Picking Equity Sectors In 2018

- **High expectations of a good equity market in 2018**
- **What will be the appropriate mix of equity exposure?**
- **Spotlight Indices has embraced a new psychology**
- **Look for ongoing "cyclical" and "sensitive" exposure**

At moments of economic uncertainty, it is only natural that questions arise pertaining as to the best approach toward making investments in the year ahead.

After-all, immediately following the Christmas break, albeit in thin markets, buoyancy in commodity prices alongside a pullback in bond yields and the U.S. Dollar drove global equities to new record highs; signalling the rally would likely extend into 2018.

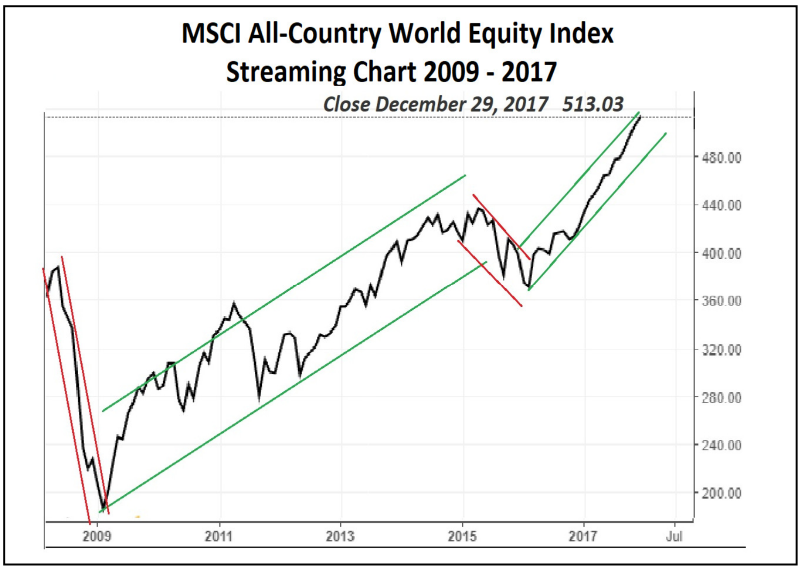

Figure 1: MSCI All-Country World Equity Index Streaming Chart 2009 – 2017
Source: MSCI

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On Saturday, December 29th, 2017 the *"Financial Times"* reported:

"...Global stocks this year enjoyed their best annual performance since the post-crisis recovery, as accelerating economic growth across the world helped power several major markets to double digit gains. ..."

The paper continued to report that global equities gained 22% during 2017, its biggest increase since 2009 and posted a gain in December 2017 of 1.6%. It has recorded up 14 straight months of gains i.e. the longest run on record.

Global equities tend to take a large cue from the path of Wall Street and in the U.S. analysts are looking for another good year for their equity market by offering forecasts for the first double-digit growth in earnings since 2011, (Source: Factset).

The most significant driver of the equity markets appreciation has been the accelerating growth in the U.S., Europe and Asia. Indeed, the outlook for global growth from all influential think tanks and institutions is one of robust optimism on a broadly-based platform of investment and industrial activity.

The approach to take in 2018

One method in considering investment, often deployed by portfolio managers, is a *"top-down"* approach. This strategy mainly focuses on the economic cycle and prevailing consumer psychology to determine whether to invest in *"Cyclical"* or *"Defensive"* sector equities.

A cyclical stock is an equity whose price is affected by ups and downs in the overall economy. These are naturally, highly correlated to the level of economic activity.

When the economy is in a recession the profits of a cyclical company have a general tendency to drop and so its share price will do the same. In contrast, when the economy is expanding, the share price tends to rise with the profit growth and guidance offered by the company's board.

As an example, consider the market for automobiles. In an economic downturn most individuals are not willing to buy a new car when their income is stagnant or declines...even if attractive credit terms are offered. This will reduce car manufacturers' revenues. On the contrary, they will be more inclined to change their vehicle if they perceive that the economy and their own economic situation is improving.

