

Perspectives Podcast

“So Many Sectors, So Little Time”

Transcript, 09 August, 2024

Adam Bass ([00:03](#)):

This is MSCI Perspectives, bringing to light insights and analysis that help global investors tackle today's challenges. I'm your host, Adam Bass, and today is August 8th, 2024. Today's episode is a tale about sector investing. Approaching the market at least partially from the perspective of whether you're investing in, say, a tech company versus an energy company is a tested approach, but it's also one that's been in the news a lot lately, not the least of which due to the focus on and the influence of the so-called Magnificent Seven.

([00:44](#)):

Given that we're talking about sectors today, we thought it would be appropriate to split our tale into sections. See what we did there? We're calling these sections In Theory and On the Ground. For the first section, In Theory, we explore recent MSCI Research into sector-based strategies over the last two decades. I had the chance to speak with the authors of the paper that resulted from that research. It's called Incorporating Sector Investing in Portfolio Management. They are...

Abhishek Gupta ([01:23](#)):

Hi, I'm Abhishek Gupta. I lead the Americas Equity Solutions research team.

Adam Bass ([01:28](#)):

And...

Dinank Chitkara ([01:29](#)):

I am Dinank Chitkara, part of the Market and Investment Insights Solutions Research team. And I'm based out of Mumbai.

Adam Bass ([01:36](#)):

And now, we present In Theory. Abhishek, let's start with you. Just set the stage for us. If we're talking about sector investing, why focusing in on the US equity market made the most sense?

Abhishek Gupta ([01:54](#)):

Yeah. So sectors, as we all understand, offer exposure to distinct segments of the economy, each with a particular combination of growth and valuation challenges and opportunities. There are multiple reasons why we looked into sector investing within US equities. First, sector investing has remained highly popular with the institutional investors and wealth managers in the US. Sectors actually form one of the largest product categories in the US. So, for instance, if you're talking about the ETF market, the AUM linked to US sectors is nearly double the size of the AUM that is linked to global ex-US sectors.

([02:36](#)):

The second reason is that the size of US equities is enormous as we all know. It makes up roughly two-thirds of the global equity market. And by that count, US sectors are significantly large. In fact, each of the top five US sectors is larger than any country across developed and emerging markets. In that [inaudible 00:03:01], US also accounts for a substantial portion of the weight of global sectors, capturing more than 50% of the weight in 10 out of the 11 sectors.

([03:10](#)):

And then, lastly, many investors, so when they're making their equity investment allocation decisions, they generally align themselves across three different regional blocks. So, for instance, they'll make allocations along US equities, international developed, and emerging markets. In this context, we wanted to study what are the primary drivers of risk and return in these markets. And what we found was that the industries played a far greater role in driving risk and return within US equities than in other global equity markets.

Adam Bass ([03:48](#)):

If we can, I want to dig into one of those facts that you gave us there in that great explanation, the fact that there are US sectors that are larger than some whole economies. Can you put that into context for our listeners? What's the implication of that from an investment standpoint?

Abhishek Gupta ([04:08](#)):

Yeah, so when investors are thinking about their global equity allocations, they have several decision points they could allocate across sectors, they could allocate across countries. Typically, as I mentioned, it's generally around, let's say, regional allocations, but within those regional allocations, they're looking at sectoral allocations, factor-related allocations.

([04:33](#)):

And so it's almost like you could invest in international developed or in emerging markets. But the decision point around investing within US equities because of the size of the US sectors themselves is so much important that it almost compares with the drivers of the decisions that you take into account when you're making your international or developed allocation decisions.

Adam Bass ([05:04](#)):

And getting back to some of your findings in the paper. When you looked across time, what did you see in terms of how sector weights had changed?

Abhishek Gupta ([05:16](#)):

Yeah, absolutely Adam. So we looked at the last 20-year history, and what we found was that there'd been notable shifts in the sector composition within US equities. This may not really come as a surprise to many, but all the secular trends that we are aware of in terms of the advancement in digital economy and so on and so forth, they have benefited quite a few sectors, but mostly the information technology and the communication services sectors. In contrast, we've also seen the global financial crisis and the challenges that it posed to the financial sector and all the consequent regulatory reforms.

