Wien Juni 2016

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What ratios are relevant in the selection of equity sectors?

Harald Egger

Shares (equities) are classified, among other criteria, according to sectors, e.g. healthcare, consumer goods, energy etc. Shareholders pursue different approaches when it comes to the classification process. In this report we follow the methodology of MSCI, a US financial service provider that offers international equity indices and risk analyses.

Healthcare shares with gains, energy shares with losses

The individual sectors have gone through a rather diverse set of developments in the recent past, as the table underneath illustrates. Whereas the listed healthcare sector has recorded an increase of 21.1% p.a. in the past five years, the holders of energy shares have had to absorb a loss of 3.2% p.a. In both cases, dividend payouts have been accounted for in the performance. That being said, in the past twelve months the healthcare sector has ended up among the losers, whereas utilities and telecoms companies have come out on top.

Performance of global sector indices (annualised; including dividends)

	5 years (p.a.) in %	1 year in %
Healthcare	21,1	-4,1
Non-cyclical consumer goods	14,9	7,3
IT	13,4	-1,1
Consumer cyclicals	13,2	-0,9

Industrials	8,8	-1,1
Telecoms	7,5	5,7
Financials	5,1	-8,3
Utilities	4,8	5,9
Base materials	-1,7	-7,8
Energy	-3,2	-7,8

Sources: MSCI sector indices in local currency; Bloomberg (as of 3 May 2016)
Note: The performance does not account for fees. Past performance is not indicative of future development.

Relevant ratios in sector selection

What are the criteria that one should adhere to when choosing sectors? In stock selection, some commonly used terms are those of “value” and “growth” as well as “large caps” and “small caps”. Does this approach work for sectors as well, or are there other ratios with a higher success rate? In order to answer this question we analysed various ratios for the following sectors (MSCI classification):

Sectors (according to MSCI)

- Consumer cyclicals
- Non-cyclical consumer goods
- Energy
- Base materials
- Financials
- Utilities
- IT
- Telecoms
- Industrials
- Healthcare

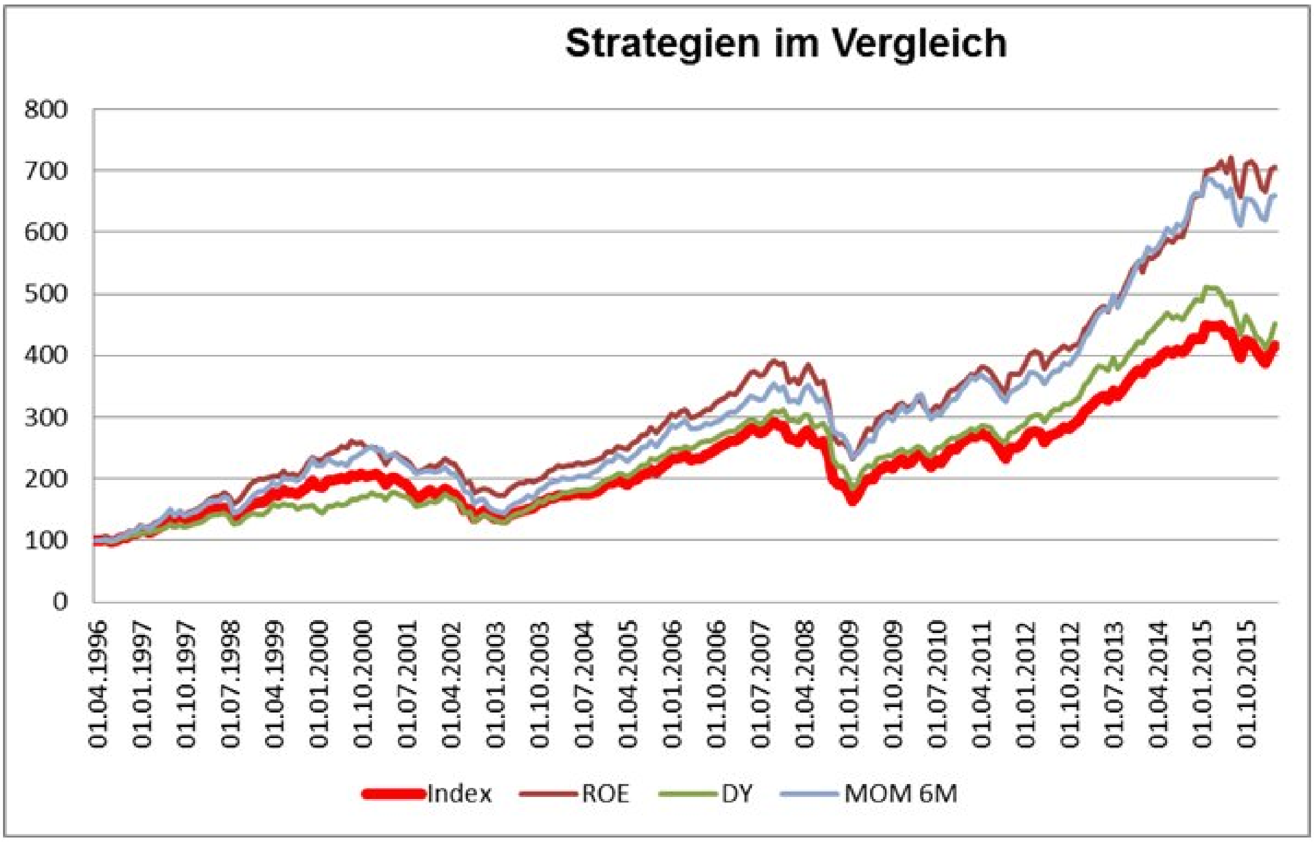
We examined the following key ratios over a period of 20 years:

