May, 2007

SECTOR ANALYSIS – WHAT DOES IT MEAN FOR US?

What is a Sector?

From Stockcharts.com: A sector is a group of companies that generate revenue in similar ways, and tend to rise and fall with the economic cycle. Sectors are commonly broken down into smaller groups called industries. The sectors tracked by the Standard and Poors Index are Basic Industries, Financials, Technology, Industrials, Energy, Consumer Staples, Consumer Services, Utilities, and Transport/Cyclicals.

What's missing?

While sector groups are pretty standard, they can vary from one reporting agency to another. Missing here are Real Estate Investment Trusts (REITs) and Telecommunications.

In similar fashion, the industries that fall into these categories can also vary from one reporting agency to another. There is no right or wrong grouping. We simply have to choose which one works best for us.

In his Lesson #2 of NAIC Plus Methodology (*found on our website under Education Assignments*), Barry Detloff asks:

What Moves Stock Prices up or down?

a) Changes in the fundamentals?
b) News about the company or industry?
c) World political events?

Answer: NONE of the above! It's the BIG MONEY's reaction to these situations that moves stock prices.

Who is the BIG MONEY?

Institutional buyers, including:
- Mutual fund managers
- Pension fund managers
- Hedge fund managers
- Large banks
- Insurance companies

Jim Cramer from Mad Money tells us that the market is dominated by this relatively small group of institutional buyers. Big institutions have to spend millions of dollars, but they can't do it quickly, like we can. They have to do it over a period of time. When a stock price is moving up or down for no apparent reason, you can rest assured it's the BIG MONEY moving in or out of that company.

Per Cramer, Big Money managers tend to come from the same school of thought, and they tend to move in a herd. If you move against them, you will be crushed! But you can follow their lead and get in (and OUT) ahead of them, if you pay attention.

Investor's Daily Edge has a slightly different take: Institutional investors operate at a different speed and scale. If you want to get decent returns from the market, don't get on the same train as the big hedge fund managers. If you do, they'll be the first ones in and out of the train every time, always leaving you trying to catch up from the back of the crowd. By the time you do, they've moved on to their next destination (or trade). Their big gains become your small gains, and their small gains become your losses. Instead of trying to keep up with them, figure out where they're going and take an earlier train. Or, figure out where they're going and go in the opposite direction.

What Moves the Big Money?

Actions of the Federal Reserve, and the direction of the economy. These cause sectors to rotate.

Per InvestorGuide.com: The basic idea behind Sector Rotation is that the economy operates according to cycles and some sectors will be up at certain times and down at others. Using Sector Rotation as an investing strategy is tough because you must identify the boom and bust cycles in the sector in which you plan to invest—buying in the down periods and selling when prices are at their peak.

How do we know what Sectors are in favor?

There are two ways of looking at this –through the rear view mirror or through the windshield.

Through the Rear View Mirror:
Use BigCharts.com to see what the Big Money is currently buying
Go to www.bigcharts.com
Click on Industries at the top
There you can see the 10 best and worst performing industries.
Big Charts defaults to 3 months, but you can choose longer periods.
Now click on the best performing industry.
Then click on the small chart in the top left corner.
Next, click on the drop down menu for "Compare to Index"
Choose S&P 500, then click on "draw"

Now you can see how this industry (or any industry) has fared against the index for the chosen time period. Note that both industry and index start at the same point. This is because the chart shows "percentage change."

Click on Industries at the top, again.
On the left menu, click on "Show All Industries."
Now you can drill down and see how each industry has fared, and see the 10 best and worst companies in each industry.

(See Barry's Lesson #3 at www.bivio.com/crowriver/files/ under Education Assignments to review his mini movie on this segment.)

Through the Windshield (#1): Value Line Investment Survey

Every 3 months, Value Line comes out with its Sector Analysis segment in the Selection and Opinion Guide. So far this year, it has appeared on 1/26/07 and 4/3/07. Attached is the latest update.

To get to the latest edition, you must do the following:
Go to www.valueline.com

Log on. Do NOT change your password.
Simply click on the Index link, next to the Log On link.
Scroll down and click on "The Value Line Investment Survey Online – Standard Edition"
(This brings us to the page you are familiar with)
Find and click on the issue dated 4/6/07 (Issue #6)
Now click on the Selection and Opinion Guide. The PDF file will open. Find the article.

