
CHAPTER 4

Which sectors to buy and
sell during the economic
cycle

'Draw a circle around those businesses you understand and then eliminate those that fail to qualify on the basis of value, good management and limited exposure to hard times'.

Warren Buffett

We now examine the competitive advantage of *individual* sectors, like beverages, rather than business models, such as moats and recurring revenue, that cut across *numerous* sectors, as discussed in chapter 2. We then discover which individual sectors to buy and sell during a typical economic cycle. The starting point is to consider UK and international competitive advantage.

UK competitive advantage

The UK initially secured international competitive advantage with the advent of its industrial revolution in the nineteenth century. This gave it first mover advantage but this waned when the rest of the world industrialised and began to catch up on the UK's first mover advantage. Other factors which strengthened its competitive advantage included language, geographical position, natural temperament of the population, reputation, history and perceptions of value.

Today, the UK's international competitive advantage is in various sectors that tend to dominate the top of the FTSE 100. They score highly in the table that follows and are beverages, pharmaceuticals and health, tobacco, food and drug retailing, oil and gas, and banks. These are followed by food producers, utilities, aerospace and defence, and life insurance. This does not mean that these sectors are attractive at all times, or that each company therein is attractive. Gems can be discovered in unattractive sectors. However, it is a useful reminder of where the competitive advantage lies and which have long-term potential. Those sectors that lack power have a low score in the table below and, unsurprisingly, include chemicals, electronics, electrical and engineering.

International competitive advantage and 'Wal-Martisation'

'While you're negotiating for a 35 hour week, remember that they have only just got 66 hours in Taiwan and you're competing with Taiwan.'

Victor Kiam, of 'I liked the shaver so much I bought the company' fame.

Asia is fast becoming the powerhouse of the world. This megatrend can be expected to last for decades and will probably intensify. From an economic point of view, the West and Asia will benefit if each specialises in those activities

where it has competitive advantage and trades goods and services with other countries where it does not. China and its billion people on low wages have a powerful competitive advantage in manufacturing, not only in low cost but, increasingly, in quality too. Southern China has reached the stage of development where costs have risen and production is shifting to the north, where they are still low. Japan has competitive advantage in high-quality goods, such as consumer electronics and cars, although its manufacturing heart is being hollowed out as production shifts to low-cost countries.

Companies that can transfer production to low-cost countries have little choice but to do so or they will be beaten by the competition. If the value created can be captured by the sector, then profits will benefit accordingly. If however, they are frittered away in ruthless competition then the consumer will benefit but this may, nevertheless, increase overall demand and perhaps provide critical mass. Some sectors are unable to benefit from this megatrend and they include general retailers, transport and oil.

Intense international competition has meant that the fat in businesses is not just being cut out but is being fried out in a pan. This reflects the megatrend towards the ‘Wal-Martisation’ of the world. Price is increasingly the main, if not the only, matter that counts in selling goods. Wal-Mart piles them high and sells them cheap, as evidenced by sales that have reached \$1 billion in a single day. Increasingly, if the correct price point is hit then customers ring the phone off the hook. Miss that price point by just a shade and the phone is silent. The internet has aided and abetted this extreme price consciousness.

Another megatrend is the dumbing down of jobs that take out the skill with easy to learn and powerful personal computers. There is great demand for cheap and cheerful bodies but much less demand for expensive middle and senior managers. This has thinned the ranks of the prosperous middle classes that spent freely and those that catered for them have seen business suffer, for instance expensive, four-star hotels in Austrian ski resorts. The cheap and cheerful chalets down the road that manage to produce a Wal-Mart type product that hits the price point remain packed. Therefore, it is increasingly important to differentiate products that add real value to the customer in order to achieve premium pricing. The alternative is to be in the Wal-Mart business with an ultra-low cost base and a very keen sense of capturing market share on a continuing basis that keeps the competition at bay. This is a difficult job to do indefinitely without hiccups. There is, however, little middle ground.

