

RIR PRODUCT USAGE BRIEF

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Downside Risk Alert Performance within GICS Sectors & Industries

Client Question

How effective is Downside Risk Alert at differentiating winners from losers within individual sectors and industries?

RIR Reply

We first explored this question nearly eight years ago, and with ever evolving sectors and industries, new sector/industry classifications for some firms, as well as a newer version of DRA since that time, it seemed valuable to revisit this topic. Sector and industry groups are frequently used as building blocks in equity portfolio construction. Many bottom-up investors form sector or industry-neutral portfolios to limit benchmark-relative risk, and as a result, focus their stock selection efforts on finding the best picks within each sector or industry group. Top-down investors willing to overweight/underweight specific sectors and industries also often implement their thematic views by selecting the best stocks within sectors or industries. Thus almost every Revelation client asks how well Downside Risk Alert (DRA) performs *within* individual sectors and industries.

To explore this question, we used the S&P GICS sector and industry classifications to create 10 sector and 65 industry universes selected from the 2300+ stocks in the MSCI U.S. Investable Market Index. To neutralize any group preferences and isolate DRA's return prediction power, we re-ranked stocks into quintiles (20%) within each sector or industry according to their DRA score. We then tested DRA's performance within each universe over the 22-year period from November 2001 to July 2023.

Table 1 summarizes our results by showing average Information Coefficients (i.e., the correlation between ranks and subsequent returns) and 12-month returns for DRA quintile cohorts relative to each sector or industry's mean return. IC values greater than zero are indicative of positive (though not necessarily significant) predictive power. Impressively, DRA has successfully differentiated winners from losers in all 10 GICS sectors and all but two GICS industries with sufficient data for calculating return spreads!

Looking first at the ten sectors, some might be surprised to see that DRA's risk averse approach has been so effective in the Health Care and Info Tech sectors where company success is often driven by growth, technology, and innovation. Another interesting finding was DRA's strong predictive power in Energy and Materials. Many investors struggle to stock pick within these sectors where company success is often driven by difficult-to-predict commodity prices. Surprisingly perhaps, DRA has performed the weakest in the Utilities sector. This may be due to utilities higher relative use of external financing and lower free cash flows compared to other sectors.

Looking next at industries, we caution against drawing strong conclusions or distinctions from what are limited sample sizes. Nonetheless, a few results stand out. Given Energy stocks' high volatility, it is notable that DRA has shown strong predictive power within both industry groups comprising the Energy sector. Though DRA has generally assigned poorer ratings to stocks in the Biotechnology, Pharmaceutical, and Life Sciences industries due to their higher downside risk (see our February 2015 Product Usage Brief), DRA has been very powerful at differentiating winners from losers *within* these industries, particularly on the downside. Unsurprisingly, given DRA's less stellar performance within the Utilities sector, DRA's predictive power has also been more modest within heavily regulated industries such as Electric and Multi-Utilities. DRA has struggled in the Entertainment sector as well. This may be due to high valuations in the industry as well as the outperformance of a few poorly ranked firms over the test period (e.g., Netflix).

In conclusion, this study shows that Downside Risk Alert can be a valuable stock selection tool in all sectors and essentially all industries. Whether an equity manager selects stocks using a bottom-up sector or industry-neutral approach or a top-down thematic approach, DRA can help identify high return, low risk stocks from within most any peer group.

