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A New Approach to Outperforming the Market

VINCENT CATALANO, CFA

Sectors and Styles

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Acknowledgments

This book is as much about how I got to be where I am today as it is about what I do. The hard work involved with going out on my own and starting my own business after 25 years at Merrill Lynch has been a journey filled with joy and challenges. The joy was shared by many, and the challenges were overcome thanks to those whom I am proud to call friends and colleagues.

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VINCENT CATALANO

Contents

Introduction

WHY THIS BOOK? WHY NOW?

To paraphrase a good friend of mine in the public relations business, "Why this book? Why now?" It's a fair question to ask when you consider that there are so many investment-related books available, and some of them are quite good, even invaluable. So, yet another book about investing had better have something to contribute to the discussion. I believe this book does for several reasons.

A CONFLUENCE OF EVENTS

To begin, the timeliness and relevance of this book rest on the confluence of three key developments—two technological and one financial—that have emerged over the past two decades: the personal computer (PC), the Internet, and exchange-traded funds (ETFs). When these are combined with a solid understanding of sound valuation principles and an investment philosophy (a set of concepts and beliefs), an investor has the makings of an investment strategy that tilts investment decision making in an investor's favor. And, just as in real life, gaining competitive advantage almost always makes the difference between success and failure.

The first of the two recent developments, the personal computer and the Internet, are great enablers of information access and processing. The third, the exchange-traded fund, is an investment vehicle that allows investors of all means to engage in the construction of an effective portfolio—a portfolio built and maintained on the principle of diversification. Let's look at each development and see how they have made the world of investing so much more democratic *for all investors.*

THE PC AND THE NET

On so many levels, the personal computer and the Internet were made for each other. The PC is a device through which information captured can be analyzed and created for presentation. The Net is the communications platform over which information is transmitted. It is also the environment within which information is presented in the form of web sites and blogs. When it comes to investing, the combination enables just about any person who has the interest and a good grasp of sound investment principles to access the necessary information to analyze the economy, industries, companies, government, and the markets and, thereby, do quality original investment research.

Thanks to the PC and the Net, an investor has at his/her disposal the essential communications and analytical tools to capture that data and incorporate it into a financial and valuation model that forms the basis for a successful investment strategy. For example, the full text and not someone else's interpretation of an important government report or a speech by a business leader or politician can be easily accessed and downloaded for review and analysis. Whereas in the not too distant past access to this information and the ability to develop it into an investment strategy required special contacts and expensive research tools and services, today this is no longer the situation. Moreover, in most cases, the cost today is delightfully either zero or some modest amount that is very affordable to nearly every investor—certainly much more affordable than in the time before the PC and the Net.

As a result, the ability to capture useful economic and financial information, analyze it, and develop it into a well-thought-out investment strategy has been freed from the constraints of privilege and power. Therefore, I think it's fair to say that the Internet (combined with the PC) has lived up to its bubble-era reputation and changed just about everything.

CONVERTING INVESTMENT STRATEGY INTO AN EFFECTIVE PORTFOLIO

Yet, for all the good that is done by having this information and drawing worthwhile conclusions, an investor needs to convert the investment strategy outcome into a productive use of time. After all, investors are just that—investors. They are not analysts who are being compensated for rendering their advice to others. Rather, investors invest. That is to say, they create and manage portfolios for themselves and, in the case of portfolio managers, for others. Here, once again, the PC and the Internet lend their combined power to enable an investor to build and maintain an investment portfolio, thereby putting that knowledge to good investment use. Portfolio management tools are so readily available from various Internet services that managing one's assets has also been brought into the twenty-first century. And here, too, the costs are most attractive.

The third development that has emerged recently is an investment instrument that enables investors to build effective portfolios—exchange-traded funds (ETFs). ETFs allow an investor to make investment bets precisely in an economic area (economic sector) and in an investment style (by market cap, by growth, by value, and so on). When ETFs are combined with the power of the PC and the Net, investors now have the wherewithal to do what only investment professionals with large resources and large research budgets could do before—build effective portfolios.

Therefore, as a result of the power of the PC, the Net, and ETFs, today's investor, investment manager, and financial adviser can conduct quality research. Together with a solid understanding of valuation principles and an investment philosophy, an investor, investment manager, and financial adviser can then develop a well-thought-out investment strategy and construct and maintain effective portfolios.

