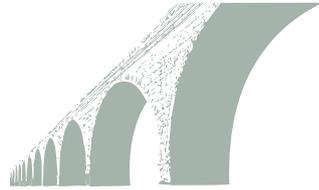




# The Leuthold Group

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## Leuthold's Group Selection Scores: A Distinctive Approach to Thematic Investing

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### Abstract

This paper examines the advantages of operating at the group level—118 distinct industries and themes—rather than relying on the traditional 11 broad sectors. Greater granularity enables clearer alignment with the business cycle, stronger factor signal extraction, and wider performance dispersion across industries. Collectively, these features enhance diversification by reducing correlations and positioning portfolios along a more efficient frontier. The long-term record of the Group Selection (GS) Scores, spanning more than 30 years of live results, confirms the robustness of this approach: Attractive groups have consistently outperformed while Unattractive groups have underperformed, across multiple time horizons. This durable performance edge is driven by three primary factors: (i) a high success rate in identifying outperforming industries, (ii) the systematic avoidance of structurally weak groups, and (iii) the early recognition of secular winners that compound value over time. Taken together, the GS Score framework provides a disciplined and repeatable process that enhances both thematic group allocation and traditional stock selection overlays, representing a proven and enduring source of excess return through shifting market cycles.

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### Considerations

Sector rotation is a well-respected technique for building equity portfolios, generally based on one of two main ideas. The first approach is based on macro-economic analysis, tilting toward cyclical sectors when the economic outlook is favorable and shifting to defensive sectors when conditions seem to be weakening. The second genre evaluates price

momentum, taking positions in sectors showing the best recent price action while avoiding the laggards.

The Leuthold Group's equity management activities center on our **Group Selection Score** methodology that organizes companies into themes or industries based on common traits. The GS Scores utilize a multi-factor model that considers *macro*



*data, price momentum, valuations and fundamental metrics* to get a well-rounded profile of every group in our universe. While this may sound a bit like other sector rotators, there are several important differences that make our Group Selection Score discipline a unique and appealing approach to managing equity portfolios, all based on decades of experience.

### A Pioneer in Thematic Investing

Steve Leuthold was a pioneer in the field of thematic group analysis, launching his first institutional strategy service<sup>1</sup> based on sectors in 1969. After founding The Leuthold Group, Steve extended this work by introducing Wall Street’s first organized effort to track the stock market based on investment themes in 1977. The popularity of Leuthold’s sector analysis among its institutional research client base ultimately gave rise to the Group Selection Scores, and in 1995 the GS Scores became the foundation of a live investment portfolio (Select Industries Strategy) which now sports a 30-year track record based on our thematic approach to equity investing.

### Setting The Stage

Many investors use the term “sector” in a generic sense to mean any grouping of stocks based on their underlying business characteristics, but more precise terminology is needed in order to appreciate the merits of our GSS process. Table 1 notes that the GICS® methodology<sup>2</sup> uses **Sector** to denote the broadest level of categorization. GICS Level 2 divides these sectors into 25 **Industry Groups**, which are further divided into 74 **Industries** and finally 163 **Sub-Industries**. Every company is a member of one group at each level, with the baskets becoming narrower and more homogenous as we move down the scale.

Table 1: GICS Mappings

Level 1:	11 Sectors
Level 2:	25 Industry Groups
Level 3:	74 Industries
Level 4:	163 Sub-Industries

**One overarching difference between Leuthold and most other firms is the number of groups or baskets of stocks under evaluation.** Sector rotation managers often focus on the 11 primary

<sup>1</sup> Steve Leuthold’s early work included the MicroGroup Project at Piper, Jaffray and Hopwood during the early 1970s.

<sup>2</sup> The Global Industry Classification Standard (GICS) hierarchy was developed by S&P Dow Jones and MSCI.

GICS groupings, whereas the GS Scores operate at a much finer level of aggregation by evaluating 118 different themes and groups<sup>3</sup>. Defining groups with this degree of focus places far greater demands on time, effort, and data resources, and this increased complexity begs the questions “why do we work at such a granular level?” and “is it really worth the effort?” The critical observation we make in this paper is that sectors are blunt instruments, masking considerable dispersion across their underlying industries. We believe the real alpha lies below the surface, where there is a wealth of information to extract by going deeper, focusing on the sub-groups that make up those sectors.

### Pure Business Cycle Exposure

One conventional approach to sector rotation relies on business cycle analysis to establish portfolio exposures. The decision rule is relatively straightforward; own cyclical sectors when the economy is healthy and accelerating, and favor defensive sectors when the economy is slowing to stall speed or entering a recession. The logic behind this approach is unassailable, and the empirical evidence shows that sectors do respond to business cycle shifts in a predictable fashion.

