ENERGY HAS BEEN A DRAG ON THE S&P 500

Here's What You Can Do About It

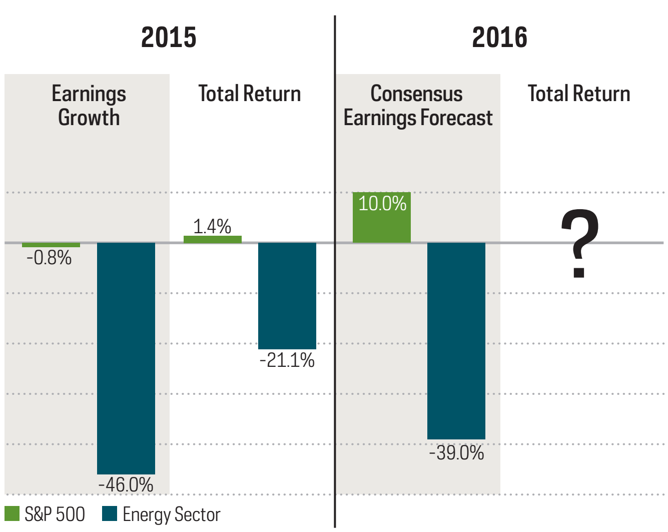
Low oil prices may be nearly as bad as falling oil prices

Even if the decline in oil prices is over, you still might want to reduce or eliminate exposure to energy in your stock portfolio. Why? Oil prices don't have to fall further for energy company earnings to continue to suffer. Indeed, most forecasters see oil prices rising from here, but the earnings consensus for energy companies is not so rosy.

Earnings forecasts tell the story

Energy prices drive energy company earnings, which in turn drive their stock prices. For example, the median forecast for the price of oil in Q4 2016 is just $55 per barrel. While that's higher than its current prices, it's still 35% lower than the five-year average and roughly half the price that prevailed in the first four of those five years. The oil price forecast translates directly into earnings forecasts for the energy sector, and the contrast with the S&P 500 is dramatic. While 2015 earnings growth for the S&P 500 was mostly flat, for the energy sector it was a dizzying decline.

To understand why earnings matter so much, take a look at what happened. S&P 500 earnings declined just 0.8%, but energy sector earnings dropped an astounding 46%. What happened to stock prices during this period? The S&P 500 was up about 1.4%, while the energy sector tumbled over 21%. This demonstrates just how poor earnings performance can inflict further damage on sectors that have already underperformed.



Source: Bloomberg. Earnings, returns and forecasts are for the full calendar year 2015 and 2016. The energy sector is represented by Standard & Poor's Energy Select Sector Index, which covers 40 large-cap energy stocks. Consensus Earnings Forecast is the average EPS estimates for a company from the universe of analysts reporting for the company for the period shown.

Reducing your exposure

Investors who believe energy stocks will continue to underperform might want to eliminate or underweight their exposure to the energy sector. That could mean looking for mutual funds that have pared down or eliminated their energy holdings. But the portfolio manager could load up on energy stocks at any time, and mutual fund holdings are disclosed with a material time lag. Another approach would be to add a short position or an inverse ETF on the energy sector, but that would require periodic rebalancing.

An alternative approach—S&P 500 Ex-Sector ETFs

Consider investing in the S&P 500 with the energy sector stripped out. That's the approach taken by ProShares S&P 500 Ex-Energy ETF (SPXE). SPXE excludes the energy stocks from the S&P 500 and allocates the sector's weight pro rata to the remainder of the stocks in the S&P 500. It's an efficient and transparent solution.

Of course, most investors don't have the conviction to completely eliminate a sector from their equity holdings. They may prefer to underweight the sector.

Eliminating or underweighting exposure to the energy sector using SPXE could work well with both active and passive funds. Pairing the ETF with an S&P 500 index fund would result in an energy underweight that preserves other aspects of the market-cap weighted index. Combining it with an active U.S. large-cap fund would deliver an energy underweight that preserves the potential for outperformance from the active fund without the need to take a short position.

Two Ways to Manage Energy Sector Exposure with SPXE

Eliminating Energy Exposure

1. Replace your current U.S. large-cap equity holdings with ProShares S&P 500 Ex-Energy ETF (SPXE).
2. Periodically assess your exposure to the energy sector.

Underweighting Energy Exposure

1. Determine how much you want to reduce your exposure to the energy sector—say by 50%.
2. Replace 50% of your U.S. large-cap equity holdings with ProShares S&P 500 Ex-Energy ETF.
3. Periodically assess your exposure to the energy sector.

The takeaway

While no one knows which direction oil prices are headed, energy company earnings may have a way to go before they are healthy again. If you believe the energy sector will continue to underperform, you may want to underweight or even eliminate it from your portfolio.

Tailor your core U.S. equity exposure.

SPXE **ProShares S&P 500 Ex-Energy ETF**

- Focuses on S&P 500 companies, except those in the energy sector
- Offers investors a way to reduce or even eliminate exposure to a sector they believe may underperform
- Can serve as a risk management tool for investors who have a large exposure to energy

Find out more

Visit ProShares.com or consult your financial advisor.