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Focussing on strong stocks in strong sectors can be a lower-risk strategy.

By Robert Brain, ATAA

In making investment decisions about which shares to include in a portfolio, there is a bewildering choice of well-accepted approaches and strategies. One of them considers the current state of the business or economic cycle, to help choose either a so-called cyclical stock or a defensive stock, as appropriate.

It all sounds good in theory. But many investors choose to ignore the cycles and select shares using a type of bottom-up approach. Which approach should be used?

The experts suggest we could invest in shares while being mindful of the economic cycle. To help us visualise the cycle we could consult the investment clock, remembering there are four stages to the economic cycle - expansion (boom time with the economy growing in the lead-up to 12 o'clock), the peak (growth slows), contraction (the slowdown after 12 o'clock) and trough (and possible recession, at 6 o'clock).

The accepted economic cycle can run for as many as 10 to 12 years. We might be able to work out the current time on the investment clock, and where we are in the economic cycle, but it is not easy to accurately predict how the economy will unfold in the months ahead.

There are several indicators of economic activity to help determine the current time on the clock, including: Purchasing Managers Indices, US job reports, Australian labour market measures, industrial production (in China and elsewhere), global and Australian commodity prices, consumer price inflation, business confidence, consumer confidence, real estate values, interest rates, and credit availability.

Other signposts we could read are bond prices around the world, and company earnings and growth forecasts. But accessing and processing all this information is not easy or simple.

Current market implications

When the economy is performing well (the expansion stage of the cycle) many conventional investment theories can apply. But with our sharemarket index in late September 2012 at the same level as seven years ago and still 35 per cent below the peak of late 2007, many traditional investment theories are now out the window.

The 'buy-and-hold' investment approach

- This strategy might work over the very long term, but we can clearly see there are periods where it can severely dent an investment portfolio. If only we could avoid the serious downturns and protect our investment capital.

Dividend income

- Many investors blindly convince themselves that dividend income can provide an acceptable return when in fact the capital value of their investment is slashed. If only these investors would do the maths they might see that there are times when it is more prudent to liquidate some equity investments and deposit the cash in the bank. This can result in preserved capital and bank interest income, which together can often outweigh the dividend income from decimated equities.

If we want to protect capital and strive for a positive return at all stages in the economic cycle, the only real conclusion is to invest in a sensible and clever manner, and work towards shorter-term shareholdings at appropriate times. This might be as short as six to 12 months, instead of many years. A sound stop-loss approach (a predetermined point at which you sell) can help with this.

Investors are different to fund managers

There are some key differences between professional fund managers and retail investors, so investment strategies and principles might not necessarily apply universally.

The first difference is that most fund managers have a documented investment mandate that strictly dictates their strategy, and in many cases this is based on a prescribed portion of their funds locked into long-term shareholdings.

Second, many fund managers have large amounts of money to invest in the markets. This makes it difficult for them to quickly exit a position without affecting the share price, so they tend to stay invested for much longer periods.

Third, in the vast majority of cases they receive management fees for funds under management regardless of the returns. They are investing other people's money, and they are being rewarded for achieving their documented performance targets. In many cases the performance targets require managers to at least match the performance of a market index; if the index falls 20 per cent in a period, they are allowed to achieve something like a 20 per cent reduction in capital value.

The case for bottom-up stock picking

One key principle of selection using some basic aspects of the price chart is to avoid a share whose price is showing a downtrend (a series of lower peaks and troughs on a price chart). Statistics show that once a downtrend is confirmed, it is likely to continue until it is confirmed to have finished.

Why would you buy a share while its price is falling? This is investing on a wish and a prayer, and just does not make any sense. Don't forget, a cheap company might get cheaper, and cheaper, and might go the same way as ABC Learning Centres, HIH, Allco Finance, Babcock and Brown, Timbercorp, Nylex, Great Southern and more.

By all means shorten a list of candidates by running some sort of quality filter. For the Australian market of more than 2000 equities, a filter might reduce the list to 400 or 500. And if we choose to invest only in liquid stocks to have a better chance of selling when we want to, the list might come down to about 300.

The quality filter approach might look for companies with a consistent return on equity, and a low debt-to-equity ratio, and perhaps a low PEG (price-earnings to growth) ratio indicating they are undervalued with good growth expected.

