SECTORAL INVESTMENT

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As globalization breaks down the barriers between countries, so the sectoral affiliation of shares is today of far greater importance than the regional affiliation. Globalization is therefore something that investors, just as much as its radical opponents, are having to come to terms with. More experienced investors are no longer pondering whether American or European shares are more attractive but are rather concerning themselves with sectors (energy, technology…), investment styles (growth vs value) and market capitalization (large or small companies).

At the same time, Slovak investors in mutual funds are gradually shifting their investments into riskier assets. The main reason for this is, however, the long-term decline in the money market interest rate, which has a direct effect on the progressive reduction in the profitability of money-market and bond mutual funds. In seeking higher-earning investment options, investors have discovered other types of mutual funds – equity funds, mixed funds and hedge funds. Also investors themselves, as they become more experienced, are better able to assess risk and are more willing to place some of their savings in riskier investment instruments.

Investment styles

Two basic investment styles – value and growth – represent a sort of first-stage sectoral investment.

The value approach is characterized by the investor primarily tracking the book value of a company whose shares he plans to purchase for his portfolio. The sought-after companies are those with an attractive market value, especially in regard to the market segment (sector) in which they operate or to the whole market. Therefore the most frequently used methods for finding "value stocks" include standard accounting criteria – profitability, indebtedness, current ratio, and so on. The lower the market-to-book ratio (i.e. the ratio of the market price of the company to the book price), the more favourable the time for purchase. Value investment also tracks the P/E ratio (price-to-earnings ratio – the ratio of the market price of one share to the earnings per share) and the P/D ratio (price-to-dividends ratio – the ratio of the market price for one share to the dividend per share for the previous year). If all these indicators are favourable, it is the right time to buy. The value style therefore favours the real valuation of a company and does not take account of expected future profits. It is not possible to precisely define which sectors are full of value stocks, though mostly they cover "old economy" industries such as the automobile industry and consumer goods industry. For example, shares in telecom companies were, before the development of mobile networks, seen as suitable for value investment.

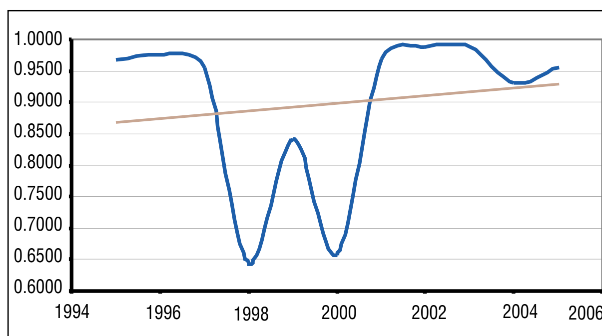
The growth approach is more complicated since the investor purchases shares assuming only that they are cheap and that they will appreciate in future. The key indicator when seeking such shares is earnings per share (EPS), which should increase year after year. The present time is therefore not examined. Typical share growth has in recent years been seen in the shares of technological telecom companies, biotechnology companies, producers of semiconductor producers, and the like.

Although there have been sufficiently lengthy periods during which the growth style has fared better, the value style has over the long-term reported the superior results. One of the reasons for this is that growth stocks do not in the end fulfil the expectations placed upon them at the outset, whereas value stocks have a tendency to be undervalued and therefore provide a pleasant surprise sooner or later. This is because value stocks are riskier – their low price often indicates problems within the company – and the investor taking on the greater risk must be rewarded with greater profit. Volatility risk does not come into it, since the volatility of value shares has been lower than the volatility of growth shares since the 1980s.

Development of MSCI indices compared

The following charts show the declining significance of regional investment. Indeed, they highlight the growth in the correlation (mutual correlation) between European shares

Chart 1 Correlation of the indices MCSI Europe and MCSI North America



Source: Bloomberg.