Value Line gives a brief overview of the latest quarterly sector results, and a look at the sectors that are ranked from best to worst for timeliness. This is not totally forward looking. They look at momentum from the past to rank stocks going forward—so it's only half forward looking. This article also explains how to use Value Line for Sector Investing.

Through the Windshield (#2): Manifest Investing ETF Sector Dashboard

Forward-looking estimates for sectors can be seen through the ETF Sector Radar Dashboard, located on the homepage at www.manifestinvesting.com.

Or, you can find it here: http://www.manifestinvesting.com/dashboard/7596.

Simply put, a Sector ETF is a group of stocks in the same sector, assembled like a mutual fund, but with shares that sell like a stock on the open market. The sectors that are currently in favor are the ones with the lowest Potential Annual Return (PAR). The sectors that are out of favor have the highest potential return. For our purposes, we need to also look at the quality rating.

Mark Robertson recommends that we start our search by drilling down to the industries that make up the out-of-favor sectors, and find the best of breed in each.

So what does this mean for us?

For starters, Cramer says:

- 50% of a stock's price movement comes from forces that affect its sector or industry.
- If you don't know what forces move your stock's sector and industry, you are not ready to buy!

However…

- George Nicholson, founder of NAIC, once wrote that he never considered the sector when buying a company. And he was an extremely successful investor.
- Mark Robertson believes that our dashboards provide us with a "natural selection" of sectors because the out of favor stocks—those with the best quality and whose prices are currently depressed—will be the ones with the best potential return—i.e. PAR.
- And therefore, sector analysis only needs to come into play when we are choosing between stock A or stock B for better diversification of our portfolio.

<u>Next Month:</u> Do you find it frustrating when we buy a stock and it goes sideways, or worse, goes down right after we buy it? We will explore the use of Money Flow and Relative Strength indicators as a means of helping us choose the right time to buy certain companies, but only after we have already completed our fundamental analysis.

Sector Analysis

Investors who want to look at the "big picture" often start by examining the state of the economy and the stock market in general, and then look, in order, at market sectors, at industries within a sector, and then at companies within a given industry.

This week, Value Line provides its quarterly update on the 10 sectors we follow, which include nearly 100 industries, highlighting any notable changes. The sector ranks are based on the Timeliness ranks of the individual stocks within the sectors, and are positioned from 1 (Highest) to 10 (Lowest) in order of attractiveness. First, we recap how the sectors have fared in the early part of 2007. Our discussion concludes with a look at sector price earnings ratios over time, and a comparison of volatility between sectors.

Volatility Resurfaces

The stock market experienced a long overdue correction at the end of February and in early March. Selling began when reports surfaced that the Chinese government might impose taxes to curtail speculative activity in the red-hot local stock market. The fallout continued when disclosures that subprime lenders in the United States were under duress caused investors to fear that the possibility of a broader business slowdown had increased. But market volatility had been unusually low since the sharp downturn that occurred last May and June. So, while the recent slump caused some pain, it was normal and probably healthy for the stock market in the long run.

Sector	% Chg since 1/26/07
Utilities	8.4
Energy	7.6
Basic Materials	7.0
Consumer Cyclical	2.8
Industrial	1.9
Value Line Universe	**1.7**
Telecom	1.4
Consumer Staples	1.0
Healthcare	-.2
Financial	-1.0
Dow Jones Industrials	**-2.2**
NASDAQ	**-2.5**
Technology	-3.5

Not surprisingly, the Technology sector gave back some gains in recent months (see table nearby). Tech stocks exhibit the greatest sensitivity to the overall market, partly since slower economic growth would mean less spending for their products. Profit taking was also a factor. Tech stocks were one of the market leaders in the run-up beforehand.

Financials were hurt, as well, given concerns that slumping conditions in the subprime lending market would spill over into traditional mortgages and undermine the U.S. banking system. However, Federal Reserve officials have provided assurance that such a worst-case scenario is not yet starting to develop.

Recent winners among the sectors include Utilities, Energy, and Basic Materials. One large factor at work, with respect to both the Utilities and Basic Materials sectors, is the emergence of private equity fund buyouts. The pending takeover of *TXU* by a group of private investors, and rumors that leading companies such as *Dow Chemical* and *U.S. Steel* could be acquired have lifted stocks in those groups.

The rise of private equity firms as a force has effected stock market performance. Buyout firms look for companies with strong cash flow that are trading at comparatively inexpensive valuations. That has allowed so-called value stocks to stay in favor for an extended period of time. Given the sizable warchests of the private equity firms, value stocks could enjoy support a while longer.