We could then use simple technical analysis to identify the rising shares, regardless of the sector. And provided we use sensible risk and money-management methods, including a sound stop-loss approach, our chance of success is increased.

This hybrid approach of using some key fundamental analysis criteria to identify quality companies, and using technical analysis for timing, can be called funda-technical analysis. But how to find the great shares that are rising strongly is another story...

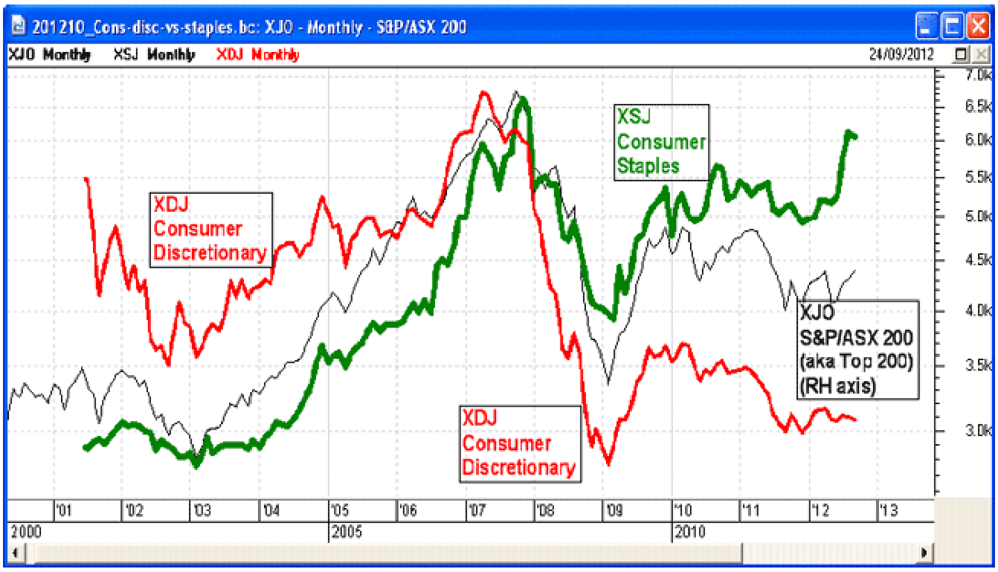
Introduction to sector indices

Most of the listed equities on the Australian market are allocated a GICS code (Global Industry Classification Standard), and all in the S&P/ASX 200 index (XJO) are also listed in the relevant (GICS) sector index.

Two of these key sector indices are the Consumer Staples (XSJ) and Consumer Discretionary (XDJ). The chart below shows these two sectors and the XJO over the period they have existed - from 2000 to now. Note that after the market fell heavily in 2008, the XSJ recovered faster, and higher, than the rest of the top-200 index, and much better than the XDJ.

This means that by selecting shares at the appropriate time from the XSJ index we do have a greater chance of better profitability. But note that this index currently has only seven stocks. If we want to select from similar Consumer Staples shares that are outside the top 200 (currently 54 in the whole of the market), we can search for those with a similar GICS code - that is, a GICS sector code of 30 - or simply peruse the published list (this is easy with some selection and charting software).

Comparing the Consumer Staples and Discretionary sector indices



*Source: © September 2012, **Robert Brain***
(chart uses a logarithmic vertical scale)

