

UNDERSTANDING SECTOR ETFS



LAYING THE GROUNDWORK

CONTRIBUTORS



MARC THÜRIG
Managing director,
capital markets, Alpha
Leonis Partners



MARTIN BÜRKI
Co-founder,
martinvestments



REBECCA CHESWORTH
Senior equity strategist,
SPDR ETFs



STEFFEN BAUKE
CEO,
Belvoir Capital



MAURICE PEDERGNANA
Managing director,
Zugerberg Finanz

MODERATOR



ANGUS FOOTE
Citywire

ANGUS FOOTE: What does sector investing mean to you?

MARC THÜRIG: For us, sector investing is an opportunistic, thematic play. We predominantly leave it to fund managers to switch from one sector to another. However, we are looking at how to exploit some sector opportunities – for example, the finance sectors on the back of rising interest rates and bank deleveraging in Europe – how to express those views and does it make sense to be involved in one sector?

MARTIN BÜRKI: For me, sector investing is based on, or benchmarked against, an MSCI sector or sub-sector. It is not always easy to see when thematic investing goes in one direction or another. For example, if you want to invest in robotics funds, there is no MSCI Robotics index. That [requires] a thematic fund. Also, looking at technology, some large tech firms are not in the MSCI [World Information] Technology index. But people who buy technology sector ETFs often want to profit from such companies.

‘It is not always easy to see when thematic investing goes in one direction or another. For example, if you want to invest in robotics funds, there is no MSCI Robotics index’

Martin Bürki
Co-founder, martinvestments

MAURICE PEDERGNANA: In an environment of rising interest rates, specific sectors – such as insurance and the banking sector – correlate positively with bond yields. So you have to favour those sectors and be negative on others. If you look at the business environment and take a view on the characteristics of each sector, then you can find huge differences and use those differences easily.

STEFFEN BAUKE: Buzzwords like nanotechnology and artificial intelligence are all influencing that sector. You can see the big dispersion between the good and bad performing sectors in equities and bonds, and these are key elements in how to invest, alongside value and style. So it's more of a matrix of these elements and how sector investing fits into that matrix and interplay. There could be three or four dimensions at play and you have to decide actively where you want to be.

REBECCA CHESWORTH: Our clients talk a lot about the opportunity to target themes, markets and the business cycle. Sector investing is used increasingly

as people appreciate those things. We're in a complex world - the MSCI World index has over 1,600 stocks. But it has just 11 sectors. Many people like sectors because it simplifies that universe into groups of stocks with the same risks and drivers. That helps you on the business cycle, but some prefer to look at the factor characteristics of the sector. So, we see people using sectors for different reasons. But the main reason why they interest me is that dispersion of returns between the top and bottom performing sector each year. Everybody wants that in this time of low yielding returns.

'It's a symbiosis, not a fight, between passive and active. There's a place for all at various times in the cycle'

Marc Thürig

Managing director, Capital Markets at Alpha Leonis Partners

MARC THÜRIG: We have to emphasise the passive-active element. If you take a broad view – you may want to be long US banks, for example – you can find a US financials ETF. But you may want to be only long certain stocks for specific characteristics. Some ETFs have characteristics that we don't want because certain stocks in a sector drive performance and some drag. Also, most ETFs are market-cap weighted. So what is the effect on small cap? With so many investments in the world going into passives, this is a huge question. So for us, it's trying to understand where to take a broad view or where to be niche and active.

REBECCA CHESWORTH: Some sectors lend themselves more to sector investing because they have a higher correlation [between constituent] stocks and it's not worth stock picking in them. Others don't. So for example, energy, tech and financials tend to have highly correlated stocks within them. They will move more together compared to something like consumer discretionary, where different trends are going on – such as leisure and internet retailers...

STEFFEN BAUKE: Whether you just buy the good stocks in this sector or just take an ETF, the dispersion makes a difference. But how to know which sectors next year will outperform and underperform - that's the search for the Holy Grail, and nobody knows where it is.

ANGUS FOOTE: What are the advantages of using sector ETFs in a portfolio and what are the potential drawbacks or risks? Many people now mix active

and passive. Do you play long-term trends with active managers and short-term tactics with passive?