The economic sensitivity of most sectors is widely recognized, with Industrials, Materials, and Consumer Discretionary usually included in the pro-cyclical bucket and Staples, Health Care and Utilities slotted as defensive alternatives. However, our research reveals that while a given sector may receive a broad-brush label concerning its economic sensitivity, *each sector’s underlying industries are in reality a conflicting mix of cyclical and defensive exposures.*

Figure 1 portrays the cyclical diversity of each sector by plotting the market betas of the highest and lowest sub-industries (GICS Level 4) in each sector. For example, Industrials is a classic pro-cyclical sector, and its highest beta group (airlines) slots at an appropriately high beta of 1.92 relative to the market. However, the lowest beta group within Industrials (environmental and facilities services) comes in at just 0.66 which indicates a clearly defensive exposure. Likewise, the lowest beta group within the indisputably defensive Health Care sector stands at 0.55 (managed care) while the most aggressive group (HC facilities) posts a higher-octane beta of 1.31.

<sup>3</sup> Our universe of 118 groups could be conceptually equated to a GICS Level of about 3.5.

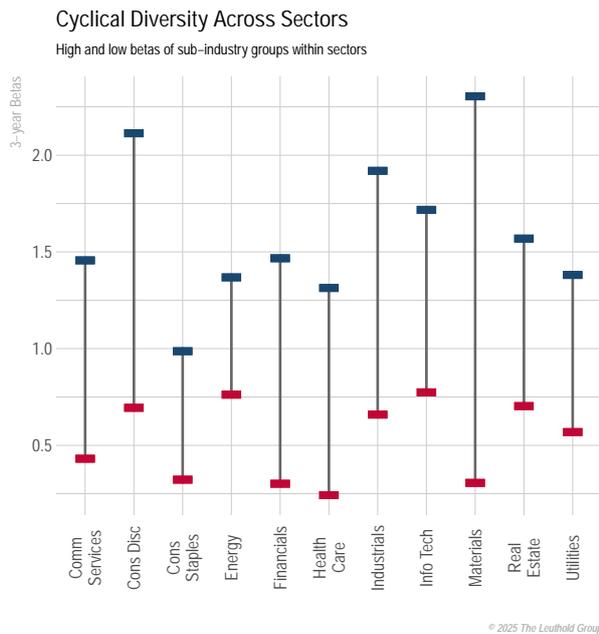


Figure 1: Sub-Industry Beta Spread

Because 10 of the 11 sectors encompass both cyclical and defensive components, applying a more granular approach to tactical shifts based on the business cycle leads to cleaner and more effective portfolios. An investor looking to become more conservative can select appropriately defensive sub-industries from each sector, and an investor desiring a pro-cyclical tilt can consider higher beta options from all but one sector (Staples). ***The ability to focus on well-defined groups creates a superior method of positioning for the business cycle, whereas concentrating on broad sectors that include conflicting sub-industries leads to a diluted mix of offensive and defensive cyclical plays within each parent sector.***

### Harvesting Larger Momentum Returns

A second mainstream approach to sector rotation uses price momentum as the key signal to drive investment decisions. Momentum is one of the essential factors in a quantitative investor’s toolbox, consistently demonstrating its effectiveness across different asset classes and multiple market cycles. This has indeed proven to be a successful factor at the sector level, but we discovered that operating at the more refined level employed by the GS Scores significantly boosts the efficacy of this powerful factor.

We calculated the return spreads between high and low momentum groups for each GICS level, and Figure 2 depicts that the positive returns associated with momentum improved by almost 50% when ap-

plied to more narrowly defined groups. Level 4’s average return spread of 6.1% easily outpaces the factor’s effectiveness at the sector level, demonstrating that ***narrower group definitions capture more of momentum’s excess return than when it is applied to broader sectors.***

