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Elston Insights

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Avoiding sector concentration with sector equal weight

- Sector concentration is a choice, not an obligation
- A sector equal weight outperformed cap-weighted version
- Sector equal weight enables active sector selection

The rise of sector concentration risk in US and World equity indices is not a new phenomenon, but has recently become pronounced. But funds do not need to aim to track or beat a capitalisation-weighted index. Our World Equity Sector Equal Weight index provides an alternative.

Sector concentration is a choice, not an obligation

Market capitalisation-based world equity indices are inherently overweight certain sectors such as Technology, while significantly underweight certain sectors such as Energy, Materials, Utilities and Real Estate.

Elston World Equity Sector Equal Weight Index takes an equally weighted approach to world equity sectors which removes the bias towards the highest market cap sectors such as Technology.

Fig.1. Sector allocation (market cap weights vs sector equal weights)

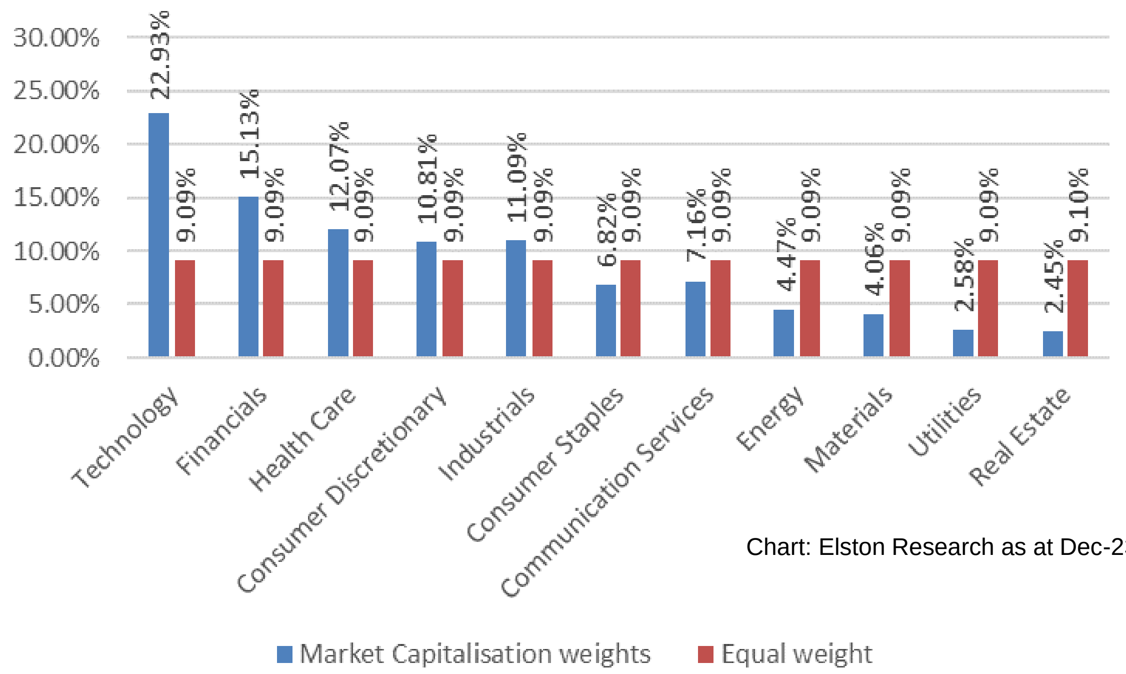


Chart: Elston Research as at Dec-23

Sector equal weight has outperformed traditional indices in last few years

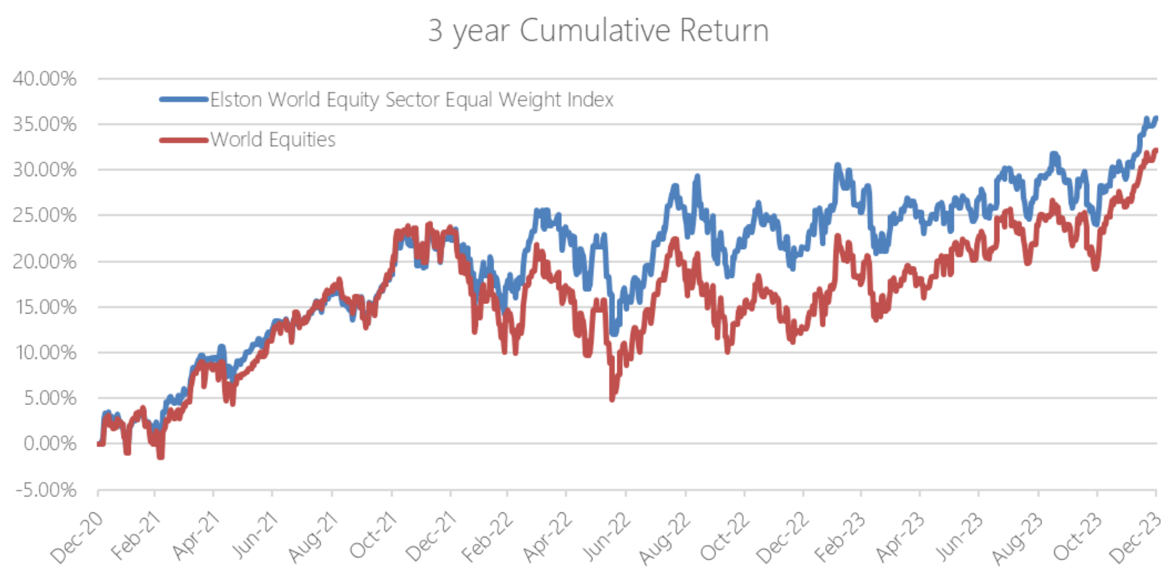
In 2022, overvalued sectors such as Technology had significant underperformance, making cap-weighted indices underperform a sector equal weight strategy.

