Cyclicals as Stand-in for Commodities

Wenzel Analytics Inc

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There is story to the evolution of every investment strategy. The small group of AAII investors that meet monthly in my family room was breaking up for the evening, when Sheryl Sostarich handed me a brand new hardcover copy of Hot Commodities by Jim Rogers. I was taken somewhat taken aback. She made the comment "I decided that you are the perfect person for this book." Well I've learned in investing that it is very important to be able to gracefully accept both the gifts and the losses, and so I thanked her. (The meetings are open to anyone interested, although I can't promise a book from Sheryl.)

The book is a delightful read and very compelling. Commodities are the asset class to overweight for the next few years, as demand is overcoming supply. It is the nature of real stuff such as oil, sugar, coffee, wheat and metals that an imbalance cannot be corrected quickly since it takes time to grow the products or find and build the infrastructure to tap and process other raw materials. Commodities are not like a brand or hot new technological product whose days in the sun can be quickly eclipsed by news or new developments.

So I decided I would learn about how to buy commodities using the modest amounts of money at my disposal, but not wanting to dispose of it through highly leveraged and risky investments. The complexities surrounding futures and options seemed overwhelming. I kept wondering how I thought I could know more and be smarter than the people whose business it was to grow or mine the stuff and sell the commodity, or the people who need to buy it for production in their factories and distribution. I found a couple commodity index funds, but then saw that the price of one had dropped precipitously. I learned that mutual funds can't buy commodities, and that the workaround being used was being challenged by the IRS. My inquiries to the firm handling the fund based on Jim Roger's commodity index have not been answered.

The story then turns to my regular reading of James Paulsen's "Economic and Market Perspective" available free from Wells Capital Management (www.wellscap.com). He is the best economic

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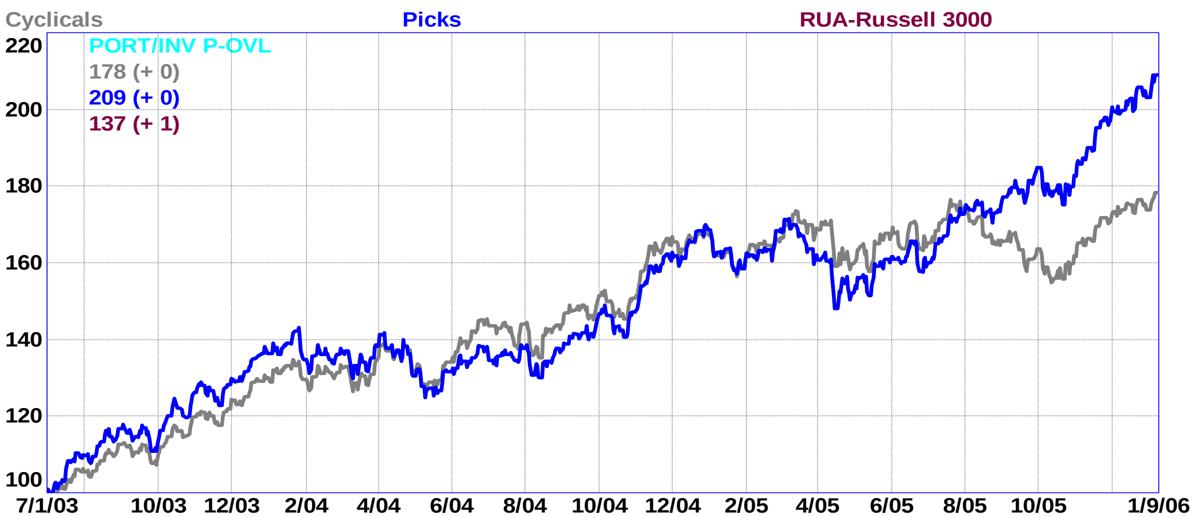
and market forecaster I have found for looking out at the next few months. On page 11 of the January issue I found the chart on the right. If cyclical stocks track the commodities and are easier to trade, why not buy them instead?