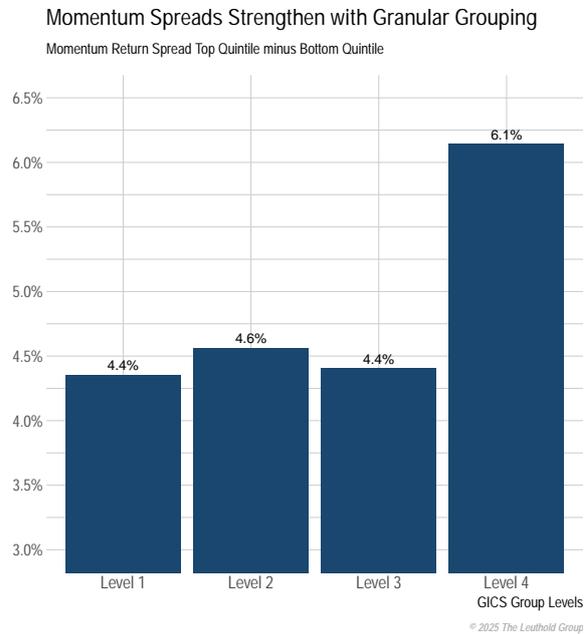


Figure 2: Momentum Spread by GICS Level

### More Substantial Return Opportunities

A portfolio manager’s ability to add value is driven in part by the distribution of returns across the various assets available for purchase. A wider return distribution increases the potential payoff for a manager skilled at identifying attractive assets, whereas narrower spreads make it more difficult for even a talented manager to add significant value.

Figure 3 plots the average annual return spread between the highest and lowest group at each GICS level. The return spread widens as we move deeper into the GICS table, with Level 4 offering nearly four times the opportunity available from selecting from Level 1 options. Skilled investors will reap greater rewards when their process is applied to an opportunity set with spreads as wide as those in Level 4, whereas equally skilled investors working at Level 1 will face a smaller potential alpha because the dispersion between high and low returns are considerably narrower.

Figure 3 reflects return dispersions across the *entire market*, and our research shows that the potential returns to investment skill are also sizeable if we measure return distributions *within* each sector. Figure 4 reports that the average annual return spreads



### Expanding Return Spreads Across GICS Levels

Average annual return spread, best minus worst

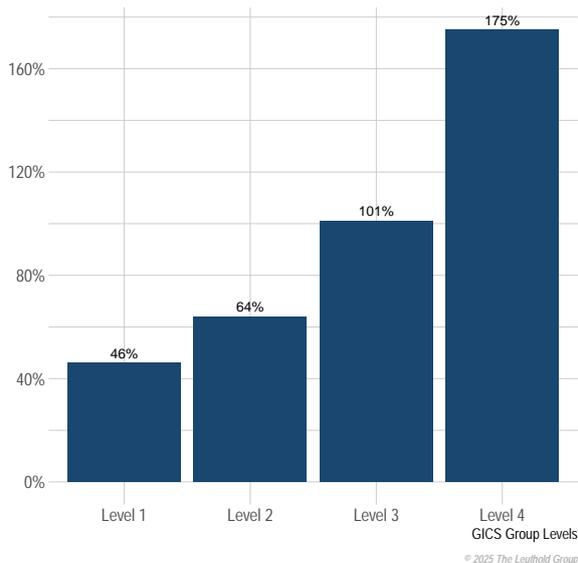


Figure 3: Return Spread by GICS Level

between groups in the same sector ranges from 35% for Utilities to 95% in Consumer Discretionary, and with most sectors at 50% or above there is ample room for skilled investors to add value even when selecting from the sub-industries of any given sector.

### Significant Return Dispersion Within Sectors

Mean annual return spread aggregated from 1995 through 2024

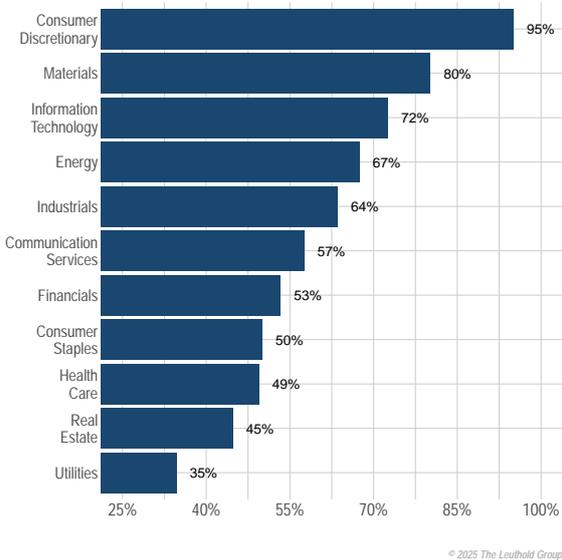


Figure 4: Sector Return Spread

### Better Diversification, More Efficient Portfolios

Harry Markowitz, the Nobel Prize-winning economist who laid the foundations of portfolio management theory, claimed that “diversification is the only free lunch in investing.” This free lunch

results from low correlations which lead to optimal portfolios that provide the lowest risk for any given return, or the highest return for any given risk. We have already seen that some sectors are pro-cyclical and others are defensive, meaning that portfolios built around sectors will naturally exhibit some degree of diversification. *Investors willing to work with a larger set of industry groups can access lower correlations across the investment universe and reap even greater benefits from the positive effects of diversification.*

Figure 5 reports the average correlations between pairs of sectors or industries by GICS level. For example, the average correlation of returns between any two Level 1 sectors is 51%. Expanding the opportunity set to include the 163 Sub-industries of Level 4 finds the average pairwise correlation dropping to 36%, a significant improvement in the potential rewards from diversification.

