Sector Rotation

Beating the street is the most sought after investment objective of investors and traders alike. But stock market, as they say follows its own path and riding the tide may be the most successful investment strategy. In the never ending pursuit to uncover the next multi bagger, portfolio managers and investors often forget how equities as a whole fit into stock market and economic cycles. In this feature, we have analyzed how economic cycles impact various sectors of the economy and how investors in stock market can benefit from this cyclicality in performances of stocks from such sectors.

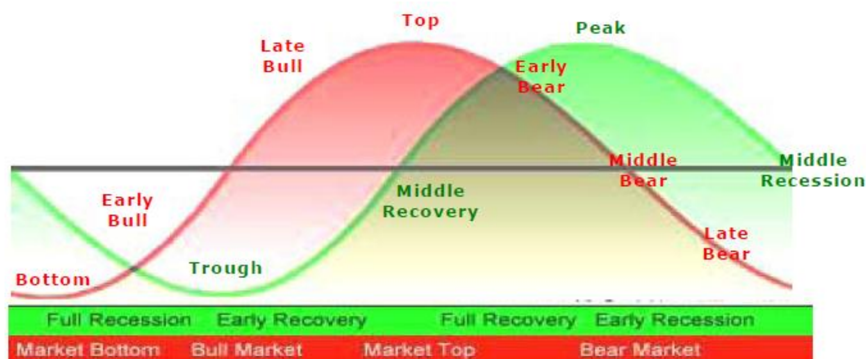
What is sector rotation?

- Sector rotation is a top-down approach style of investing involving movement of money from one industry sector to another by anticipating the various stages of economic cycle in an attempt to beat the markets.
- It is based on the assumption that certain sectors provide relative strength to different stages of business cycles and thus has the capability to outperform the markets.
- Sector rotation is similar to tactical asset allocation. Instead of investing in a particular asset class—such as stocks, bonds, or commodities—in order to take advantage of current market conditions, the investor constructs portfolio using selected economic sectors or industries.

According to Peter Lynch, *"If you are in the right sector at the right time, you can make a lot of money very fast"*. However, the challenge here is to both correctly select sectors and correctly time the economic-cycle – an intimidating task for even the most astute investor. According to Sam Stovall, the author of two books on the topic: 'Sector Investing' and 'Standard & Poor's Guide to Sector Investing', different sectors gain in different phases of economic cycle i.e. expansion and recession.

Sector rotation and Economic cycles

An economic cycle is a period during which a country's economy moves from strength to weakness and back to strength and has four stages namely *Recession, Depression, Expansion/Recovery and Peak*. It is proven fact that the stock markets are leading indicators on the business cycle and normally leads by 6-9 months. Various economic indicators like GDP, Industrial Production, interest rates and yield curve gives us vital clues on what direction the economy is headed and the performance of the stock market.

