The Merits of a Sector-Specialist, Sector-Neutral Investing Strategy

Perhaps the primary concern faced by asset managers, investors, and advisors is the need to focus portfolio risk where more skill has been demonstrated, while reducing or eliminating risk where there has been less skill proven. Surprisingly, limited research has been done on this topic, even though the issue is critically important to both institutional and individual investors who seek to find portfolio managers who can not only outperform their benchmarks, but also do so on a consistent basis over long horizons. A sector-specialist, sector-neutral approach is one portfolio construction model that focuses active risk on the stockpicking ability of sector-specialist managers to help investors achieve their desired performance outcomes.

Improving repeatability of performance

The active investment decision to focus risk where managers have evidenced skill has an impact on risk, return, and the consistency of performance through time. To demonstrate these interrelated factors conceptually, Exhibit 1 (below) depicts the potential for active return and negative outcomes versus the probability of repeat success for typical investment approaches.

EXHIBIT 1: Repeatability of performance improves as number of active investment decisions increases.

Consistently positive active returns may be more likely when risk exposures are focused where equity portfolio managers have demonstrated skill, namely in stock selection rather than sector selection, style rotation, market timing, or other investment decisions.

- Limiting active sector exposures in a portfolio can be a simple and beneficial way to minimize negative outcomes, while allowing skilled sector-specialists the opportunity to add value through stock selection.

- A sector-specialist, sector-neutral approach to stock selection can lead to meaningful active share, increase the potential for repeatable success, and provide natural diversification benefits to a portfolio over time.

- With their potential for consistent results, investment strategies that focus portfolio risk exposures on sector-specialist stock-picking ability may be attractive to investors who use the core/satellite approach and/or specific risk paths in portfolio construction.
and the likelihood of negative outcomes, as well as the probability of repeat success for four typical active investment decisions in a portfolio.1 The top left circle represents market timing: active investment decisions to move assets from cash to equities or from equities to cash. Timing such decisions correctly can result in a higher potential for active return, but with only two decisions to make, there is a lower probability of repeat success and a higher likelihood of negative outcomes over time. The middle circles demonstrate the relationship of return to repeatability for style rotation, where there may be three decisions—for example, core to growth or value—and sector rotation, where there may be 10 decisions—for instance, overweighting five of the 10 GICS sectors and underweighting the other five.

The bottom right circle shows the payoff from stock selection, where there may be 100 or more active decisions. This investment approach may have a lower return profile, but over time it has the potential to deliver a higher repeatability of success. And as risk is spread out over many stocks, the shape of the active return distribution is heavily truncated, reducing the probability of negative outcomes relative to the other three approaches.

**Active share and tracking error**

It is fairly common for some investors to confuse the investment statistics of tracking error and active share. High or low tracking error represents high or low volatility of portfolio returns relative to benchmark returns. High or low active share specifically reflects high or low active stock weightings in the portfolio relative to the weightings in its benchmark.2 Meaningful active share has consistently been shown to be an important factor in generating significant active returns.3

Exhibit 2 (right) illustrates the relationship between active share and tracking error.4 Portfolio 1 has an active share of 86.8 with 100 small active positions in only the energy and materials sectors of the benchmark Russell 1000 Index.5 Even the small active positions in this portfolio will generate high predicted tracking error of 11.9, primarily because stocks in the energy and materials sectors have high correlations—averaging around 0.77—and the portfolio does not hold any stocks in the other eight sectors. Therefore, much of the risk exposure in the portfolio is sector risk.

Portfolio 2 also holds 100 stocks, but the manager has constructed the portfolio with 10 stocks in each of the 10 sectors. Although the manager has controlled the portfolio’s sector weights to be equal to the benchmark’s weights, the manager has taken large active stock positions supported by the belief that he has skill in stock selection. Compared with Portfolio 1, Portfolio 2 has even higher active share of 98.7, but lower predicted tracking error of 8.7 thanks to its broadly diversified and controlled sector weights and relatively uncorrelated stock-specific weights. It is possible to construct portfolios with constrained sector weights with meaningful active share—an important characteristic to generate alpha. Said another way, the manager is able to spread risk over many stocks.

