Issue N° 8
June 2013

Equity Solutions

EQUITY IN A NUTSHELL

LEVEL

Cyclical vs. Defensive Stocks

Introduction:

In times of economic uncertainty, numerous questions arise about the best way to invest. One commonly used approach by portfolio managers is the top down one. This strategy mainly focus on the economic cycles and among different choices highlights whether to invest in Cyclical or Defensive stocks. Even though it might seem easy, identifying those stocks is a more complex exercise.

Cyclical vs. Defensive stock

First, let's start by defining the concepts of cyclicality and defensiveness. A Cyclical stock is a stock highly correlated to the economic activity. When the economy is in a recession the profits of a Cyclical company tend to drop and so its share price. Conversely, when the economy is in a good shape (expansion), the share price tends to goes up with the profit growth. The best example is the automobile sector. Indeed an individual is not willing to buy a new car when his income lowers, which drags car manufacturers' revenues down. On the contrary, he will be more tempted to treat himself with a new car if his economic situation is improving. Another example would be IT firms. A company is more reluctant to invest in renewing its computer system if it is in the middle of an economic turmoil and facing a declining activity. This expenditure will certainly be postponed until the recovery.

A Defensive (or non Cyclical) stock is a stock whose profit growth and therefore its price has a very low correlation to the economic activity. No matter how the economy is doing, the revenues, the earnings and the cash flows of the company remain relatively stable and so the share price. Health care, household and Personal Care (HPC) stocks are known as Defensive. Indeed, even though an individual has decreasing revenues, he will not significantly reduce his soap or toothpaste spending.

A top down approach for investing

Understanding those concepts is crucial for an investor in his investment process. Indeed, as we said earlier, the main difference between Cyclical and Defensive stocks is their correlation to the economic cycle. Bearing that in mind, the successful investor will try to integrate the economic scenario in his investment decision. He will also try to anticipate and identify the inflexion points of the economy to switch between stocks' universe.

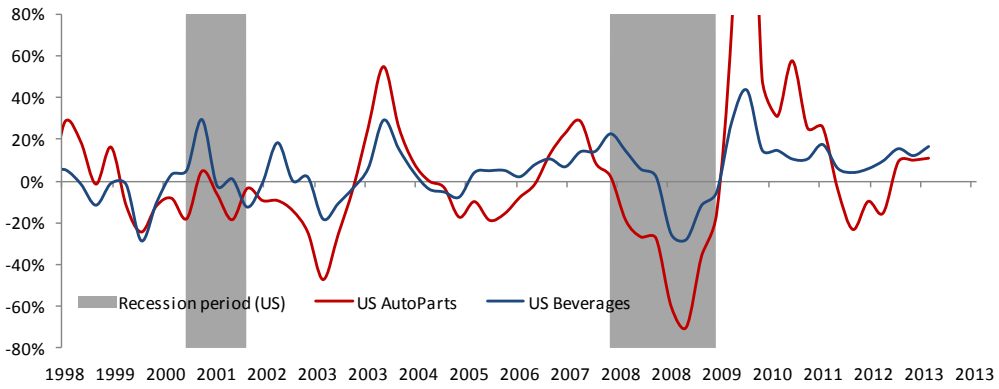
There is a large number of tools to measure the economic activity. One of the most commonly used is the Gross Domestic Product (GDP). It represents the value of all the products and services produced within a country, and gives an indication on the economic health.

Another indicator is the "Purchasing Managers Index" (PMI). It is a monthly survey conducted by private companies or trade associations (ex. Markit) among the purchasing managers of private companies in a certain country. This survey aims to determine quickly whether there has been an improvement in the business activity or not.

These indicators allow to identify the economic cycle and thus help the investor in his decision.

The graph below provides a concrete example on how Cyclical and Defensive stocks behave. We have chosen the automobile (Cyclical) and beverages (Defensive) sectors in the US and compared their performance. We have also highlighted the main recession periods

US Automobile vs. Beverages performance /Recession Periods (US)



We obviously notice at a first sight the higher amplitudes of the automobile sector against the beverages, but the most important thing that this chart illustrates, is the behavior of these sectors in a period of contraction. As we can see in the 2008 crisis for example, the decline in prices in the performance of the automobile sector is way larger than beverages. This means that the investor holding an automobile stock like Ford would have suffer larger losses.

What about their valuation?

Defensive stocks are usually said to be expensive, But this affirmation is not totally correct. For a better understanding, we are going to focus on three aspects that drive Cyclical and Defensive stocks performance and price.

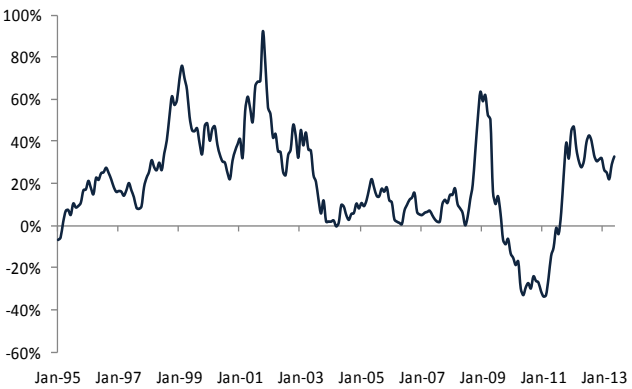
The first aspect is the beta of these stocks, also called the systemic risk. The beta coefficient is a statistical measure of the sensitivity of the stock vs. the market. In other words, if the beta of a stock is 1.5, and the market drops by 10%, the stock is supposed to drop by 15%. Since Defensive stocks performance is more resilient to the market downturn, their beta is usually low (lower than 1). In our example, a Defensive stock like Coca Cola that has a beta of 0.5 will only drop by 5%. However, if the market rebound by 10%, my Defensive stock will only gain 5% while a Cyclical stock like Ford Motors with a 1.4 beta will gain 14%.

