Can the Approach Work in Different Countries?

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¹ Sources: Bloomberg Finance L.P., State Street Global Advisors, as of 31 March 2021.  
* Frequent trading of ETFs could significantly increase commissions and other costs such that they may offset any savings from low fees or costs.
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Research on sector rotation, which is a popular tactical asset allocation technique, often centres on using price momentum as the sole criterion to identify outperforming sectors. The aim here is to give investors ideas on implementing a tactical sector rotation strategy systematically using sector ETF building blocks. In this paper, we examine the viability of implementing a sector rotation strategy using a blend of parameters. These include macroeconomic indicators and fundamental information, in addition to price momentum.

The selection approach was simulated across different geographies (namely the US, Europe and World developed markets) and rebalanced at the end of every month. We call this approach the Sector Selection Research Model.

Results show that the sector rotation strategy beat its respective benchmarks across all regions over the entire period, and with diminished volatility. The tactical nature of the allocation means that the portfolio turnover, which is a major driver of transaction costs, was remarkably high (~200%). Even so, the outperformance of the simulated sector rotation strategies remained robust after including estimated transaction costs. This suggests there may be merit in combining multiple criteria to select the most attractive sectors.

2 Source: State Street Global Advisors, as of 31 March 2021.
Sector Rotation
Across Regions

Can Sector Rotation Work in Different Countries?

Most Existing Research is Based on Momentum Applied to the US

Sector allocation has been one of the main pillars in institutional equity portfolio management and is a key component of tactical asset allocation. The central principle of this investment technique relates to the ability of investors to back sections of the market that are experiencing favourable conditions while avoiding those in distress.

Much of the publicly available research concentrates on approaches to sector rotation in the US. However, its applicability to other regions attracts far less focus and is often overlooked. Commentators have offered various explanations for this observation. Some believe that regions outside of the US lack the sector diversity needed to implement a viable sector rotation strategy. In the past, these challenges were compounded by the limited availability of liquid and competitively priced sector building blocks needed to execute a rotation strategy successfully.

The rise of sector ETFs has eliminated that last hurdle. The ETF trend appears set to consolidate even further as a high dispersion of sector returns may give investors more profit-making opportunities. Indeed, the current spread between global sector returns continues to widen to its largest level since 2000.¹

At the heart of sector rotation strategies is the tenet that return can be improved by timing or tilting to sectors on the strength of economic or other quantitative information. Of the different methods used to pick sectors, price momentum is by far the most studied. For instance, Moskowitz and Grinblat (1999)² reviewed the returns of single stocks and sectors between 1963 and 1995 and concluded that momentum strategies applied to sectors generated a higher return than those applied to individual stocks.

Other authors, such as Burch and Swaminathan (2001), found that institutional investors — most notably, insurance companies, banks, investment advisors and fund managers — often use momentum as a means of making their equity investment selections.

Besides momentum, another extensively employed technique is to consider macroeconomic data and the business cycle. The rationale behind this is that if the correct phase in the business cycle is identified, then it is possible to predict the performance of different sectors. Kouzmenko and Nagy (2014)³ assessed the relationship between sector performance and business cycles between 1976 and 2009 using both inflation and the OCED Composite Leading Indicators. They found that the returns of cyclical sectors were higher in economic expansions than countercyclical ones.

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In this paper, we seek to add to the current body of research in this area by examining the performance of a sector rotation technique that blends both macroeconomic, fundamental and quantitative data, including price momentum, in different regions. To test the feasibility across different geographies, the strategy — which is known as the Sector Selection Research Model — was created and tested in the US, Europe and World developed markets.

In our study, we also examined the impact of estimated trading costs on return. The initial selection universes used for the analysis include the 11 GICS sectors that make up the S&P 500, MSCI Europe and MSCI World Indices. These sectors are communication services, energy, materials, health care, industrials, consumer discretionary, consumer staples, financials, real estate, information technology and utilities. In addition to using publicly available sources for price and fundamental data, the analysis in this research also utilises proprietary information on investor positioning derived from anonymised custody data of institutional investors from State Street Global Markets.
The Sector Selection Research Model deploys a rule-based, sector rotation approach that targets the most relatively attractive sectors using a blend of price, macroeconomic and fundamental factors. The importance of these selection factors is captured in the dynamic weighting scheme of the research model.

Furthermore, the model provides for a mechanism that ensures risk is controlled and opportunities arising from dispersion are seized. In all, the approach comprises two major steps: sector selection and sector weighting. This process is repeated on a monthly basis.