Another good example would be firms that operate in the field of Information Technology or IT. This is because clients of the IT firm are likely to be more reluctant to invest in renewing computer systems if it is in the middle of an economic turmoil and facing a declining activity. This is a line of expenditure will usually be placed on hold until an economic recovery is in evidence.

Cyclical stocks relate to companies that sell discretionary items consumers can afford to buy more of in a booming economy and cut back on during a recession.

A *"Defensive"* (or non-cyclical) stock is an equity whose profit growth and by implication its price has a very low correlation to the economic activity.

No matter how the economy is doing; expanding or contracting, the revenues, profits and cash flows of the company remain relatively stable and so does the share price.

Health Care, and Utilities are examples of defensive sectors. The reasoning being that even though an individual household faces uncertainty when the economy turns down there will be no significant reduction in the spending level devoted to prescribed medicines that are essential to the quality of life or electricity/gas consumption.

In short; spending in cyclical sectors is income elastic whereas spending in defensive sectors is income inelastic. In economics, income elasticity of demand measures the responsiveness of the quantity demanded for a good or service to a change in the income of the people demanding the good, *ceteris paribus*.

It is calculated as the ratio of the percentage change in quantity demanded (Q) to the percentage change in income (I).

$$\textit{Income Elasticity of Demand} = \%\delta Q \div \%\delta I$$

Income Elasticity of Demand:

Luxuries (Cyclical)	Necessities (Defensive)
Income elasticity more than 1	Income elasticity less than 1, but more than 0
As income grows, proportionally more is spent on luxuries	As income grows, proportionally less is spent on necessities
Examples:	**Examples:**
Consumer goods Expensive holidays Branded goods	Staple groceries (e.g. milk) Own-label goods

Table 1: Income Elasticity of Demand for Cyclical and Defensive Sectors
Source: www.tutor2u

Valuation of cyclical and defensive sector equities

It is important to focus on three considerations that help determine cyclical and defensive equities in terms of performance and price.

- **Beta (β)**

This is the systemic risk as the β coefficient is a statistical measure of the sensitivity of the individual equity in relation to the market or index within which it trades.

For example, if the β of a stock is 1.2 and the market rallies by 10%, the equity, or stock is theoretically meant to advance by 12%.

Since Defensive sectors have a performance that is more resilient to the market downturn, their β is usually low (< 1).

As an example, consider two equities, one cyclical and the other defensive.

- ***β Cyclical = 1.2   β Defensive = 0.8***

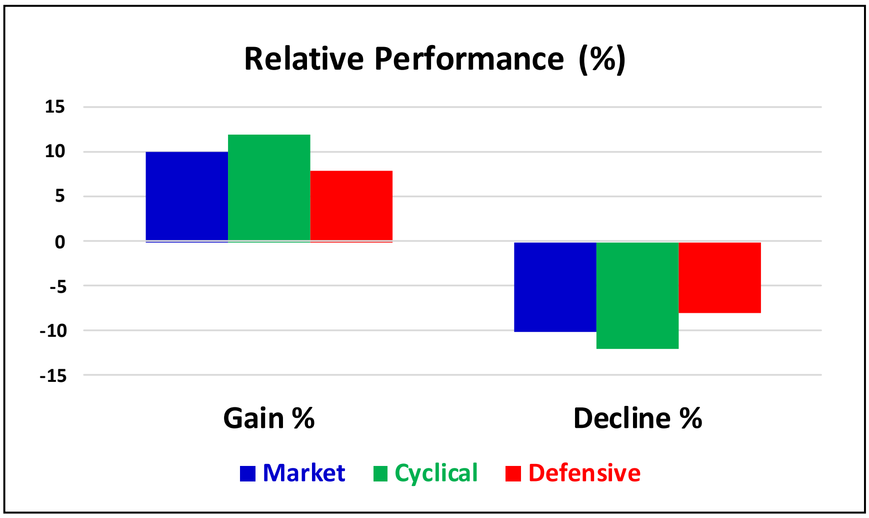

Figure 2: Market, Cyclical and Defensive ~ Relative Performance
Source: Spotlight Ideas

In this example, one can see that the greater gain is achieved from the cyclical sector equity when the overall market rises, however, that also suffers the greatest decline when the overall market is in retreat.