REBECCA CHESWORTH: We do see that. Some people use a sector rotation model, but increasingly – and particularly, in the private wealth world where you get to know the active managers well – you don't want the fund to turn over too quickly. You may be in it for two years. Maybe the fund is underweight energy and [as is the case currently] people are worrying about inflation. Energy has been volatile, maybe you don't want to be short, so you buy your ETF. That is a trend, but it's only one way that people are using them.

MARTIN BÜRKI: Many pension funds are going into ETFs and away from active funds. But that creates an advantage for active funds because we need a mix of stocks that are in the benchmark and not in the benchmark, or are smaller in the benchmark.

STEFFEN BAUKE: Our clients give us complete leeway between active or passive. They say, 'do whatever you want, just bring bottom line and Sharpe ratio performance compared to the market and peers'. That allows us a broad universe of how we can invest. We've seen opportunities in the small-cap sector, for example, where you should use active managers or active stock picking. Broader markets, like the S&P are different – it's the most researched market in the world, so [how do you] choose outperforming stocks every year? I don't know. But you have to have a view about where you want to invest. I see this now with our investors. If you don't, you will be wiped out [by just doing] ETF long investing].

You just buy the MSCI World, go to sleep and look back three years later. I wouldn't do that. But there are many approaches. Passive-passive uses both passive asset allocation and funds. Passive-active is active asset allocation, using passive funds; or passive allocation using active funds. Active-active uses active asset allocation and funds. You can mix all of them and you have to define where you want to be. We are more in active-active and active-passive because that's where we try to add value.

MARTIN BÜRKI: An active manager must have a chance to deliver alpha. To do that, he needs at least 200 stocks to select from. So for example, the MSCI World Utilities has 83 shares. That's not enough to deliver alpha. In the MSCI [World Information] Technology, you have 167 stocks... closer to 200. Then you have a chance.

STEFFEN BAUKE: Alpha doesn't come necessarily through diversification.

MARTIN BÜRKI: Yes, but if you can only over- or underweight stocks that's not enough to bring good outperformance. You need stocks that are not in the

benchmark. For example, in the MSCI [World Information] Technology, the biggest 10 stocks make 35% of the index. So the major decision is whether you take these ten stocks in or not. You need more stocks to choose from or you need specialist expertise in a particular area.

REBECCA CHESWORTH: In fact, there are just two main tech stocks driving the sector. If you don't pick those stocks, you're taking a huge risk. But we haven't touched on diversification as a risk benefit. Some say sector investing allows them to diversify their portfolio. 'I'm not taking much risk and I can have one sector here and one that's completely uncorrelated.' It's another way to use it.

'Sectors are the active choice for passive instruments. They're perfect for that kind of strategy'

Rebecca Chesworth
Senior equity strategist, SPDR ETFs

MARC THÜRIG: If we view a sector broadly, an ETF makes sense. But if there's a high dispersion in that sector, it may make more sense to be active with a hedge fund or a manager that can identify the right stock within that sector.

All those products – ETFs, hedge funds, long-only funds – are wrappers. It's still the same underlying market, so we try to take a macro view on it. Then we want to do bottom-up single stock selection, and ask whether we want to be active in a sector or even more broadly? You can use one or the other to express your view. But we need to take a view and not just say, 'I do long-only investing'.

REBECCA CHESWORTH: Over the last two years, we've seen low yields. More people want to do more with their equities and that plays to sectors. We've also seen a significant rise in all markets this year; and people wanting to be more selective in finding the sharpest tool in the toolbox - that's where sectors also come into play.



SECTORS IN THE SPOTLIGHT

'It makes no sense to buy an active fund if the manager is conservative and you think the sector will outperform'

Martin Bürki
Co-founder, martininvestments

ANGUS FOOTE: What sectors do you favour currently and what strategies are you using?