### Deeper Granularity, Greater Diversification

Average correlation between industry groups within a GICS level

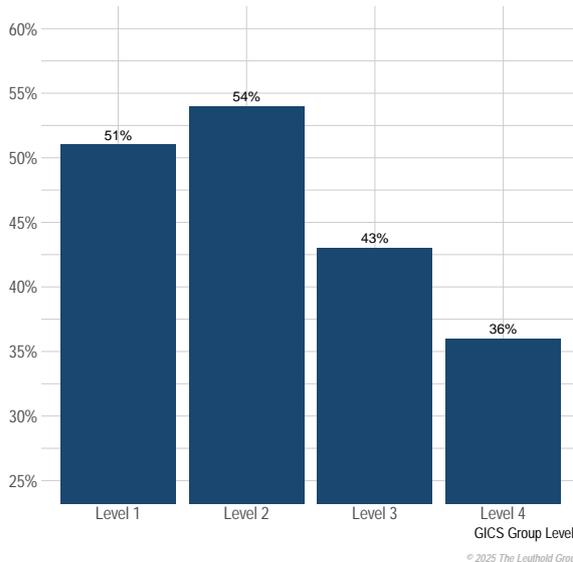


Figure 5: Sub-Industry Return Comovement

The benefits of greater diversification achieved through lower correlations can be seen in the classic image of the efficient frontier. This notion evaluates risk and return on a two-dimensional graph by plotting the portfolios that deliver the maximum return for each level of risk. Figure 6 depicts the efficient frontier for portfolios built using Level 1 Sectors and Level 3 Industries<sup>4</sup>. The solid line dominates the dashed line across the risk spectrum, indicating that portfolios built from Level 3 alternatives are more efficient, and therefore more desirable, than portfolios

<sup>4</sup>We didn’t build an efficient frontier for Level 4 because the dimensionality of the required covariances becomes unwieldy, and referencing Level 3 tells the story just as convincingly.



that select from just the eleven primary sectors.

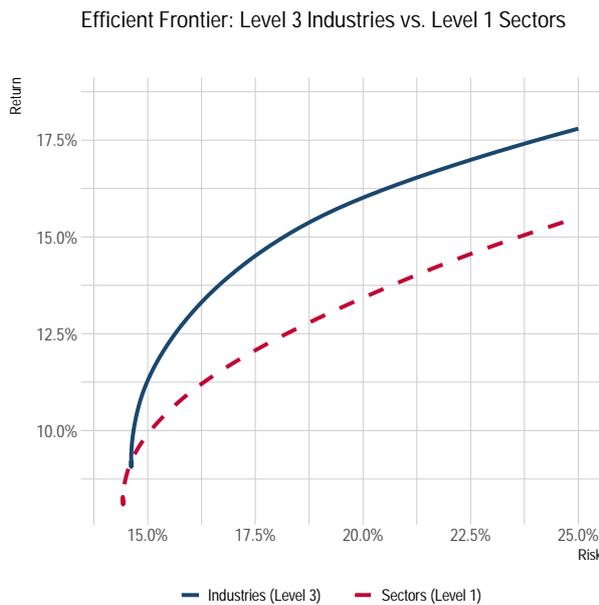


Figure 6: Efficient Frontier by GICS Level

### Thirty Years of Investing Success

The GS Scores serve as our guide for navigating this diverse landscape of industries and themes. By integrating fundamentals, valuations, price action, and macroeconomic data, the framework evaluates each group from multiple angles, producing signals that are more resilient than those based on any single input. This depth of analysis gives us confidence to take concentrated, high conviction positions within the Select Industries strategy.

The GS Score framework is not only conceptually compelling and validated by over 30 years of live performance, a lengthy track record for any quantitative approach. Figure 7 highlights this history: Attractive (top-ranked) groups, shown in blue, have consistently outperformed, while Unattractive (lowest-ranked) groups, in black, have lagged. The average group in the universe, represented in grey, serves as a clear midpoint between the two extremes. The relative returns of the Attractive and Unattractive groups demonstrate a unique ability to segregate outperforming from under-performing industry groups. Crucially, that performance has proven durable over multiple time horizons – with the Attractive outperforming not only the early years, but also over the last three-, five-, and ten-year time periods.

