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INVESTMENT STRATEGY

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Equity Sector Guidance Framework

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Strategy Highlights

Recommended Sector Weightings

Consumer Discretionary - 11%
Consumer Staples - 10%
Energy - 9%
Financial Services - 17%
Health Care - 15%
Industrials - 10%
Technology - 19%
Materials - 3%
Communications - 3%
Utilities - 3%

When building an equity portfolio, we recommend investing in high-quality companies, maintaining proper diversification, and holding for the long term. Long-term investment performance is largely driven by asset allocation, which is the mix of cash, equities and fixed income in a portfolio. It is also important to own a mix of investments within these asset classes, such as laddering across bond maturities and investing across the various equity sectors in appropriate amounts. In this report, we discuss our recommended equity sector weightings and the framework we use to support this guidance.

The Framework

We believe short-term forecasts based on the economy, interest rates or energy and other commodity prices are often inaccurate and can change frequently. Therefore, when deciding the appropriate portfolio weightings for each sector, we use a framework that is more strategic in nature.

Key inputs to determine the recommended weightings include

Using the S&P 500 as a Starting Point - We use the S&P 500 as the benchmark, and we review historical trends of each equity sector. Our recommended allocation to each sector will normally be within 0% - 3% of its weight in the S&P 500.

History as a Guide - We analyze the earnings pattern from each sector relative to the total market and consider relevant factors that could change those trends in the future. We try to distinguish between short-term cyclical changes vs. longer-term fundamental changes in order to capture significant shifts in the economy and market.

Relative Performance and Valuation - Market leadership across sectors tends to rotate over time as industries move in and out of favor with investors. Sectors that significantly outperform can become overvalued, while lagging sectors eventually become more attractive relative to the market.

Evaluate the Business Cycle - Sector performance is also typically tied to the stages of the business, or economic cycle. During expansionary periods more cyclical sectors (such as technology and industrials) tend to outperform as they benefit from healthy economic growth, while defensive sectors (such as consumer staples and health care) tend to hold up better during economic downturns or recessions.

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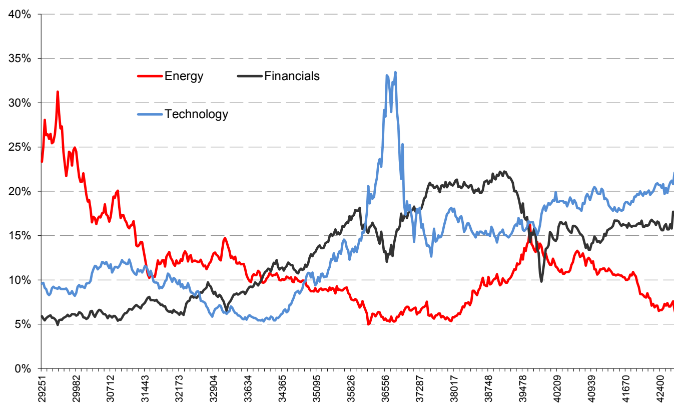
Figure 1. Sector Weights Can Vary Significantly Over Time



Source: FactSet, Edward Jones. The S&P 500 Index is based on the average performance of 500 widely held common stocks. The S&P Energy Index consists of 40 energy companies within the S&P 500 Index, the S&P Financials Index 88 financial services companies, and the S&P Technology Index 69 tech companies. These are unmanaged indexes and cannot be invested in directly. Past performance does not assure future results.

Determining the Right Balance - Equity Research sector teams look for major deviations in performance, assesses sector valuation, and incorporates its long-term outlook for each sector to help determine the most appropriate sector weighting to recommend.

