Elston

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Elston Insights

Alternative approaches to equity diversification

- Regional equity allocation is starting to look dated
- Sectors, factors and themes offer an alternative approach
- These offer greater potential for returns dispersion

The most traditional approach to world equity diversification is a regional approach. This gives investors the ability to overweight or underweight particular markets, on the outlook of their economies.

Whilst this is straightforward, cheap and aligned with fund sector classifications, it is restrictive and increasingly dated.

A lot of what drives share price performance is based on which *sector* they are in (Energy stocks are having a great time now, Consumer Discretionary less so), the *factors* that drive their returns (Value is currently outperforming Growth), or long-term structural *themes* (like food production or cyber security).

Indeed many managers talk sectors, factors or themes, but invest by region. This doesn't make much sense. So sector, factor and thematic ETFs can help.

How do we differentiate between these categories?

Sectors group companies by their business activity. These industry classifications are long-standing and relatively stable enabling research as regards sector performance in different economic regimes.

Factors group equities with similar style characteristics. Factors are the broad persistent explainers of return explored in academia. Examples of factors include Value (companies whose price is cheap relative to their fundamentals), Size (small cap vs large cap), Quality (higher ROE and gross margin), Momentum (companies with rising share prices) and Minimum Volatility (less volatile share prices).

Themes group companies by exposure to a structural long-term theme that could act as a tailwind for growth. Examples of themes include food security, cyber security, medical cannabis & life sciences, to name a few.

By allocating according to sectors, factors, or themes, investors can capture investment style while minimizing idiosyncratic risk.

Sectors, Factors and Themes offer a more coherent grouping of companies than the region of their headquarters. This provides a more nuanced way to implement tactical views and a more targeted approach to equity diversification.

The dispersion between sectors, or factors or themes can be more pronounced than between region, and this enables greater potential diversification and selectivity.

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