Ratio (acronym)	Ratio	Strategy
P/BV	Price/ book value	Purchase of the five most attractive (“cheapest”) sectors
PE	Price/earnings ratio	Purchase of the five most attractive sectors
DY	Dividend yield	Purchase of the five sectors with the highest dividend yield
ROE	Return on equity	Purchase of the five sectors with the highest profitability
EPS trend	Deviation of most recent earnings from long-term trend	Purchase of the five sectors with the most significant negative deviation from the long-term trend
EPS slope	Regression of the earnings of the past ten years	Purchase of the five sectors with the highest slope

MOM 6M	6M performance	Purchase of the five sectors with the best performance over the past six months (momentum strategy)
ROE trend dev	Trend profitability of equity over the past ten years	Purchase of the five sectors with the biggest positive deviation
EPS growth	5Y earnings growth	Purchase of the five sectors with the highest earnings growth

This is how we proceeded in order to derive the success of a particular investment strategy: for example, in case of P/BV, we examined how the five most attractive (“cheapest”) sectors have performed in comparison with all ten, also equally weighted MSCI sectors.

Performance of different strategies in comparison



Index = equity index with equal sector weightings
ROE = Return on equity (purchase of the five most profitable sectors)
DY = Dividend yield (purchase of the five sectors with the highest dividend yield)
MOM 6M = Momentum strategy (purchase of the five sectors with the best performance in the past six months)
Sources: Datastream; own calculations
Note: The performance does not account for fees. Past performance is not indicative of future development.

High profitability, momentum, and an above-average dividend yield ensure higher rate of return

Our analysis reveals that two specific ratios would generate an ongoing surplus return vis-à-vis the overall market: investors should focus on those sectors that are highly profitable and those that come with high momentum. A portfolio consisting of the five sectors with the highest dividend yield also outperformed an equity index with equal sector weightings. Please refer to the chart.

Attractive valuation does not guarantee success

Selecting sectors with low price/book value or price/earnings ratios is not overly promising; neither is the earnings growth rate of the past five years.

We are currently developing a strategy on the basis of our findings that we will introduce in our next blog entry.

Harald Egger

Harald Egger is Chief Analyst and has worked at Erste Asset Management since 2001. Previously he worked for four years as a fund manager and analyst for AXA Investment Management in London. He headed the equity segment within Erste Asset Management and was CIO until April 2013. He has been employed in the finance industry since 1992.