Table 1: Downside Risk Alert Performance within S&P GICS Group (MSCI IMI Index Members, 12M Holding Periods, 2002 - 2023)							
S&P GICS Group	Avg 12M IC	Avg 12M % Excess Returns vs Group Mean					Avg #Co
		Qn1	Qn2	Qn3	Qn4	Qn5	
Communication Services (all stks)	0.11	1.1	-0.7	-3.7	-1.2	0.6	103
Diversified Telecom Services	0.18	3.4	3.0	-5.6	-5.7	-1.7	23
Media	0.12	-1.4	-0.1	-4.0	-0.8	-0.4	59
Entertainment	-0.03	1.0	-6.5	-1.5	-0.2	12.9	13
Interactive Media & Services		Not enough observations					6
Wireless Telecom Services		Not enough observations					2
Consumer Discretionary (all stks)	0.10	0.3	-0.4	0.4	-0.1	-2.6	299
Auto Components	0.16	0.3	1.8	-0.6	-1.5	-12.8	23
Automobiles		Not enough observations					6
Distributors		Not enough observations					4
Diversified Consumer Services	0.12	4.4	0.5	-2.4	-1.6	-1.1	42
Hotels, Restaurants, & Leisure	0.07	-2.2	1.6	1.7	1.2	-2.5	67
Household Durables	0.12	2.1	1.4	-1.7	-0.6	-1.9	41
Leisure Equipment & Products	0.25	7.2	5.5	-1.4	2.2	-11.4	14
Broadline Retail	0.19	2.2	-0.6	-0.6	4.5	-7.7	15
Specialty Retail	0.12	-0.2	-5.3	-4.3	-0.9	10.0	82
Textiles, Apparel, & Luxury Goods	0.07	1.4	-0.7	-0.7	2.2	-2.3	27
Consumer Staples (all stks)	0.12	2.4	1.2	1.8	-1.2	-4.6	150
Beverages	0.19	7.0	2.7	-1.3	-2.3	-6.8	30
Food Products	0.10	1.6	1.3	1.2	-1.5	-3.3	44
Consumer Staples Distribution & Retail	0.09	-0.6	0.8	0.5	-2.3	0.0	45
Household Products	0.12	2.4	2.9	3.6	2.5	-11.6	12
Personal Products	0.17	10.1	3.8	3.7	-5.1	-13.2	12
Tobacco		Not enough observations					7
Energy (all stks)	0.13	2.3	3.1	3.8	3.0	-2.5	223
Energy Equipment & Supplies	0.13	3.8	-0.6	1.2	-0.1	-5.2	87
Oil, Gas, & Consumable Fuels	0.12	-1.4	1.7	2.0	2.9	-3.6	136
Financials (all stks)	0.11	3.1	1.1	0.5	-0.5	-3.3	397
Capital Markets	0.11	2.0	1.8	-1.2	-3.0	-0.5	61
Commercial Banks	0.08	1.0	1.3	0.7	0.0	-2.5	161
Consumer Finance	0.11	3.3	1.5	-1.2	-3.2	-0.3	63
Diversified Financial Services	0.12	-0.3	0.5	1.5	2.1	-3.8	19
Insurance	0.10	1.2	1.6	1.3	0.0	-4.2	92
Health Care (all stks)	0.19	2.1	1.8	0.2	-0.6	-6.5	325
Biotechnology	0.17	1.8	5.4	1.3	-5.6	-7.0	105
Health Care Equipment & Supplies	0.14	1.1	1.9	0.1	1.2	-4.8	77
Life Sciences Tools & Services	0.18	3.2	0.1	1.7	-2.1	-2.3	19
Pharmaceuticals	0.21	0.6	6.3	1.1	-1.5	-9.0	44
Providers Services	0.13	1.9	-0.1	0.2	-1.7	-4.1	70
Technology	0.15	2.4	6.1	-0.6	-3.3	-4.1	11
Industrials (all stks)	0.13	1.5	1.1	1.1	-0.5	-3.3	223
Aerospace & Defense	0.09	0.1	1.7	-0.4	0.2	-1.8	44
Air Freight & Logistics	0.02	-0.6	-2.1	0.3	0.1	2.1	26
Passenger Airlines	0.08	0.5	-0.3	-0.7	-0.3	-1.2	35
Building Products	0.06	-0.5	-1.6	0.0	0.5	-0.6	67
Commercial Services & Supplies	0.13	2.3	0.5	1.4	-0.8	-5.7	77
Industrial Conglomerates	0.11	2.3	0.9	0.5	2.0	-5.9	21
Construction & Engineering	0.12	3.5	2.2	-0.7	-2.6	-2.2	49
Electrical Equipment	0.22	3.9	2.1	1.6	-0.9	-3.0	43
Machinery	0.11	0.8	0.9	-0.3	1.0	-2.0	86
Marine		Not enough observations					4
Professional Services	0.13	0.6	2.4	3.1	-2.7	-4.3	34
Ground Transportation	0.20	3.1	2.9	-0.6	-5.7	-4.3	23
Trading Companies & Distributors	0.05	1.8	-2.8	-1.3	1.3	1.7	24
Transportation Infrastructure		Not enough observations					1
Information Technology (all stks)	0.13	1.1	0.7	0.3	-1.5	-3.0	342
Communications Equipment	0.09	1.1	-0.7	1.4	0.9	-4.8	44
Technology Hardware, Storage & Perip	0.14	1.7	0.5	0.1	-0.2	-5.0	138
Electrical Equipment & Components	0.15	3.1	0.6	0.2	-1.3	-4.5	58
IT Services	0.08	0.8	-0.1	0.8	1.5	-4.0	53
Semiconductors & Semi Equipment	0.10	0.3	1.2	-0.7	-3.4	0.0	71
Software	0.11	1.6	1.2	-0.2	-0.3	-2.7	91
Materials (all stks)	0.11	-1.0	-0.1	1.3	-0.2	0.2	120
Chemicals	0.10	-0.5	-0.9	0.0	0.3	0.9	55
Construction Materials		Not enough observations					6
Containers & Packaging	0.00	-0.7	-1.5	-0.7	2.1	2.0	17
Metals & Mining	0.14	0.4	0.7	2.4	2.9	-5.1	30
Paper & Forest Products	0.08	-2.0	3.2	1.3	-5.9	-2.4	11
Utilities (all stks)	0.04	0.7	-0.5	-0.5	0.1	-2.7	80
Electric Utilities	-0.01	0.3	-0.8	-0.7	0.1	1.4	32
Gas Utilities	0.07	1.7	0.4	-0.2	0.1	-1.4	15
Indepen Power Producers & Traders		Not enough observations					5
Multi-Utilities	0.03	-1.4	-1.7	-1.8	0.2	-5.1	20
Water Utilities		Not enough observations					5