Sectors are chosen based on three factors, hereafter known as ‘components.’ These components are: price momentum, macroeconomic environment and fundamental data (see Figure 1). Sector selections are conducted independently and are based solely on the criteria that make up the component and the best five sectors are selected in each component.

Once the selections are determined, a return time series is generated for that component. If all the sectors record a negative reading across most of the criteria in a given component, no sectors will be selected and the return for the month is assumed to be cash.

Figure 1 How the Sector Selection Research Model Selects Sectors

Source: State Street Global Advisors. For Illustrative purposes only.
Sector Selections are Done Independently Using Momentum, Macroeconomics and Fundamentals

- **Sector Momentum Component** In this component, sectors are ranked based on the historical 12-month price momentum as well as the most recent investor flow positioning metric, which is a proprietary State Street indicator that shows how real money investors are positioned. Sectors that are heavily held by investors, the so-called ‘overcrowded sectors,’ are also removed at this stage.

- **Macroeconomic Indicators Component** The current macroeconomic regime is determined principally by leading economic indicators, supported by the Citi Economic Surprise Index. Once the current regime is ascertained, sectors are chosen on the strength of their past performance whilst being in the same macroeconomic regime in the past.

- **Sector Fundamentals Component** Sector fundamentals account for both trailing fundamental information as well as forward-looking analyst consensus forecasts. Trailing information includes return on equity and net profit margin (or, in the instance of the finance sector, net interest margin). On the other hand, forward-looking information includes the percentage change between analyst upgrades and downgrades for a given sector. Sectors are then classified by means of a blend of trailing and forward-looking measures.

**Sector Weighting**

Weighting is Based on the Relative Importance of Components, as well as Risk Control and Dispersion

Sector weighting is influenced both by the dynamic weighting of the components as well as the subsequent calibration of final weights. This approach is designed to limit risk and capitalise on opportunities stemming from sector dispersion.

Having selected the most relatively attractive sectors in the previous step, the research model applies a dynamic weighting scheme to reflect the relative importance of the components. This ultimately affects the weight of the sectors that the strategy chooses and is achieved through a mean-variance optimisation process, which uses the time series of the components computed previously, in such a way as to maximise the portfolio risk-adjusted return (see Figure 2). The outcome of this process is what produces the ‘pure sector strategy.’

**Figure 2  The Dynamic Weighting Scheme of the Components in the Research Model**

Source: State Street Global Advisors. For illustrative purposes only.
The final step in determining the sector weights involves restricting the amount of risk the pure sector strategy incurs, as well as encouraging it to run more risk where opportunities from dispersion emerge. To avoid running excessive risk, the Sector Selection Research Model targets a tracking error of 10% p.a. and any excess tracking error is curbed through increasing the allocation in the benchmark.

In addition, the research model also evaluates whether there is a sizeable opportunity in making sector bets by examining the average sector dispersion. A high sector dispersion signifies that there is a material difference between the best and worst performing sector and that, if the sector bet is correct, there is potentially a substantial gain from it. For this reason, the research model has embedded a mechanism whereby if there is material sector dispersion, it will reduce the allocation in the benchmark and boost the allocation in the pure sector strategy and vice versa.
Strategy Performance

Overview

Here we examine the allocation sector decisions of the Sector Selection Research Model in each region. We also analyse how the strategies performed against their reference benchmarks over the entire study period, as well as during specific historical periods.

US Sector Selection

In the US, the US Sector Selection Research Model (SSRM) exceeded the S&P 500 benchmark over the entire study period (January 1999 to February 2021) and in the majority of the calendar years (see Figure 5). On an absolute basis, the model outperformed the S&P 500 benchmark by around 3% p.a. with a correspondingly lower volatility and, together, this produced a strong risk-adjusted return of 0.64, which is nearly twice that of the benchmark (see Figure 4). This level of performance was achieved by virtue of the strategy’s dynamic monthly rebalancing mechanism.

Another notable observation was the seemingly defensive nature of the sector strategy, which is evidenced by having a quite lower market beta of around 0.80 and a substantially lower maximum drawdown than its benchmark (-40% versus -54%). We can potentially attribute this observation to the strategy’s capacity to allocate into cash or defensive sectors during bear markets.

However, during the last year the strategy underperformed against S&P 500 benchmark. This underperformance was mainly due to a lack of direction and heightened volatility in the financial markets. That being said, the strategy incurred a lower drawdown than the S&P 500 during the COVID-19 market turmoil.

