: 25.18%</p> <p>Low</p>
Information technology	13.92%	
Industrials	12.10%	
Consumer discretionary	10.95%	
Materials	10.84%	
Utilities	6.54%	
Consumer staples	4.21%	
Healthcare	4.03%	
Telecommunications	0.62%	
Energy	0.11%	
REITs	-1.02%	

Sources: Standard and Poor’s, WTIA

Sectors, however, offered a wider range of returns during this time period, with the top sector returning 24.16% and the bottom returning -1.02%. 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 timeframe. You’ll see wide swings among sectors, for example, in 2014, with real estate showing 31.7%, while energy reaped a dismal -7.8%, and the S&P fell in-between the two extremes at 13.7%.

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FIGURE 3
Disparity = opportunity
Annual performance of various sectors (December 2001–December 2016)

2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016
-3.7	47.3	31.2	31.3	37.2	34.5	-16.1	62.1	30.9	19.3	30.1	42.8	31.7	10.5	27.1
-6.4	37.0	26.3	16.8	35.5	21.4	-23.3	46.9	27.3	13.9	24.4	41.0	28.7	7.1	23.5
-6.8	36.3	24.5	10.8	24.1	19.2	-29.2	41.7	26.8	13.6	20.3	40.9	25.1	6.9	22.0
-14.3	32.7	19.6	6.5	21.1	16.8	-30.4	31.9	22.9	12.5	17.8	40.4	20.3	6.6	18.3
-14.9	32.5	18.5	6.3	19.5	13.8	-32.9	21.4	20.6	6.7	17.3	28.6	15.5	5.6	16.6
-19.1	30.9	13.8	4.7	19.0	11.7	-34.6	19.9	19.3	5.6	15.3	26.2	13.0	3.4	16.6
-22.9	26.3	10.4	3.9	18.5	11.6	-40.0	18.9	14.3	5.0	15.1	25.8	10.0	-2.6	13.7
-25.9	24.5	10.2	2.8	14.4	7.3	-42.7	14.9	10.7	2.5	14.9	25.3	9.9	-2.7	6.1
-26.7	16.2	8.2	1.2	13.0	-13.5	-43.5	13.8	10.5	-0.3	10.4	12.6	7.2	-5.2	5.4
-33.6	15.6	3.7	-5.3	8.9	-17.8	-44.6	11.7	5.7	-9.5	4.8	12.4	1.9	-8.6	1.4
-38.1	7.1	1.8	-5.5	7.6	-18.5	-55.9	7.4	3.5	-20.3	1.6	2.0	-7.8	-21.2	-2.3
-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	1.4	12.0

 Consumer discretionary	 Healthcare	 Real estate
 Consumer staples	 Industrials	 Telecommunication services
 Energy	 Information technology	 Utilities
 Financials	 Materials	 S&P 500 Index

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). Past performance is no guarantee of future results.

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

As sectors are often characterized by disparate performance, investing along these lines (within a risk-controlled framework) may offer superior opportunities to add value.

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–December 31, 2016. 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 0.76; 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 time period. With some exceptions, sector correlation

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FIGURE 4
A comparison of varying market capitalization and style indices' performance (from 12/31/1991–12/31/2016)

	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	0.80	1.00		
Russell Mid Cap	0.95	0.89	0.90	1.00	
Russell 2000 Small Cap	0.83	0.79	0.76	0.92	1.00

Sources: Factset, WTIA.

FIGURE 5
Correlation among returns of economic sectors (from 12/31/1991–12/31/2016)

	Energy	Materials	Industrials	Consumer discretionary	Consumer staples	Healthcare	Financials	Information technology	Telecommunication services	Utilities	Real estate
Energy	1.00										
Materials	0.65	1.00									
Industrials	0.59	0.83	1.00								
Con. discretionary	0.45	0.73	0.84	1.00							
Consumer staples	0.35	0.51	0.60	0.55	1.00						
Healthcare	0.36	0.45	0.57	0.51	0.66	1.00					
Financials	0.48	0.67	0.80	0.76	0.59	0.58	1.00				
Info. technology	0.38	0.54	0.65	0.74	0.35	0.43	0.51	1.00			
Telecom. services	0.31	0.39	0.48	0.54	0.44	0.40	0.44	0.50	1.00		
Utilities	0.48	0.30	0.38	0.26	0.42	0.37	0.35	0.16	0.33	1.00	
Real estate	0.36	0.60	0.64	0.60	0.44	0.40	0.61	0.38	0.27	0.41	1.00

Sources: Factset, WTIA.

coefficients were generally lower. In fact, each of the 10 sectors showed a performance correlation of below 0.64 with at least one other sector, and the overall average correlation of sector.

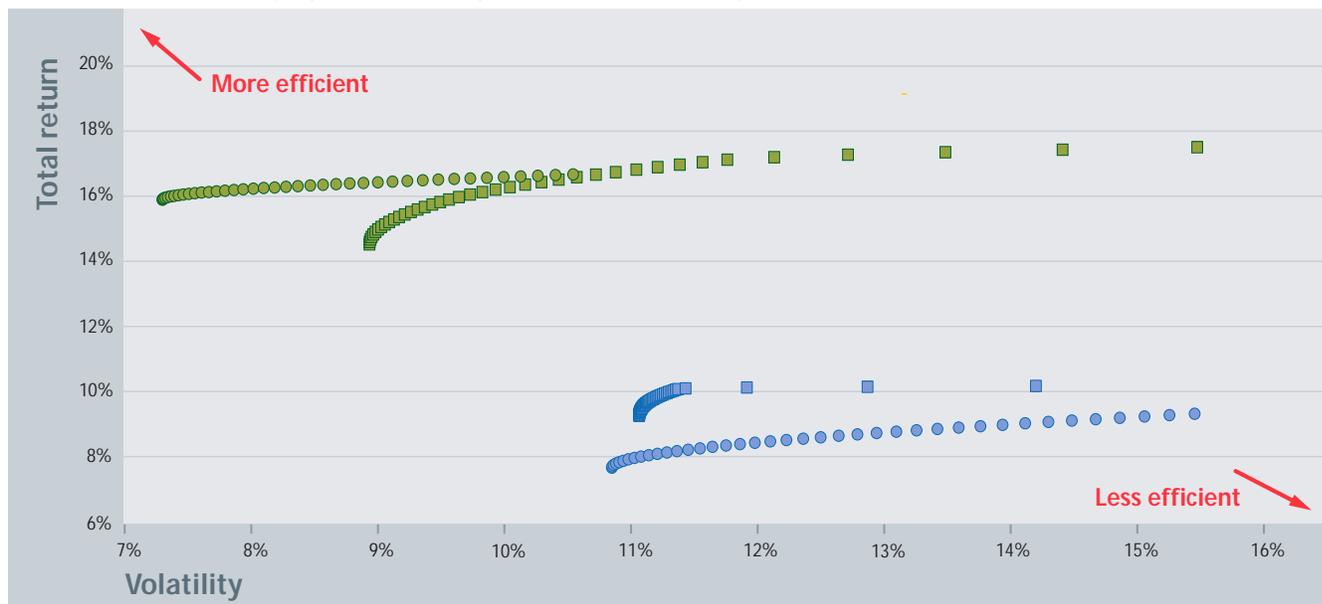
As we've seen, sectors have less correlated returns than traditional style indexes. By using a sector-based

approach, 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

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FIGURE 6

Efficient frontier: U.S. equity sectors and styleboxes (for periods ending 12/31/2016)



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

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

Sources: Factset, WTIA

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 30, 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

As we saw in Figure 3 on page 4, 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 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

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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.

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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.

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