The Rising Tide of SECTOR & INDUSTRY INVESTING

New Research on One of Today’s Most Important Investment Trends

STATE STREET GLOBAL ADVISORS SPDR®
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ANOTHER ROUTE TO RETURNS

Increasing volatility and uneven market performance over the past few years has intensified the search for strategies with the potential to deliver more than just market beta.

At the sector and industry level, however, tactical investment opportunities that have the potential to generate a return in excess of the broader market are available. For example, the S&P 500 Index ended 2015 with a meager 1.38 percent return for the year, its lowest figure since 2008. However, upon further analysis, winners and losers were noticeable. Although falling oil prices caused the energy sector to lose over 21% of its value in 2015, lower gas prices at the pump fattened consumers' wallets. Accordingly, in 2015, the consumer discretionary sector gained over 10%, led by an 83% gain from Internet and catalog retailers.1

In such periods of generally uncertain markets, sector and industry investing may offer the potential to add excess returns. No wonder, then, that investors are expressing increased interest in sector and industry investment vehicles.

In this report, we bring you up to date on the current state of sector and industry investing, including how investment professionals are using it and why, how they’re incorporating sector and industry investing into portfolios; and what they plan to do going forward. This report is based on survey responses2 from over 400 US-based financial advisors and interviews with a number of advisors, completed in the first quarter of 2016.

Research Methodology

This report is based on State Street Global Advisors’ Survey of Investment Professionals’ Sector and Industry Investing Attitudes and Usage, a research study conducted in late 2015 into early 2016. The study comprised web-based and phone interviews.

Our web-based quantitative survey of financial advisors and wealth managers received 419 responses. The channel breakdown of respondents was 34% registered investment advisors, 27% independent broker dealers, 23% national broker dealers, 7% regional broker dealers, 3% private wealth managers, 2% family offices and 4% other. Additional telephone interviews were conducted with 12 respondents from the web-based survey.

All charts and graphs on the following pages are based on the results of the quantitative survey unless otherwise noted.
“When the bull market and economic recovery reach their next stage, a rising tide may no longer lift all boats and investing may require a more precise approach. For investors looking to harness the next stage of the US recovery cycle, we think it will prove beneficial to favor substance — by way of sectors and industries — over style.”

— Nick Good, Senior Managing Director, Co-Head, Global SPDR ETF Business
USE OF SECTOR & INDUSTRY FUNDS

A Growing Trend

Not many years ago, sector investing was relatively uncommon and difficult to execute. An investor seeking sector exposure would need to buy numerous stocks to ensure adequate diversification within a given sector. The introduction of SPDR® Select Sector Exchange Traded Funds (ETFs) in 1998, followed by the introduction of more targeted industry funds several years later, provided a new and efficient means of expressing sector views in portfolios.

At State Street Global Advisors, we believe sectors and industries provide an efficient tool for responding to changing market cycles with agility and precision. Investors can improve their core equity exposure by implementing sector and industry investing strategies instead of style investing or stock picking. In this research report, we offer a view into how today’s most sophisticated Investment Professionals are using sector and industry funds, and explore how these solutions can help other investors evolve their investing strategies.

Diversification does not ensure a profit or guarantee against loss.
Advisor Use of Sector/Industry ETFs

Our research indicates that a large majority of Investment Professionals believe in the basic premise of sector investing such that under any market conditions, there will be sectors that outperform the market and sectors that underperform. Strategies that invest in outperforming sectors and underweight or avoid poor-performing sectors can potentially improve risk-adjusted performance.

Over 85% of survey respondents had some exposure to sector and/or industry funds, with more than a quarter indicating sector/industry investing was a major part of their US equity strategy. Interestingly, uncertainty about how to execute a sector strategy was a key factor cited by non-users, who often indicated a willingness to try sector/industry investing if given sufficient information and guidance.

