

Understanding the Nuances of Sector Fund Exposure

Not all sector ETFs and funds are the same. They can differ substantially in their market-cap breakdown, international exposure, style exposure, and weighting. These important factors can have a significant impact on portfolio construction and performance.

Sector investing can be a powerful tool in providing investors with opportunities to fine-tune or manage risk in their portfolios. It is rare for any single sector to be a consistent top or bottom performer year-over-year because different sectors tend to perform differently in various market conditions. Investors may choose to invest in

certain sectors that they believe will outperform the market, or choose to avoid certain sectors that they believe will underperform the market. Figure 1 shows how sectors have performed relative to the S&P 500® since 2014.

GICS® Sector Performance vs. S&P 500® (2014-12.31.2022)

										Year S&P 500®										
											2022 -18.11%	Materials -12.27%	Financials -10.53%	Industrials -5.48%	Health Care -1.95%	Consumer Staples -0.62%	Utilities 1.57%	Energy 65.72%		
		Utilities 17.67%	Consumer Staples 18.63%	Industrials 21.12%	Comm. Services 21.57%	Consumer Discretionary 24.43%	Health Care 26.13%	Materials 27.28%		2021 28.71%	Technology 34.53%	Financials 35.04%	Real Estate 46.19%	Energy 54.64%						
		Energy -33.68%	Real Estate -2.17%	Financials -1.69%	Utilities 0.48%	Consumer Staples 10.75%	Industrials 11.06%	Health Care 13.45%		2020 18.40%	Materials 20.73%	Comm. Services 23.61%	Consumer Discretionary 33.30%	Technology 43.89%						
Energy 11.81%	Health Care 20.82%	Materials 24.58%	Utilities 26.35%	Consumer Staples 27.61%	Consumer Discretionary 27.94%	Real Estate 29.00%	Industrials 29.37%		2019 31.49%	Financials 32.13%	Comm. Services 32.69%	Technology 50.29%								
			Energy -18.10%	Materials -14.70%	Industrials -13.29%	Financials -13.03%	Comm. Services -12.53%	Consumer Staples -8.38%		2018 -4.38%	Real Estate -2.22%	Technology -0.29%	Consumer Discretionary 0.83%	Utilities 4.11%	Health Care 6.47%					
			Telecom -1.25%	Energy -1.01%	Real Estate 10.85%	Utilities 12.11%	Consumer Staples 13.49%	Industrials 21.03%		2017 21.83%	Health Care 22.08%	Financials 22.18%	Consumer Discretionary 22.98%	Materials 23.84%	Technology 38.83%					
							Health Care -2.69%	Consumer Staples 5.38%	Consumer Discretionary 6.03%		2016 11.96%	Technology 13.85%	Utilities 16.29%	Materials 16.69%	Industrials 18.86%	Financials 22.80%	Telecom 23.49%	Energy 27.36%		
				Energy -21.12%	Materials -8.38%	Utilities -4.85%	Industrials -2.53%	Financials -1.53%		2015 1.38%	Telecom 3.40%	Technology 5.92%	Consumer Staples 6.60%	Health Care 6.89%	Consumer Discretionary 10.11%					
				Energy -7.78%	Telecom 2.99%	Materials 6.91%	Consumer Discretionary 9.68%	Industrials 9.83%		2014 13.69%	Financials 15.20%	Consumer Staples 15.98%	Technology 20.12%	Health Care 25.34%	Utilities 28.98%					

Source: Bloomberg, 12.31.2022. Performance displayed is past performance and is no guarantee of future results. Returns shown are subindex performance of the S&P 500®. All components of the S&P 500® Index are assigned to one of the 11 Select Sectors Indices, based on the Global Industry Classification Standard (GICS®). Real estate was added as GICS® sector on 8.31.2016. See index definitions on page 5. The referenced indices are unmanaged and not available for direct investment.

Understanding sector exposure and construction has perhaps never been more important given the major sector changes that were introduced by the Global Industry Classification Standard (GICS®) in September 2018—changes that resulted in thousands of companies being reclassified globally. According to Morningstar, there are approximately 887 available sector funds and ETFs (as of December 31, 2022), so it may be a challenge to choose a sector fund that matches the needs of specific portfolios. Sector fund construction can vary significantly, based on how companies are

classified, whether they include global and/or domestic stocks, and which capitalization ranges might be included (large, mid, and/or small). With the emergence of smart beta and alternative weighting approaches, the weighting of stocks within a sector fund can vary significantly. These different sector classifications, inclusion strategies, and weighting approaches may cause performance among sector funds to vary substantially. That is why, before investing in a sector fund, it is important to understand the methodology employed.








Not All Sectors Are the Same

Market sectors are a way to classify different stocks into common groups that may perform similarly in certain economic conditions. There are a number of different sector classification systems, which classify companies based on different criteria such as the markets served, revenue sources, or the products/services offered. GICS® is one of the most well-known sector classifications, but a few other

popular ones include the Industry Classification Benchmark (ICB), Bloomberg, and FactSet Revere Business Industry Classification System.

