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It's the Trees, not the Forest!

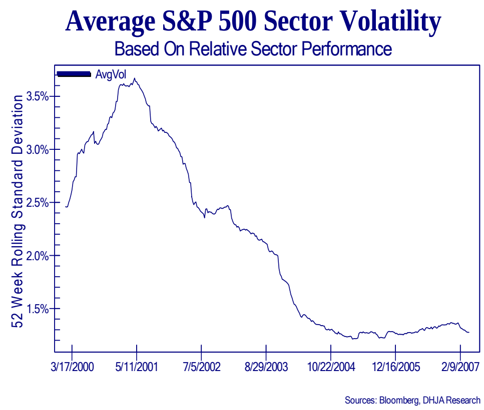
A common question asked of money managers is "What sectors are you overweight or underweight versus your benchmark?" The term sector refers to the various pieces of the economy, such as utilities or energy. But if you think about it, how sectors are defined is a rather arbitrary process. Stocks driven by capital spending could be grouped into one sector or divided into two sectors, one related to industrial spending and one related to technology spending. Even individual companies can be classified in different ways. For example, a company that provides software systems to healthcare institutions could be classified as either Healthcare or Technology.

Thus it is not surprising that various classification systems have been devised to categorize stocks into sectors. Standard & Poor's, the most widely used source, divides stocks into ten economic sectors, which are then further divided into industry groups. Although the major economic sectors are widely known, many people are surprised at how many industry groups are contained in each sector. Healthcare, for example, is divided into ten industry groups, including managed care, pharmaceuticals and life sciences.

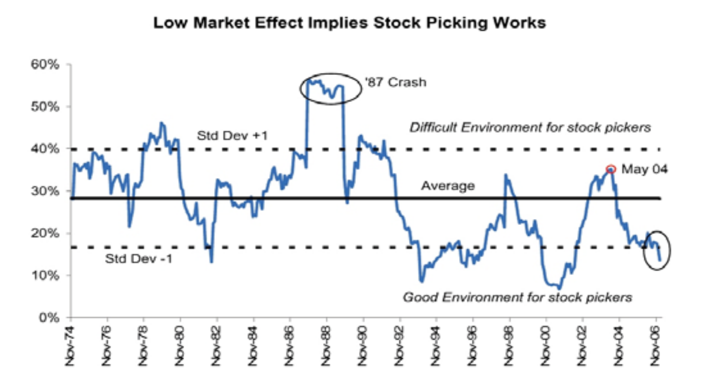
Historically, sector performance has followed economic cycles. When interest rates fall, the economy starts to accelerate, beginning with the consumer. Interest-sensitive financials and consumer discretionary stocks are the first to move. Spending by consumers causes businesses to expand. Initially, this may mean hiring more people, upgrading technology, and improving existing facilities. As we move further into the business cycle, further expansion may require adding new technologies and building new facilities. Thus technology stocks should do better in the middle of the economic cycle and industrials should do better late in the cycle. As the economy slows, sectors not as sensitive to the economy, such as Consumer Staples and Healthcare, should outperform. A traditional approach to managing a portfolio is to analyze where we are in the economic cycle and use that assessment to decide what sectors to emphasize. Sectors are overweighted or underweighted versus a benchmark, such as the S & P 500 Index, according to one's views on the economy, taking into account other factors such as valuation.

However, this approach has become increasingly difficult to execute. First, there has been a lack of significant macro change in the economy over the last few years. We have been in a strong upcycle exacerbated by global growth and emerging markets for some time. In fact, sector volatility has declined markedly since 2001, as shown in the first graph, reducing the opportunity for sector rotation based on the economic cycle.

In addition, the dominance of hedge funds and ETF's has significantly boosted short term trading, so that any actual or perceived shifts in the economy are quickly discounted.



In contrast to the decline in sector volatility, the dispersion of returns within a sector has increased, as the graph below from Morgan Stanley illustrates. This means that getting the individual stocks right is more important than getting the sector right.



Source: Morgan Stanley Quantitative Research
Note: Market Effect is the median R-square of 24 month rolling regression between stock returns and market returns. Universe S&P 500. Data as of 1/31/2007

One conclusion may be to focus more on stocks rather than sectors. Our investment process does just that. We target companies that are experiencing above-average or accelerating growth that we believe can exceed expectations over time. While we consider macro variables, we are more interested in how these factors affect individual companies, using diversification guidelines to control risk. The result is that rather than a broad, top-down call, our sector weights relative to the benchmark are primarily bottom-up driven and based on the compelling investment prospects that we identify within a given sector.

With all of our market factors at neutral readings, we continue to expect some consolidation in the market near-term, but remain constructive for the balance of the year, particularly for high quality growth companies with strong earnings fundamentals.

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Managing Partner
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A copy of our Form ADV, Part II is available upon request.
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