### Figure 4

<table>
<thead>
<tr>
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<th>Sector Selection Research Model (without costs)*</th>
<th>S&amp;P 500 Net Total Return</th>
</tr>
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<tbody>
<tr>
<td>Annual Return (%)</td>
<td>8.96</td>
<td>6.46</td>
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<tr>
<td>Annual Volatility (%)</td>
<td>13.04</td>
<td>15.16</td>
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<tr>
<td>Return per unit Risk</td>
<td>0.64</td>
<td>0.36</td>
</tr>
<tr>
<td>Maximum Drawdown (%)</td>
<td>-39.63</td>
<td>-53.69</td>
</tr>
</tbody>
</table>

Source: Bloomberg Finance L.P., State Street Global Advisors. As of April 2021. Monthly data from January 1999 to February 2021. Past performance is not a reliable indicator of future performance. Index returns are unmanaged and do not reflect the deduction of any fees or expenses. This information should not be considered a recommendation to invest in a particular sector or to buy or sell any security shown. It is not known whether the sectors or securities shown will be profitable in the future. The results shown represent current results generated by our Sector Selection Research Model. The results do not reflect actual trading and do not reflect the impact that material economic and market factors may have had on State Street Global Advisors’ decision-making. The results shown were achieved by means of a mathematical formula, and are not indicative of actual performance which could differ substantially. The performance reflects management fees, transaction costs, and other fees expenses a client would have to pay.

* Transaction costs, which include taxes, commissions and trading costs, are assumed to be minimal, such that there is little to no impact on the categories above.
Figure 6: Calendar Year Returns of US Sector Selection Research Model Compared to S&P 500

Source: Bloomberg Finance L.P., State Street Global Advisors. As of May 2021. Monthly data from January 1999 to February 2021. Past performance is not a reliable indicator of future performance. Index returns are unmanaged and do not reflect the deduction of any fees or expenses. The results shown represent current results generated by our Sector Selection Research Model. The results do not reflect actual trading and do not reflect the impact that material economic and market factors may have had on State Street Global Advisors’s decision-making. The results shown were achieved by means of a mathematical formula, and are not indicative of actual performance which could differ substantially. The performance reflects management fees, transaction costs, and other fees expenses a client would have to pay.

European Sector Selection

The sector selection strategy in Europe surpassed its MSCI Europe benchmark on an absolute basis over the study period, which spans from January 2001 to February 2021 (see Figure 6). Risk-adjusted performance of the sector selection research model was equally robust at more than double that of the benchmark. The more anticyclical nature of the strategy also means that its maximum drawdown over the entire study period was much shallower. As seen in the US model, the European counterpart was dynamic and racked up a portfolio turnover of 200% p.a., owing to its embedded monthly rebalancing feature.

Judged over the entire period, the strategy only assigned a modest weight to cash and did not have any material sector biases. A careful examination of the strategy’s allocation decisions shows that it was overweight consumer staples, especially in the second half of the period when we saw heightened turbulence in the equity markets.

Over recent years, the strategy outperformed significantly especially during periods of market stress. A case in point is the turbulence experienced in the financial markets at the start of the COVID-19 pandemic. The drawdown experienced by the strategy was 13%, which was just under half the amount the MSCI Europe benchmark experienced (24%).
Similar to both the US and Europe, the World Sector Selection Research Model outperformed the MSCI World benchmark on both an absolute and relative basis (see Figure 8). This can partly be attributed to the monthly rebalancing mechanism, which has allowed it to react to prevailing market conditions. As a result, the strategy incurred an average portfolio turnover of around 200% p.a., which is a typical feature of highly tactical allocation strategies.

When viewed over the whole period, sector allocations were anodyne as they were largely evenly spread, and no single sector stood out among the rest. During this period, the sectors with the largest allocations were the industrials, consumer discretionary and IT sectors, which had around a 10% weight apiece. However, once the entire period is parsed into two 10-year periods, the differences in the selections that the strategy made become more obvious.

In fact, during the first half of the time period, which was marked by several major crises, the strategy held 3–4 times more cash than it did in the second half, although allocation in cash was low in both periods. In the second half of the period, which covered mainly the bull market over the last decade, allocations were most notable in cyclical sectors (namely the IT and consumer discretionary sectors) as well as in the health care sector, which is somewhat unexpected.