([05:55](#)):

So that has certainly diminished the influence of financials in terms of index weight. As of today, IT actually stands to be one of the largest sectors, constituting roughly 28% of US equities. But I want to drill down a little more from here on the CICS framework allows us to do a deeper dive and decompose sectors into industry groups, industries, and sub-industries. And what we found was that the 10 largest industries in the US, and there are 74 industries by the way, so 10 out of those 74 industries in the US, they composed roughly half of US equities, which, by the way, points to some concentration issues, which we can touch on a little later.

([06:43](#)):

But it just shows the enormity of certain industries within the US sectors. Six out of these 10 industries, they came from information technology and financials. I want to specifically point out the rise of the semiconductor industry over the past 20 years. So it has seen a tremendous amount of weight increase and, as of today, is the largest industry currently at about 10% of the US equity market. And this is again closely followed by another IT industry software, which is just shy of the 10% mark.

Adam Bass ([07:25](#)):

So Dinank, I'd like to turn to you now. When we talk about the performance across the different sectors. What drove that performance? What was behind it?

Dinank Chitkara ([07:36](#)):

Sure, sure. Thanks, Adam. So, as you mentioned, like the analysis period of what we have covered is 20 years, over the last two decades, there has been some variation. I think some of the sectors that Abhishek pointed out, something like IT consumer discretionary healthcare, they have been in the news, and they have been the strong outperformers over the last two decades. And if you look at the flip side, there are sectors such as energy, communication services, and maybe few others which ended up underperforming the index and broadly were the bottom performers as well.

([08:10](#)):

In our research, our aim was to look at that, okay, what there... these are the performance aggregate over the last two decades, what are the underlying fundamental drivers? And we try to look at some factors here, which

just could be profit margin expansion, sales growth. These two combine in the earnings part. Then there is valuation change and then the dividends. Sectors such as IT, consumer discretionary, as we mentioned, these are the top two performing sectors.

(08:38):

They benefited from sales growth and profit margin expansion together. Then, we look at sectors such as healthcare and consumer staples. Their gains came from sales growth. The profit margin expansion was on the weaker side. Utilities returns were driven by dividends and profit margin expansion together. If you look at the overall 20 years and the drivers that you mentioned, valuation changes had a very minor impact across all sectors. Maybe in case of materials, it was evident, but yeah, for others, it was relatively minor.

Adam Bass (09:13):

So let's dig into those results and some of the considerations a bit there, Dinank, because especially as we've moved out of the COVID era, so to speak, one aspect that's really come up for investors is geopolitical risks. And Abhishek alluded to regional considerations earlier, but investors are very focused on their portfolios exposure to the different countries, different regions around the world. Tell us about what you found in terms of that area.

Dinank Chitkara (09:51):

So I think you correctly mentioned that there have been a lot of issues, supply chain shocks post-COVID, and a lot of geopolitical tensions because of some of the other crises that are happening across the world. So these discussions are very much there. And so, just taking a step back and just giving some background on the data set that you mentioned, the economic exposure data set. So the whole aim is that through this data set, it helps estimate the portion of a company's global revenues from various markets and regions.

(10:21):

This could be country or could be clubbed at a region level. And when we try to do it at an index level that what we are trying to show it is calculated by multiplying the constituents rate with the revenue exposure of that constituent. Why does it become important? Because US sectors are known to have a very... in general derive their exposure from across the whole world. And as you mentioned, there is some significant variation during... between those sectors, and this we try to focus on at the latest data, which is as of [inaudible 00:10:56].

(10:56):

Sectors such as IT and materials, they had more or less a very diversified economic exposure, owned over 50% of their revenue internationally. The prominent or the dominant end market there was China. When we talk about the least diverse sectors, first was utilities. It generated nearly all of its revenues domestically, and this was followed by real estate, which was the second least diverse sector. It had around slightly more than 80% of its revenues from US.

Abhishek Gupta (11:28):

Yeah. So I just want to add to what Dinank mentioned here. We see that there is a lot of variation in terms of where sectors are really deriving their revenues from. But just in terms of some of the implications here, there is both a risk angle as well as an opportunity angle. Companies, let's say, that belong to a certain sector in a specific country, they may face challenges if there are trade barriers that are imposed by the countries that they already traditionally exported to.

