# A Standout ETF in the Recently Upgraded Financials Sector

The Financials sector was recently upgraded to Attractive from Neutral and ranks second in our 4Q17 Sector Rankings for ETFs and Mutual Funds. The Financials sector moved up one spot from third in our 3Q17 report. This sector rating is based on an aggregation of our fund ratings for the 24 ETFs and 35 mutual funds under coverage in the Financials sector. These funds collectively hold $67 billion of assets.

There are wide holdings variations among Financials sector ETFs and mutual funds, even among funds with similar labels. These variations can create very different investment outcomes, and therefore ratings. Our Robo-Analyst technology helps investors navigate the sector by sifting through the holdings of all Financials-focused ETFs and mutual funds, which hold anywhere from 47 to 581 stocks. In the process, we uncovered a particularly attractive ETF that backward-looking fund research is likely to overlook.

This focused sub-sector ETF stands out as a potential alpha-generating opportunity within Financials sector funds. It ranks fifth among 59 Financials sector ETFs and mutual funds, which include 31 Attractive-or-better rated funds. This ETF is poised to remain near the top of the rankings based on its superior holdings quality and low total annual costs (TAC). The Insurance Sector SPDR (KIE) receives our Very Attractive fund rating and is also this week's Long Idea.

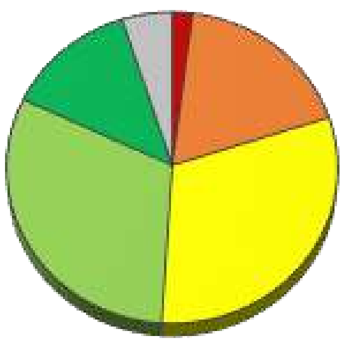
**Holdings Analysis Reveals Favorable Allocations**

The only justification for an ETF to charge higher fees than its passively managed ETF benchmark is "active" management that leads to out-performance. While KIE is technically classified as a "passive" Financials sector ETF, we consider its concentrated Insurance sub-sector focus to be an active management decision.

A fund is most likely to outperform if it has higher quality holdings than its benchmark. To make a determination on holdings quality, we leverage our Robo-Analyst technology to drill down to the individual stocks[1] of every fund. This capability empowers our unique holdings based ETF and mutual fund rating methodology.

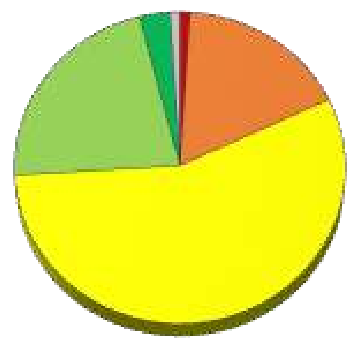
**Figure 1: KIE Asset Allocation by Holding-Level Risk/Reward Rating**

**Stock Rating Allocations vs Benchmark - Insurance Select Sector SPDR Fund (KIE)**



| KIE Allocations | | XLF Allocations |
|---|---|---|
| 2% | Very Unattractive | 1% |
| 18% | Unattractive | 17% |
| 31% | Neutral | 56% |
| 31% | Attractive | 22% |
| 13% | Very Attractive | 3% |
| 5% | Unrated | 1% |
| -- | Cash | -- |

Holdings as of 09/30/17
Ratings as of 10/2/17



Sources: New Constructs, LLC and company filings

Per Figure 1, KIE allocates 44% of its assets to Attractive-or-better rated stocks compared to just 25% for the benchmark Financial Sector SPDR Fund (XLF). As a result, the allocation to Neutral-rated stocks is much lower for KIE (31% of assets) than for XLF (56% of assets). Exposure to Unattractive-or-worse rated stocks is similar at 20% for KIE and 18% for XLF, although this is more than offset by KIE's Attractive-or-better rated stocks.

Given the high allocation to Attractive-or-better rated stocks, and equal allocation to Unattractive-or-worse rated stocks relative to the benchmark XLF, KIE appears well positioned to capture upside potential while taking on an average level of downside risk. Compared to the average ETF or mutual fund, KIE has a better chance of generating the outperformance required to justify its management fees above the cost of the XLF benchmark.

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[1] Ernst & Young's recent white paper "Getting ROIC Right" proves the superiority of our stock research and analytics.

**KIE Represents Financials Sector "Value"**

True value investing still works despite the proliferation of passive strategies. KIE is a good example of how to utilize a relatively low-cost, passively-managed ETF to make an "active" investment decision. The ETF's sub-sector focus does an effective job allocating capital to higher-quality companies with lower relative valuations, the cornerstone of the value investing discipline.

Figure 2 contains our detailed fund rating for the Insurance Sector SPDR (KIE), which includes each of the criteria we use to rate all funds under coverage. These criteria are very similar to our Stock Rating Methodology, because the performance of a fund's holdings equals the performance of a fund. The results of this analysis reveal important information for investors in KIE.