MAURICE PEDERGNANA: You don't have to look for the Holy Grail, you just need common sense. If you believe that this interest rate environment is not in balance with a huge growth rate, for example, here in Europe, then you need different views on different sectors. The financial sector was negative in 2011 in the midst of the eurozone crisis. Now, we have high growth rates for Europe, outside the UK, and therefore, financials will win in the next one or two years. Insurance will win in the next two or three. I will avoid anything to do with real estate. So it might be difficult to have the right weight at the right time, but to be just some way above the average using sector investing is not difficult.

STEFFEN BAUKE: We take the macro view. You can choose sectors without doing a single stock pick. They're perfect tools for playing top-down.

REBECCA CHESWORTH: Some say one reason active has underperformed is that there have been [high] correlations between stocks. Over the last two years, stock correlations have come down, led by decreasing sector correlations. This creates a bigger opportunity to make a difference. Then you can start to talk more about your diversification benefits and risk benefits. It's why we're seeing so much money come into sector funds.

STEFFEN BAUKE: [Because of lower correlations between two sectors] a lazy asset manager could just take two bets on sector ETFs at the beginning of the year, and rebalance at the end of the year. This will not under or outperform in a big way compared to other asset management styles.

MAURICE PEDERGNANA: The period from 2008 to 2011 was not easy for sector investing due to the high correlations and high volatility. Now, we are in an ideal situation for picking, because we have low volatility.

MARTIN BÜRKI: We had a good discussion about active versus passive, but it's a combination. In some sectors, it makes sense to use ETFs if you just want to

play in one direction. It makes no sense to buy an active fund if the manager is conservative and you think the sector will outperform. Overall, it's the mixture that is important.

MARC THÜRIG: But we've had the lowest volatility in the last 30 years, which worries me. It will revert at some point. Volatility will spike, and it will make less sophisticated investors run for the door. We will see a sell-off in the passive world.

REBECCA CHESWORTH: People selling out of ETFs will speed up the trend. But the question of liquidity is too long to answer here because it depends on the asset class.

STEFFEN BAUKE: Isn't it a good chance for active managers to snipe the ETF world? The next correction will tell us. There is no way to sell all this stuff... so we will see shocks. The regulators try to make the markets safer by putting regulations around liquidity and transparency, but I fear it will be the other way around.

ANGUS FOOTE: What sectors are you avoiding?

MAURICE PEDERGNANA: The illiquid asset class is real estate. That's why you need some views on sectors. At least you could choose to avoid real estate or utilities. If you look at the balance sheet of a typical utility, in an environment of rising interest rates, there will be less margin for net earnings. But you will have more net earnings in the financial sector. That's why it always begins with your macro view, then you need a sector view.

MARTIN BÜRKI: Low volatility is a concern for many people. Normally, it is a counter signal and shows that people are not as afraid as they should be. But most people are underinvested. We don't currently see big selling pressure if it goes down a bit, so we're not afraid of volatility.

MARC THÜRIG: A few people ask me, 'will we see a correction?' I'm still buying, but most of our managers have reached their exit prices and are going into cash. Volatility is not giving us an entry point for the next trade. So many managers are sitting on a lot of cash waiting for the next correction.

MARTIN BÜRKI: If the taxi driver asks you what stocks to buy, then you should sell everything.

MAURICE PEDERGNANA: You need a conviction and, whether [or not you believe in the US Federal Reserve's projections], we are entering a different period in the next two years and some sectors will suffer more than others. That's

why you have to think in sector views and not just in asset classes.

ANGUS FOOTE: How do you select the sectors you invest in?

REBECCA CHESWORTH: Selecting a sector is not that different from picking stocks. You start from the top-down, but you are still looking for earnings growth, earnings momentum, and a good valuation. What's going to make it move over your timeframe; where are investors positioned in this stock and what is

'You need to be active in a changing world and that is why you need to invest in sectors along the cycle. That is also why you have to differentiate between sector strategies. Use your common sense as a smart investor and you will beat the average'

Maurice Pedernana
Managing director, Zugerberg Finanz

their sentiment; where are the flows going? You're just not meeting the chief executives. Another crucial advantage of sectors is the flexibility of being able to pick a different sector for different regions. We're at slightly different points in the cycle with the US and Europe.