Energy stocks also made a comeback. Cold late-winter temperatures cut into heating oil and natural gas inventories, and tensions with Iran lifted oil prices.

Timeliness Ranks

As shown in the table below, Technology remains top-ranked for Timeliness among the sectors. Positive factors for Technology include the trend toward automation to improve productivity, and greater equipment needs on the part of customers as employment rolls rise. The advent of a replacement cycle with the arrival Microsoft's Vista operating system is another plus. The worry is that a slowing economy will negate these advantages.

VALUE LINE SECTOR RANKINGS

Sector	Rank 4/6/07	Rank 1/26/07
Technology	1	1
Basic Materials	2	2
Healthcare	3	4
Industrial	4	3
Telecommunications	5	5
Consumer Cyclical	6	7
Consumer Staples	7	9
Financial	8	6
Energy	9	8
Utilities	10	10

SECTOR INVESTING

To implement a "sector approach" to investing, do the following:

1. Select the three or four sectors that are most attractive from the above table.

2. Select the most attractive industries within the sectors. Our sector groups are shown on the facing page. Industry Timeliness ranks may be found in the tables on the front cover, or on page 24 of the *Summary & Index.*

3. Select one or two of the most attractive stocks within those industries. The table called "Timely Stocks in Timely Industries" on page 25 of the *Summary & Index* is a good starting place.

The major mover on the upside is the Consumer Staples sector, which advanced two ranks, to seventh place for Timeliness, partly since the group is considered a safe haven during times of market turmoil. On the downside, the Financial sector took it on the chin, falling two spots, to eighth place for Timeliness as subprime mortgage woes arose.

Price-Earnings Ratios

Most of the sector price to earnings ratios are trading within the boundaries set over the past five years (see table nearby), although valuations in the Utilities and Consumer Staples sectors have broken out to the upside, given greater takeover possibilities. P-E ratios were higher in the 2002-2003 timeframe, when Corporate America was coming out of a profit slump, but have since normalized. The Energy sector is an exception, as that group is now trading at a much lower P-E. The rise in oil prices has allowed the stocks of many Energy companies to realize a considerable amount of their potential from five years earlier.

Sector	Current P-E Ratio	5-Year Range
Technology	23.9	22.0-35.4
Telecom.	23.2	20.3-32.6
Healthcare	22.5	20.0-23.1
Consumer Staples	19.5	16.5-19.5
Consumer Cyclical	19.4	16.6-20.0
Basic Materials	18.5	15.9-24.5
Industrial	17.9	17.3-20.9
Utilities	17.7	12.3-17.7
Financial	14.9	13.6-16.0
Energy	14.3	11.7-20.4

Volatility Measures

Our final table this week compares the standard deviation (a measure of dispersion) of the sector P-E ratios and Value Line's Safety ranks, by sector. In this case, the sectors are ranked from one (least volatile or highest relative Safety) to 10 (most volatile). There is a good correlation at the top and bottom of the lists, but variation in the middle.

Rank	Std Dev Sector P-E	Value Line Safety Ranks
1	Finance	Utilities
2	Consumer Cyclical	Finance
3	Consumer Staples	Consumer Staples
4	Healthcare	Energy
5	Industrial	Basic Materials
6	Utilities	Consumer Cyclical
7	Energy	Healthcare
8	Basic Materials	Industrial
9	Telecom.	Telecom.
10	Technology	Technology

Part of the variation can be explained by company size. The Energy sector contains a number of large, financially strong companies that add stability to the group. We've also noted that takeover possibilities have affected shares and added volatility in the Utilities and Basic Materials sectors. In any event, investors should be prepared for the ups and downs of the stock market, and use periodic dips to their advantage.

Robert Mitkowski, Jr.
Associate Research Director

SECTOR GROUPS
BY INDUSTRY

BASIC MATERIALS
Chemical (Basic)
Chemical (Diversified)
Chemical (Specialty)
Metal & Mining (Div.)
Paper & Forest Products
Precious Metals
Steel (General)
Steel (Integrated)

FINANCIAL
Bank
Bank (Canadian)
Bank (Midwest)
Financial Svcs (Div.)
Insurance (Life)
Insurance (Prop/Casualty)
Investment Co.
Investment Co. (Foreign)
R.E.I.T.
Securities Brokerage
Thrift

TECHNOLOGY
Computer & Peripherals
Computer Software & Svcs
E-Commerce
Internet
Semiconductor
Semiconductor (Cap Equip)