Like the US and Europe SSRM strategies, the World SSRM strategy proved reasonably resilient during the recent COVID crisis and incurred a lower drawdown than the MSCI World benchmark.
**Figure 8**  
Risk-Return Characteristics of World Sector Selection Research Model from January 1999 to February 2021

<table>
<thead>
<tr>
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<th>Sector Selection Research Model (without costs)</th>
<th>MSCI Europe Net Total Return</th>
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<tbody>
<tr>
<td>Annual Return (%)</td>
<td>6.66</td>
<td>5.73</td>
</tr>
<tr>
<td>Annual Volatility (%)</td>
<td>12.78</td>
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<tr>
<td>Return per unit Risk</td>
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<tr>
<td>Maximum Drawdown (%)</td>
<td>-42.22</td>
<td>-56.62</td>
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**Figure 9**  
Calendar Year Returns of World Sector Selection Research Model Compared to MSCI World

Source: Bloomberg Finance L.P., State Street Global Advisors. As of May 2021. Monthly data from January 1999 to February 2021. Past performance is not a reliable indicator of future performance. Index returns are unmanaged and do not reflect the deduction of any fees or expenses. The results shown represent current results generated by our Sector Selection Research Model. The results do not reflect actual trading and do not reflect the impact that material economic and market factors may have had on State Street Global Advisors’ decision-making. The results shown were achieved by means of a mathematical formula, and are not indicative of actual performance which could differ substantially. The performance reflects management fees, transaction costs, and other fees expenses a client would have to pay.
Conclusion

In summary, the results show that the sector rotation strategy beat its respective benchmarks across all regions over the entire period, and with diminished volatility. The tactical nature of the allocation model means that the portfolio turnover, which is a major driver of transaction costs, was remarkably high (~200%). Even so, the outperformance of the simulated sector rotation strategies remained robust after including estimated transaction costs. This suggests there may be merit in combining multiple criteria to construct a sector rotation strategy.

Endnotes

1 Paying attention to your sector selection pays, State Street Global Markets, April 2020.


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**SPDR ETF Information**

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**World Sector Funds**

- SPDR MSCI World Communication Services UCITS ETF: IE00BYTRRG40
- SPDR MSCI World Consumer Discretionary UCITS ETF: IE00BYTRRB64
- SPDR MSCI World Consumer Staples UCITS ETF: IE00BYTRRF76
- SPDR MSCI World Energy UCITS ETF: IE00BYTRRF863
- SPDR MSCI World Financials UCITS ETF: IE00BYTRRG970
- SPDR MSCI World Health Care UCITS ETF: IE00BYTRRF994
- SPDR MSCI World Industrials UCITS ETF: IE00BYTRRC02
- SPDR MSCI World Materials UCITS ETF: IE00BYTRRF33
- SPDR Dow Jones Global Real Estate UCITS ETF: IE00B6GF1M35
- SPDR MSCI World Utilities UCITS ETF: IE00BYTRRH56

**US Sector Funds**

- SPDR S&P U.S. Communication Services Select Sector UCITS ETF: IE00BFWPXG0
- SPDR S&P U.S. Consumer Discretionary Select Sector UCITS ETF: IE00B8GF1M35
- SPDR S&P U.S. Consumer Staples Select Sector UCITS ETF: IE00B8GF1M35
- SPDR S&P U.S. Energy Select Sector UCITS ETF: IE00B8GF1M62
- SPDR S&P U.S. Financials Select Sector UCITS ETF: IE00B8GF1M62
- SPDR S&P U.S. Health Care Select Sector UCITS ETF: IE00B8GF1M62
- SPDR S&P U.S. Industrials Select Sector UCITS ETF: IE00B8GF1M62
- SPDR S&P U.S. Materials Select Sector UCITS ETF: IE00B8GF1M62
- SPDR S&P U.S. Technology Select Sector UCITS ETF: IE00B6GF1M62
- SPDR S&P U.S. Utilities Select Sector UCITS ETF: IE00B6GF1M62

**Europe Sector Funds**

- SPDR MSCI Europe Communication Services UCITS ETF: IE00BW00N82
- SPDR MSCI Europe Consumer Discretionary UCITS ETF: IE00BW00C77
- SPDR MSCI Europe Consumer Staples UCITS ETF: IE00BW00D48
- SPDR MSCI Europe Energy UCITS ETF: IE00BW00F09
- SPDR MSCI Europe Financials UCITS ETF: IE00BW00G16
- SPDR MSCI Europe Health Care UCITS ETF: IE00BW00H23
- SPDR MSCI Europe Industrials UCITS ETF: IE00BW00A47
- SPDR MSCI Europe Materials UCITS ETF: IE00BW00L68
- SPDR FTSE EPRA Europe ex UK Real Estate UCITS ETF: IE00BSJCV50
- SPDR MSCI Europe Technology UCITS ETF: IE00BW00K51
- SPDR MSCI Europe Utilities UCITS ETF: IE00BW00P07

1 Sources: Bloomberg Finance L.P., State Street Global Advisors, as of 31 March 2021.

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- Build from breadth
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