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Ebbs and Flows of Stock Sectors' Popularity

We all know that the popularity of different industry sectors with investors varies considerably over time. But few people realize how wide the swings in popularity are, so most investors miss the warning signals of excessive enthusiasm and the appealing signals of undue pessimism as prices move to extremes.

These shifts can best be measured by tracking the weighting of industry sectors in the Standard & Poor's 500. That index is calculated by adding up the total market value of all the shares outstanding for each of the five hundred companies. Thus, when the stock prices of a particular industry group rise rapidly, as technology issues did in the late 1990s, its weighting in the index increases – and vice versa when prices turn down.

The latest example of this, to which I referred last February (*Binge Spending and Binge Borrowing*), was financial stocks. Here's how their weighting has fluctuated over the past 27 years:

Financial Stocks as % of S&P 500

1981	5.7%
1997	16.4
1999	13.2
2006	22.5
2008	17.4

Back in 1981 bank and insurance stocks were in the investment backwater – nice, solid companies, but not growing very fast and really quite boring. Then, as borrowing by businesses, consumers, and governments began to mushroom in the 1990s and many new financial instruments were developed, and as investment banks converted from private partnerships to publicly traded companies, financial companies' earnings soared. The stocks followed suit and after a temporary dip in 1999, they really took off, reaching by far the largest weighting in the S&P of any industry sector (four times their position 25 years earlier). Perhaps most surprising, they even outpaced the energy industry, which was in an unprecedented boom at the same time, with financials reaching a weighting an amazing 67% higher than energy.

But all good things come to an end. The culmination of greed, manifested in irresponsible lending to try and push profits ever higher, caused the massive loan losses that have dominated the headlines in the past twelve months. And, of course, financial stocks have fallen way back, losing one-quarter of their previously very large weighting in the S&P. Looking at the mountain of losses in the business, it's really surprising they haven't declined even more.

Going back in history, we reach the granddaddy of all stock boom-bust cycles: technology, almost a decade ago. That roller coaster looks really huge when we trace this industry's S&P weightings over a quarter century.

Technology Stocks as % of S&P 500

1983	13.5%
1991	5.5
2000	30.2
2006	15.1
2008	16.2

Over the years, there have been several big technology booms, all keyed to major waves of product development. In the industry's early years (the 1960s and 1970s) these included the advent of the transistor and the first practical mainframe computer, followed by the integrated circuit and the minicomputer. Then came the personal computer in the early 1980s, and the emergence of the Internet in the late 1990s. In between were fallow periods when not much happened and technology stocks fell significantly out of favor. In fact, I recall that in 1991 Merrill Lynch's technology analyst became so discouraged with his sector that he told me he was going to request a transfer to another industry. That was not a great call, coming just before technology entered the biggest boom of any industry in history. Fortunately, he thought better of his gloomy idea and did hang on.

Technology has become so essential to current business and consumer needs that even when it fell out of enthusiastic favor with investors in the early 2000s, it retained the second-largest weighting in the S&P 500 – albeit at only half the ridiculous peak reached eight years ago.

Looking further back, we find the third greatest industry overweighting in the S&P's long history: <u>energy</u>, in 1981. That was followed by the biggest fall from grace that's ever occurred for a market sector.

Energy Stocks as % of S&P 500

1981	22.4%
1999	4.9
2008	13.5

Ebbs and flows in energy stocks' popularity naturally follow fluctuations in oil prices, and they have been tremendous, always driven by shifts in the balance of supply and demand.

Back in the early 1970s the world was awash with oil and its price had been stuck between two and three dollars a barrel for 25 years. Then, as demand around the world continued to grow and political turmoil bubbled up in the Middle East, the Organization of Petroleum Exporting Countries (OPEC) tightened its members' production quotas to drive prices up. They succeeded with a vengeance. Oil prices began to rise rapidly, through the teens in the mid- to late-1970s and all the way up to $38 at the peak of the supply squeeze in 1980-81. This generated great earnings for oil companies. Exxon's net per share jumped 140% in 1980-81 and its stock soared 85%.