**Figure 2: Insurance Select Sector SPDR (KIE) Rating Breakdown**

**State Street SPDR Series Trust: SPDR S&P Insurance ETF (KIE)**

Closing Price: $90.59 (Oct 02, 2017)
Dividend Yield: 1.3%
Sector: Financials

| Risk/Reward Rating | Portfolio Management: Quality of Earnings: Econ vs Reported EPS | Portfolio Management: Quality of Earnings: ROIC | Portfolio Management: Valuation: FCF Yield | Portfolio Management: Valuation: Price to EBV | Portfolio Management: Valuation: GAP | Total Annual Costs |
|---|---|---|---|---|---|---|
| Very Unattractive | Misleading Trend | Bottom Quintile | <-5% | >3.5 or -1<0 | >50 | >4% |
| Unattractive | False Positive | 4th Quintile | -5%<-1% | 2.4<3.5 or <-1 | 20<50 | 2%<4% |
| Neutral | Neutral EE | 3rd Quintile | -1%<3% | 1.6<2.4 | 10<20 | 1%<2% |
| Attractive | Positive EE | 2nd Quintile | 3%<10% | 1.1<1.6 | 3<10 | 0.5%<1% |
| Very Attractive | Rising EE | Top Quintile | >10% | 0<1.1 | 0<3 | <0.5% |
| **Actual Values** | | | | | | |
| **KIE** | **Positive EE** | **8%** | **2%** | **1.1** | **15 yrs** | **0.4%** |
| **Benchmarks** | | | | | | |
| Sector ETF (XLF) | Positive EE | 8% | 4% | 1.4 | 15 yrs | 0.2% |
| S&P 500 ETF (SPY) | Positive EE | 18% | 2% | 2.5 | 24 yrs | 0.1% |
| Small Cap ETF (IWM) | Positive EE | 6% | -1% | 3.0 | 34 yrs | 0.2% |

Sources: New Constructs, LLC and company filings

The return on invested capital (ROIC) for KIE's holdings is 8%. These returns are in line with 8% ROIC earned by Financial Select Sector SPDR Fund (XLF) holdings and slightly below above the 9% average for 465 Financials stocks under coverage. As one can see, there is little variation between the holdings of KIE, XLF and the average Financials sector stock in terms of ROIC, which is the primary driver of stock prices. The primary advantage of KIE holdings is in their valuation and lower embedded market expectations.

The market-implied expectations for future profits baked into the prices of KIE holdings are meaningfully lower than for those for XLF holdings. The price to economic book value (PEBV) ratio for KIE is 1.1 compared to 1.4 for XLF. This ratio means the market expects the after-tax profits (NOPAT) of XLF stocks to increase 40% from current levels while KIE stocks are priced for expectations of 10% NOPAT growth from current levels.

Our discounted cash flow analysis of fund holdings reveals a market implied growth appreciation period (GAP) of 15 years for KIE. KIE's GAP matches that of the broader financial sector (XLF), which is not surprising, but is far shorter than the 24-year GAP for the broad market (represented by SPY). In other words, KIE constituents only have to grow economic earnings for 60% as long as companies held by SPY to justify their current stock prices.

### Focused Capital Allocation with Underlying Diversification

The Insurance Sector SPDR (KIE) hold 48 stocks, which is on the low end of Financials sector funds. However, there are no large allocations to any single stock. The top-10 holdings represent 23% of total assets, the top holding accounts for 2.5%, and the average holding accounts for 2%. KIE also diversifies across five Insurance business lines, including: property & casualty (41%), life & health (27%), reinsurance (11%), multi-line (11%) and brokers (11%). Holdings are domiciled 76% in the U.S, 22% in the U.K and 2% in Switzerland). There is no style drift either. 100% of the fund is in the Insurance sector and directly exposed to its industry trends.

### Beware Funds with Similar Labels

The proliferation of ETFs with similar labels yet vastly different holdings shows how truly passive investing is made difficult, if not impossible, by the sheer number of options and the wide variations among them. An analysis of the iShares US Insurance ETF (IAK) compared to the Insurance Sector SPDR (KIE) provides a good case study. While it is difficult to tell the two ETFs apart on the surface, IAK earns a Neutral fund rating vs. a Very Attractive rating for KIE. IAK has a similar allocation to Attractive-or-better stocks, but also holds 30% Unattractive-or-worse rated stocks vs. 20% for KIE. Relative to KIE holdings, the ROIC for IAK holdings is lower, while the PEBV ratio is higher and the GAP is longer.