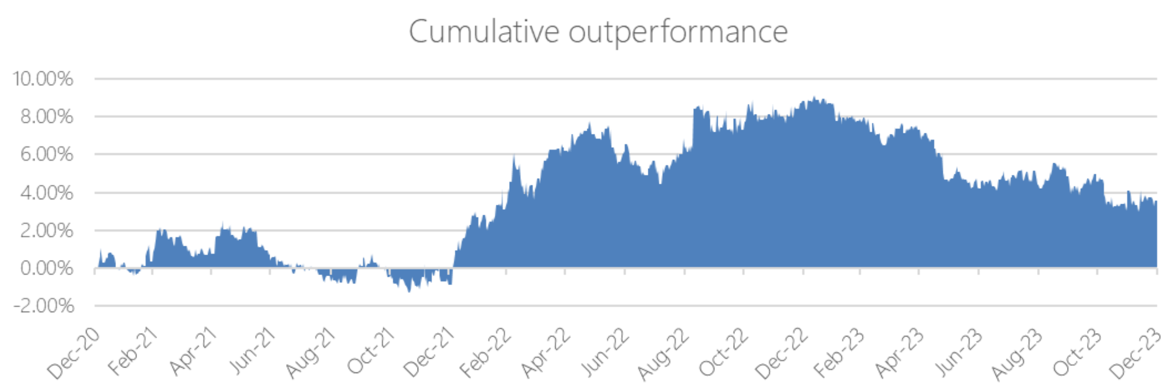
While in 2023, the Technology sector had significant outperformance compared to the Energy sector.

Over the last three years, cumulative returns have favoured sector equal weight over traditional capitalisation weight. Having an alternative weighting strategy can act as a diversifier.

But that's not the only point. This is about having a more relevant benchmark for active sector selection strategies.

Fig.2. Cumulative return and relative performance





Source: Elston research, Bloomberg data

Overtime relative performance will vary: the value of a differentiated index is not in its performance relative to another index, but in providing a relevant benchmark for a differentiated approach to equity allocation. For example, whether funds are actively selecting sectors relative to a sector equal weight benchmark, or passively tracking an equal weight benchmark, an alternatively weighted index provides a differentiated approach.

Sector equal weight enables active sector allocation decisions

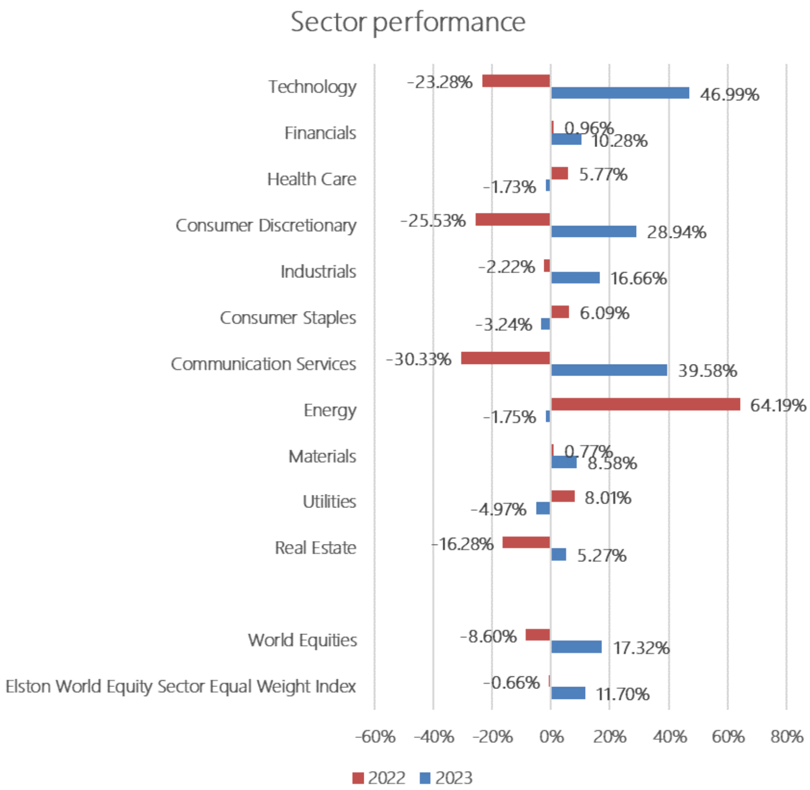
Higher dispersion between securities within an index, enables higher potential for alpha from security or sector selection.

If security or sector performance is very different to the overall index (dispersion is higher), whatever you select, could have performance highly differentiated to the overall index, so the potential for alpha is higher.

If security or sector performance is all similar to the overall index (dispersion is lower), regardless of what you select, performance will also be similar to the overall index, so the potential for alpha is lower.

Recent market shocks have triggered large dispersion in sector performance. The differential between the best performing and worst performing sector in 2023 was a staggering 93 percentage points. The figure for 2022 was 63 percentage points. Both these years show higher than typical dispersion. For active managers, dispersion is your friend as it creates the opportunity for alpha through active sector allocation.

Fig.3. Sector performance 2022 and 2023



Source: Elston research, Bloomberg data, in GBP terms

Summary

Concentration risk is a choice, not an obligation. A sector equal weight approach provides an alternative benchmark both for active managers seeking to actively select sectors, and for passive managers seeking to track an alternatively-weighted index.

In this era of high sector dispersion, active sector selection has potential for alpha.

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