- **Stability of Earnings Per Share (EPS)**

Earnings Per Share (EPS) refers to the profit a company makes from its commercial activity after it has met all its expenses, divided by the number of shares.

EPS is closely correlated to the revenues of a company; i.e. higher revenues should imply higher EPS.

As mentioned above a defensive company can maintain revenues *...or maybe one should say, limit the losses...* during an economic recession. In contrast a cyclical company will see a large part of its revenues decline. This instability explains the volatility of cyclical EPS cf. defensive EPS, over the course of the economic cycle, Figure 3.

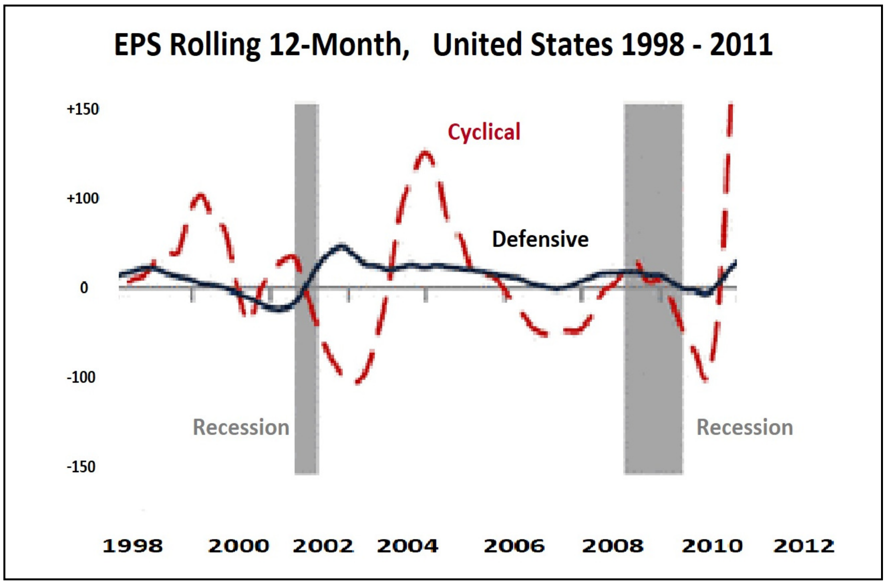

Figure 3: 12-Month Rolling EPS, United States, Cyclical and Defensive 1998 - 2011
Source: NYSE and Spotlight Ideas

Price Earnings Ratio (PE)

The third aspect we consider is the Price Earnings Ratio (PE). It is one of the most frequently used equity metrics in the market. As the name suggests it compares the price of the stock to its EPS (Price / EPS or PE).

It indicates to the investor what multiple of earnings they are paying to buy the underlying equity. As an example, if the PE of a specific equity is 12, it means that the investor is paying 12 times of EPS to buy the stock. That, of course assumes the EPS remain equal.

This ratio is mainly used to determine the expensiveness of an equity. As has been suggested a defensive sector company is able to maintain stable revenues, EPS and so its share price should prove relatively stable. For that reason, one often finds that over the medium to long-term this ability allows defensives to trade at a premium against cyclicals.

Since 1995 the global averages suggest that defensives are generally more expensive than cyclicals with an average premium over the past 22 years of 21%.

Sector classification

Identifying whether a sector is *"Cyclical"* or *"Defensive"* is not as straight forward as one may imagine. For example, energy feeds the defensive sector benchmark of utilities, and yet is critical for industrial activity in basic resources and can exert a large influence over auto demand.

What of financials? Banking and the provision of liquidity is essential to consumer behaviour, i.e. when buying consumer staples, but it also suffered tremendously during the global financial crisis and economic downturn of 2007/8.