There will be a place for niche producers in the West for the likes of up-market

car manufacturers, such as BMW, that have immense image and prestige. However, the long-term outlook for manufacturing is bleak. It has been shrinking faster in the UK than Germany, France and the US since 1997. It has fallen from 21% of GDP to 17%. Services, for example leisure, are difficult to import and are largely immune from overseas competition. In some sectors, like telecommunications, banking, software and engineering consultancy, the back office and call centres can be transferred to low-cost countries.

Which sectors to buy and sell during the economic cycle

The economic cycle of opportunity table, which follows, starts with the asset class to hold over the cycle, namely cash, bonds, shares and property, and this was discussed in chapter 3. Each sector is scored for its recession resistance and competitive advantage. The annual profit growth over the last five years and the profit margin is also specified.

There is a time to buy and sell various sectors, as illustrated in the table. Non-cyclical sectors are: beverages; food producers and processors; pharmaceuticals; health and personal care; tobacco; food and drug retailers; telecommunications; and utilities. They should ideally be bought in the third year of the cycle when share prices are depressed but demand for these goods is robust, as they are needed in good and bad times. Consequently, they tend to have strong recession resistance. They can then be held until near the end of the cycle and sold around year nine. Alternatively, they are candidates for holding if an investor decides to have an exposure to shares regardless of the cycle, as explained in chapter 3.

Cyclical sectors are resources, basic industries, general industrials, cyclical consumer goods, cyclical services, information technology and financials, which includes real estate. They should be bought later than non cyclical in year five when their prices are rock bottom. Share prices then begin to increase, as the market will anticipate the end of the recession by approximately nine months. Demand will recover and will boost profits enormously. These sectors are sold earlier than non cyclical sectors, in around year eight. An investor will then be partly or fully out of the market before it begins to discount the top of the cycle when it will de-rate these recession-prone sectors harshly.

Note that the sector headings and order correspond to the FTSE Actuaries Share Indices classification for ease of reference, as this details performance, dividend yield and cover, PER and total return in summary form. This classification is also used to group all of the individual shares into sectors. Both are listed daily in the Financial Times. Thus, an investor can track sectors that are of interest and then

drill down to see individual shares in that sector from a quick perusal of the paper.

There are likely to be shares that will do well in any sector and a stock picker will focus on these, rather than be swayed by sector moves. However, the job is made harder without a reasonable sector tailwind. Note that this chapter analyses each individual sector and thus complements chapter 2, as that examination of competitive advantage cuts across numerous sectors. For example, sector consolidation discussed in chapter 2 applies to banks, pharmaceuticals and oil. Each of these sectors is assessed below individually to see what competitive advantage they possess.

The economic cycle of opportunity table, overleaf, scores the recession resistance and competitive advantage of each sector over a typical ten-year economic cycle. Although these scores are subjective, they should provide a reasonable guide. The competitive advantage points are awarded in the same manner as for sector business models in chapter 2, namely the power of the sector to achieve low cost and/or differentiate itself so that it adds value. Above all, it is crucial to be able to control revenues streams.

We now look at each of the sectors in detail. The score for recession resistance and competitive advantage is 1 for highest and 5 for lowest, with an average of 3. Note that this does not score them as attractive sectors on valuation or technical analysis grounds since these change daily. The sector's capitalisation as a percentage of the UK stock market at the end of 2004 is also shown. This is also the date used for the profit and growth margins in the table.

4a. Non cyclical consumer goods

Beverages: recession resistance 2, competitive advantage 1.
Percentage of stock market capitalisation 3%.

'Diageo. Based on the Latin word for day and the Greek word for world. Diageo captures what this business is all about – bringing pleasure to consumers every day around the world.'

The logic behind the new name for the merged Guinness and Grand Metropolitan.

Beverages is an attractive sector as it offers defensive growth. It is essentially a tried and tested, simple business, although changing tastes and fashion are important factors. There has been consolidation amongst the players, as economies of scale are significant so that products achieve critical mass, for example, in distribution networks.

Its resistance to recession is above average because beverages are low-ticket items and there is high compulsion to consume. People are reluctant to give up their tittle when they need cheering up in hard times. However, there will be some fall-off in demand and trading down to cheaper brands when consumers are forced to tighten their belts.