Advisor Use of Sectors & Industries

<table>
<thead>
<tr>
<th>Advisor Type</th>
<th>Use as Big Part of US Equity Strategy</th>
<th>Use in Certain Cases</th>
<th>Do Not Use</th>
</tr>
</thead>
<tbody>
<tr>
<td>National Broker Dealer</td>
<td>20%</td>
<td>66%</td>
<td>14%</td>
</tr>
<tr>
<td>Independent Broker Dealer + Regional Broker Dealer</td>
<td>25%</td>
<td>62%</td>
<td>13%</td>
</tr>
<tr>
<td>Registered Investment Advisor (RIA)</td>
<td>26%</td>
<td>53%</td>
<td>20%</td>
</tr>
<tr>
<td>Private Wealth Manager</td>
<td>50%</td>
<td>42%</td>
<td>8%</td>
</tr>
</tbody>
</table>

Charts may not total 100% due to rounding.
Varying Levels of Exposure

Our research revealed a broad spectrum of exposures to sector and rotation strategies, as measured by assets invested in sector/industry ETFs.

At one end were advisors using ETFs to tactically overweight or underweight specific sectors or industries to take advantage of changing market conditions. Many described their investment approach as “strategic with a tactical overlay.” For these advisors, sector and industry investing was generally a non-core strategy that was applied tactically at the margins of their portfolios. Yet, the use of sector and industry investing was often cited as being central to their efforts to add the potential for alpha to an active or passive core. In fact, an advisor from the independent brokerage channel said that “sector ETFs are the tactical portion of my [US equity] portfolio, offering a way to find low-cost alpha.”

Assets Allocated to Sector/Industry ETFs

<table>
<thead>
<tr>
<th>National Broker Dealer</th>
<th>24%</th>
<th>28%</th>
<th>47%</th>
</tr>
</thead>
<tbody>
<tr>
<td>Independent Broker Dealer + Regional Broker Dealer</td>
<td>22%</td>
<td>26%</td>
<td>51%</td>
</tr>
<tr>
<td>Registered Investment Advisor (RIA)</td>
<td>29%</td>
<td>17%</td>
<td>54%</td>
</tr>
<tr>
<td>Private Wealth Manager</td>
<td>27%</td>
<td>27%</td>
<td>45%</td>
</tr>
</tbody>
</table>

Charts may not total 100% due to rounding. AUM = Assets Under Management
REASONS FOR USING SECTORS & INDUSTRIES

The view of sector rotation strategies as tactical opportunities is the common thread among virtually all sector and industry investors.

More specifically, our survey revealed broad agreement among advisors on the particular opportunities they saw in sector and industry investing, such as diversification, risk management and pursuing alpha through expression of their tactical views.

Advisors’ Rationale for Using Sectors & Industries

<table>
<thead>
<tr>
<th>Reason</th>
<th>% of Respondents Who Agreed</th>
</tr>
</thead>
<tbody>
<tr>
<td>Portfolio Diversification</td>
<td>66%</td>
</tr>
<tr>
<td>Expressing Tactical Views</td>
<td>65%</td>
</tr>
<tr>
<td>Obtaining Alpha</td>
<td>49%</td>
</tr>
<tr>
<td>Managing Risk in the Equity Market</td>
<td>42%</td>
</tr>
</tbody>
</table>
There are two main approaches to indexes when it comes to sector and industry ETFs

1 Market Capitalization-Weighted Methodology

Market-cap weighting — the approach taken by many popular indexes is easily understood as a methodology and can provide more “pure” exposure to the sector or industry, which can be beneficial when seeking to express a point-of-view on a specific sector or industry. However, market cap-weighted indices have the potential to increase a portfolio's concentration to a particular holding, which can be problematic when targeting a narrow market segment like sector sub-industries.

2 Equal Weighting

Equal weighted index methodologies apply an equal weight to each stock. This approach has the benefit of mitigating stock-specific risk. One particular flavor of equal weighting is Modified Equal Weighting, or MEW. With MEW, the index equally weights each stock, then modifies the weight for liquidity to maintain the investability of the index. For industry ETFs in particular, MEW may offer benefits by reducing the portfolio's large cap bias and amount of overlap to the broader sector. However, with larger allocations to small and mid-cap stocks, MEW may exhibit more volatility than market-cap weighted exposures.

