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Using Industry Rotation to Gain an Edge – XI

Short-term outperformance is hard to achieve, but my research indicates that careful selection of industries can lead to 7%/year of outperformance, prior to transaction costs. This model forecasts one month into the future; it is a short-term model.

Using the industries in the S&P 1500 Supercomposite, from October 1995 to December 2008, investing in the Supercomposite yielded an annualized price return of 4.0% (with dividends 5.5%). The annualized price return for each quintile based off of my short–term performance criterion was as follows:

- Top — 11.3%
- Second — 4.4%
- Middle — 6.5%
- Fourth — 1.7%
- Bottom — 0.2%

My criterion, which uses momentum and a few other factors, outperforms the S&P 1500 Supercomposite over 80% of the time. At present, it suggests that the following industries and companies are worth investing in (new industries highlighted in yellow):

- Auto Retailers (really, Auto Repair and Spare Parts) – ORLY, AZO
- Internet Retail – NFLX, PETS
- Water Utilities –WTR
- Education Services – COCO, ESI
- Brewers – TAP
- Gold & Precious Metals Miners (Newmont) – NEM
- Home Improvement – SHW
- General Merchandising – FDO
- Restaurants – SNS, PEET. BWLD, PFCB, DRI, PNRA,
- Health Care Services – HMSY, RHB, LHCG, OCR, AFAM
- Home Furnishings – RNT
- Soft Drinks – HANS
- Reinsurance – RE
- Household Products – CENTA, CLX
- Tobacco – MO
- Pharmaceuticals – VRX, SLXP, SGP, WPI
- Packaged Foods – GMCR, LANC, JJSF, DMND, THS
- Computer Storage & Peripherals – SYNA, NVTL, QLGC
- Paper Packaging – RKT
- Communications Equipment – PALM, COMS, ARRS, SYMM, VSAT, TLGD, FFIV
- Managed Healthcare – AGP, CNC, MOH
- Agricultural Products – ADM
- Footwear – ICON, NKE

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- Distributors (wholesalers) – GPC
- Drug Retailing – WAG
- Metal & Glass Containers – PTV
- Specialty Stores – BGFV, TSCO, JAS

For the most part these are non-cyclical sectors. Healthcare, Technology and Consumer Staples lead the way. **That said, there are a lot more cyclical industries in the list now than there were six weeks ago.** The signal does not feel right to me, but it is the signal… for those buying the lighter cyclicals in retail and other areas, just be aware that in an era of debt deflation, it pays to emphasize balance sheet soundness.

What industries does the model say to avoid (new industries in yellow)?

- Diversified REITs
- Residential REITs
- Industrial Conglomerates
- Oil & Gas Storage & Transportation
- Electronics Manufacturing
- Construction & Farm Machinery
- Metals and Mining
- Commercial Printing
- Other Financial Services
- Oil & Gas Equipment & Services
- Consumer Electronics
- Oil & Gas Drilling
- Diversified (it's Leucadia)
- Home Entertainment Software
- Motorcycle Manufacturers (Harley)
- Broadcasting & Cable TV
- Retail REITs
- Office REITs
- Steel
- Coal
- Independent Power Production
- Commodity Chemicals
- Thrift & Mortgage Finance
- Aluminum
- Industrial REITs
- Multiline Insurance (think AIG)
- Photographic Products (Kodak)

So, avoid most Cyclicals and most Financials, for now. At a time like this, when so many things are uncertain, outperformance of stable sectors is likely to persist. In spite of the rally of last month, emphasize the stable sectors in the first group, and downplay the cyclical sectors of the second group. These findings are consistent with my macro view that things will get worse for the Global and US economies due to a need for deleveraging. Stick with stable sectors now, with perhaps some small tilt to inflation-sensitive sectors, in case things get out of control.

Full disclosure: long ADM GPC

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