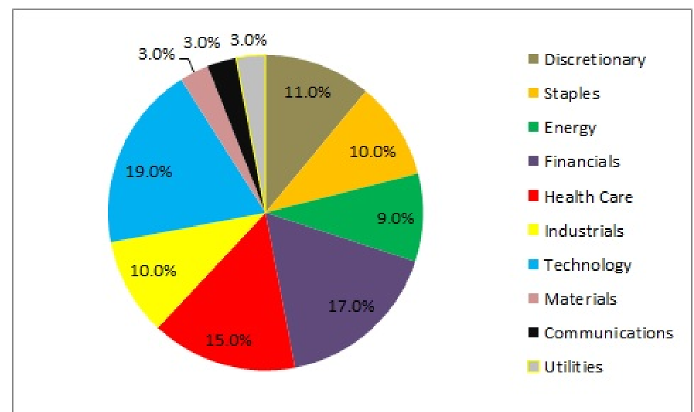
We believe it's more important to focus on the long-term trends, and we do our best to identify significant areas of opportunity and risk resulting from situations where the valuation of a sector has moved beyond a range that we deem appropriate. We also cap our recommended weightings to a maximum of 20% and set a minimum of 2% to ensure proper diversification.

As illustrated by Figure 1, there have been several instances when using this type of framework would have highlighted potential risk in the market, and when incorporating our maximum cap of 20% to any given sector, would have benefited investors. For example, during the early 1980s when commodity prices were historically high, the weighting of the energy sector climbed to over 30%. Following the peak, the energy sector went through a prolonged period of low prices, and many stocks in the sector underperformed. We saw this again during the late 1990s with the technology sector, which was followed by the "tech bust" in 2001. More recently, we experienced this with the financial services sector in the mid-2000s. In all three instances, we believe the framework would have helped identify these potential risks.

When assessing historical weightings, it is also important to account for structural changes that may be taking place that would justify a higher or lower portfolio weighting. For example, technology has continued to increase its role throughout the world, and profits from this industry have risen over time. As a result of its growing earnings contribution relative to the total market, the weighting of the sector has increased and now is a larger percentage of the total market. Other sectors, such as utilities and telecommunications, have seen their earnings contribution to the S&P 500 shrink over time and their market capitalizations have followed suit.

Other factors we consider are sector price performance, valuation and growth. So to summarize, we target weightings that are close to their respective historical averages while accounting for different variables that would justify a higher or lower weight.

Our Recommended Weightings



Sector Outlooks and Recommended Weightings

Energy - 9%

Oil and natural gas prices have rebounded from their lows but remain well below their peaks set in mid-2014. This has led to volatility and the underperformance of stocks in the energy sector in recent years. As a result of lower commodity prices, most companies reduced their capital expenditures, which is gradually leading to lower supplies of oil. Oil prices have recovered to some extent, and are approaching the low end of our long-term expected range of $55-$65 (West Texas Intermediate). We believe oil prices should continue to strengthen over the next several years as the energy markets rebalance, and thus, we recommend an energy weighting that is above the current market weighting of 6%.

Utilities - 3%

Investors primarily invest in utilities for their higher yields and rising dividends, which can act as an inflation hedge over time. We expect utilities to grow earnings 5% annually, driven by capital investments to maintain and improve utility infrastructure as well as meet environmental standards. That said, utility stocks are sensitive to interest rate movements, and

many companies are trading towards the high end of their historical range. Should long-term interest rates rise, we believe the sector could underperform the market. Our recommended weighting is in line with the current market weighting of 3%, reflecting the balance between solid long-term fundamentals offset by valuation of the sector.

Health Care - 15%

Uncertainty over the fate of the Affordable Care Act has weighed on the health care sector, and we expect that to continue. That said, we believe the sector remains attractive and that growth will be driven by continued medical innovation over time and favorable demographic trends, such as the aging population and growth from emerging markets as demand for medical products increases. We recommend a 15% weighting, slightly higher than the current market weighting of 14%.

Technology - 19%

Today's technology landscape is being defined by those who have key positions in areas such as the cloud, big data analytics and mobile. While some of the younger technology firms are quickly establishing leadership positions, more traditional technology firms are investing in or acquiring new technologies. The technology sector has performed well due to new product innovation and increasing adoption of newer technologies. Given the strong performance and fair valuation of the sector, our recommended weighting is below the current market weighting of 22%.

