

Sector Strategy: Alpha from the middle



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IN A NUTSHELL

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Sector Strategy: An opportunity in between equity index and stock selection

Most asset owners and primary advisors focus on asset allocation. This includes how much of the total portfolio should be in the S&P 500 strategically and tactically. Many seek stock selection strategies to enhance returns. But, stock selection is risky and might bring tactical beta or other macro factor exposures that can conflict with desired asset allocation. This is why many allocators prefer to construct portfolios with index funds or stock selection strategies with limited beta and other macro factor active risk. However, opportunities exist to enhance returns with specialized macro factor management without large beta tilts and also without active stock selection risk. This is the opportunity of a pure sector strategy.

Pure sector strategy gives asset allocators a distinct third choice in portfolio building blocks from that of the usual passive index and active stock selection strategies. Index funds are efficient for tactical management and several dedicated stock selection strategies have the potential to generate uncorrelated alpha to add value. Adding a pure sector strategy allows a targeted pursuit of alpha at desired size from variation in sector and industry returns.

Macro minded intrinsic investing, expressed through sector and industry tilts

The philosophy and premise of our sector strategy is that investment allocated to S&P 500 opportunity/ risk can be enhanced by overweighting its sectors favorably exposed to macro trends without taking company specific active risk. We describe our strategy as macro minded intrinsic investing. We focus more on macro than micro, but use the same intrinsic valuation methods that most stock analysts use to seek the best intrinsic value available.

Our strategy is fundamental in nature with a focus on forward year and normalized earnings estimates by sector: S&P earnings per share (EPS) “middle-up.” Our earnings estimates reflect DWS CIO Views on key macro conditions likely to prevail in the current economic cycle. These include pace and duration of economic growth, inflation and real interest rates. Also, which regions and segments of the global economy offer the best growth; such as investment vs. consumption and within such segments, like capacity expansion vs. productivity enhancers or goods vs. services consumption. DWS CIO Views for commodity prices, key asset values, credit conditions, foreign exchange rates, taxes and other policies affect our earnings outlook.

We capitalize normalized earnings with cost of equity estimates by sector supported by history and models that use current long-term interest rates and risk premium indicators. We aim for reasonable cost of equity estimates across sectors relatively to justly account for differing systematic risk, but to avoid an overpowering sensitivity. Beyond capitalized value of normalized earnings, we consider whether or not each sector has probable long-term economic profit growth potential or decay. These considerations produce fair present values, which we compare to observed market values. We position our sector tilts consistent with the favor of macro trends, unless our valuation analysis suggests excessive market expectations of such. We

consider sentiment signals and price momentum, but mostly to call our attention to where our forecasts might be wrong and require scrutiny.

Sector Strategy: Tilt determination process, time horizons and active risk targets

We aim to keep each of the 11 sector's tilts within +/- 500bp of index weight. This keeps the strategy from being too sensitive to large tilts on just one or two sectors. Our strategy is not about rotating into a few favored sectors at a time, but rather moderate tilts usually across most sectors and on key industries within sectors. Tilts on industries (S&P Global Industry Classification Standard (GICS) 3) are the active risk building blocks of this strategy. We establish tilts with the goal of working within and for at least 6 months. Once an industry's target weight is established, as its benchmark plus active weight, each stock therein is held at its industry weight in the benchmark. This eliminates active risk from stock selection, other than that from the industry tilt. Some stock active risk might exist in portfolios for trading efficiency. Low active share in a sector strategy is not low active risk. Even small sector tilts can bring significant active risk, it's difference difficult to diversify away. Different in right spots beats benchmark.

S&P is Digital Dominated: Sector strategy beyond Tech, as Tech is a market call

Our strategy still prefers intangible over physical assets, as more scalable and nimble, thus more profitable and risk resilient. Asia's industrialization has matured, thus global growth to be more consumption and service driven. All equities are real assets, strong businesses provide best inflation protection; beware of 1970's style inflation protection value traps. The global saving glut suggests no real return without risk and low returns without innovation. Health Care is an underappreciated innovator; it's the key for 21st century productivity. We see attractive capitalized earnings value at Financials, Utilities and Real Estate Investment Trusts (REITs). We underweight Energy, Materials, most Industrials and are selective by industry at the Consumer sectors.

GLOSSARY

Active Share measures the percentage of stock holdings in a manager's portfolio that differ from the benchmark index. Active Share is calculated by taking the sum of the absolute value of the differences of the weight of each holding in a portfolio versus the weight of each holding in the benchmark index and dividing by two.

Alpha refers to returns in excess of a benchmark's return.

Asset allocation is the division of investments into individual asset classes (e.g. stocks and bonds).

A **benchmark** is an index or other value against which an investment's performance is measured.

Beta is a measure of volatility that captures a security's systematic risk according to the capital asset pricing model.

Cost of equity (CoE) is the return (often expressed as a rate of return) a firm theoretically pays to its equity investors, to compensate for the risk they undertake by investing their capital.

Earnings per share (EPS) is calculated as a company's net income minus dividends of preferred stock, all divided by the total number of shares outstanding.

FX or **foreign exchange** is the currency — literally foreign money — used in the settlement of international trade between countries.

The **Global Industry Classification Standard (GICS)** is a four-tiered scheme to hierarchically classify firms by the sector and industry these firms primarily operate in.

Inflation is the rate at which the general level of prices for goods and services is rising and, subsequently, purchasing power is falling.

The **intrinsic value** is the one that comes closest to the value that an objective fundamental analysis would ascribe to an asset.

Momentum refers to the rate of growth of an index or security's price. Momentum investors believe that strong growth is likely to be followed by further gains.

Productivity measures how much economic output is produced for a given level of inputs (such as capital and labor).

A **Real Estate Investment Trust (REIT)** is a company that owns and, in most cases, operates income-producing real estate. REITs sell like a stock on the major exchanges and invest in real estate directly, either through properties or mortgages.

The **real interest rate** is the nominal interest rate adjusted for inflation as measured by the GDP deflator.

The **risk premium** is the expected return on an investment minus the return that would be earned on a risk-free investment.

The **S&P 500** is an index that includes 500 leading U.S. companies capturing approximately 80% coverage of available U.S. market capitalization.

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