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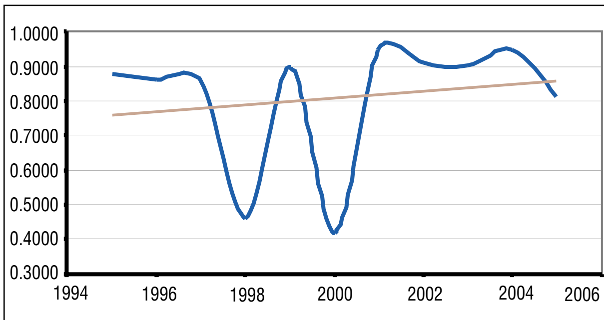
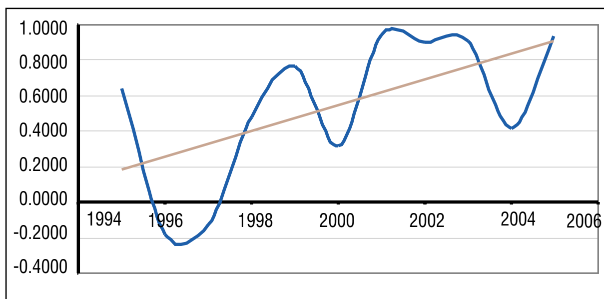
Chart 2 Correlation of the indices MCSI Europe and MCSI ACWI Latin America



Source: Bloomberg.

Chart 3 Correlation of the indices MCSI Europe and MCSI ACWI Pacific



Source: Bloomberg.

and the shares of other investment regions from 1995 to 2005. The growth trend in this correlation is clearly shown. The data is recalculated from the annual evaluations of the following indices: MSCI North America, MSCI Europe, MSCI ACWI Pacific and MSCI ACWI Latin America.

The increasing integration between countries means companies must get through a greater range of trading operations than they did in the past. As a result, many companies no longer compete locally but operate and compete globally. Following, for example, the creation of the single European market, many companies and investors see the euro area as one market. In many sectors, moreover, companies are forming alliances with other companies in order to consolidate their competitive position. In the automobile and aluminium industry, for example, 5 aluminium companies control 80% of the world market

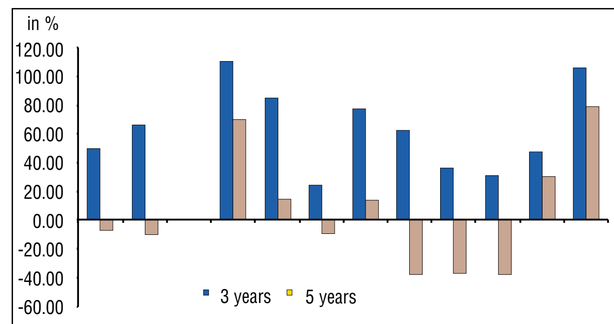
Table 1 Correlation coefficients of share indices of selected regions between 2001 and 2005

	North America	Europe	Asia	Latin America	Emerging Europe
North America		0.8712	0.8835	0.5796	0.4985
Europe	0.8712		0.8192	0.2315	0.1529
Asia	0.8835	0.8192		0.6668	0.6164
Latin America	0.5796	0.2315	0.6668		0.9878
Emerging Europe	0.4985	0.1529	0.6164	0.9878	

Zdroj: Bloomberg.

and 7 automakers produce 70% of all automobiles. It is natural that investors, whether minor or institutional (e.g., collective investment funds), are seeking to exploit these dynamic trends for their own benefit. These circumstances are also reflected in the comparison of the development of the MSCI regional indices presented in Table 1. As the following chart based on MSCI share indices shows, sectoral considerations may be more interesting than regional ones: over the past three years and five years there were

Chart 4 Comparison of the development of sectoral and territorial MSCI indices for the last three years (2003 – 2005) and for the last five years (2001 – 2005).



Source: Bloomberg.

sectors which grew and also others which declined. The regional indices either grew (development over the past three years) or they fell (development over the past five years). Understandably, this correspondence is not repeated in all periods, but the comparison of the development in sectors and regions is sufficiently characteristic.

Overlap of sectors and styles

Each sector may be classified into the style of growth or value. This is based on the fact that at different phases of the business cycle, the shares in companies from particular sectors develop differently. Merrill Lynch company has come up with an "investment clock" which tracks two parameters – economic growth and liquidity – and on this basis sectors are divided into the categories of value or growth.

Since economic growth and liquidity grow as well as decline and since particular sectors are either very dependent on the business cycle (being cyclical) or are less dependent on the business cycle (defensive, cyclical), any of four phases of the investment clock may arise with different sectors profiting in each of them.