(12:01):

However, this can also be an opportunity for certain other companies in similar sectors but in other countries where the trade barriers are not there. And so this whole dynamic of economic exposure where companies are really deriving their from and the trade barriers that are being imposed, I think it has both a risk implication as well as an opportunity implication.

Adam Bass (12:28):

So even if you're taking a sector-based approach, clearly there are many other considerations that go into building and managing a portfolio from what you're pointing out in terms of economic exposure.

Abhishek Gupta (12:43):

Yes. So we might think that a sector is a uniform set of companies that are all doing very similar type of business. However, there's a lot of nuances there. These companies, where are they deriving their revenues from, where are their operations? Where are their assets?

(13:05):

All of that is extremely important to understand that even within that same sector, what companies, let's say, stand to benefit from a certain economic scenario or a geopolitical scenario compared to other companies within that same sector.

Adam Bass (13:21):

And another one of those aspects that you looked at was around thematic investing. For the benefit of our listeners, although we have talked about it previously on the program, first, can you define what we mean when we say thematic investing framework?

Dinank Chitkara (13:41):

Sure. So thematic investing is slightly the future-focused investment approach. We already have there is a sector investing. There is factor investing, which has been there in existence for a very long time.

(13:54):

The whole approach here is to slightly make it a more futuristic approach that broadly relies on research to explore maybe macroeconomic, geopolitical, and technological trends that are somehow expected to evolve over time. And how we try to include this.

(14:12):

So this is the thematic investing is encapsulated in the MSCI's thematic investing framework. And what MSCI's thematic investing framework helps, is... helps investors gain exposure to the structural changes in the businesses and economies.

Adam Bass (14:30):

And in terms of when you conducted your research and you're looking through the thematic lens, which themes did you focus on, and what did you find in terms of the exposure of certain sectors?

Dinank Chitkara (14:46):

Sure. Through our research, we try to analyze the sector exposures four broad megatrends. First one being environment and resources, second one being transformative technologies, then health and healthcare, and the last one being society and lifestyle. And this was, in turn, evaluated on a different certain sub-themes, which could be digital economy, disruptive technology, FinTech innovation, et cetera.

(15:13):

So when we looked at the data and at an index level sectors, such as maybe IT and communication services had a high exposure to technology-related themes, which could be digital economy internet innovation, and as well as societal themes, which is like something like smart cities. If you look at on the other sites, sectors such as healthcare had the highest exposure to digital health and a theme called genomic innovation.

(15:41):

And what are the implications of that? So what investors understanding the sector's thematic exposure is crucial for aligning their investments in the overall evolving landscape that we are seeing on the different factors that I mentioned earlier, macroeconomic, geopolitical, as well as technological.

Adam Bass (15:59):

So earlier, we talked a bit about the drivers behind the performance. Abhishek, I'd like to turn back to you now in terms of different sectors and their exposure to fundamental factors. Can you dig into those findings a little bit for us and what some of those changes over time have looked like?

Abhishek Gupta (16:21):

Let me start by saying that factors are systematic drivers of risk and return in equity portfolios. On the value growth spectrum, which is a very fundamental way of looking at factors, there are certain sectors that are more growth-oriented, and then there are others that have a value bias. For instance, there are sectors such as information technology and consumer discretionary. They have a substantial overlap with a universe of companies that are categorized as growth. However, you have sectors such as utilities that provide an almost pure play on the value style.

(16:58):

Now, looking beyond this whole value growth dimension, there are... there is actually a way to look at this at a much more deeper level using the MSCI equity risk models, where we have a large number of factors. So historically, when I say historically, I mean the past 20 years, what we've seen is that utilities and consumer staples were the most defensive sectors. They had a strong negative data exposure compared to the market. They also had stable earnings across economic cycles. Utilities also had lower profitability, which is quite consistent with the regulated nature of the sector.

(17:41):

But in contrast, you would see certain sectors, such as consumer sectors, both discretionary and staples, that display higher profitability. We did this analysis over the last 20 years, but we also recognize that factor characteristics can actually change over time. And so we wanted to look at a more recent window. So we looked at the average factor exposures over the last 12 months and contrasted that with the deeper historical average numbers. We found that for some sectors, recent exposures to certain factors were more pronounced compared to the long-term average.