Why this book? Why now? Because investing in the twenty-first century just got that much better for all investors.

WHO SHOULD USE THIS BOOK

No one book can be all things to all people. In the case of this book, that is certainly true. Although every investor should find value, this book is written primarily for the more active investor—someone who has a degree of knowledge as to how to analyze the economic and investment climate and how to construct and manage a portfolio. That does not mean that you have to be an analyst or portfolio manager to learn and apply the principles and processes in this book. But it does mean that I am assuming that the reader has some knowledge and, preferably, experience in investing so that a better perspective can be applied.

As for investor types who like to trade a lot, let me clearly state that this not a book for you—unless, of course, you wish to reconsider the need for action and replace it with a more consistent methodology for making money, not to mention the opportunity to live life less stressfully and with more knowledge and clarity on what makes stocks (and portfolios) go up and down.

I am fairly certain that serious investors, professional and nonprofessional, seeking to gain an edge will find their time well spent reading these chapters. Such a person is the audience for this book.

STRUCTURE OF THE BOOK

I have written this book in the same manner in which I teach my equity analysis classes, write my research reports, and conduct my various analyst society events:

- Concepts presented in a (hopefully) logical flow.
- Each point building upon the previous one.
- Constant references to the core concepts.
- Examples to illustrate a given point.
- Real-world situations to bring reality into the equation.
- A conversational style.

I also apply my "critical variable" principle to the information within. What matters most gets the most ink. This point warrants a further word.

The critical variable principle is my attempt to identify what matters most and devote the most time and energy on that point(s). This is especially necessary given the scale and scope of the topics discussed in each chapter. Specifically, the topics and even some of the subtopics discussed in every chapter are so large that entire textbooks are devoted to them. What I have done is distill each topic down to the critical variables that I have determined matter most. A reader may beg to differ with what I have chosen as the critical variables for a topic. But it is hard to argue with the fact that not every aspect of any topic is equally important. Therefore, judgment must be exercised. This is what you will find in every chapter—judgment as to what matters most.

As for completeness, every effort is made to provide the deepest understanding possible. To this end, I also provide information that helps round out the picture. Some of the information may not be central to the theme of a chapter but helps in broadening the context of a chapter and, thereby, making the chapter focus more clear.

CHECKMATE

The last point to be made is the distinctively real-time and real-world feel to the book. Examples and articles are taken from a variety of sources but all are framed in the context of today, for this book is written for those seriously interested in making investment decisions in a world dominated by change and uncertainty—the beginning decade of the twenty-first century. Moreover, given the dynamic change that the real and financial economies are undergoing, an investment book focused on the world we live in today should be more useful than a book about theoretical concepts. In other words, this a practical book written for practitioners and serious investors interested in developing their skills as managers of money. The book is rooted in timeless concepts and principles while at the same time it recognizes that there are many unresolved issues at work in the dynamic, interdependent, interconnected, interactive world of investing. It is a truly dynamic process with answers still be discovered and questions still be raised. It is, in effect, the ultimate chess game—only with live pieces.

With that said, here is the flow of the book:

Start with Valuation Principles

It is necessary to first understand what constitutes good investment principles. For one cannot analyze the real economy (economic environment, both domestic and global) and the financial economy (the financial markets) without first understanding where the analysis is relevant. Put differently, it is the context of the analysis that must be first understood so that the information and analysis can lead you to the useful tools.

Develop an Effective Investment Strategy

Moreover, it is especially relevant to place the analysis in a real-time context. Therefore, this is a book that seeks to combine the principles of sound investment analysis and asset management with contemporary events. The principles act as the foundation, while the contemporary events serve to illustrate the principles in action. The contemporary events of another time (past or future) would serve just as well to illustrate what works. However, thanks to key macro trends such as globalization and technology, the investing environment has changed sufficiently so that spending most of our time in the present-day era should serve our interests best.

As for the analytical process that I use, the approach focuses on government, economy, and the markets (GEM). GEM is a fairly in-depth exploration of the factors that impact government action and economic performance, and the markets' take on both. It is a rich and robust way to analyze all the important aspects of both the real economy (the G and E part) and the financial economy (M) so that our analysis and conclusions about what *should* happen are cross-checked with what *is* happening in the markets. I have found that GEM gives the best chance of getting the investment strategy right, especially the critical asset allocation decision.