SPDR sees more upside in Europe now and our picks are more towards cyclical sectors in Europe. The two that we're looking most closely at are consumer discretionary to play the growing consumer confidence, and materials. In the US, many things, including most of the sectors, look expensive. The only place I want to look in the US is financials.

STEFFEN BAUKE: We look into value classes and end up with the same sectors: consumer staples, and companies with free cash flow, and high dividend yields, looking at pay-out ratios. You would never have ended up in a utility company in the last five to ten years. Most of the time, you end up in the same more defensive sectors.

But once you've chosen the sectors, it is difficult to find good sector ETFs. Some of your competitors closed ETFs because they were [too small and not profitable]. We have a vehicle where we play sector rotation and it's not that easy. So we've taken the 15 largest stocks in each sector once they cover 80% of the sector. That makes it complicated to just be beta long with the market and then over and underweight the sectors by an allocation mechanism. So I put it back to

the ETF providers. How do you play sectors?

REBECCA CHESWORTH: SPDR has three Europe domiciled ranges. Some who want a large order may look at our US domiciled range, which is much bigger, and you can short those. There are some reasonable size funds compared with the competitors. The sectors with the highest correlation in them – the ones that people want to use more, such as technology and financials – have attracted billions of flows in the US and Europe.

‘Don’t try to reinvent the world, just follow the world and be smarter. Take bets if you have to, either macro or micro. You need to have active weightings and give the managers their freedom’

Steffen Bauke
CEO, Belvoir Capital

STEFFEN BAUKE: We’ve seen growth in sector and theme ETFs over the years, but then in the last two years it has shrunk with ETFs closing. We talk about 19 sectors in Europe and the underlying sectors are not that liquid.

MAURICE PEDERGNANA: It’s difficult for an average investor to pick [tech stocks] such as Amazon, Tencent, Baidu, Alphabet, Alibaba. So the sector investment is a good instrument.

MARC THÜRIG: For me, sector investing is a macro play. Within some sectors, some companies [have vastly different PE ratios] and are over or underleveraged. So if you want to do fundamental work on that, you become a stock picker and do the work. But if you want to take a macro view in a cycle, sector investment is right. [Smart beta is another way of looking at fundamentals within a sector] and has increased rapidly. People are looking for low volatility ETFs, dividends, quality earnings and value.

REBECCA CHESWORTH: You’re not doing what a stock picker would do, building a model, talking to managers and doing your own profit forecasts. But you are looking at the fundamentals and trying to understand what is driving maybe the top five stocks that could be 80% of the index. You’re just doing it at a higher, aggregate level.

We have a wide range of clients – from institutions who are in there for the long



term and don't need the intraday liquidity of ETFs, to hedge funds who use them increasingly. They've picked up banking and financial shares as they've gone down. So they demand [the intraday trading that] ETFs offer... This year, about 35% of US equity flows are into sectors. The money that's gone into technology and financial ETFs is huge.

US funds, and world and emerging market funds are all keen on technology. We've been much keener on financials, with banks coming back and tax cuts coming in the US, we're seeing people use that as a buying opportunity. Also, US investors have been selling out of defensive sectors in October and November. There are some bullish people out there.

'Different investors use ETFs in different ways. We have cases where it makes sense to use ETFs and where it makes sense to use active funds'

Martin Bürki

Co-founder, martininvestments

MAURICE PEDERGNANA: That's smart because you have a negative correlation between those sectors with rising US bond yields. There is no issue of heavy balance sheets in the technology sector.

MARTIN BÜRKI: Why is nobody launching a smart beta sector ETF?

STEFFEN BAUKE: We're talking about sectors, but we never talked about smart beta.

REBECCA CHESWORTH: Many people are playing them both. You can use sectors for smart beta, but be aware that they don't get reweighted as quickly. Smart beta sectors rebalance quarterly to bring it back to low volatility, growth or value. A more sophisticated way to do it may be to dive down into a factor, such as sensitivity to interest rates or to oil price. We have something called a 'sector dashboard'. People looking to choose a sector are looking at that kind of thing.