(18:20):

So, for instance, energy and utilities, it had a much stronger value tilt over the recent past. Consumer staples, energy, and healthcare, they appear to be more defensive compared to the broader market. Now, of course, the longer-term historical average is important. The near-term averages are also important, but what any of this is really telling you is that what are the drivers of risk and return in these sectors. And so, investors need to take cognizance of this and build their portfolios or make the investment decisions around some of these important considerations.

Adam Bass (19:02):

Now, we can't talk about sector investing without mentioning the Magnificent Seven mega-cap tech stocks and the implications there in terms of market concentration. What did you find?

Abhishek Gupta (19:18):

So before I give you the broader context, I just want to maybe describe a little bit how did we really measure concentration. So we looked at three different measures. The first is a very simple combined weighting of the 10 largest stocks. The second measure that we looked at is the effective number of constituents, which measures concentration by not just looking at the top 10 stocks but looking at the entire index universe of constituents and their weight distributions. And then the last measure we looked at is the risk concentration, meaning that what is the proportion of the total risk that is coming from, let's say, the top 10 stocks?

(19:56):

What we found was that there are certain sectors, such as communication services, consumer staples, energy, they have been concentrated for a very long time. You take different snapshots in time, and you see that each one of these three sectors were highly concentrated. However, there are other sectors, such as consumer discretionary and information technology, they appear to have gotten more concentrated more recently. And we talk about the concentration issue within the broader US equity market. But now imagine that there are these 11 sectors within that equity market, and those same companies are now coming at higher weights and higher proportion of their weights within those sector indexes.

(20:41):

So, in some ways, the concentration issue gets magnified within sectors. Now, this is quite a bit of challenge for many investors how to deal with that issue of concentration. One common approach to address this has been to cap the issuer weights. We have something called the MSCI 25/50 index methodology. It follows a certain set of methodology, but it aims to reduce concentration in a way that no issuer would exceed 25% of the index weight. And all issuers that are representing a weight of more than 5%, they will not exceed 50% of the index weight. This is implemented at each quarterly rebalancing.

(21:32):

So what we have done at MSCI is that we've applied the 25/50 index methodology as an overlay on top of the US sectors. And what we found is that, you know what, it brings down concentration to the defined limits, meaning that there is a 25% limit and the 50% limit. So the index would never breach these concentration limits

on the date of the rebalancing. But what are the implications of this? Some investors might think that this can result in significant departure of this 25/50 overlay from the parent sector index, but what we found was that the tracking error between the capped variant and the underlying sector index was mostly within bounds of 1% tracking error.

Adam Bass ([22:22](#)):

Are you also potentially giving up some performance if you're investment product that tracks this index versus a different benchmark that might allow you to be fully invested in, let's say, tech at this point?

Abhishek Gupta ([22:36](#)):

Yeah, so that is also, of course, a very important consideration. So we did not just look into tracking error, but we also looked at the performance of the 25/50 variant relative to the parent sector index, and we didn't really find as much of a deviation in the performance. The maximum deviation was for the energy sector, where actually the 25/50 index led to an outperformance by about 70 to 80 basis points analyzed over the last 20 years.

Adam Bass ([23:11](#)):

What about correlation between the different sectors, Dinank? How has that looked over time?

Dinank Chitkara ([23:20](#)):

The aim for us to show the correlation was to help investors, like who invest in different sectors, to assess the overall diversification of the portfolio and maybe how it has changed over time. For our research, for the correlation method that we used was based on the active monthly returns over the parent index or the different sectors. So if we have to make a generalized assumption there, it could be said that US sector active returns generally had lower or negative correlations. But yes, there were few exceptions if we look at the overall 20-year history.

([23:56](#)):

There were positive correlation amongst utilities, consumer staples, real estate, and healthcare, and also materials, industrials, and energy exhibited positive correlations with each other. Other sectors had overall low pairwise correlation doing a similar exercise... similar pairwise correlation exercise over the last five years, there were some shifts in the return correlation. IT and communication services which showed stronger negative correlation with most sectors, whereas financials became more correlated with sectors such as energy, industrials, and materials.

