Investor

Now is the time to have exposure to underperforming North American equity sectors

Valuations matter over the long term

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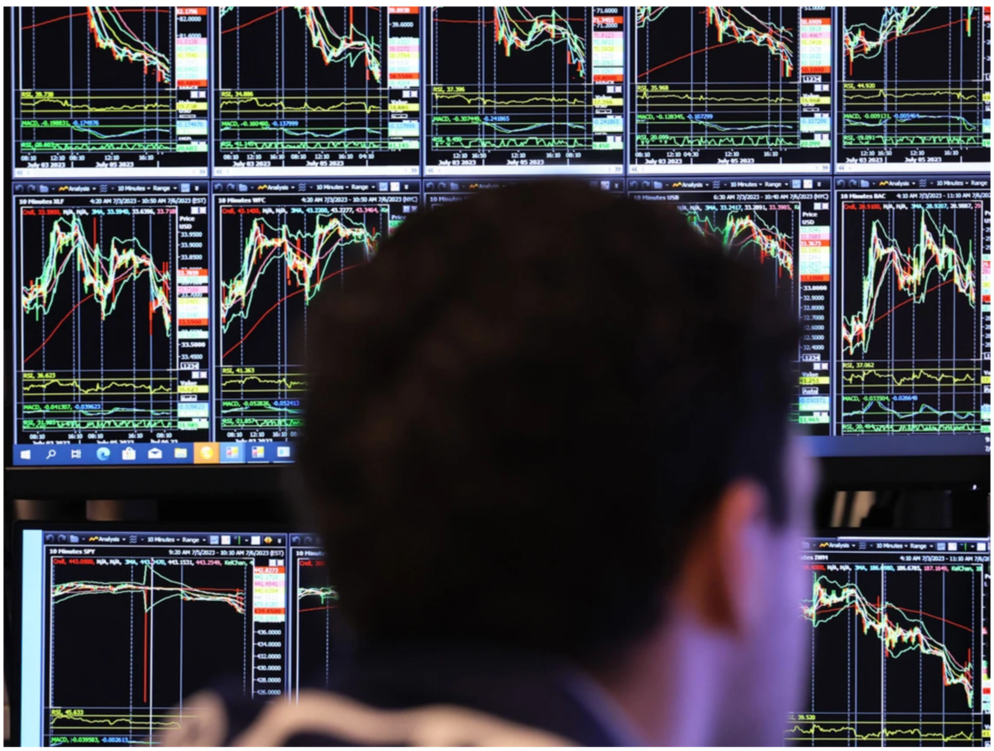

A trader working on the oor of the New York Stock Exchange. PHOTO BY MICHAEL M. SANTIAGO/GETTY IMAGES FILES

By Jonathan Pinsler

The S&P 500, the widely recognized benchmark for the United States stock market, consists of 500 large-cap companies across various sectors. At times, the index may experience a lack of breadth, with a handful of sectors outperforming while others lag. Currently, it is the narrowest in almost three decades with megacap technology names keeping the index buoyant.

The S&P 500 index is up 18.14 per cent year to date as of July 21 versus the Dow Jones being up 6.27 per cent, according to FactSet (in 2022, the Dow was down approximately half of the S&P 500). Most investors have not been fully market-cap weighted towards many of the index's companies. Valuations, higher interest rates and a slowdown in the economy have temporarily tempered our enthusiasm.

If you exclude eight of the largest technology companies, the S&P 500 is up nominally on the year. This situation can raise concerns or frustration for well-diversi ed investors, but it also presents a great opportunity to invest in underperforming sectors. Here are three reasons why.

Favourable risk/reward ratio

Underperforming sectors often trade at lower valuations compared to their historical averages or the broader market. This provides investors with a favourable risk/reward ratio.

By investing in sectors that have temporarily fallen out of favour, investors can potentially capitalize on the recovery and subsequent growth, yielding higher returns compared to investing in already overvalued sectors.

Cyclical nature of the market

The stock market is cyclical, with sectors taking turns in leading and lagging performance. Sectors that are currently underperforming may simply be going through a down cycle, and history has shown these cycles tend to reverse over time.

Investing in underperforming sectors during their troughs can position investors to benefit from the eventual upturn as market dynamics shift in their favour.

Diversification and long-term growth

Adding exposure to underperforming sectors can enhance diversification within an investment portfolio. This environment warrants spreading investments across a range of sectors.

Investors can reduce their exposure to any single sector's risks and potentially achieve more stable long-term growth.

The lack of breadth in the S&P 500 may raise concerns, but it also opens doors to exciting investment opportunities. Our viewpoint is that through careful consideration and strategic thinking, investors can navigate the market and make the most of underperforming sectors within the S&P 500 and other markets.

Additionally, we think the Canadian market has many sectors that have compelling valuations: banks, real estate investment trusts and energy stocks are trading at the low-end range of their historical price-to-earnings multiples yet currently have attractive fundamentals. Bottom line: valuations matter over the long term.

Jonathan Pinsler, CFA, is a senior portfolio manager at TD Wealth Private Investment Advice. The contents of this document are not endorsed by TD Wealth Private Investment Advice and are subject to change based on market and other conditions.