Reflecting on these historical return spreads, we believe the the source of this outperformance is three-fold:

### 30 Years of Live GSS Performance: Top vs. Bottom Quintiles

Group Selection Scores (GSS) annualized performance

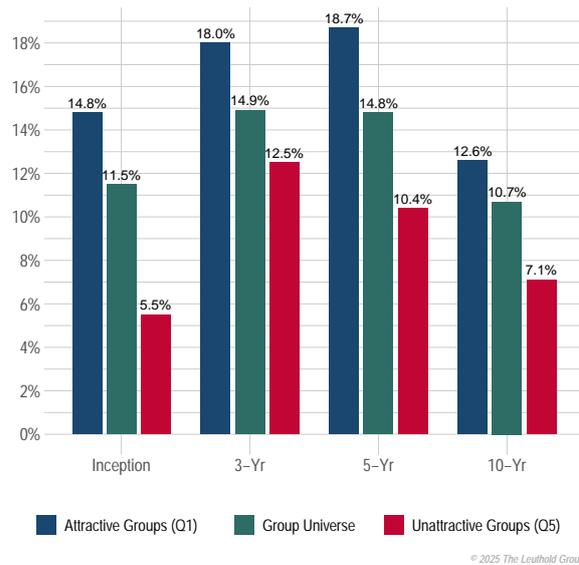


Figure 7: GSS Performance Comparison

- **High hit rate.** A strong batting average in correctly identifying winning groups, leading to compounding gains over time.
- **Industry avoidance.** The ability to sidestep persistent laggards and deteriorating themes, reducing downside exposure.
- **Secular winners.** Early identification of long-term themes—such as technology infrastructure or shifts in consumer behavior—that provide sustained growth opportunities.

These attributes, stemming directly from the ideas explored in this paper, combine to generate sustainable and repeatable results through inevitable market cycles, and together they underpin the enduring strength of the GS Scores across shifting environments.

### Group Overlay Enhances Equity Selection

Our thoughts thus far have dealt with group-based investing as a standalone process, but we also believe that a group analysis overlay can improve the performance of traditional bottom-up stock selection. For example, Leuthold’s stock market analytics include a step that ranks companies on a set of characteristics that we find particularly promising, and Table 2 illustrates the effectiveness of our multi-factor stock rankings since 1996. The highest ranked stocks in our research universe handily outperform the median stock, while the lowest ranked quintile trails far behind the pack.

It might seem that a stock selection model with a strongly positive success rate would be all you need,



Table 2: Leuthold Stock Selection Multifactor Ranking

	Leuthold 3000 Universe
Highest Ranked Stocks	14.6%
Second Quintile	12.0%
Third Quintile	10.5%
Fourth Quintile	7.5%
Lowest Ranked Stocks	0.6%

but we found that **overlaying an already promising stock selection discipline with a group ranking model leads to significantly improved performance.** Table 3 repeats the results of our multifactor stock selection model in the center column, then adds the impact of Group Selections Scores to each side. For example, the 17.7% return in row one of column one represents the combination of *of highly ranked stocks in the most attractive groups, while the 9.0% return in column three reflects highly rated stocks in unattractive groups.*

Table 3: Leuthold Stock Selection Multifactor Ranking with Group Score Overlay

	Attractive Groups	L3000 Universe	Unattractive Groups
Highest Ranked Stocks	17.7%	14.6%	9.0%
Second Quintile	15.2%	12.0%	5.5%
Third Quintile	15.1%	14.6%	4.1%
Fourth Quintile	12.9%	14.6%	-0.1%
Lowest Ranked Stocks	8.5%	0.6%	-7.2%

The value of a group score overlay is consistently strong in each row of Table 3, demonstrating the importance of looking at companies in a group context. **A stock selection model that is efficacious in its own right will perform even better when group dynamics are considered, and portfolios that select stocks without the added benefit of group-level analysis may be leaving significant excess returns on the table.**

### Summary

Operating at the level of 118 well-defined thematic groups rather than 11 broad sectors brings numerous advantages to our investment process and reveals that investors acting at the broad sector level are missing out on important sources of excess returns. Our use of multiple signals (rather than just focusing on the business cycle or price momentum) combined with the narrower group definitions that underlie the GS Scores yield significant advantages over a sector-based effort, from identifying attractive groups to building efficient portfolios.

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