As **Table 1** illustrates, a company's classification can vary depending on the sector methodology used.

Table 1: Sector Classification Variations

	 TARGET	 Walmart	 amazon	 Disney	 NETFLIX	 TESLA	 Alphabet
GICS® Sector	Consumer Discretionary	Consumer Staples	Consumer Discretionary	Communication Services	Communication Services	Consumer Discretionary	Communication Services
ICB Industry	Consumer Discretionary	Consumer Discretionary	Consumer Discretionary	Consumer Discretionary	Consumer Discretionary	Consumer Discretionary	Technology
Bloomberg	Consumer Staples	Consumer Staples	Communications	Communications	Communications	Consumer Discretionary	Communications
FactSet RBICS	Consumer Non-Cyclicals	Consumer Non-Cyclicals	Consumer Non-Cyclicals	Communication Services	Technology	Consumer Cyclical	Technology
Guggenheim/Rydex Proprietary Classification	Retailing	Retailing	Retailing, Internet	Leisure	Leisure, Internet	Transportation	Technology, Internet

Source: Guggenheim, FactSet, Bloomberg, ICB, GICS® 12.31.2022. The logos listed are trademarks of their respective owners and are used for illustrative purposes only and should not be construed as an endorsement or affiliation with Guggenheim Investments.

While sector classifications typically remain constant, recently there have been several significant changes in the popular GICS® classifications. In 2016, real estate was carved out of the financials sector to reflect its increased importance. In September 2018, GICS® made more substantial changes by creating a new communication services sector, which combined the now-defunct telecommunication services sector with parts of the information technology and consumer discretionary sectors. The new sector was created to demonstrate the changes in the way consumers communicate and access entertainment content and other information. Among the more notable changes:

- Facebook and Alphabet moved to communication services from information technology.
- Netflix and Walt Disney moved to communication services from consumer discretionary.

In March of 2023, GICS® restructured some of the industries and sub-industry levels of their classification system. While this didn't have the same type of impact seen in 2016 and 2018, there were a few large names that switched sectors, most notably Visa and Mastercard were reclassified from technology to financials.

These sector changes underscore the need to understand how a sector strategy classifies companies. Certain companies, particularly ones with well-diversified lines of business or ones in emerging technologies or industries, can be difficult to pin down.

Guggenheim's philosophy on classification is that sector portfolios should be reflective of the broad economic performance of specific sectors. If a company is integral to the economic performance of more than one sector, then it should be included in all of the relevant sectors.

For example, Amazon has a significant impact on retail, a strong online presence, and offers internet hosting services and web-based data and

services. The case can be made for including Amazon in both retailing and internet sector funds, as Guggenheim does. GICS® classifies Walmart and Target in different sectors (Walmart in consumer staples and Target in consumer discretionary). However, both of these companies compete directly in retail, and, accordingly, Guggenheim includes both Walmart and Target in the Rydex Retailing Fund.

After a consultation process with market participants GICS® made some adjustments to their classifications in March 2023 including moving some well-known companies from the consumer discretionary sector to consumer staples, as well as moving some names from technology to financials or industrials.

Domestic or Global?

Sector categorization is the broadest way to deconstruct sectors, but there are many other considerations, such as geographic exposure (global, domestic, region-specific) or capitalization factors (large-, mid-, small-cap stocks).

In today's globalized economy, as firms grow larger, it's not uncommon for them to become more and more exposed to markets outside of the United States. A case in point is the S&P 500® Index, one of the most common benchmarks for U.S. equities. The average stock in this index generates 31% of its revenues from outside the U.S. (as of December 31, 2022), according to FactSet. FactSet also reports that more than a quarter of index members earn less than 50% of their revenue domestically, demonstrating that even this

well-known benchmark composed of U.S. stocks has a considerable global footprint and exposes investors to international markets. Guggenheim believes it makes sense to look at sectors in holistic terms and include global exposures through international stocks that trade on U.S. stock market exchanges, such as American Depositary Receipts. For example, including Unilever in the consumer products sector and Novartis in the health care sector may provide a truer sector exposure than excluding them.

Guggenheim includes international stocks in its sector classifications because it believes that a global frame of reference can be beneficial to help create a purer sector definition.

Does Company Size—Large, Mid, Or Small—Matter?

A sector index's starting universe can have a significant effect on composition and performance. For example, if the sector is solely selected from the S&P 500®, it will be dominated by large-cap stocks and may miss opportunities in smaller stocks or international stocks. Guggenheim believes a more inclusive approach is

appropriate and includes companies from various cap ranges in its sector strategies. Table 2 shows the market capitalization and international exposure composition of the Rydex Health Care Fund compared to two popular health care indices (percentages indicate the relative composition of stocks from each category).

Table 2: Health Care Capitalization and International Exposure Comparison

	Rydex Health Care Fund	S&P 500® Health Care Select Sector Index	MSCI US IMI Health Care 25-50 Index
S&P 500®	55%	100%	15%
S&P MidCap 400	14%	0%	10%
S&P SmallCap 600	0%	0%	19%
Other U.S.	22%	0%	54%
International	10%	0%	2%

Source: Guggenheim, Bloomberg. 12.31.2022. See index definitions on page 5.