Then the political furor calmed down for a while and supplies continued to grow. This occurred mostly from new oil discoveries in non-OPEC countries, so the cartel lost its influence and over the next 18 years oil prices fell a startling 75%, to a brief low of $10 per barrel in 1999. The stocks followed in lockstep, losing 78% of their weighting in the S&P 500 by 1999 – the largest sector downswing in the history of the index.

The next change in this huge industry was caused by the rapid economic development of China and, on a lesser scale, other "emerging" countries, during the past decade. This produced large additional demand for oil; and as it became increasingly difficult to find new supplies, despite frenzied exploration, oil prices once again turned upward – ultimately soaring to over $130 per barrel at the end of May, 3.3 times the 1981 peak. Inevitably, oil stock prices skyrocketed (tripling in the past five years) and this sector is now up to the third-highest weighting in the S&P.

Other industries have experienced notable, but less spectacular, swings in weighting, because their earnings performance has been less volatile. Two are worth noting.

First is <u>health care.</u> For years this was a steady, rapid grower. So, as shown below, by 1991 it reached the fourth-highest weighting in the S&P, tied with energy.

Health Care Stocks as % of S&P 500

1985	6.8%
1991	11.2
1993	7.2
2001	14.4
2008	11.4

But while the pharmaceutical companies in the group were sailing serenely along then, the wife of the new President elected in 1990 established a "task force" to develop a comprehensive new health care program for the country. And when the plan was introduced in January 1992, it was based on widespread new government involvement and controls on all aspects of health care, including selection and pricing of prescription drugs. Quickly seen as a threat to the pharmaceutical firms, it drove their shares down 40% before Congress finally rejected the program as unworkable, a year later.

Then the drug industry resumed its introduction of profitable new drugs and rising earnings from them. In recent years, though, it has had difficulty developing innovative new pharmaceuticals to succeed older drugs going off patent, so earnings growth for some companies has decelerated. Part of the slack has been taken up by the strong growth of the medical devices market, but overall, the health care group has slipped in investor popularity. Thus, its weighting in the S&P has fallen three percentage points.

Finally, there is the <u>consumer staples</u> sector (household products, food, beverages, drug stores, etc.). Here the fluctuations in the S&P weightings have been fairly large for what are, by definition, quite stable businesses.

Consumer Staples as % of S&P 500

1981	10.6%
1991	17.8
2000	8.2
2008	10.5

Because consumer staples are a refuge of safety in poor economic times, their shares do particularly well in recessions – such as occurred in 1991. And they look uninspiring in times when rapid growth is taking place in more exciting businesses. This was clearly the case during the technology bubble that peaked in 2000. Currently, consumer staples are only moderately popular because some of the group's components, notably food companies, are experiencing profit margin pressure from sharply rising raw material costs.

The major ebbs and flows of stock popularity I've cited here are sometimes slow to develop, and at other times they happen quickly. But whatever their pace, they are important and should be watched closely. Driven by accelerating investor optimism or pessimism, they provide good buying opportunities at low points and risks of losing a lot of money at highs. Almost invariably, investors get sucked in at the peaks, or hang on too long up there, hoping for even more price appreciation, from stocks that are already overpriced.

Looking at the numbers I've shown, several useful conclusions stand out:

1) Whenever the weighting of an industry sector drops by one-half or more, those stocks are probably good buys.

2) Whenever the weighting doubles, the group has reached a dangerous price level.

3) *For certain*, when the weighting of a sector rises to exceed 20% of the S&P, it's time to strap on the parachute. The stocks may stay in the stratosphere for a while, but eventually they're sure to plummet, to prices well below those that temporarily boosted the group's S&P weighting over 20%.

This is a simple form of stock analysis, but like most types of simple, common sense, it has great validity. And you don't even need a computer or a Ph.D. in math to figure it out!

We are happy to be able to provide you with Ruminations. Please be aware that while Mr. Perry is a member of our Advisory Board, he is not an employee and his opinions are his own and not necessarily those of Marble Harbor Investment Counsel, LLC.

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