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Using Industry Rotation to Gain an Edge – XIX

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) – LAD, AN
- Agricultural Products – ADM
- Internet Retail – NFLX, AMZN
- Investment Banking & Brokerage – GHL, PJC, SF
- Brewers – TAP
- Systems Software – ROVI, MFE, CVLT
- Computer Storage & Peripherals – SYNA, EMC, SNDK
- Independent Power Production – AES
- Semiconductors – CY, KOPN, CREE, ATML, RFMD, SLAB, SMTC
- Computer Hardware – TDC, JAVA
- Water Utilities – WTR
- Education Services – CECO, COCO
- Home Furnishings – AAN
- Communications Equipment – PALM, COMS, ARRS, SYMM, BCSI, DGII
- Internet Software and Services – VCLK, TRAK, JCOM
- Reinsurance – RE
- Gold & Precious Metals Miners (Newmont) – NEM
- Restaurants – SNS, CBRL, DIN, PFCB, TXRH
- Drug Retailing – WAG
- Health Care Services – HMSY, , HB, BRLI, IPCM, ODSY, LDR
- Home Improvement – HD
- Info Tech Consulting – MMS, CTSH
- Metal & Glass Containers – MYE
- Specialty Chemicals – NEU, LZ, VAL, ZEP
- Health Care Technology – QSII

- Technology Distributors – SNX, IM
- Tobacco – AOI
- Pharmaceuticals – NOVN, SLXP, VRX, SGP
- Biotech – ARQL, AMGN, VRTX

For the most part these are non-cyclical sectors. Healthcare, Technology and Consumer Staples lead the way. **That said, most of the cyclical industries that entered over the last three months have gone.** 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)?

- Paper Products
- Household Appliances
- Other Financial Services
- Oil & Gas Refining & Marketing
- Construction & Farm Machinery
- Diversified Chemicals
- Coal
- Office Electronics
- Home Furnishings
- Thrift & Mortgage Finance
- Commercial Printing
- Industrial Conglomerates
- Life Insurers
- Airlines
- Forest Products
- Diversified (it's Leucadia)
- Diversified REITs
- Residential REITs
- Home Entertainment Software
- Multiline Insurance (think AIG)
- Regional Banks
- Office REITs
- Motorcycle Manufacturers (Harley)
- Retail REITs
- Broadcasting & Cable TV
- Commodity Chemicals
- Aluminum
- Industrial REITs
- 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. In spite of the recent rally, 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