Watch Your Weight

In traditional sector portfolios, stocks are weighted by market capitalization, which can result in overweighting or dominance by the largest stocks. In the past decade, smart beta has become a popular way to create investment strategies for many areas of the market, including sectors. Smart beta generally refers to any strategy that differs from a conventional market-cap-based weighting. Some sector funds use equal weighting to limit the size bias. Others may use factor weighting techniques, such as dividend yield or momentum scores, to weight stocks.

Cap-weighting provides a representation from a business landscape perspective, with larger stocks getting larger weights, whereas equal weighting provides a good representation of an investor's opportunity set with all stocks equally able to contribute to

performance. Guggenheim's modified cap-weighted approach, which, in general, takes the square root of each company's market capitalization, acts as a midpoint between these two perspectives, allowing the market leaders to retain the most influence without unduly dominating the sector and negatively impacting diversification. For more than 20 years, Guggenheim has used this approach as a basis for its Rydex sector funds because we believe it reduces stock-specific risk and broadens sector exposure.

Table 3 shows a hypothetical example of the differences in weights between the top 10 S&P 500® Energy Index allocations, based on market capitalization, equal weight, and modified market-capitalization methodologies.

Table 3: Energy Sector Weighting Comparison

Stock	Weighting Scheme		
	Market Cap	Modified Cap	Equal
Exxon Mobil Corp.	26.27%	12.29%	4.35%
Chevron Corp.	20.07%	10.75%	4.35%
ConocoPhillips	8.50%	7.00%	4.35%
EOG Resources Inc.	4.40%	5.03%	4.35%
Schlumberger NV	4.38%	5.02%	4.35%
Occidental Petroleum Corp.	3.31%	4.36%	4.35%
Marathon Petroleum Corp.	3.15%	4.26%	4.35%
Pioneer Natural Resources Co	3.14%	4.25%	4.35%
Phillips 66	2.84%	4.05%	4.35%
Valero Energy Corp.	2.83%	4.03%	4.35%
Weight in the Top 10 Stocks	78.89%	61.05%	43.48%
Weight in Remaining 13 Stocks	21.11%	38.95%	56.52%

Source: Guggenheim, Bloomberg. 12.31.2022

Bottom Line: No Two Sector Funds Are Alike

Not all sector ETFs and funds are the same and they can differ substantially in their market-cap breakdown, international exposure, style exposure, and weighting. All of these factors impact performance and how the sector strategy will be integrated into the

overall client portfolio. Understanding the nuances of a sector fund's security selection process can result in a better outcome for meeting portfolio risk-return objectives.

Authors



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Before joining Guggenheim Investments, Mr. Bachman spent six years at Arrow Investment Advisors. Prior to that, Mr. Bachman spent 11 years at Rydex Investments, now a part of Guggenheim. As portfolio manager, Mr. Bachman managed a sector rotation strategy and several sector funds and aided in the management of other tradable Rydex funds. Mr. Bachman has a B.S. in finance and international business from the University of Maryland, College Park.



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INDEX DEFINITIONS: S&P 500® Index is a stock market index tracking the stock performance of 500 of the largest companies listed on stock exchanges in the U.S. The **S&P MidCap 400® Index**, more commonly known as the S&P 400, is a stock market index that serves as a gauge for the U.S. mid-cap equities sector. The **S&P SmallCap 600® Index** is a stock market index that covers the small-cap range of American stocks, using a capitalization-weighted index. The **S&P 500® Health Care Select Sector Index** comprised those companies included in the S&P 500 that classified as members of the Global Industry Classification Standard (GICS®) healthcare sector. The **MSCI US IMI Health Care 25-50 Index** is designed to capture the large, mid and small cap segments of the U.S. equity universe. All securities in the index are classified in the GICS®.

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Investing in sector funds is more volatile than investing in broadly diversified funds, as there is a greater risk due to the concentration of the funds' holdings in issuers of the same or similar offerings. The funds may invest in American Depositary Receipts ("ADRs") therefore subjecting the value of the funds' portfolio to fluctuations in foreign exchange rates. The funds are subject to active trading risks that may increase volatility and impact the fund's ability to achieve its investment objective. The funds are considered nondiversified and can invest a greater portion of their assets in securities of individual issuers than more diversified funds. As a result, changes in the market value of a single security could cause greater fluctuations in the value of fund shares than would occur in a more diversified fund.

The GICS® is an industry taxonomy developed by MSCI and Standard & (S&P) in 1999 for use by the global financial community. The GICS® structure consists of 11 sectors, 24 industry groups, 68 industries, and 157 sub-industries into which S&P has categorized all major public companies, according to the definition of the principal business activity.

Read the fund's prospectus and summary prospectus (if available) carefully before investing. It contains the fund's investment objectives, risks, charges, expenses, and other information, which should be considered carefully before investing. Obtain a prospectus and summary prospectus (if available) at GuggenheimInvestments.com.

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