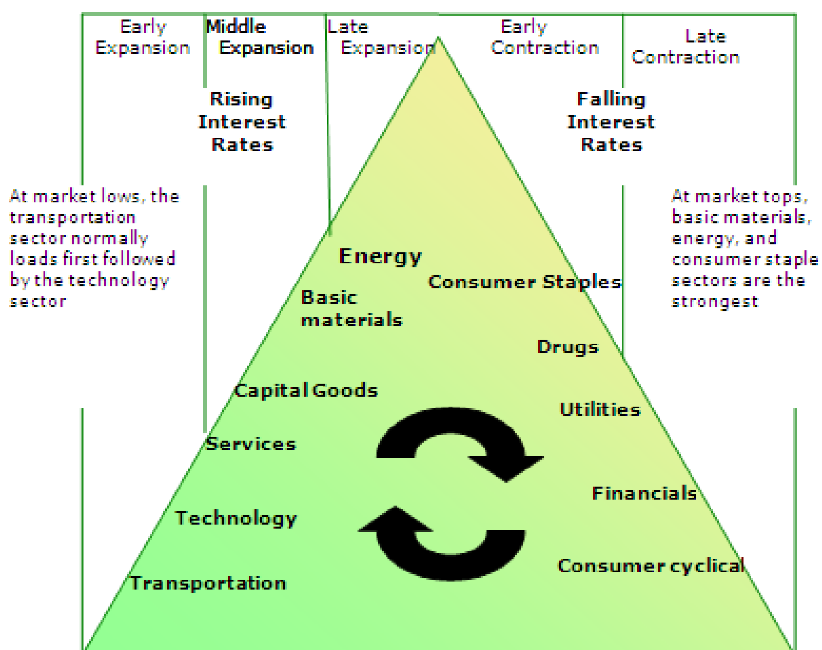


This theoretical model is based on Sam Stovall's S&P's Guide to Sector Rotation and states that different sectors are stronger at different points in the economic cycle. The Market Cycle precedes the Economic Cycle because investors try to anticipate economic effects.

Stage in economic cycle	Full Recession	Early Recovery	Full Recovery	Early Recession
Consumer Expectations	Reviving	Rising	Declining	Falling Sharply
Industrial Production	Bottoming Out	Rising	Flat	Falling
Interest Rates	Falling	Bottoming Out	Rising Rapidly	Peaking
Yield Curve	Normal	Normal (Steep)	Flattening Out	Flat/Inverted

** Sam Stovall's Sector Investing, 1996*

The chart below shows a typical business cycle and the points at which various sectors tend to outperform the broader market.



- According to the theory, before an economic data can actually reflect a recovery, the cyclical (auto, housing) will start forming a base and start a phase of accumulation and favorable price action.

- Any higher than consensus expectation of economic announcement will under most circumstances lead to fall in bond prices and corresponding increase in yields, rise in commodity prices, and rise in cyclical and fall in defensives and consumer non durable

- On the contrary, lower than expected economic data can lead to rise in bond prices (and fall in yields), fall in commodity prices, fall in cyclical and rise in defensives and consumer non durable.

Sector positioning in different periods

Every year different sectors outperform and underperform. Table below ranks sectors performance during each year.

Rank	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013
1	Oil & Gas	AUTO	AUTO	AUTO	Cons. Dura.	Cap. Goods	Cap. Goods	Oil & Gas	AUTO	Cons. Dura.	Cons. Dura.	FMCG	FMCG
2	Metal	Oil & Gas	Metal	Metal	Cap. Goods	AUTO	Oil & Gas	Metal	Metal	AUTO	FMCG	Healthcare	Healthcare
3	FMCG	Metal	Cap. Goods	Cap. Goods	Bankex	FMCG	Bankex	FMCG	Bankex	Metal	Healthcare	AUTO	Bankex
4	Cap. Goods	Cap. Goods	Bankex	Bankex	IT	Cons. Dura.	Metal	Cap. Goods	FMCG	IT	IT	Cons. Dura.	Cons. Dura.
5	Healthcare	Cons. Dura.	Oil & Gas	Oil & Gas	FMCG	Oil & Gas	Cons. Dura.	Healthcare	Cap. Goods	Bankex	AUTO	Bankex	AUTO
6	AUTO	Healthcare	Healthcare	Healthcare	Metal	IT	IT	Bankex	IT	Healthcare	Bankex	IT	Oil & Gas
7	Cons. Dura.	IT	IT	IT	AUTO	Metal	Healthcare	Cons. Dura.	Oil & Gas	Cap. Goods	Oil & Gas	Oil & Gas	IT
8	IT	FMCG	Cons. Dura.	Cons. Dura.	Oil & Gas	Bankex	AUTO	AUTO	Healthcare	FMCG	Metal	Cap. Goods	Cap. Goods
9			FMCG	FMCG	Healthcare	Healthcare	FMCG	IT	Cons. Dura.	Oil & Gas	Cap. Goods	Metal	Metal

Pros & Cons

Like all strategies, Sector rotation also has its own benefits and drawbacks:

Sector rotation, if done prudently, could give investors the opportunity to ride the best period of a particular sector

- Exit and entry point matters a lot in this strategy
- A contrarian view on sector could go wrong and leave investors reeling
- Also too much switching could leave investors burdened with high expense to bear

Sector rotation strategy can help investors align their investments with their market outlook. With an understanding of how certain sectors react to the business cycle, investors may be able to optimally position their portfolio. To sum up, beating the street may be a difficult task but it is definitely not impossible.

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