Taken from the chart, I looked up Morgan Stanley's Cyclical Stock Price Index. It is comprised of twenty seven large industrial company stocks – familiar names such as Caterpillar, Honeywell, Hewlett-Packard, Motorola, Goodyear and Ingersol Rand. So I began reviewing the charts for these companies, comparing them to the Index, to the Russell 3000, and looking for nice growth patterns over multiple time frames. I then imported them into Worden's TeleChart and examined them by technical indicators. Next I checked the letter grade Louis Navellier assigned to each. From this process I divided them into three groups: my picks, those I could pick, and those I wouldn't pick.

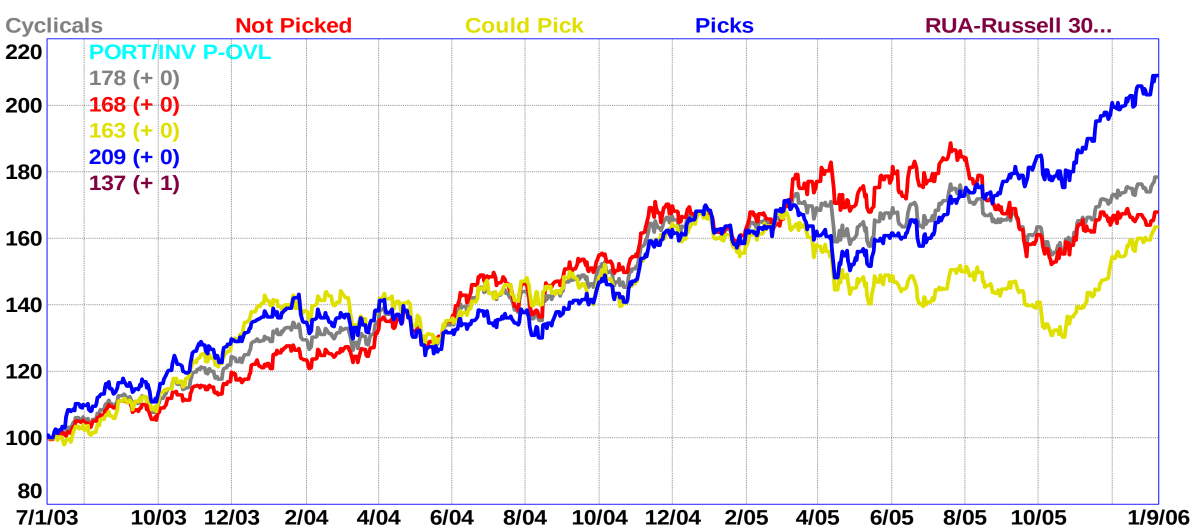
Picks from Morgan Stanley's Cyclical Stock Price Index.



The annual return rate for the picks over the two and half years shown in the chart was 34%. The comparable annual return rate for the Russell 3000 was 13.2%. (For the Could Picks it was 21% and for the Wouldn't Picks it was 23%.) For a strategy with good longer-term potential and modest variation, that looks good to me.

The chart below is rather busy, but shows the same returns plus that of the Could Pick and Not Pick.

Picks and Non-Picks from Morgan Stanley's Cyclical Stock Price Index.



While I expect this to be a fairly low-turnover strategy, from the chart above it is obvious that one needs to monitor the selections as these stocks do not all move in lockstep. This is evident from the five-year picture shown below.

Five-Year Chart, Picks and Non-Picks from Morgan Stanley's Cyclical Stock Price Index.

Over five years, the annual return rate for the cyclicals of the index was 14%, for the Picks it was 16%, and for the Russell 3000 it was 1%.

The positions currently selected from the Index are:

CAT	Caterpillar
CSX	CSX Corp
FDX	Fedex Corp
GT	Goodyear Tire & Rubber
HPQ	Hewlett Packard
IR	Ingersoll Rand
JCI	Johnson Controls
MOT	Motorola, Inc.
PD	Phelps Dodge Corp

Sorry this story has only a beginning. We will have to wait for the ending.

I invite your perspectives on both the strategy and my methodology.