Understanding the differences among indices can help achieve the most precise exposure. While there is no perfect index, investors will benefit from understanding how the chosen index is constructed and what exposures or hidden biases may exist.
At State Street Global Advisors, we believe sector investing enables investors to get more from their core and help manage risk, offering an alternative to traditional stock picking and style boxes.
In our view, sectors have four distinct advantages over style investing:

1 **Sectors Are A Key Driver of Risk**

Sectors consistently account for a larger contribution to equity risk within the S&P 500 Index than do styles. Over the last 17 years, sector exposure within the S&P 500 explains a large proportion of the Index’s contribution to risk. Even within style indices such as the S&P 500 Growth and Value Style Indexes, the sectors drive more of the risk — a clear sign of the advantage sectors have over styles.

2 **Differentiated Correlations To The Broader Market**

A lower average correlation means returns are more differentiated from one another, which may positively impact asset selection strategies such as rotating between sectors to manage risk and potentially improve diversification.

Over the last 17 years, the S&P 500 Index’s average correlation to growth and value is 0.98 and 0.97, respectively. Meanwhile, average sector correlations to the broad market are much more diverse, ranging from 0.60 for Utilities to 0.92 for Industrials. Unlike sectors, based on these metrics, the return patterns of styles are not that different than the S&P 500.

The correlation coefficient measures the strength and direction of a linear relationship between two variables. It measures the degree to which the deviations of one variable from its mean are related to those of a different variable from its respective mean.

Source: State Street Global Advisors, FactSet, as of 8/31/2015.
3 Wider Dispersion of Returns

Return dispersion is an important metric when evaluating the opportunity to generate alpha by over- or underweighting a certain segment of the market, as it measures the magnitude of differences between a given set of exposures. A wider dispersion of returns is more attractive, as a low dispersion typically means the return of any particular exposure is more similar to the average.

Sector returns differ greatly over time, while style returns vary less. From 2000 to 2015, the average yearly difference between large cap growth and value was 7.8%. Meanwhile, the average difference between the best- and worst-performing sectors was 36.1%. This wider pattern of historical return dispersion may present the opportunity to generate alpha by overweighting top performers. Since, unlike styles, those sector returns may be much different than the average.

Sector Dispersion of Returns

Source: FactSet, State Street Global Advisors, as of 8/31/2015. FactSet based on estimates, actual portfolio level returns may vary.

4 Economic Cycle Dependency

Sector performance from year to year is quite variable, with some sectors going from worst to first. The reason for this is cycle dependency, as specific sectors may out- or under-perform during different phases, driven by cyclical factors such as corporate earnings, interest rates and inflation.

Cycle dependency allows investors to potentially generate alpha by overweighting certain sectors while underweighting others to harness macro trends, with the potential for more precision and focus than styles.

For instance, as recessionary fears increased at the start of 2016, investors gravitated toward defensive sectors such as utilities and consumer staples.
Drivers of Sector/Industry Investments

When asked what actually drove them to add a sector or industry ETF to a client portfolio, over half of advisors surveyed cited a change in market conditions. This follows naturally from the prevalent view of sector and industry investing as a way to benefit from specific areas of the market that are advancing or retreating.

The second most common reason for investing, cited by nearly a quarter of advisors surveyed, was third-party guidance, generally from an industry expert or product provider. According to one advisor, while market conditions drive actions, “research from a variety of firms helps me identify shifts that need to be made.”
Reasons Advisors Invest in Sector and Industry ETFs

53% Response to change in market conditions

22% Third-party guidance

9% Adherence to paper portfolio/investment model

8% Positive result from same ETF in other portfolios

5% Other

3% Colleague’s Advice
Sectors Or Industries, Or Both?
Survey respondents tended to use both sector and industry ETFs as part of their strategies, with sectors garnering a higher usage rate. For advisors, sector funds and more narrowly focused industry funds were both viewed as a means for addressing perceived market opportunities. In all markets, particularly those characterized by low growth and volatility, the ability to invest more precisely through industries can be attractive. Increasingly, we are seeing investors use industry ETFs in addition to sectors to gain more targeted exposure and amplify the drivers of sector growth.

Liquidity, Holdings and Expense Ratio Guide Fund Selection
When choosing specific ETFs to execute sector and industry strategies, liquidity, fund holdings and expense ratio were the most important criteria, according to survey participants.