The second aspect, is the stability of the Earnings Per Share (EPS). The EPS refers to the profit a company makes from its activity after paying all its expenses, divided by the number of shares. The EPS are tightly linked to the revenues of a company. Indeed, the higher your revenues the higher are your EPS supposed to be. As we have seen earlier, a Defensive company is able to maintain (or at least limit the losses) its revenues in a period of economic turmoil, while a Cyclical one will see a large part of its revenues decline. This instability explains the volatility of Cyclical stocks EPS against Defensive.

The graph below shows this difference. It can be noticed that the annual changes in EPS of US automobile companies (Cyclical) varies largely, while the Beverages companies EPS remain relatively stable (we highlighted the major recession phases of the US economy).
However, this affirmation should not be taken as granted. In fact, we have just presented the general case. Sometimes, a Cyclical company may be able to preserve its earnings in a negative macroeconomic scenario by optimising its costs for example. For instance, Inditex that is supposed to be a Cyclical stock has been able to maintain a stability (even showing a nice growth) in its earnings through a mass distribution business model. On the contrary, Pharmaceutical companies might suffer a slump in their revenues due to a phenomenon known as "the patent cliff" (refers to the expiration of certain medicine's patent and the outbreak of generic medicines).

The last aspect we are going to discuss is the Price Earnings Ratio or PE. The PE ratio is one of the most commonly used by investors in the market. It compares the price of the stock to its EPS (Price / EPS). In other words, it shows the investor how many times of earnings he is paying the stock. If for example a stocks PE is 12, it means that the investor is paying 12 times of EPS to buy the stock (assuming that the EPS remain equal). This ratio is usually used to determine the expensiveness of a stock. As we have seen, a Defensive company is able to maintain stable revenues, EPS and so its share price. Its this ability that makes the Defensive stocks usually trade at a **premium** against Cyclical stocks. For a better understanding, have a look at the graph in the top right corner. It shows the evolution of the European Defensive stocks P/E vs. Cyclical since 1995. We can clearly notice that the Defensive are generally more expensive than Cyclical. In fact their average premium since 1995 is around 21%.

European Defensive vs. Cyclical P/E (Premium)



Sector Classification	
Cyclical	**Defensive**
Materials	*Consumer Staples*
Industry	*Health Care*
Consumer Discretionary	*Telecom*
Information Technology	*Utilities*

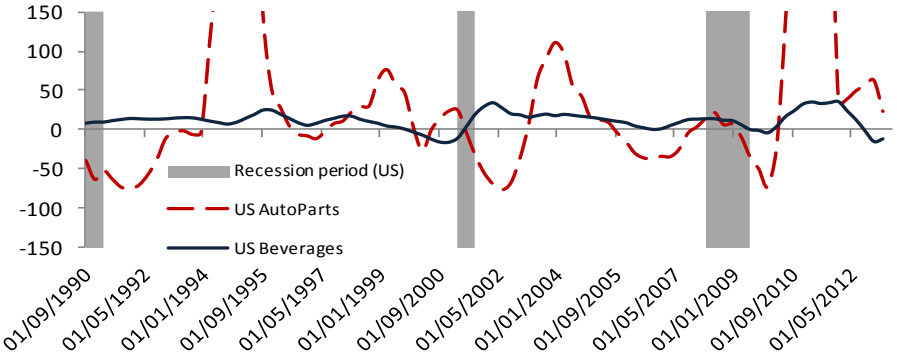
Classification

Identifying whether a sector is Cyclical or Defensive might seem easy at first sight. However this exercise is trickier than we think. The table above shows the traditional sector classification. First, two sectors are missing (energy & financials). Indeed their classification is quite difficult because of the instability of the way they behave.

Second, the Utilities sector that has always been considered as Defensive. Although, since the crisis, the sector behaves more like a Cyclical due to its tight link to the sovereign debt.

But these are not the only concerns. For example, the industrial sector is indeed Cyclical, though the subsector aerospace & defence is Defensive.
In addition, some sectors might change their status during their lifetime. The best example is the sub-industry: "Apparel, Accessories & Luxury Goods" that has been Cyclical for a long time, but now is considered as Defensive. This shift is due to the ability of companies like LVMH to maintain and even grow their revenues / earnings in emerging markets.

12Months change in EPS



Conclusion

Processing through a top-down approach by being able to identify the different cycles of the economy and anticipate its changes is a major concern for today's investors. Understanding the concept of Cyclicality, enables to take advantage of the different economic phases.

Nevertheless, an investor should never neglect the importance of a bottom up approach, a key issue in the stock picking process. Indeed it's not because a stock belongs to a Defensive sector that his revenues will remain stable. A smart investor will then combine both these approaches to make the right investment decision.