Financial Planning Newsletter

November 2014 | Volume 4, Issue 11
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Equity Sectors

According to Modern Portfolio Theory (MPT), utilizing assets that do not have a high correlation with one another helps to lower the overall volatility of a portfolio and could lead to higher risk-adjusted returns. When investing in equities, it is important to look at which sectors a portfolio is invested in as this is one of the drivers of equity performance. Here is a brief summary of these sector types and how each tends to perform during different stages of the economic cycle.

Consumer Goods

This sector is comprised of companies that relate to items purchased by individuals rather than by manufacturers and industries. This sector includes companies involved with food production, beverages, packaged goods, clothing, automobiles, and electronics.

Performance in this sector is highly dependent on consumer behavior. When the economy is in an expansion phase, the sector will see an increased demand for higher-end consumer discretionary products. When the economy is in a recession, there is an increased demand for consumer staples products.

Consumer Services

The companies in this sector produce intangible goods and primarily consist of truck transportation, warehousing; rental and leasing services; professional, scientific and technical services; administrative and retail services; health care and social assistance; and arts, entertainment and recreation services. Individuals employed in this sector provide services rather than produce goods.

Performance in this sector is highly dependent on consumer behavior. When the economy is in an expansion phase, the sector will see an increased demand for consumer services. When the economy is in a recession, this sector will be adversely affected.

Energy

Companies in this sector produce or supply energy and include businesses involved in the exploration and development of oil or gas reserves, oil and gas drilling, or integrated power firms.

Performance in this sector is mainly driven by the supply and demand for energy on a global basis. Also, this sector is sensitive to political events, historically causing significant fluctuation in oil prices.

Financials

This sector includes banks, brokerage companies, trust companies, insurance companies and real estate and they usually perform best in low interest rate environments.

A significant percentage of this sector generates revenue from underwriting loans, which gain value as interest rates drop. Furthermore, when the business cycle is expanding, this sector benefits from additional investment. Improved economic conditions usually lead to more capital projects and increased personal investing.

Healthcare

This sector relates to medical and healthcare goods or services and includes pharmaceuticals, biotechnology companies, hospital management firms, health maintenance organizations (HMOs), and companies that make medical products.

Companies in this sector are often considered to be defensive since the products and services are essential. Even during periods of economic downturns, individuals will still need prescription drugs and medical services. Having a consistent demand for goods and services makes this sector less sensitive to business cycle fluctuations.

Industrials

Companies in this sector are involved in producing goods used in construction and manufacturing as well as those involved with aerospace and defense, industrial machinery, tools, lumber production, construction, cement and metal fabrication.

Performance in this sector is largely tied to supply and demand for building construction - as well as the demand for manufactured products. When the economy is in recession and consumers spend less, activity in this sector declines because companies will postpone expansion and produce fewer goods.

Materials

These comprise of companies involved with the discovery, development and processing of raw materials and include the mining and refining of metals, chemical producers and forestry products.

This sector is sensitive to changes in the business and economic cycles since companies supply materials for construction. Companies in this sector are also subject to fluctuations in the supply and demand of raw materials.

Technology

In this sector are companies that are involved in the research, development and/or distribution of technologically based goods and services and those focused around the manufacturing of electronics, creation of software, computers or products and services relating to information technology.

The technology sector offers a wide array of products and services for both consumer and businesses in other sectors. Consumer goods like personal computers, televisions, and tablets are continuously being improved and upgraded, offering the latest technology to all users. Businesses receive information and services from software and database systems, which allow the companies to make strategic business decisions.

Utilities

This sector contains companies that provide electric, gas and water as well as those that are integrated providers.

Because utilities require significant infrastructure, they often carry large amounts of debt which cause them to be sensitive to changes in interest rates. This sector performs best when interest rates are falling or remain low.

Summary

Given each of these sectors' unique characteristics, these can be used as an effective way to diversify one's portfolio taking into account current global economic and market conditions to further improve performance while managing overall risk.