Of the top five most important factors, weighting methodology is the most complicated and can play a significant role in the performance of an ETF and its value in portfolios.
The Rising Tide of Sector & Industry Investing

Factors Impacting Advisors’ Fund Selection

<table>
<thead>
<tr>
<th>Factor</th>
<th>Extremely Important</th>
<th>Somewhat Important</th>
<th>Not At All Important</th>
</tr>
</thead>
<tbody>
<tr>
<td>Liquidity</td>
<td>163</td>
<td>82</td>
<td>12</td>
</tr>
<tr>
<td>Expense Ratio</td>
<td>142</td>
<td>89</td>
<td>26</td>
</tr>
<tr>
<td>Holdings</td>
<td>139</td>
<td>109</td>
<td>9</td>
</tr>
<tr>
<td>Weighting Methodology</td>
<td>97</td>
<td>139</td>
<td>21</td>
</tr>
<tr>
<td>Index Provider</td>
<td>44</td>
<td>183</td>
<td>30</td>
</tr>
<tr>
<td>Fund Provider Offering Guidance</td>
<td>28</td>
<td>133</td>
<td>96</td>
</tr>
<tr>
<td>Fund Provider’s Brand Awareness</td>
<td>28</td>
<td>158</td>
<td>71</td>
</tr>
</tbody>
</table>
Advisors Use Four Main Strategies

Tactical over/underweighting and a core/satellite approach were the most widely used among the four main implementation strategies for sector and industry investing. In follow-up interviews, however, it became clear that in following any of these strategies, advisors are often not utilizing a standard blueprint. Compared with other tactics in the advisor’s toolkit, sector and industry investing tends to be more subjective and more open to individual interpretation. For example, while one Registered Investment Advisor interviewed allocates up to 5% of AUM to sectors, tilting to those that were thought to be undervalued, another advisor in the independent brokerage channel allocates a maximum of 25% to sectors, finding opportunities that are validated by fund ratings and making changes based on market conditions.

Advisor Implementation

- **184** Tactical Over/Underweighting based on opportunities
- **156** Core/Satellite based on market opportunities
- **111** Rotation Strategies based on economic factors
- **77** Diversification to balance concentrated single stock positions
- **11** Other
How State Street Global Advisors Implements Sector Investing

Sector rotation strategies can help investors better align their investment strategy to their market outlook and position a portfolio to get more from the core. These strategies can take many forms. For instance, through a top-down approach, an investor can underweight or overweight a sector based on market and macroeconomic views such as rising rates or a resilient consumer. Using a bottom-up approach, an investor can underweight or overweight based on a sector’s fundamentals or momentum characteristics.

The SPDR SSGA Global Allocation ETF [GAL], a portfolio that uses SSGA's tactical asset allocation process that systematically blends quantitative and fundamental components, implements a sector rotation strategy by carving out a portion of the US large cap exposure for just sectors. In GAL, the sector rotation strategy allocates equally to the three most attractive equity sectors, based on valuation, sentiment, momentum, and macroindicators. While the size of the allocation may vary over time, over the last year, the sector rotation strategy comprised an average of 40% of US large cap exposure.

Source: State Street Global Advisors, as of 07/31/2016.
Increasing Acceptance and Use

With most survey respondents indicating they plan to maintain or increase their exposure, advisor use of sector and industry ETFs appears to already be widely accepted and growing. When asked what is driving their increased usage in an increasingly volatile and uncertain market environment, advisors predominantly view sector and industry investing as a way to potentially add value over broad-based equity indices.

Expected Changes in Advisors’ Near-Term Sector and Industry Allocation

<table>
<thead>
<tr>
<th>Category</th>
<th>Increase</th>
<th>Remain the Same</th>
<th>Decrease</th>
</tr>
</thead>
<tbody>
<tr>
<td>National Broker Dealer</td>
<td>58%</td>
<td>40%</td>
<td>0%</td>
</tr>
<tr>
<td>Independent Broker Dealer + Regional Broker Dealer</td>
<td>48%</td>
<td>49%</td>
<td>3%</td>
</tr>
<tr>
<td>Registered Investment Advisor (RIA)</td>
<td>31%</td>
<td>59%</td>
<td>5%</td>
</tr>
<tr>
<td>Private Wealth Manager</td>
<td>70%</td>
<td>10%</td>
<td>20%</td>
</tr>
</tbody>
</table>

Charts may not total 100% due to rounding.
Looking Ahead

The use of sector and industry strategies is clearly on the rise. Financial advisors are increasingly recognizing the potential of these strategies to add alpha over traditional buy-and-hold allocations in the face of the persistent “low and slow” growth environment and market volatility. Building on a small set of common themes, investment professionals view sector and industry ETFs as valuable tools for potentially capturing the opportunities that exist within market complexity.