**Controlling sector exposure and volatility**

Using a sector-specialist, sector-neutral model to focus risk exposures where asset managers have skill may allow them...
to create discipline and consistency in their investment processes and portfolio construction approaches. For example, a manager can structure a group of sector specialists to closely align sectors to the benchmark weights, thereby minimizing not only sector volatility and potential alpha degradation, but also the likelihood of negative outcomes that could result from large sector variances. Using this approach, a manager can construct the portfolio so that the majority of active return is generated from a specific skill set in stock selection. Just as with the more traditional single-portfolio-manager approach, the investment process can be designed to be consistent through time rather than varying as investment resources change—an issue that has bedeviled many investment managers and their clients over the years. Other outcomes of the portfolio construction process, such as levels of tracking error, amounts of active share, and sources of performance attribution, also can be managed and tracked within this structure. Again, the goal of the approach is to focus alpha-seeking where there is skill, in a disciplined and consistent manner.

Based on historical experience, volatility among the major equity market sectors can be substantial. Exhibit 3 (below) shows that the average volatility of sectors in the Russell 1000 Index has been about 31% over the past 20 years, and substantially more through periods of heightened economic stress, such as in 2001 and 2008. When sector exposure is not controlled during such spans of significant volatility, it can lead to a higher variance in portfolio returns relative to a benchmark. The good news is that because sector weights in a respective index tend to move relatively slowly, sector selection can be very easily controlled by periodic rebalancing (e.g., monthly) to stay within 100–150 basis points above or below benchmark sector weights. The aggregate volatility of other factors such as value, growth, and momentum has been no more than 15% historically. These factors tend to move much less predictably, however, so it is more difficult to control for them in the portfolio construction process.

That it is relatively easy to control for sector exposures does not mean that sector-controlled portfolios are excessively risk-controlled and thus limited in their ability to generate alpha. Quite the contrary, there are many significant opportunities to add value by focusing risk on stock selection within each sector. For example, Exhibit 4 (below)
depicts the three-year return dispersion for stocks in each sector of the Russell 1000 Index. In the consumer staples sector, the best-performing stock returned 819% and the worst-performing stock lost 80%, while the median stock advanced 17% during the past three years. A wide dispersion of stock-specific returns occurred in most other sectors as well.

Taken together, Exhibits 3 and 4 demonstrate that controlling for sector allocations allows portfolio managers to limit risk where there may be minimal skill to exploit and focus risk where there is skill, pursuing the substantial stock-specific opportunities that may exist.

The importance of skill
As discussed earlier, being able to identify managers who have demonstrated skill is critical to all investors and their advisors. Focusing risk exposures in the portfolio construction process primarily on stock selection can be an efficient way to add value. Although identifying attractive stocks is not an easy task given the competitiveness and high efficiency of the broader equity market, some portfolio managers and asset management firms have demonstrated the ability to generate positive active return from stock selection.

Exhibit 5 (left) displays the percentage of total cumulative active return from both stock selection and sector selection for actively managed Fidelity mutual funds with track records dating from the mid-1990s. During the past 18 years, 88% of the active return contribution to these funds can be attributed to stock selection, compared to 12% from sector selection. In an environment characterized by increased market efficiency and intense competition for actionable and undiscounted information, employing multiple sector specialists in the stock selection process and focusing portfolio risk where there is skill can be a desirable approach to portfolio construction.

Sector-specialist model may provide diversification benefits
Just as asset allocation strategies using multiple asset classes can achieve diversification, a disciplined, sector-neutral portfolio construction approach employing multiple sector specialists may also provide diversification benefits. A multi-sector-manager model includes a variety of investment styles, processes, and experience, which may ultimately lead to diversification in investment outcomes from each sector and across an entire portfolio.

For example, a single-manager approach has the potential to over-emphasize an individual’s biases and point of view across an entire portfolio. Multi-sector stockpickers, by contrast, may have different views that are manifested in their stock selections, which can have a diversifying effect.

Exhibit 6 (see page 5) demonstrates this diversification effect by showing the correlations of active returns for Fidelity sector-specialist portfolios during the past 10 years. These correlations are very low and, in many cases, negative. The average correlation across all sector portfolios was 0.17, representing almost no correlation of active returns. Over the same time period, a sample of
sector active returns across diversified portfolio managers had a correlation of 0.29—still low enough to be diversifying but 70% higher than the correlation across the sector portfolio manager returns.

