It's all about the sectors

Economies and central banks around the world are moving in lock-step with each other. Andrew Cole argues that choosing the right sectors – rather than the right regions – is now key to maximising investment returns

Which economy will grow faster this year: the euro zone or the US? Which central bank will surprise markets the most? Fund managers spend an inordinate amount of time debating these issues and their implications for asset classes in different regions.

But in fact, there hasn't been much divergence in economic and monetary cycles for some time. We are in a period where global growth has finally synchronised, while policies have become broadly aligned. As a result, differentiating between countries hasn't really helped drive investment performance, with share price moves dictated more by individual companies' earnings.

In this environment, we believe there are much better opportunities for alpha generation to be had from looking at asset allocation by global sector rather than by region. Both our market analysis and the attribution of our own portfolio returns support this view.

The average 12-week dispersion of returns within the MSCI All-Country World Index – the extent to which earnings differ from the mean – shows that sectors have been increasing in importance relative to regions. Indeed, this trend has been in place for much of the past three years.

Furthermore, quarterly rolling correlation of share price performance in different regions is hovering around its long-term average. Correlation between sectors, in contrast, has been heading lower and now stands at just 52 per cent – meaning sector indices move in tandem with each other only around half the time – versus the long run average of 69 per cent.

Cyclical bias

So, if sectors are the way to go, the next question is which ones to pick? Firstly, that means identifying those that will thrive and those that will struggle at this particular point in the economic cycle.

For us that means a continued, albeit modest, bias towards cyclicals – industry sectors that do especially well when the economy is expanding. Consequently, we favour materials, energy and construction, which are likely to be among the winners as the global economy expands.

Technology is another traditionally cyclical sector, albeit one where valuations look stretched after months of outperformance. Nonetheless, we continue to like the long-term growth of robotics and the digital economy. If companies can deliver real growth at a time when it is hard to come by, then a valuation premium could well be justified.

On the other side of the coin, we are cautious on more defensive sectors like telecoms, utilities and consumer staples.

Indeed, the importance of sector allocation bodes well for thematic investing more broadly. Companies that benefit from secular growth will gradually take a bigger slice of the economic pie. Today, everyone has an equity income fund. Tomorrow, perhaps, everyone will have a robotics or automation fund.

That's not to say that investing by country or by region should be completely overlooked: each one has its sectoral strengths and weaknesses. Take information technology: such stocks make up 26 per cent of MSCI US index versus just 5 per cent of MSCI Europe. This helps to explain both why US has outperformed this year and why Europe looks cheap on traditional valuation metrics. When you rebalance for sectors, much of that cheapness disappears.

Of course, economic and policy divergences may yet re-emerge. In the US, for example, there is support for Reagan-style supply side reform: lowering taxes in a bid to increase total budget revenues. It is hard to see such policies being passed in Europe, where strict EU rules necessitate greater control over public debt. The rise of populism can play a part in triggering divergences as populist parties are more likely to follow non-conventional agenda or focus on domestic priorities. That would lead to greater dispersion of returns and lower correlations in the performance of their respective stock markets.

Spotting and exploiting any shifts in the relative importance of sectors and countries is an important challenge for active managers. By identifying the segments of the market with strong earnings growth potential they can deliver attractive returns and outperform passive strategies. Such opportunities for alpha generation are further boosted by an increase in stock-level dispersion within major indices.

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