Cyclical stocks and sectors

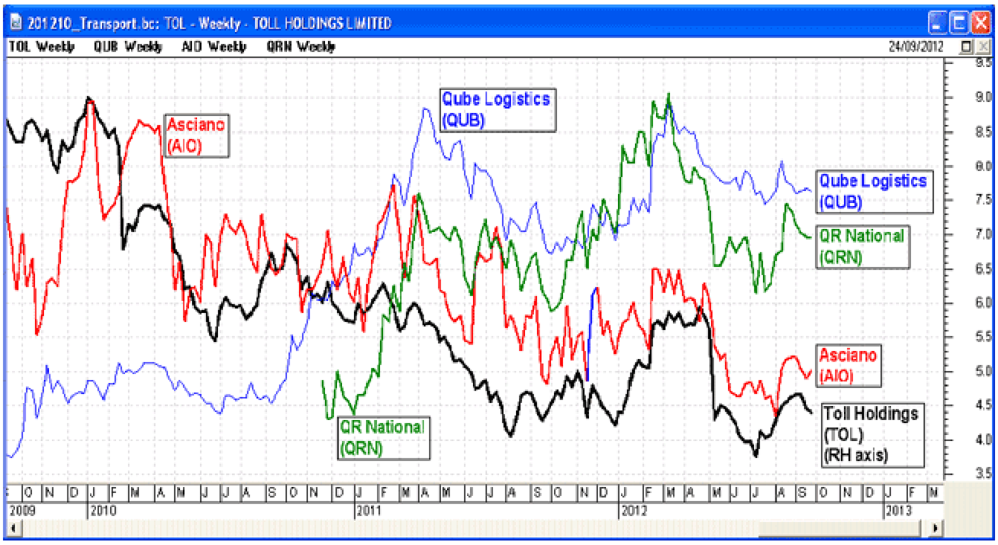
If we thought the Australian economy had passed through the bad times and turned the corner, we might want to bias our investing towards cyclical companies - such as media or transport, for example. It is easy to find a list of these with appropriate tools, but the Australian market does not have a sector index that exactly matches these industries so it is not easy to compare a company to a desired sector index.

For instance, there are currently 26 transport-specific shares listed on the Australian market. They are grouped with another 200 shares in the Industrials GICS sector (GICS code 20), and some of them are bundled with 34 others into the XNJ sector index (S&P/ASX 200 Industrials), which is easy to chart but perhaps not very useful in the current context.

The chart below shows the weekly closing prices for some of Australia's larger transport companies since late 2009. Although there is some amount of correlation between them at times, the only successful investing strategy in any of these over the past three years would have been a shorter-term trend-trading approach, with a sensible stop-loss.

To find investment candidates in our preferred cyclical market sectors, we might need to use a clever market scanning tool, or search for all shares with a specific GICS sector and industry-group code (available via the ASX website).

Comparing four Australian transport shares



*Source: © September 2012, **Robert Brain***

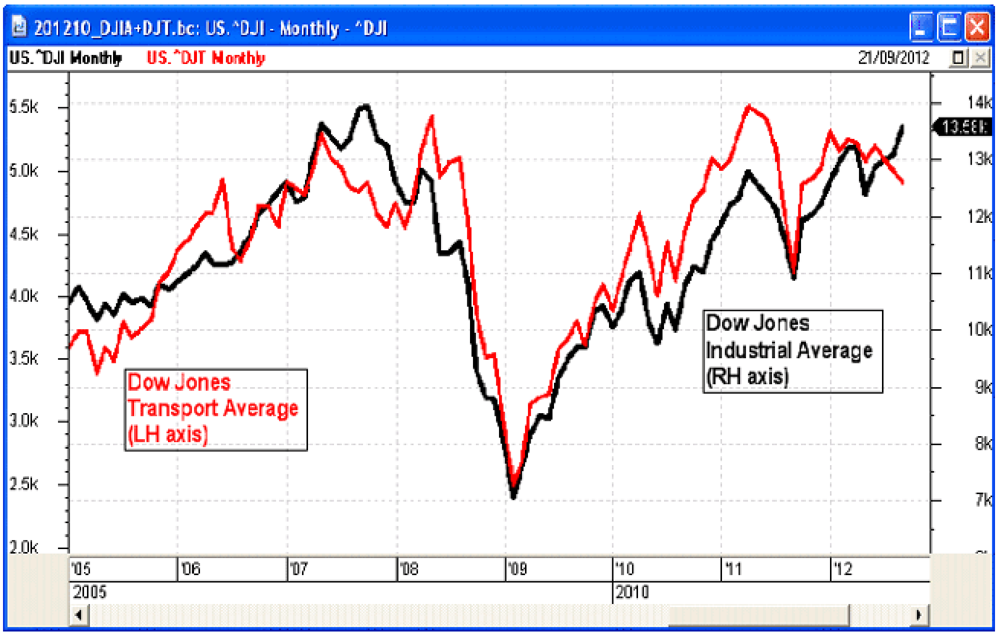
Compare the averages

One of the six key tenets of Dow Theory explains that for a bull market to be under way the Dow Jones Industrial Average (DJIA) index and the Dow Jones Transport Average (DJTA) index both need to be moving together. The logic is that if the broader economy that is represented in the Industrial Average is performing well, then the Transport Average should also be performing, indicating that goods are being shipped around the country.