Adam Bass ([24:39](#)):

What are the implications for investors in terms of this correlation? What should I take away from that?

Dinank Chitkara ([24:44](#)):

As I mentioned, the broader case for correlation is to see how diversified the overall portfolio is that invest... if the investors are invested in sectors which are more or less positive, very, very strongly positively correlated with each other, then the diversification slightly becomes lower because if the market goes in the negative direction, both the indexes or both the performance will overall go negative.

([25:11](#)):

So negative correlation between the two investment generally tends to act as a diversification and tends to provide those benefits for investors. So investors could take the... take cognizance of this fact that how the sector correlations have been, what the exceptions have been, and how it has been changing over from 20 years to the last five years.

Adam Bass ([25:34](#)):

We've been really digging into the details, some of the micro issues that are going on in terms of a sector-based approach. But let's pull up a bit now to different macroeconomic environments, which are very top of mind for investors right now, whether it's around inflation and interest rates and growth within, I guess for purposes of this within the US particularly, but also around the world. So help us look forward by looking back if you could, and let's talk a little bit to knock about how different sectors performed across varying macroeconomic environments over these 20 years.

Dinank Chitkara ([26:20](#)):

Yeah, yeah. So to analyze the sector performances over different macroeconomic cycles, we tried to define four regimes based on two macroeconomic factors, which was inflation and growth. So what were the four regimes? First was stagflation, characterized by falling growth, rising inflation. Second was slow growth, which is falling growth and falling inflation. The third was Goldilocks, which is rising growth, rising inflation. And the last one was heating up, which was rising growth and rising inflation.

[\(26:56\)](#):

And the overall approach was, like for the last 20 years, the analysis period each month was classified in one of these regimes, and it was decided based on proxies for growth. We had taken the OECD composite leading indicator CLI, and for inflation, we had again taken OECD CPI. Our analysis showed like sectors, defensive sectors like consumer staples, healthcare, and utilities outperformed during stagflation and slow growth, but they underperformed during Goldilocks and heating-up phases.

[\(27:32\)](#):

On the other hand, during periods of Goldilocks, the top performers were consumer discretionary and materials. And when we talk about the heating-up environment, IT and financials were the top performers. Based on their own expectations about the future, investors could keep this fact in mind that [inaudible 00:27:50] sectors historically have done better or worse in different macroeconomic environment.

Adam Bass [\(27:58\)](#):

So what does all this look like within a live portfolio? For section two of our tale, On the Ground, we lay down a blanket and sit down with Vanguard's own...

Andrey Kotlyarenko [\(28:11\)](#):

My name is Andrey Kotlyarenko. I'm a senior product manager at Vanguard responsible for our equity index product. And my main responsibilities include a healthy product offer as well as client engagements to provide a better insight into a philosophy in our approach.

Adam Bass [\(28:28\)](#):

And Andrey, welcome to the program. We're very happy to have you here. Let's start where we just left off with talking about what you do at Vanguard. Let's get a little more specific. What are the kinds of products you look after? Any background that would help our listeners get a sense of your role?

Andrey Kotlyarenko [\(28:48\)](#):

As I mentioned, I am responsible for the full equity index franchise. I'm covering mutual funds, ETFs, as well as the collective investment trust. And this includes products that are both investing into US market as well as internationally.

Adam Bass [\(29:04\)](#):

What we're talking about today is kind of a sector-based approach. So let's just get right to it. What role do sectors play, or can they play in a diversified portfolio?

Andrey Kotlyarenko [\(29:18\)](#):

Yeah, Adam, thank you for that question. So we have a long-term partnership with MSCI on bringing sector products to the marketplace, and we offer representation in all 11 sectors ranging from financials to ITs to consumer discretions. And there is a pretty big role that they can play in a client's portfolio. The simplest role is really gaining access to a broadly diversified total market, and you can easily do it by combining all 11 sector products in their appropriate weights and that will give you a full representation of the US total market, but that's certainly not the only use case there.

[\(30:01\)](#):

Another option could be portfolio completion. So for the clients that may be underweight energy or healthcare sector, they may pick individual sector products to complete their portfolio for a full exposure. In addition to gaining more passive access to the market, there is an opportunity to use these index products in an active way. And the most well-known strategy is a sector rotation.