Communication Services - 3%

The communications sector has been underperforming the market amid concerns over increasing competition, and its weighting of the total market is near historical lows. To help drive longer-term growth, network providers are upgrading their networks in support of increasing mobile traffic and data usage. Opportunities we see in the space are customers' willingness to pay for faster Internet speeds and the growing demand for digital video content. While we believe the growth outlook for the sector is among the lowest in the market, valuation looks relatively attractive, and as a result we recommend a 3% weighting relative to the current market weight approaching 2%.

Industrials- 10%

Industrial companies are the backbone of the U.S. economy, with a wide range of products and services ranging from machinery manufacturers and defense companies to railroads. The industrial sector is cyclical, as earnings tend to follow the overall pattern of economic growth. Most of the sector has performed well over the last year amid optimism around improving growth, especially overseas. We believe the valuation of the industrial sector is appropriately balancing shorter-term headwinds with the longer-term opportunities tied to infrastructure growth in emerging economies, and thus our recommended weighting is aligned with the current market weighting of 10%.

Materials - 3%

The materials sector is largely made up of metals and mining companies, chemical companies (both specialty and commodity), and agriculture-related companies, namely the fertilizer and seed producers. The sector has underperformed the S&P 500 over the last five years, as weaker commodity prices have resulted in reduced earnings expectations for many miners and agriculture-focused firms. Over the long term the sector will likely be driven by a growing urban population, emerging-market economic growth, and global fixed-asset investment. Our recommended weighting is in line with the sector's weighting in the market of 3%.

Consumer Staples - 10%

Consumer staples stocks are trading towards the upper end of their historical range, in part due to their attractive dividend yields in the low interest rate environment. Slowing emerging-market growth has led to slower sales growth at many food and household-product companies. Longer-term, we believe consumer staples companies will benefit from a growing middle class in emerging markets. We expect rising wealth in developing economies to lead to increased demand for everyday items, such as food and household products. Due to the recent pullback in the sector, which has left valuations slightly more attractive, our recommended weighting is slightly above the current market weighting of 9%.

Consumer Discretionary - 11%

An improving U.S. job market, rising wages, lower gas prices, and a stronger market for housing generally helps consumers feel better about spending money. We believe improving developed-market economies will lead to increased consumer spending. These positive trends have led to very strong sector performance, resulting in relatively high valuation from a historical perspective. In light of this, our recommended weighting of 11% is below the current market weighting of 12%. Longer-term, we expect rising incomes in emerging markets to lead to increased consumer spending, which should benefit many global consumer companies.

Financial Services - 17%

Slowly rising interest rates and the prospect of less financial regulation have buoyed the U.S. financial services sector. Additionally, the increasing financial strength of many firms has led to rising share buybacks and dividends to shareholders. However, loan growth has been slowing, and losses on bad loans are likely to pick up as we move later in the business cycle. Longer-term, we believe the financial services sector will be driven by a growing global middle class, the globalization of world economies, and an aging population. We recommend a 17% weighting in the sector, in line with the current market weighting of 17%. We note that S&P broke out REITs as a separate sector within the S&P 500 Index in September 2016. We continue to include REITs within the financial services sector as it is a small part of the overall index (approximately 3.0%), and more importantly, REITs continue to be closely tied to interest rates and financial services in general.

Review and Rebalance

We review our equity sector guidance on a quarterly basis because we believe maintaining proper diversification helps reduce risk and increase returns over time. In turn, we encourage investors to conduct frequent reviews of their portfolios, as well, and make the proper adjustments when necessary. Investment performance, over time, is derived from asset allocation, which is the mix of cash, equities and fixed income. It is also important to own a mix of investments within these asset classes, such as laddering across bond maturities and investing across the various equity sectors in the appropriate amounts.

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