Looking ahead, SSGA sees the need for increased education and guidance from fund providers to make sector and industry investing more accessible to advisors and more widely known and understood by clients. As the co-creators of the first sector ETFs, SSGA will play a leading role in delivering this guidance. Toward that end, we have recently rolled out Sectors & Industries: Where To Go For Growth & Value, a quarterly overview of what we believe are the top sector opportunities with picks for the top sector for growth and value. In addition, the SPDR Sector & Industry Dashboard, offers a quarterly analysis of ETF Flows and key data, and advisors can visit SPDR Blog (blog.spdrs.com) for ongoing commentary and portfolio guidance on sector investing.

1 FactSet, State Street Global Advisors, as of 12/31/2015, based on GICS sectors in the S&P 500 Index.


3 FactSet, State Street Global Advisors, as of 8/31/2015. FactSet based on estimates, actual portfolio level returns may vary.
“Sector investing expands the size and style toolbox, offering the ability to gain granularity to the equity markets, investors can use sectors to diversify their core and improve their potential for alpha.”

— Dave Mazza, Managing Director, Head of ETF & Mutual Fund Research

For further discussion of sector investing and related topics, take a look at the latest blog posts from SSGA thought leaders on blog.spdrs.com.

Glossary

Alpha A gauge of risk-adjusted outperformance relative to a benchmark.

Beta Measures the volatility of a security or portfolio in relation to the market, usually as measured by the S&P 500 Index. A beta of 1 indicates the security will move with the market. A beta of 1.3 means the security is expected to be 30% more than the market, while a beta of 0.8 means the security is expected to be 20% less volatile than the market.

Fundamentals A method of evaluating a security or asset class in an attempt to measure its intrinsic value, by examining related economic, financial and other qualitative and quantitative factors with the goal of producing a quantitative value that can be compared with an investment’s current price, thus indicating whether it is undervalued or overvalued.

Macroindicators The part of economics concerned with large scale or general economic factors such as interest rates and national productivity.

Momentum The tendency for a stock price to maintain a certain direction of price trajectory.

Quantitative Financial analysis that aims to understand or predict behavior or events through the use of mathematical measurements and calculations, statistical modeling and research. Quantitative analysis is employed for a number of reasons, including measurement, performance evaluation or valuation.

Sentiment The overall attitude of investors toward a particular security or asset class. It is the feeling or tone of a market, as revealed through the activity and price movement of the securities traded in that market.

Tactical Asset Allocation An active management portfolio strategy where the manager starts with strategic weights but then increases exposure to asset classes the manager believes to be attractive relative to other asset classes in order to take advantage of market pricing anomalies or strong market sectors.

Valuation The current worth of a security or asset class.
About Us
For nearly four decades, State Street Global Advisors has been committed to helping our clients, and those who rely on them, achieve financial security. We partner with many of the world's largest, most sophisticated investors and financial intermediaries to help them reach their goals through a rigorous, research-driven investment process spanning both indexing and active disciplines. With trillions* in assets, our scale and global reach offer clients access to markets, geographies and asset classes, and allow us to deliver thoughtful insights and innovative solutions.

State Street Global Advisors is the investment management arm of State Street Corporation.

* Assets under management were $2.30 trillion as of June 30, 2016. AUM reflects assets under management as of State Street Corporation.

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Investing involves risk including the risk of loss of principal.
Because of their narrow focus, sector investing tends to be more volatile than investments that diversify across many sectors and companies.
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Bonds generally present less short-term risk and volatility than stocks, but contain interest rate risk (as interest rates rise, bond prices usually fall); issuer default risk; issuer credit risk; liquidity risk; and inflation risk. These effects are usually pronounced for longer-term securities. Any fixed income security sold or redeemed prior to maturity may be subject to a substantial gain or loss.

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