

Cyclical stocks: ins and outs, ups and downs

A company can provide outstanding goods or stellar services. It can be well run by a board of directors and officers who choose the best and the brightest of employees, who, in turn, manage day-to-day business operations with skill and finesse.

Seems as if purchasing shares of this business would provide a good investment opportunity, right? It might. Then, again, it might not.

As everyone knows, even a successful company's earnings and, ultimately, the value of its shares are influenced by a variety of external, economic factors, some companies more than others. The latter are especially sensitive to the business cycle and are categorized as cyclical stocks.

Identification and prediction

In a nutshell, a business cycle is defined as a predictable, long-term pattern of alternating periods of economic growth and decline. The cycle involves among other things, interest, inflation and unemployment rates. A rise in any of these factors usually depresses profits. A drop usually spells good news.

It's relatively easy to identify cyclical company stocks. They are the stocks of businesses that depend heavily for their success on the condition of the economy as a whole. Often, these businesses produce luxury and big-ticket items (think new cars, expensive vacations). Or they offer goods and services for home construction and leisure-time activities. Or they serve markets that are tied to capital-equipment spending.

The stocks of automobile manufacturers are cyclical stocks because buying a car is very often discretionary. The purchase may be accelerated or delayed based upon one's personal finances—which, very often, are a reflection of how the economy is doing. Shares in companies in food industries—the staples of one's diet, that is—are not. Everyone has to eat.

Predicting a business cycle, however, is not as simple. What's more, the rise in value of cyclical stocks usually leads the business cycle by six to ten months. In essence, many of the prices of cyclical stocks may start dropping while the economy is still seemingly healthy or start rising several months before the country comes out of a recession.

Value and timing

How can investors determine which cyclical stocks are deserving of being added to their portfolios?

Benjamin Graham, author of the 1934 classic *Security Analysis* and widely considered the father of value investing, maintained that an investor should consider purchasing a cyclical stock based upon its average earnings over the previous ten years, the length of a typical business cycle. Although not a guarantee of success, using this time frame would, at least, give the investor a rough idea of how the value of a company's shares have tracked the business cycle.

Looking back at the early 1990s from the early years of the 21st century, we could see, at first, an economy in poor shape (partially a result of an uneven recovery from recession around the time of the Gulf War). Then came the bull market and a robust economy, followed by economic instability in the latter phase of that ten-year time period. According to Graham's theory, then, an investor who considered an investment in a cyclical stock, say in 1999, and calculated average earnings before making a decision, was likely to have made the better choice, rather than one who looked just at current earnings.

An invitation

Buying shares of cyclical companies can be profitable for the investor willing to do the research and then make an educated guess about the future of the economy. For the investor who is willing to jump in and out of cyclicals, as he or she anticipates a surge or a drop in the economy.

Purchasing shares in cyclical companies is probably not for the neophyte or part-time investor. Cyclicals are more likely to be prospects for a place in the portfolio of investors who are in the markets for the long term and who feel relatively comfortable assuming some degree of risk.

We have the professionals on board and the tools at hand to assist investors in cyclical businesses in making their choices. If you are one of those investors, or someone who would like to know more about investing in cyclical companies, let us know. We will be glad to set up an appointment to speak with you.

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Any developments occurring after January 1, 2008, are not reflected in this article.