**Figure 3: iShares US Insurance ETF (IAK) Rating Breakdown**

**iShares Trust: iShares US Insurance ETF (IAK)**

Closing Price: $64.33 (Oct 03, 2017)
Dividend Yield: 1.7%
Sector: Financials

| | Portfolio Management | | | | | |
|---|---|---|---|---|---|---|
| | Quality of Earnings | | Valuation | | | |
| Risk/Reward Rating | Econ vs Reported EPS | ROIC | FCF Yield | Price to EBV | GAP | Total Annual Costs |
| Very Unattractive | Misleading Trend | Bottom Quintile | <-5% | >3.5 or -1<0 | >50 | >4% |
| Unattractive | False Positive | 4th Quintile | -5%<-1% | 2.4<3.5 or <-1 | 20<50 | 2%<4% |
| Neutral | Neutral EE | 3rd Quintile | -1%<3% | 1.6<2.4 | 10<20 | 1%<2% |
| Attractive | Positive EE | 2nd Quintile | 3%<10% | 1.1<1.6 | 3<10 | 0.5%<1% |
| Very Attractive | Rising EE | Top Quintile | >10% | 0<1.1 | 0<3 | <0.5% |
| **Actual Values** | | | | | | |
| **IAK** | **Positive EE** | **7%** | **4%** | **1.6** | **27 yrs** | **0.5%** |
| **Benchmarks** | | | | | | |
| Sector ETF (XLF) | Positive EE | 8% | 4% | 1.4 | 15 yrs | 0.2% |
| S&P 500 ETF (SPY) | Positive EE | 18% | 2% | 2.5 | 24 yrs | 0.1% |
| Small Cap ETF (IWM) | Positive EE | 6% | -1% | 3.0 | 35 yrs | 0.2% |

Sources: New Constructs, LLC and company filings

### KIE Should Earn Its Relatively Modest Fees

With total annual costs (TAC) of 0.39%, KIE expenses are lower than 81% of Financial sector ETFs and mutual funds under coverage. Coupled with its quality holdings, below average fees make KIE more attractive. For comparison, the average TAC of all Financials sector ETF and mutual funds is 1.71%, the weighted average is 0.72%, and the ETF benchmark (XLF) has a TAC of 0.15%. KIE's expense ratio closely approximates the true costs of investing in the fund as its 0.39% TAC is only 0.04% higher than its stated expense ratio.

While we recognize that past performance is no guarantee of future results, KIE's concentrated allocation of capital to the insurance industry has led to outperformance relative to the Financials sector (XLF) over the past one, three, five and ten-year periods. KIE has also outperformed the broader market (SPY) over the past one, three and five-year periods, while lagging by <1% over the past 10 years.

The amount of outperformance required by KIE's management fees (above the XLF benchmark) is a minimal hurdle that has been surpassed by the KIE over the past decade. Based on the annualized monthly returns reflected in Figure 4, KIE has beaten its XLF benchmark by nearly 6% annually.

We note that all Financials sector stocks, including insurance, have underperformed the SPY year-to-date. However, with the market again making new highs, interest rates rising, and the "reflation" trade back on, we view the YTD underperformance of the KIE as a buying opportunity.

**Figure 4: Insurance Select Sector SPDR (KIE) vs. XLF & SPY**

| | | Annualized Monthly Returns | | | | |
|---|---|---|---|---|---|---|
| **Sector SPDR ETF** | **Ticker** | **YTD** | **1-Year** | **3-Year** | **5-Year** | **10-Year** |
| Financials SPDR | XLF | 6.9% | 25.9% | 11.3% | 17.1% | 1.0% |
| Insurance SPDR | KIE | 7.4% | 20.1% | 12.8% | 18.3% | 6.8% |
| S&P 500 SPDR | SPY | 11.9% | 16.2% | 9.5% | 14.3% | 7.6% |

Sources: New Constructs, LLC and company filings.

**The Importance of Holdings Based Fund Analysis**

Investors have many options when looking to invest in Financials sector ETFs and mutual funds. There is middle ground between a high-cost, actively managed mutual fund and the lowest cost passive ETF option. Insurance Select Sector SPDR (KIE) is among a limited group of passively-managed ETFs that justifies its fees (above the XLF benchmark) through focused asset allocation.

Diligence is required to make such informed investment decisions, and truly "passive" investors analyzing funds solely on fund labels or fees are exposing themselves to unnecessary risks. Each quarter we rank the 10 sectors in our Sector Ratings for ETF & Mutual Funds and the 12 investment styles in our Style Ratings For ETFs & Mutual Funds report. This analysis allows us to find funds that investors using traditional fund research may overlook, such as the Insurance Select Sector SPDR (KIE).

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*Disclosure: David Trainer, Kenneth James, and Kyle Guske II receive no compensation to write about any specific stock, style, or theme.*

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4. **Relevant** - Empirical evidence must provide tangible, quantifiable correlation to stock, ETF or mutual fund performance.

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