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Tom Lydon

FOLLOWING EFFECTIVE TRENDS IN SECTOR INVESTING

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Following Effective Trends in Sector Investing

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There are now so many sectors available to you as an investor, and the market has been sliced and diced to give you more choice and opportunity than ever before. Some have been critics of the level of slicing and dicing, but when investors have choices and options, it keeps competition healthy. And today's technology has given us the tools we need to do the proper research and watch trends develop in real time.

Check under the broad market umbrella, and you'll find literally thousands of subsectors with trends (and minds) of their own. Maybe the Dow is down, but healthcare, or even more specifically, medical devices, might be riding a huge bull wave.

Trends in subsectors can run contrary to the broader market. In other words, you could stand to make money instead of lose it in down markets or make a whole lot more money in up markets by investing in subsector trends.

These subsectors provide huge profit opportunities regardless of the broad market climate. I'm talking about opportunities in every nook and cranny of the markets—emerging countries, economic powerhouses, commodities, currencies, semiconductors, utilities, telecommunications, transportation, and a whole lot more.

A number of sectors make up the U.S. economy, including aerospace and defense, transportation, media, healthcare, utilities, finance, and engineering. Investors who want to drill down even further can get into subsectors, such as regional banks, biotechnology, airlines, pharmaceuticals, water, and more. Opportunities to get into sectors abound, and many operate independently of one another. For example, healthcare and transportation are marching to the beat of their own drummers. If one sector is transitioning out of an uptrend, you can no doubt find another sector just entering into one.

With Exchange Traded Funds (ETFs), investors can access all of these areas. It's just a matter of how specialized you want to get. Accessing a broad sector, such as utilities, will deliver a little more stability. But if you choose to invest in wind technologies, you might see more drastic movements.

One issue that often comes up when discussing sectors is that of cyclical investing. This often involves identifying companies or sectors that tend to do well in certain periods of the markets. Automobile companies, steel, and fine dining are types of companies that tend to follow in lockstep with the broader economy. As the economy booms, the auto and restaurant industries tend to be beneficiaries. On the downside, this can make them vulnerable in recessionary periods.

Some investors might experience success with cyclical investing, and while there are merits to it, I feel that trend following is a better way to capture these movements because it doesn't involve predicting market upswings (or downswings). As you have probably often seen, the market isn't always perfectly predictable, which is why listening to the messages that it's sending will benefit you more in the long run than trying to guess what it's going to tell you ahead of time.

In the past two decades, one of the most exciting sectors in the world has been technology. Many Americans today have watched the computer evolve from a massive machine that took up an entire room to something they can fit in their pockets. Millions of people around the world want information right at their fingertips, and companies are positioned to create billions' worth of value.

But this growth hasn't come without some hiccups and volatility, as people figure out what this industry means to them and the world. As an example, we need to look no further than the 1990s.

Technology: High Highs and Lower Lows

The U.S. military created the Internet decades before "dotcom" became a household name. It vastly underestimated the numbers and enthusiasm of people wanting to go online. By 1995, the Internet caught on like wildfire, with an estimated 18 million users. Soon speculators were barely able to control their excitement over this new economy: The Internet seemed like one technology that wouldn't be disappearing anytime soon. No wonder everyone believed it was a "can't lose" bet.

Technology became the sexiest and most profitable investment game in town. You couldn't swing a stick without hearing about some kid who had millions in stock options at his hot new tech job. At the height of the bubble, a new IT company could raise significant amounts of money through its initial public offering (IPO), even though its coffers had run dry or, in some instances, had never made a penny.

Investors wanted to believe that they could be making all that money, too. They stepped into the market, ignored the state of companies' balance sheets, and bought stocks on the promise of growing demand for IT products and future profits. Although "fundamentals" aren't the be-all end-all, they shouldn't be disregarded, either. This kind of information about tech companies could have kept investors on guard for a fall.

Greed soon kicked in. Early in the frenzy, in December 1996, former Fed chairman Alan Greenspan uttered his famous "irrational exuberance" phrase to describe the mania enveloping technology stocks. Investors simply bought anything with a dotcom label attached to it: Pets.com. Webvan.com. The dotcom graveyard is vast.

In October 1990, the tech-laden NASDAQ Index was at a low of nearly 300. By March 2000, it reached a high of just above 5,000—an increase of 1,456%. The index gained 86% in 1999 alone. After 1997, technology improvements kept coming and productivity kept rising. Profits, however, did not.

Sector-Specific ETFs

Sector ETFs take it a step further than domestic market ETFs that track broad indexes. By targeting specific sectors, these ETFs enable you to invest in a bunch of companies in one industry instead of going out on a limb and buying an individual stock that might or might not go belly-up.

These ETFs epitomize diversity and have become more relevant as the importance of diversity becomes more apparent. Think about it: Hundreds of thousands of companies out there make up any given sector today. How can anyone pick just one to bet on? Why not hold 50 or 100 of them instead, and just target the industry overall? Finding the next Google (GOOG) or Microsoft (MSFT) is a one-in-a-million shot.

ETFs seem to be getting more specialized by the day, especially as the broad sectors have been pretty well covered. How narrow to get is entirely up to you. A broad choice, for example, is a general healthcare ETF. To go narrower, other ETFs target biotechnology or pharmaceuticals.