Sectors also have subgroups and branches. This is because some subgroups of one sector (e.g., industry) are defensive and others are cyclical, and it is therefore necessary to divide them more specifically. That said, all the subgroups of the information technology sector are cyclical-growth and it is therefore not necessary to further divide them for the purpose of the investment clock. The following table shows the basic breakdown of sectors or individual subgroups with the sector given in brackets.

Table 2 Breakdown of sectors by investment style

	Cyclical	Defensive
Value	automobiles (cyclical consumption), industry, retail (cyclical consumption), real estate (financial sector), transport (industry), household goods (cyclical consumption)	aviation and defence (industry), sale of foodstuffs (non-cyclical consumption), distributors, tobacco industry
Growth	banks (financial sector), oil and gas (energy), media (cyclical consumption), IT hardware producers (information technology), software and PC services (information technology)	telecom services, insurance (financial sector), pharmacy (health care)

Characteristics of selected sectors

Consumer goods industry – non-cyclical

Shares in the non-cyclical consumer goods industry (foodstuffs) and in growth consumer goods industries (cosmetics and tobacco industry, brewing) are heading towards steady growth and are less sensitive to changes in the business cycle. Traditionally, investors take an interest in these shares when a bull market has matured or is in the early stages of contraction.

Consumer goods industry – cyclical

Like the business cycle, shares in this category are sensitive to interest rates. Investors usually go for them when the economy is in the later stages of contraction.

Pharmaceutical industry, biotechnology, health care

Generally speaking, the fluctuation of shares in this sector is similar to that in the non-cyclical consumer goods sector. This sector is considered defensive, which means its companies are generally not affected by economic fluctuations.

Financial sector

Shares in household-related industries have a tendency to react favourably to falling interest rates, and they are therefore often targeted by investors between the middle and later stages of economic contraction. In general, banks (independent of mortgages) are boosted by the growth in commercial and consumer lending, and investors favour them during the middle phase of the cycle.

Technology

Technology shares may to a certain extent be cyclical, depending on capital consumption and demand from companies and consumers. Nevertheless, technology shares can offer long-term growth potential depending on the development of new technology and the expanding application of existing technological products.

Basic industrial sectors

Profits in the basic industrial sectors are driven up by the high use of capacity and the strong market demand for products. That is why shares in this sector are popular during the later phases of economic expansion. In this regard, companies are also affected by the overall economic picture and the relationship between supply and demand.

Basic equipment industry

Capital consumption has a rising tendency when the economy is overheating and higher demand for products is leading companies to increase their capacity. Global export demand is the crucial factor for agricultural equipment, industrial machines and mechanical equipment.

Transport

Railways and other forms of surface transport tend to react sooner than usual to economic recovery. The aviation industry is subject to cyclical fluctuations in areas such as fuel costs, utilization vis-à-vis capacity, and competition in flight prices.

Energy

This segment includes large integrated companies, domestic (USA) exploration (geological) companies and energy service companies. The dynamics of this sector are fuelled by world energy prices. Political events have in the past had significant consequences for this sector. It is in the later phase of the business cycle that investors are drawn to shares in this field of industry.

Services

Power companies are highly sensitive to interest rates due to the heavy financial outlays (debt) with which they finance the building of infrastructure. Shares in these companies perform very well when interest rates are falling. Telecom companies may provide attractive long-term growth opportunities in regard to the most recent development in the deregulation of the telecoms market.

Precious metals

Shares in companies that extract and process precious metals could be affected by industrial and consumer demand. But the biggest factor behind volatility in this sector is usually inflationary pressure. Investors usually cluster around this segment in the later phase of expansion.

Different sectors have a tendency to perform well or poorly at different phases of economic development. Defensive sectors develop well during recession (when regional indices are mostly falling) and cyclical sectors prosper during economic expansion. Over the past twenty years the sectors which have really profited are those categorized as value or growth under the investment clock. However, detailed analysis cautions against blind following of this fact. The investor wanting to make a profit also during recessions should not merely focus on the regional affiliation of his shares, but also take an interest in their other characteristics.