[\(30:29\)](#):

And this is really when people are trying to be a little bit more defensive during difficult market conditions and go with products like utilities that tend to perform a little bit better. Or at the times of large market growth periods, you can go with information technology product and gain some of that access. And really depending

on market cyclicality, you can go between one or the other. And then, finally, another option is tactical allocation. So for consumers that have certain views on certain segments of the market, they can use sector products to overweight and gain additional exposure for a period of time in their portfolio.

Adam Bass (31:09):

Let's talk about that last one a little bit more. If you're taking a stance that is unrelated to this sector-based approach, how exactly does a focus on sectors help me accomplish that?

Andrey Kotlyarenko (31:24):

So one of the things that we've seen happening more recently is that as AI becoming a big topic of conversation, we've seen a lot more activity go into a sector like IT where you have a greatest concentration in the companies that particularly dealing with that particular segment of the market. So if you're very bullish on that, consumers may choose to get extra exposure to that particular sector, and they would use a product like IT ETF.

Adam Bass (31:55):

Let's talk about the other side of the ledger if we can. What are some of the risks inherent in a sector-based approach?

Andrey Kotlyarenko (32:02):

Yeah, really, the most obvious risk is concentration. As you sort of stepping away from the broad diversification of the overall US market, the selection of the securities becomes a little bit more narrow. And with that, you're losing some of the diversification benefits. So, with sector markets being more concentrated, that's certainly the risk to keep top of your mind. Also, as you are focusing on a specific market segment or specific sector, those products could go through periods of higher volatility, especially as they could have a somewhat higher correlation to a particular effect that's impacting the entire segment.

(32:43):

And with that, once again, if you're losing some of that diversification benefit from getting exposure to offsetting factors, you could go through a periods of larger outperformance or also underperformance. Good examples of that could be if you have high exposure to energy sector and you're heading into an energy crisis that's going to negatively impact that entire segment, you could experience periods of poor performance.

(33:08):

And something that we've lived through in the past and well known to everybody in more recent history is banking crisis. So if you have a big overweight to financials, a large segment of the financial sector was impacted by that. And then, finally, the additional risk that you have, this could impact your investment strategy, whether it's broadly diversified or sector rotation or tactical, it's the need to rebalance and also the risk of market timing. As we know it is very difficult to time the market and come up on top of that.

Adam Bass (33:39):

So that's a great segue. Let's combine a couple of issues that you've raised here around market concentration and asset allocation, as well as AI and tech. So let's bring it all together. No big secret, obviously, and you just mentioned it about market concentration this year, particularly in the US market, particularly in the IT sector. So what effect has this had on asset allocators?

Andrey Kotlyarenko (34:08):

Yeah, that's really great question. It's probably top of mind for a lot of investors, but maybe I'll take a quick step back and really point out that the concept of the concentration in certain market segments, it's not new. It's something we experienced throughout the history. We had periods of high concentration in select few securities or select few sectors in early 2000s. There is something that unique, though, about what we're experiencing right now.

(34:37):

One of those things, it's really the path to the concentration was built out over the last several decades, and that really stems from the overall reduction in publicly traded securities from the historical level. So, if we go back to late 90s, we're dealing with about 7,500 securities of publicly traded companies in US market, where now it's represented by slightly over 4,000 securities. So that definitely contributed to the overall concentration of the US market. What transpired in a more recent period is really rapid developments in AI and huge

popularity of that particular segment. And Magnificent Seven securities really rising to the top that created even further concentration in the market. And that's something to keep top of mind.

(35:27):

And a lot of those securities, they do fall in one specific sector, which is technology, right. And really, when it comes to the point of, I think one benefit that you definitely get from the sector products that Vanguard brings to the market with the help of MSCI is the idea that we have all-cap exposure. So we're not concentrated in just the largest securities, but there is some additional level of diversification of spreading that investment across both large, mid, and small-cap segments of the market.

Adam Bass (36:00):

So this kind of leads into the investor point of view there. Generally speaking, how much should investors think about this idea of concentration or be concerned about it?

Andrey Kotlyarenko (36:11):

That's something we've certainly heard from from some of the clients. And the biggest risk that exists there if you're trying to move away from the current market concentration by using some of the alternative approaches and really stepping away from the market cap-weighted indices is, once again, the idea of market timing.