Understand the Essential Elements of an Effective Portfolio

Investors invest. That is their purpose. To this end, the creation of an effective portfolio, a portfolio designed to meet an investor's needs, needs to be understood. We explore what goes into creating and maintaining a portfolio that is effective, that works to satisfy an investor's needs.

Give Thanks for the Useful Technological and Financial Tools

With our valuation principles and analytical process and what constitutes an effective portfolio in hand, the investment tools of the Internet and ETFs are then described. There is a great deal of attention given to the practical part of the process: What information web sites are necessary? What data about ETFs do we need to know? What web sites can we use to construct and manage our portfolios? The investment tools to use are the enablers of achieving the goal of building and maintaining an effective portfolio.

Put It All Together: Creating and Maintaining an Effective Portfolio

The final step is when we put it all together. The valuation principles, the investment philosophy, the investment strategy, the elements of an effective portfolio, and the tools that make it all happen culminate in a portfolio construction and maintenance process that results in an effective portfolio. The valuation principles provide the foundation upon which the dynamic aspects of the real and financial economy can be evaluated. The effective portfolio is the end result.

Like the inputs into the valuation model, putting it all together is conceptually easy but extremely difficult to do successfully. Each piece is interconnected to the other. And the failure to get one part of the puzzle right has more than a singular effect on the whole. There is no other way, though, to build and manage an effective portfolio to produce consistent results. Granted, there may be other investment strategy approaches used, but the overall comprehensive approach taken here ensures that all the important bases are touched, priorities are determined, and judgment is exercised. At a minimum, the reader will gain a deeper insight into the process of analysis, investment strategy, and portfolio management. And that is all to the good as it advances the reader's knowledge of sound investment principles. At its best, the reader will be on the path to successful asset management that will last a lifetime.

CHAPTER FORMAT

Most chapters in this book adhere to the following sequence, whether explicitly stated or not:

- For the most part, chapters begin with, in effect, a statement of purpose. This *overview* provides the context or framework of the chapter and sets the tone for what follows.
- The need to grasp the central principles is dealt with next. *Core concepts*, including concepts and principles, definitions, and descriptions are presented—a description of the core principles and practices at work, if you will.
- The economic and financial worlds are not issue-free, however. Established rules and traditions are constantly challenged, new concepts and methodologies emerge threatening the established order, and developments in seemingly unrelated areas that have an impact on the real and financial economy need to be discussed, if not understood, as they often play a role in the valuation model inputs, even if it is not apparent at first glance. Therefore, the *issues* section of a chapter is where the debate exists. Sometimes it is lively and profoundly meaningful and at other times peripheral but important.
- To help illustrate concepts and principles, *real-world examples* are presented in which events—current and past—are reviewed to help put the core concepts and issues into action. Most examples are from the recent past but some reach back over time. Whatever it takes to make clear the concepts and principles is used.
- Most chapters conclude with a summary section. Like the cuffs on a pair of pants, this section puts on the finishing touches by summarizing the key points just discussed and provides the logical sequence to the next chapter. It therefore also serves as a bridge, hopefully ensuring the natural flow of one thought to another.

Throughout the book, intrachapter examples, similar to the real-world examples presented at the end of a chapter, are used to help illustrate the core concepts and issues discussed. Tables and charts serve the same purpose.

A FEW CAVEATS

Here are a few warnings, or more correctly caveats, to bear in mind when reading this book.

This Is Not the Complete Book on Valuation and Equity Analysis

The valuation principles described in this book might lead some to believe that all that is needed to know about investment strategy and equity analysis is contained within. This is not the case, however. Granted, equity analysis is central to the valuation process and to understanding from a bottom-up perspective the investment strategy derived, both of which culminate in the asset allocation decision and portfolio construction and management. Therefore, valuation principles and equity analysis are closely linked. What is covered in this book in regard to valuation will help form the basis on which a reader can do decent equity analysis. But my advice is to then seek out other materials that will enable you to complete the complex process of analyzing companies and their stocks and to fill out your knowledge base. For while it is impossible to write a book about investing without touching upon key aspects of the valuation and equity analysis process, such as financial models, industry analysis, and competitive analysis, the in-depth analysis of companies and their stocks is not the purpose. How to make good sectors and styles investment decisions is.