The sector has high international competitive advantage, driven by the power of leading brands, heavy advertising and global reach. This enables its claim on disposable income to remain steadfast. However, it is not all plain sailing as the market is mature and there is tough competition from overseas brands, as well as from supermarkets' own label drinks. Although the sector does supply own label, the margins tend to be lower. Other downsides include heavy 'sin' taxes and a trend towards a healthy lifestyle. Overseas developing markets are attractive as incomes rise and consumers can start to afford such high status products. Please also see leisure and hotels below.

The profit growth of the sector over the last five years was 6% per annum, compared to 9% for the stock market as a whole, and the 19% profit margin is above the stock market's 15%. The dominant player is the peculiarly named Diageo, with Allied Domecq a long way behind. Diageo is a gorilla and the world's number one seller of spirits with long-proven brands like Johnnie Walker, Smirnoff and Guinness. Market segments have been established with new products like alcopops. This has driven growth, although demand can be fickle and some new launches have failed. Both Diageo and Allied Domecq are exposed to US dollar weakness. The temptation for the gorillas has been to diversify to boost profit. This has resulted in mountainous goodwill and expensive failures, such as Diageo with Burger King and Scottish & Newcastle with Center Parc. The key, then, is to buy when the sector is cheap, as the share price will more likely be driven by a re-rating rather than profit growth. The niche players lack powerful brands and have less competitive advantage than the gorillas.

Food producers and processors: recession resistance 1, competitive advantage 2. Percentage of stock market capitalisation 2%.

Like beverages, food producers and processors is an attractive, defensive sector. It is a stable but mature market, with sales stimulated by flair and new product launches.

Demand is robust in a recession because the products are staples of life and are low-ticket items. Brands are important to achieve premium pricing and strong product differentiation, established over many years through reputation, value for money and advertising. Supermarkets' own brands are a threat and supplying this market has to be at keen prices and top quality. This is a tough space to occupy, as Northern Foods has found.

It has above average competitive advantage overall and is dominated by gorillas like Unilever and Cadbury Schweppes, which have significant economies of scale after extensive takeover activity but has resulted in high levels of goodwill. Nevertheless, there is strong competition from overseas giants like Nestlé, which also has been acquisitive. Generally, the space to occupy is selling the brand to the consumer and capturing that value, like Cadbury Schweppes, rather than being squeezed into producing commodity products like sandwiches and milk for supermarkets, like Geest and Dairy Crest. Such minor players struggle to pass on higher input costs to powerful supermarkets and have to resort to cost cutting. Nevertheless, gorillas can struggle in this regard too and Unilever has embarked

on an expensive, five-year restructuring programme to reduce the ‘noise’ of having too many brands and to focus on the most promising 400. Likewise, Cadbury Schweppes has announced a somewhat similar restructuring programme. In such cases, share performance can be at the mercy of meeting restructuring targets.

The profit growth over the last five years was 10% per annum and the margin is 13%, which are both similar to the stock market as a whole. Niche players like Richmond Foods and Inter Link Foods have sound business models, in spite of supplying to powerful supermarkets, are growing fast and are more attractive than the gorillas. They both have low costs and differentiated products, with Richmond’s Nestlé brands and Inter Link’s customer relationships and new lines. Both have avoided the trap of being overly reliant on too few customers.

Pharmaceuticals, health, personal care: recession resistance 1, competitive advantage 1. Percentage of stock market capitalisation 9%.

‘What good is health? You can’t buy money with it.’

Charlie Munger, Vice President of Berkshire Hathaway.

Pharmaceuticals, health and personal care is the first of only three sectors to earn the maximum score for recession resistance and competitive advantage. The sector was riding high in the mid-1990s to the end of the decade, as the market was growing, new blockbuster drugs were launched, prices were increasing and regulatory approval times were falling. This led to overvaluations based on the lure of defensive growth. This optimism then hit the realism of a high cost base, few new drugs and a weak pipeline, strong generic competition as important drugs came off patent, longer regulatory approval times, worsening economic conditions and opposition to prices from government and healthcare bodies. Visibility of earnings dropped sharply and emphasised the high operating risk. The next few years offer little respite from these problems so an investor should be wary in spite of the strong recession resistance and competitive advantage.