Note in the chart below that these two do move up and down together most of the time, with a couple of exceptions. To spot the exceptions we can look at the peaks and troughs. The first was in 2008 when the DJIA led downwards while the DJTA made a new high, only to eventually follow suit. The second exception of note is in 2012 where the Transport Average has been unable to make new highs, while the Industrial Average is making new highs.

On the chart we call this divergence, and it suggests one of two possible outcomes - either the factories are producing product which will soon result in increased transport activity and a lift in the Transport Average; or the Industrial Average will soon also fall.

Comparing the Dow Jones Industrial and Transport Average



*Source: © September 2012, **Robert Brain***
(chart uses a linear vertical scale)

Strong shares in weak sectors?

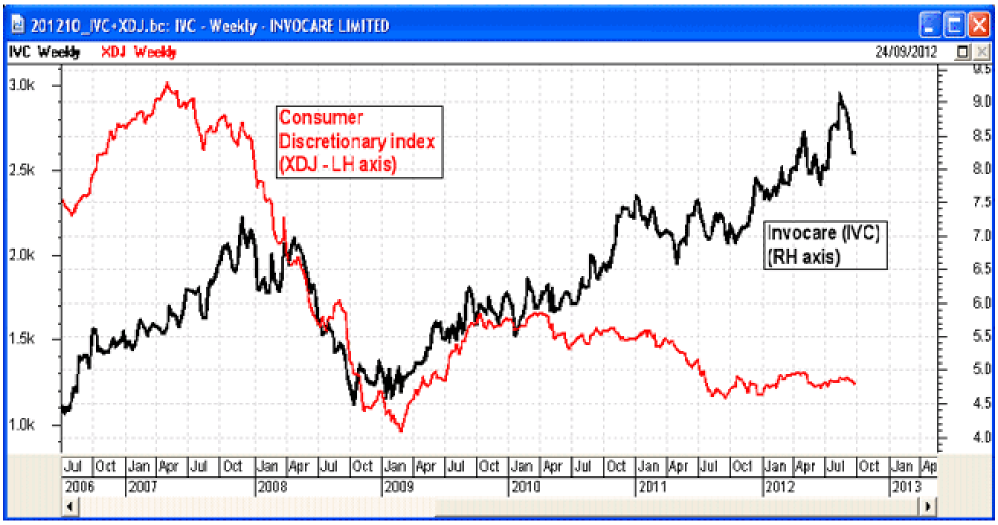
We are often encouraged to look for strong shares in strong sectors - a very sound approach that certainly increases the likelihood of investing success. The chances of one of these shares performing poorly are very low, so the chance of success is increased. But there is a downside: when we ignore all the shares in weak sectors, we are also ignoring any strong ones.

Invocare Limited (IVC) is a provider of funerals, burials and cremations, with a GICS sector code of 25 (Consumer Discretionary), and a GICS industry group code of 30 (Consumer Services). It is in the XJO index (about 129th on the list) and it participates in the S&P/ASX 200 Consumer Discretionary index (XDJ).

The chart below shows the performance of Invocare versus the XDJ index and it clearly shows that IVC's share price fell from about $7 to $4.50 in 2008 during the GFC, but has rallied to new all-time highs above $8 in the four years since. This is while the Consumer Discretionary index has languished.

This is a clear demonstration of shares that can be missed if we focus only on strong sectors.

Invocare outperforms its sector index



*Source: © September 2012, **Robert Brain***
(chart uses a linear vertical scale)

In conclusion, investing with the economic cycle can be very much hit-and-miss, especially if we misjudge the time on the investment clock. Investing in strong companies in strong sectors is a relatively lower-risk approach, with limitations. Searching for any rising share in any market is higher risk, but can be rewarding.

About the author

Robert Brain is a share trader and sharemarket analyst, and runs **Brainy's Share Market Toolbox** web-based business supporting investors and traders. He is a national director of the Australian Technical Analysts Association (ATAA), and vice-president of the Melbourne ATAA Chapter. All the charts here are produced using the **Australian BullCharts software** and Robert heads up the Australian BullCharts User Group.

About the Australian Technical Analysts Association (ATAA)

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