CONSUMER-CYCLICAL
Advertising
Apparel
Auto Parts
Auto & Truck
Cable TV
Educational Services
Entertainment
Entertainment Technology
Foreign Electron/Entertn
Furniture/Home Furnishings
Home Appliance
Homebuilding
Hotel/Gaming
Manuf Housing/Rec Veh
Newspaper
Publishing
Recreation
Restaurant
Retail Automotive
Retail Building Supply
Retail (Special Lines)
Retail Store
Shoe

TELECOMMUNICATIONS
Telecom Equipment
Telecom Services
Wireless Networking

CONSUMER STAPLES
Beverage (Alcoholic)
Beverage (Soft Drink)
Food Processing
Food Wholesalers
Grocery
Household Products
Tobacco
Toiletries/Cosmetics

HEALTHCARE
Biotechnology
Drug
Health Info Services
Medical Services
Medical Supplies
Pharmacy Services

UTILITIES
Electric Utility (Central)
Electric Utility (East)
Electric Utility (West)
Natural Gas (Distrib)
Water Utility

ENERGY
Canadian Energy
Coal
Natural Gas (Diversified)
Oilfield Services/Equip
Petroleum (Integrated)
Petroleum (Producing)

INDUSTRIAL
Aerospace/Defense
Air Transport
Building Materials
Cement & Aggregates
Diversified Co.
Electrical Equipment
Electronics
Environmental
Human Resources
Industrial Services
Information Services
Machinery
Maritime
Metal Fabricating
Office Equip & Supplies
Packaging & Container
Power
Precision Instrument
Railroad
Trucking/Trans Leasing

My Dashboards

This dashboard is public and published at: http://www.manifestinvesting.com/dashboard/7596

Dashboard: EFT Sector Radar													Date: 05/09/2007
Company	**Symbol**	**Shares**	**Price**	**Value**	**% of Total**	**Growth**	**Proj P/E**	**Proj Yield**	**Fin Str**	**EPS Stab**	**Qlty**	**PAR**
Vipers Vanguard Technology	VGT		$56.46	$0	0.0%	11.4%	23.3	0.6%	81%	59%	**67.3**	12.8%
Vipers Vanguard Discretionary	VCR		$63.33	$0	0.0%	6.9%	20.3	1.1%	68%	68%	62.0	11.3%
Vipers Vanguard Financials	VFH		$66.67	$0	0.0%	9.1%	14.5	2.4%	80%	73%	63.5	10.8%
Vipers Vanguard Industrials	VIS		$71.47	$0	0.0%	6.5%	17.7	1.6%	85%	79%	**70.0**	10.8%
Vipers Vanguard Telecomm	VOX		$80.06	$0	0.0%	5.5%	34.5	1.1%	43%	47%	53.0	9.9%
Vipers Vanguard Staples	VDC		$67.67	$0	0.0%	6.2%	18.8	1.9%	85%	89%	**74.4**	9.7%
Vipers Vanguard Healthcare	VHT		$62.40	$0	0.0%	6.6%	18.8	1.5%	88%	81%	**67.7**	8.7%
Vipers Vanguard Materials	VAW		$82.55	$0	0.0%	4.3%	16.7	1.8%	63%	53%	53.5	6.5%
Vipers Vanguard Energy	VDE		$94.90	$0	0.0%	4.7%	14.6	1.6%	81%	41%	58.4	5.4%
Vipers Vanguard Utilities	VPU		$88.38	$0	0.0%	4.9%	14.0	3.5%	65%	69%	64.3	3.2%
Totals & Averages				$0		0.0%	0.0	0.0%	0%	0%	0.0	0.0%

Portfolio Averages	
PAR	0.0%
Quality	0.0
Growth	0.0%
Average P/E Ratio	0.0
Average Yield	0.0%
Financial Strength	0
EPS Stability	0

Quality Legend:	
Blue	Excellent with quality greater than 65.
Green	Good with quality between 55 and 65.
Neutral	Average or below average with quality between 35 and 55.
Red	Poor with quality less than 35.
PAR Legend:	
Green	PAR is within the target range of MIPAR +5-10%, currently 13.8-18.8%.
Yellow	PAR is above the target range of MIPAR +10%, currently 18.8%.
PAR	Projected Annual Return
MIPAR	The Manifest Investing Median PAR of all stocks in the database.
MIPAR	8.8%
*	Company is not covered by Value Line Standard Edition.

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