The strong recession resistance reflects the fact that drugs are ‘must-have’ products, are low-ticket items and typically free or subsidised for the end user. Therefore, demand and growth are never ending. Demographics favour the business, as the population is ageing, and drugs are much cheaper than hospital stays. It rides the tailwind of governments spending more on health and this is a

main objective in some cases, such as in the UK. However, various health reforms over the years have played their part in holding down the cost of drugs. Personal care includes household products and the gorilla Reckitt Benckiser dominates this sub sector. It has an impressive list of brands, like Dettol, that helped to increase margins in this very defensive play. Warren Buffett likes this sort of company because it has a strong consumer franchise and is similar in this regard to Gillette, in which he has a large holding.

International competitive advantage is very good and the gorillas are GlaxoSmithKline, the fourth biggest UK company, and AstraZeneca. There has been significant consolidation to cut costs, an example being the £5 billion Amersham takeover, and the amount of goodwill on the balance sheets is significant. There are very high barriers to entry due to the massive economies of scale that are needed to fund the enormous research and development expenditure, trials and the long time it takes to bring a blockbuster to market. However, once this has been achieved, the company can enjoy that most wonderful of competitive advantages, a monopoly, for years and the super profits roll in. Eventually, the drug comes off patent, which lasts up to 20 years, and generic competition leads to price-cutting. It is a race, therefore, to bring out new products from a long pipeline more quickly than old ones lose patent protection and such a race has similarities to the oil sector. It is preferable to concentrate on a few blockbusters rather than be an average competitor in many products, as the development costs for each are comparable.

The profit growth over the last five years was 10% per annum, just above the market's 9%. The margin is an impressive 20%, five points above the overall stock market. Niche operators are more attractive than the gorillas, examples being Celsis, which provides contamination testing and Synergy Healthcare that offers sterilisation services.

Tobacco: recession resistance 1, competitive advantage 1.
Percentage of stock market capitalisation 2%.

'We'll all be jockeying for position in Playboy and Penthouse.'

RJ Reynolds, on new tobacco advertising bans.

Tobacco is the second sector to score maximum points on the recession resistance and competitive advantage yardsticks. It is a unique product as it is highly addictive and is the only legal product sold that can be lethal if used in the

manner intended. Advertising bans and smoking restrictions become ever tighter and tobacco is on the black list of ethical investors. The market is stable and there is no product obsolescence.

It is difficult to imagine a product that has a stronger resistance to recession. The addiction means that customers are hooked, so demand is extremely robust and insensitive to the high price charged. Although the developed world is a mature market, there is growth in the developing world, which feeds off rising living standards that increasingly enable such products to be bought. Young populations and per capita incomes are the most significant growth drivers.

It has very high international competitive advantage. This is a remarkable testament considering it is achieved by a commodity product where little value is added in production. It is strongly cash generative, creates value for shareholders and the cost of production is very low compared to the high selling price, which is mostly comprised of punitive taxation. There is an old saying: what other products are like tobacco that cost a penny to make and sell for a dollar? The high price encourages consumption by both legal and smuggled importing from low tax countries. Brands are important as consumers respond to status and health messages. The profitability of the sector has been undermined in the US due to price-cutting by generic brands. The PER is usually low and the yield generous, reflecting the dullish growth. The latter has been boosted by numerous takeovers and goodwill is material.

The profit growth over the last five years was 11% per annum, slightly above that of the market, but the profit margin is the highest at 28%. The strong cash flow encourages high, tax-efficient gearing. The risk of litigation is high and awards in the US are astronomical, from both the civil courts and the government, which aims to extract \$280 billion in a settlement with tobacco companies. Litigation news has a major bearing on sector share prices and can provide buying opportunities. Therefore, it is important to avoid British American Tobacco, as it has US exposure, whereas Gallaher and Imperial Tobacco do not. The latter two are smaller players and takeover potential is good. This is a very popular sector in a bear market but is ignored in a raging bull market, when high growth is the mantra, so sell in the former and buy in the latter. Profit warnings are rare, which is a major advantage.