Going further, one can see that the industrial sector is indeed cyclical, though the subsector aerospace & defence is defensive. This sector can be seen as one of fluctuationg spending that is determined by the:

- Base level of spending to preserve national security and defence alliances
- The level of national GDP and government reveues accruing from taxation
- Political disposition of the elected government and approach toward defence

The edges can be blurred. It usual to regard consumer discretionary as cyclical, and yet given the demand for luxury goods from rapidly emerging markets, sub-sectors such as high-end clothing and accessories these areas have been able to maintain top line revenue and so keep the bottom line healthy ...so for some analysts *"Luxury Goods"* have become defensive. Similarly, are auto products such as Porsche or Rolls Royce, motor cars or luxury goods?

Given the blurred edges at Spotlight we are going to follow a new pattern by classifying sectors as:

- ***Cyclical:*** ***Auto...Basic Resources...Capital Goods...Financial***
- ***Defensive:*** ***Consumer Staples...Healthcare...Tobacco...Utilities***

...and then considering a third option

- ***Sensitive:*** ***Communication...Defence...Energy...Technology***

How have these performed over the past rolling 12-Montn period?

	Rolling 12-Months (%)
Communications	-25.10
Energy	-6.68
Auto	3.56
Financial	5.79
Tobacco	8.71
Health Care	11.30
Technology	14.49
Basic Resources	22.39
Defence	22.68
Con Staples	25.66
Con Cyclical	29.34
Utilities	36.71
Capital Goods	40.69

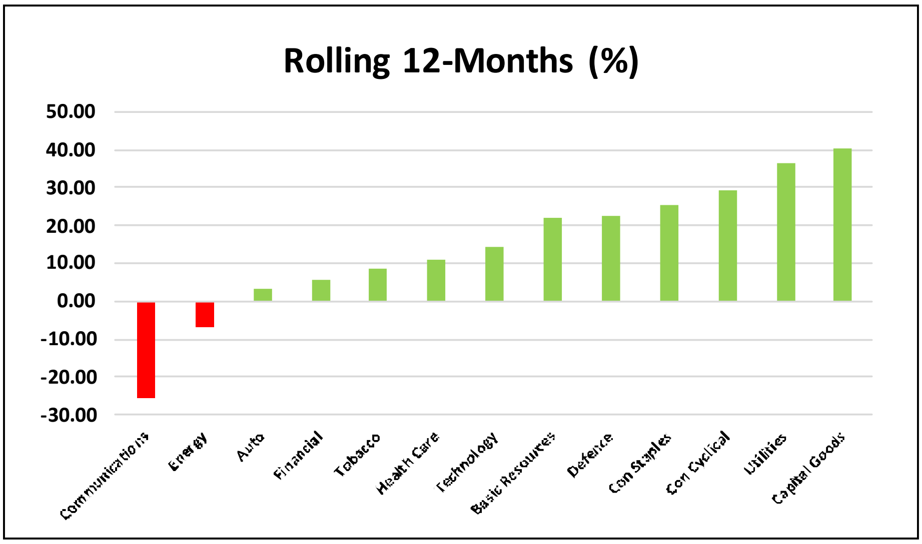

Table 2 and Figure 4: Sector Performance for the past 12-Months to December 29th2017
Source: Spotlight Indices

Over the course of 2017, the funds under management at Spotlight Capital secured a return of 23.17% and considering 2018 it is our intention to continue with a strong level of cyclical equity exposure across the developed markets. We will follow emerging markets, although mostly at an index level of exposure as against becoming too granular in our analysis.

As well as equities it is our intension to work with forex and commodities although we are not yet prepared to embrace cryptocurrencies. We appreciate the potential of the blockchain, however, the underlying volatility of the coin units themselves is too great for our tolerance levels.

Where cash is not deployed into invested assets we will position that money neutrally in the 1-Year US Treasury Bill as has been our custom in past years.

Stephen Pope