Nor Is This the Complete Book on Portfolio Management

If constructing and maintaining an effective portfolio is a final goal of this book, then perhaps a reader might conclude that this is a complete exploration of portfolio management. As with equity analysis, this book takes the reader into important areas that lead to the construction and management of effective portfolios but it cannot and does not cover in detail and in depth the myriad of other approaches and styles one could incorporate using the principles, tools, and process described.

Having said that, let me be clear on one point: In both cases—equity analysis and portfolio management—this book provides an important foundation upon which good investment strategy can be developed and practiced. A reader could take what is contained in these pages and put it to good use. But investing is more like a movie than a snapshot. Things change over time. New methodologies will emerge, existing methodologies will evolve, and the timeless principles described in these pages will find new applications. Moreover, the breadth and depth of both equity analysis and portfolio management can and should be explored. For example, an investor could never gain too deep an insight into the impacts of corporate strategy on the competitive advantage principles of Michael Porter's Five Forces and Three Generic Strategies. Nor could an investor understand too deeply the geopolitical circumstances of globalization.

My advice: Take the principles and process in this book and add as much useful depth and breadth to them as you can, and you will be a better investor.

And This Book Is Most Definitely Not about Financial Planning

The discussion of equity analysis and portfolio management does not reach the point of financial planning. Personal finance and financial planning are valuable processes, and all investors should spend time and energy engaged in them. Life planning decisions such as retirement planning, asset and income protection policies (life insurance, long-term care, etc.), and other obligations and needs are the domain of the financial planning and financial adviser expert. Portfolio management is the tool, the instrument through which personal finance goals are satisfied. That is what this book attempts to assist in. For all other personal financial matters, you will have to read another good book.

COMMENTS

With the principles and process expressed in this book, there is no hiding behind the argument that you were right about the sector but wrong about the individual stocks you bought or sold or sold short. Those days are over. With ETFs, the principles of diversification and choice guarantee that an investor will participate in the correct strategy and sector bets made. As for the investment strategy you might use, you don't have to use the investment strategy described—GEM—to reap the benefits of this book. For most readers, the process undertaken in its comprehensiveness will provide ample valuable information. Obviously, I believe in the approach. Perhaps, however, there is another investment strategy approach you prefer. That is just fine. In fact, just about any well-grounded investment strategy approach that works can take advantage of the technological and financial innovations of the past two decades.

There is a related issue that warrants further comment. It has to do with the underlying assumption that following the principles espoused in this book will result in better investment performance. In fact, just about every book written about investments has this underlying theme to it—read this book, practice its principles and processes, and you stand a better chance of generating better investment results than you would have otherwise. A few comments on this line of thinking.

First and foremost, I wrote this book in the same spirit as I conduct my classes and events: to make sure that the buyer feels that he/she got his/her money's worth. To this end, the very least that I can do is increase a reader's investment knowledge, with the assumption being that a more knowledgeable investor should be a better investor. This is my minimum goal: to increase your knowledge base on what constitutes good investment principles and practices. With that knowledge, the odds increase that your investment results should be better than they would have been otherwise *and* the results should be due more to skill and less to luck.

The second point I wish to make has to do with your point of departure. Better performance results depend on what your present approach to investing is, how successful have you been, and, if you have been a successful investor,[1] how consistent those results have been, and what are the true causes of that success. In other words, was success due to skill or luck?

Therefore, this book seeks to achieve:

- An understanding of good investment principles and processes.
- A methodology by which an investor can achieve alpha (returns in excess of the returns he/she would have received investing in an index fund, adjusted for the degree of portfolio risk taken and based on the risk tolerance of the investor).

The principles are timeless. The tools (ETFs, the PC, and the Net) are fairly recent innovations. The combination will empower investors as never before.

Speaking of innovation, let me conclude by noting that this book is as much about *innovation* as it is about the principles and process of good investment management. Take a good look at what is contained within the following pages and you will note that there is nothing that has actually been *invented*, but a whole lot has certainly been *innovated*. By taking advantage of the innovations of past decades, adhering to sound investment principles, and applying well-thought-out investment strategies, investors will be able to construct effective portfolios for the benefit of themselves or, in the case of financial professionals, their clients. It is in that spirit that I encourage you to view this book—as both a guide to making money consistently and an example of what a little innovative thinking can do. Now, what can you innovate with what you will learn on the following pages?