The sector-specialist, sector-neutral model allows the sector specialists to tailor their equity analysis to sector-specific fundamental drivers. In the energy sector, for example, a value approach to security selection may be an optimal alpha strategy, so energy stock analysis to generate alpha can be tailored to that style. On the other hand, in the technology sector where there is less sensitivity to valuation, a more optimal style may be to focus on companies with potential for surprisingly strong earnings growth driven by new product cycles. Ultimately, as multiple sector-based managers are able to employ different approaches to their stock-selection processes within their own sectors, there can be an opportunity for enhanced portfolio diversification benefits.

Less volatility and more transparency appealing to asset allocators
Multi-class asset allocation managers often attempt to generate a particular portfolio outcome or use a core/satellite approach. Targeting specific and consistent outcomes in the investment process can be very attractive to asset allocators. For example, lifecycle portfolio managers who pursue specific paths based on historical assumptions of risk, return, and correlations for each asset class should find a sector-specialist, sector-neutral strategy appealing. These asset allocators are given a high level of confidence that portfolio returns will behave in a certain manner through time. And in the manager selection process, they are able to get transparency into the specific skills that sector specialists can provide. Asset allocators who employ the core/satellite approach may also find these attributes attractive. In particular, the consistent investment process and portfolio construction of a sector-specific strategy makes it effective for fulfilling the requirement of the core element of the approach.

Investment implications
In a marketplace that has become increasingly efficient over time, employing a sector-neutral portfolio construction model using sector specialists is one approach that offers the potential for asset managers—and thus investors—to achieve desirable risk-adjusted returns relative to their benchmarks. This analysis is based on past performance, which does not guarantee future results. Nevertheless, the sector-specialist, sector-neutral approach limits the likelihood that sector volatility will influence performance, and focuses risk on the sector experts who have historically demonstrated an ability to achieve positive active returns through stock selection.

Also contributing to this article were Rich Biagini, Quantitative Analyst; Zlatelina Bezheva, Investment Production Associate; and Chris Luongo, Investment Capability Manager.
Before investing in any mutual fund, please carefully consider the investment objectives, risks, charges, and expenses. For this and other information, call or write Fidelity for a free prospectus or, if available, a summary prospectus. Read it carefully before you invest.

Stock markets, especially foreign markets, are volatile and can decline significantly in response to adverse issuer, political, regulatory, market, or economic developments. Because of their narrow focus, sector funds tend to be more volatile than funds that diversify across many sectors and companies.

Diversification does not ensure a profit or guarantee against loss. Past performance is no guarantee of future results.

a The Global Industry Classification Standard (GICS®), developed by Standard & Poor’s and MSCI Barra, consists of 10 sectors, 24 industry groups, 68 industries, and 154 sub-industries.

b The Russell 1000® Index is a market capitalization-weighted index of larger company stocks.


2 Active share measures the percentage of holdings in an equity portfolio that differ from the benchmark index. This measure may predict portfolio performance because managers with high active share tend to outperform their benchmarks.


4 The two hypothetical portfolios in Exhibit 2 are constructed using the stocks in the Russell 1000 Index to demonstrate the potential effects of few versus many bets in a portfolio (as in Exhibit 1) and the potential impact of sector constraints on portfolio active share and predicted tracking error. We recognize that other hypothetical portfolios could be constructed that may not demonstrate the same effects on active share and tracking error. We also understand that other factors (style, capitalization, momentum, yield, liquidity, etc.) can affect risk in the portfolio construction process.

5 The total volatility of factors in the Barra Global Equity Model factor suite has ranged between 10% and 15% from Dec 31, 1996 to Mar 31, 2011.

6 Funds selected are Fidelity’s 22 diversified U.S. equity funds that have history prior to 1996. Attribution period is LOF (life of fund) or 1994 (start of Fidelity attribution system) through Mar 31, 2011.

7 Correlation matrix of monthly active returns for Fidelity’s 10 major GIC select funds for the 10 years ended Mar 31, 2011.

8 Average active correlation calculated based on 45 observations in the Exhibit 6 matrix.

Fidelity Brokerage Services, Member NYSE, SIPC, 900 Salem Street, Smithfield, RI 02917
Fidelity Investments Institutional Services Company, Inc., 100 Salem Street, Smithfield RI 02917
587770.2.0