Sector Correlations and Active Management

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Year to year, the surrounding conditions, environments, and situations affecting the stock market change. Some settings are favorable for active managers in their attempt to beat indexes, others are problematic. In some years, active managers prevail and generally outperform indexes. In other years, active managers generally lag behind. ICON contends that those managers do not get any smarter or work any harder in years when they prevail, nor do they get stupid or lazy in the years they lag. Rather, they stick to their investment strategy and are quite steady in their behavior year to year. It is the occasional problematic setting that proves too difficult to overcome. Conditions in 2011 were extremely unfavorable for active managers, while conditions in 2012 so far are quite favorable for active managers. Sector correlation helps to show why market conditions can be favorable or problematic for active managers.

On January 1, 1995, Standard & Poor's introduced the S&P 1500 Index and its ten sector component indexes. Table 1 shows correlations between each of the ten sector indexes and the 1500 Index based on weekly data from January 1, 1995 through December 31, 2010. The middle column shows the correlations for just 2011 and the right column shows the correlations for the first quarter of 2012 (+1 is perfect positive correlation). For all ten sectors, the correlations were higher in 2011 than the historic norms for 1995 – 2010. For the first quarter of 2012, all ten sectors are lower from 2011 to 2012, many even lower this far in 2012 than their historic norm.

Correlation of Sectors with S&P 1500 Index

	1995-2010	2011	1/1/12 - 3/31/12
Consumer Discretionary	0.91	0.96	0.74
Consumer Staples	0.66	0.86	0.32
Energy	0.65	0.93	0.72
Financials	0.85	0.95	0.89
Health Care	0.73	0.93	0.73
Industrials	0.92	0.98	0.88
Information Technology	0.80	0.94	0.89
Materials	0.77	0.94	0.70
Telecommunication Services	0.67	0.83	0.34
Utilities	0.59	0.80	-0.17
Average	**0.75**	**0.91**	**0.60**

Past Performance is no guarantee of future results.

Table 2 shows three examples of cross-sector correlations over the same three time periods. In each case, the correlation was much higher than normal in 2011, but back lower in 2012.

Correlation of Sectors with S&P 1500 Index

	1995-2010	2011	1/1/12 - 3/31/12
Financials & Inform. Tech	0.53	0.84	0.71
Health Care & Energy	0.36	0.82	0.37
Consumer Staples & Utilities	0.53	0.87	0.58

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Why would high correlations among sectors be problematic for active managers? Recent research out of Yale and New York University shows that superior managers are willing to have their portfolios be very different from indexes, which suggest these stock pickers underweight and overweight industries and sectors. If sectors are performing highly similar, it is very difficult for managers to differentiate themselves from indexes or other managers.

Good active managers stick to their strategy and select stocks that have fundamentals important to them. Naturally, different strategies focus on different fundamentals, but for all strategies, managers hope investors will ultimately recognize those fundamentals and re-price stocks accordingly. To ICON, the fact that sectors were so highly correlated in 2011 is evidence that investors were not interested in fundamentals — they were scared. They were instead focused on Greece and what became labeled as the "European Debt Crisis." All stocks danced to one drummer, so to speak, and fundamentals that active managers count upon to be recognized did not matter temporarily.

Now in 2012, investors are not preoccupied with Greece and seem to be focusing on fundamentals. Active managers are getting rewarded for their insight and patience. Health Care and Energy stocks, for examples, are behaving differently from each other and we would presume being priced on their respective (probably different) fundamentals.

The fundamentals that go into ICON's valuation equation have been favorable for companies the last three years. While stock prices have generally risen, our estimates of underlying value have also grown. As of the end of the first quarter 2012, we still see stocks generally priced below our estimate of intrinsic value. With stocks still appearing cheap, we like owning equities. Valuation has also pulled us toward strong industry and sector tilts. We, as most other active managers, like the lower, more normal correlations we have seen so far this year.

Investing in securities involves inherent risks, including the risk that you can lose the value of your investment. There is no assurance that the investment process will consistently lead to successful results. An investment concentrated in sectors and industries may involve greater risk and volatility than a more diversified investment.

Opinions and forecasts regarding sectors, industries, companies, countries and/or themes, and portfolio composition and holdings, are all subject to change at any time, based on market and other conditions, and should not be construed as a recommendation of any specific security, industry, or sector.

ICON's value-based investing model is an analytical, quantitative approach to investing that employs various factors, including projected earnings growth estimates and bond yields, in an effort to determine whether securities are over- or underpriced relative to ICON's estimates of their intrinsic value. ICON's value approach involves forward-looking statements and assumptions based on judgments and projections that are neither predictive nor guarantees of future results. Value readings are contingent on several variables including, without limitation, earnings, growth estimates, interest rates and overall market conditions. Although valuation readings serve as guidelines for our investment decisions, we retain the discretion to buy and sell securities that fall beyond these guidelines as needed. Value investing involves risks and uncertainties and does not guarantee better performance or lower costs than other investment methodologies.

The Correlation Coefficient shows the degree of relationship between two sets of data. The measurement ranges between "+1.00," which indicates perfect correlation and a exact relationship and "-1.00," which indicates negative correlation and an opposite relationship. A measurement of "0.00" indicates the two data sets show no relationship.

The unmanaged Standard & Poor's (S&P) Composite 1500 Index is a broad-based, capitalization-weighted index comprising 500 large-cap, 400 mid-cap, and 600 small-cap U.S. companies. The unmanaged Standard & Poor's (S&P) 1500 Sector Indexes track the performance of sectors that comprise the S&P 1500 Index. Individuals cannot invest directly in an index.

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