(36:32):

If you were to reduce that concentration right now, is there a risk of losing out on some additional appreciation? And at the same time, how quickly would it take for any future corrections to take place, right, and how long that rally may continue? So this is really, I think everybody who's in the business of portfolio construction should keep top of their mind as they're sort of battling with the concepts of market concentration, how they're trying to mitigate some of those risks.

Adam Bass (37:05):

Let's talk in particular about the 25/50 approach, starting simply with the definition. What are we talking about when we talk about that?

Andrey Kotlyarenko (37:15):

Yeah, really the 25/50 approach deals with the regulatory limit that exists to have products considered to be diversified. And this is the regulatory limit that is instated and governed by IRS. And this deals with the concept of funds and in ETFs being registered as a registered investment company, which brings some of the benefits to the end user as they do get a much more preferential tax treatment.

(37:44):

So with that, in order to maintain your registered investment company status, or RIC for short, you have to maintain certain conditions. One of those conditions is that no security in portfolio can exceed more than 25% weight in that particular portfolio. In addition to that, securities that are over 5% in aggregate cannot add up to more than 50%. If you were to fail any of those tests, there is a risk that a product may lose its diversification status and its RIC compliance and, as a result, be subject to a very different taxation system.

Adam Bass (38:23):

And is there a particular type of client or investor who would look for this type of approach?

Andrey Kotlyarenko (38:31):

This primarily would impact taxable shareholders, but it's really impacting the entire universe of clients of US clients, in particular, that are investing in mutual funds or ETFs. And it's really deals with the concept of potential double taxation because having the RIC status allows the income and capital gains to flow through to the shareholders.

(38:57):

And really shareholders would be responsible for paying taxes on any realization of either income or capital gains, where, if you were to lose the RIC status, then this tax hurdle would also fall on the asset manager itself, and that could have a pretty drastically impact to the overall performance experience.

Adam Bass (39:18):

Andrey, before we let you go, we always like to end with as much as we can looking ahead. Clearly, a very, let's say, interesting year in the US right now. We don't need to get into all the reasons why it is so interesting. But as you look ahead to the rest of 2024 and perhaps into 2025, what are the questions on your mind as you look

at these types of portfolios, both from a sector-based perspective, as well as you mentioned some of the tax benefits of this 25/50 approach?

Andrey Kotlyarenko (39:53):

That's a great question, and it's definitely part of my job to look forward into the future and really address a lot of the strategic questions and really different asset classes going through different stages of development, and that some could be a little bit more exciting. Like on the fixed-income side, there's a lot of new product development opportunities. But with my particular area of coverage and responsibilities being equity indexing, it is a very mature product offer.

(40:22):

We do have products that pretty much cover every single segment of the market from the broadly diversified investment perspective. So my biggest concerns over short term as well as over the longer term time periods is really keen focus on risk and risk mitigation and really making sure that our products continue to meet their primary objective of tracking the indices closely. And with that, we have to keep top of mind any sort of regulatory constraints that may come in the way of it.

(40:57):

And this is where index provider, like yourself, play a big role of making the indices more investible by incorporating this 25/50 approach in the construction process. But also, in addition to that, is really making sure that we continue to maintain a very healthy product lineup that remains competitive and really meets the main objective that very closely aligns with Vanguard's overall objective of giving clients best chance for investment success.

Adam Bass (41:29):

That's all for this week. Our thanks to Abhishek, Dinank, and Andrey and to all of you for listening. Once again, Abhishek and Dinank's paper is called Incorporating Sector Investing in Portfolio Management, and you can find that on the Research and Insights section of MSCI.com.

(41:50):

One programming note before we go, we'll be shutting down our studio for the rest of the summer. But please don't forget to join us on our next new episode on September the 5th when we look at why some have said, "It may be best to look at the energy transition as an energy addition."

(42:10):

We'll talk to coiner of that phrase, Tyler Rosenlicht of Cohen & Steers, along with our own Chris Cote and Yu Ishihara. In the meantime, have a great rest of your summer, and remember, until next time, I'm your host, Adam Bass, and this is MSCI Perspectives.

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