If you want to target the transportation industry, there's an ETF for that. But if you'd rather get exposure to just airlines and subtract trucking and rail from your exposure, there's an airline ETF available to do so. You'll find broad financial ETFs, but there are regional banking and global banking funds as well. You can also find broad alternative-energy ETFs, along with solar, wind, and nuclear power funds, too.

Sector ETFs aren't simply for investors who have trouble making decisions—often you make an investment in what you believe in, and your outlook on the world comes into play. If you're invested in a healthcare ETF, perhaps you believe that the aging baby boom population will need increased medical care, raising the value of healthcare-related stocks. Perhaps you're even part of the baby boom generation and this sector has particular meaning for you.

Narrowing sector exposure to specific segments of a sector can increase volatility. Just as having a broad range of stocks within a fund can keep risk and volatility lower, so can broader exposure in a sector. But having the option to access a specific segment of a sector can also give investors the chance to identify more uptrends. For example, healthcare ETFs could be ailing, but biotechnology might be showing real mobility.

Many sectors are available in the United States and globally. Let's consider some of them.

Power Up with Utility ETFs

Utilities are also attractive because of the tax rules on the income generated by dividends paid by utilities ETFs. In a nutshell, this income is deemed qualified dividend income and is taxed at the beneficial rate of 15%, not at ordinary income rates.

So if you want to play the utilities game, you can choose from a vast array of ETFs. Here are three of them:

- **Utilities Select SPDR (XLU)**—The largest utility ETF. Tracks utility stocks in the S&P 500 (www.spdrs.com).

- **Vanguard Utilities ETF (VPU)**—Follows the MSCI U.S. Investable Market Utilities Index (www.vanguard.com).
- **Rydex S&P Equal Weight Utilities ETF (RYU)***—Tracks utility stocks in the S&P 500, but weighs them all equally and is not based on market capitalization (www.rydex.com).

Checking Up on Healthcare ETFs

Healthcare stocks are typically viewed as a defensive play. This sector is another area investors are eyeing in hopes that our healthcare system will finally see some serious reform.

Investors must watch the trend lines before jumping into any stock or ETF, and must enter with a solid strategy they can stick to. Let's take a look at a few healthcare ETFs and note their differences, because they all have something different to offer:

- **iShares Dow Jones U.S. Health Care (IYH)**—Gives exposure to 139 stocks in the healthcare sector, chosen based on market share or size. The average market cap of selected stocks is $2 billion. The expense ratio is 0.48%. (www.ishares.com)
- **Health Care Select Sector SPDR (XLV)**—Represents healthcare stocks found within the S&P 500. This is the largest ETF in the sector; it focuses on companies involved in healthcare equipment and supplies, healthcare providers and services, biotechnology, and pharmaceuticals makers. XLV's annual expenses are 0.21%.
- **Rydex S&P Equal Weight Health Care ETF (RYH)***—Follows the health-related stocks within the S&P, but stocks are weighted equally instead of by market cap. The lean is toward small to midsize companies. The index is rebalanced every quarter. RYH's annual expense ratio is 0.50%.

*Full disclosure: Tom Lydon is a board member of Security Global Investors/Rydex Investments.

Banking on Financials

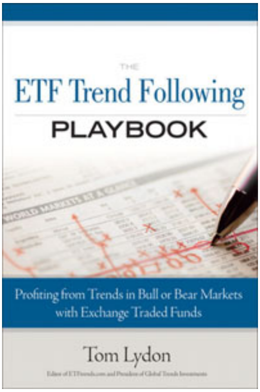
Although this sector has a big black eye after the events of 2008, that doesn't mean it's not a popular consideration for investment. The most popular financial ETF is the Select Sector SPDR Financial (XLF), which consists of stocks of more than 80 of the largest financial institutions in the United States. It's also one of the most heavily traded from day to day.

As with other sectors, investors have the opportunity to take very broad to very narrow views of financials. Among the other ETFs that represent this segment of the market are:

- **KBW Regional Banking (KRE)**—Made up of 50 regional banks from around the United States. Regional banking is one of the best examples of a sector that has outperformed its parent sector, at least in 2008. Most regional banks had little to no exposure to toxic assets during the market downturn, enabling them to stay relatively healthy while their larger brethren were collapsing. It should be noted, though, that this subsector was still down—just not as sharply. (www.spdrs.com)
- **iShares Dow Jones U.S. Financial Services (IYG)**—Consists of 127 companies in the financial services sector.
- **iShares S&P Global Financials (IXG)**—Holds the stock of more than 200 financial institutions from around the world, including the United States.
- **Rydex S&P Equal Weight Financials (RYF)***—Holds more than 80 equally weighted stocks from various financial institutions.

So many sectors and subsectors exist that this should give you a good illustration of the available choices. It should also help you understand that whereas one sector might be suffering in general, you can still find investment opportunities.

*Full disclosure: Tom Lydon is a board member of Security Global Investors/Rydex Investments.



If you liked this Element, you might like the book by Tom Lydon, *The ETF Trend Following Playbook: Profiting from Trends in Bull or Bear Markets with Exchange Traded Funds* (ISBN: 978-0-13-702901-3).

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