A BETTER MOUSETRAP

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Sam Stovall, Chief Equity Strategist Technicians frequently compare the relative performance of the S&P Consumer Discretionary sector and the Consumer Staples sector for guidance on the market's "risk-on" or "risk-off" trend. When the more cyclical Consumer Discretionary sector, which contains such sub-industries as autos, homebuilding and retail, is outperforming the more defensive Consumer Staples group, which includes food, beverage and tobacco companies, investors look upon that as a sign that the S&P 500 is entering into, or maintaining, an upward trend, and vice versa.

I have recently heard technicians complain that the Consumer Discretionary/Consumer Staples (CD/CS) relative strength indicator has been less reliable than in the past. What's more, in the past 20 years, the Consumer Discretionary and Consumer Staples sectors both beat the S&P 500 four times (1991, 2001, 2008 and so far in '11), and came within 50 basis points of doing it a fifth time in 1997.

One reason CD/CS could be losing its timing touch may be that nearly one-third the number (and almost 40% of the cap-weighting) of the sub-industries in the Consumer Discretionary sector have lower betas than the market itself. Specifically, those groups with five-year betas that are below the market are Apparel Retail, Automotive Retail, Distributors, Education Services, Footwear, General Merchandise Stores, Home Improvement Retail, Leisure Products, Restaurants, and Specialized Consumer Services. A glaring example is Restaurants, which is dominated by the fast-food giant McDonalds, a company more frequently associated with defensiveness than cyclicality. This group, which represents nearly 14% of the entire Consumer Discretionary sector, has a beta of 0.60.

A Suggested Solution

S&P recently introduced two indices: the S&P 500 High Beta Index and the S&P 500 Low Volatility Index (HB/LV). As their names imply, the S&P 500 High Beta Index measures the performance of 100 constituents of the S&P 500 that are most sensitive to changes in market returns, while the S&P 500 Low Volatility Index measures the performance of the 100 least volatile stocks in the S&P 500. As a result, an investor now has two mutually exclusive, pure-play indices, which should allow them to truly compare apples with oranges, rather than oranges with tangerines.

To see which indicator (CD/CS or HB/LV) was better at offering "risk on/risk off" guidance, I looked at monthly price performances from 12/31/99 through 10/14/11, capturing the S&P 500's price return whenever HB beat LV, but applying no change when LV beat HB. The same was done for CD and CS: capture the S&P 500 monthly price change whenever CD beat CS, but apply no change when the reverse was true. Obviously, I had no way of knowing in advance if HB or CD would beat their defensive counterpart. I was merely interested in seeing which pair delivered superior results whenever their market timing signals were "on" or "off." As a result of this hypothetical market timing study, I found that the HB/LV pairing did a better job than the CD/CS pair in signaling when to buy and when to sell the S&P 500.

Test Results

If someone invested $1,000 in the S&P 500 on 12/31/99 and received no dividends, it would have been worth $833 on 10/14/11. However, if that individual had the uncanny ability to own the S&P 500 during those months in which the S&P 500 Consumer Discretionary Sector beat the S&P 500 Consumer Staples sector, but be in cash during those months when CS beat CD, their initial investment of $1,000 would have grown to $5,630. Yet if that same individual owned the S&P 500 during those months in which the S&P 500 High Beta Index beat the S&P 500 Low Volatility Index, but be in cash during those months when LV beat HB, their initial investment of $1,000 would have growth to $8,211. Remember, of course that past performance is no guarantee of future

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results.

So there you have it. It appears as if there is an alternative for those who chart the relative performance of the S&P 500 Consumer Discretionary sector against the S&P 500 Consumer Staples sector, yet have been a bit disappointed with recent signals. Or they are just concerned that there are too many sub-industries with defensive characteristics in a traditionally cyclical sector. Maybe now a new and better mousetrap is available in the form of the S&P 500 High Beta Index and the S&P 500 Low Volatility Index, each of which is also available in an ETF: The Powershares S&P 500 High Beta Portfolio (SPHB, $18, OW) and the Powershares Low Volatility Portfolio (SPLV, $24, OW). Now if I could only figure out exactly when HB was going to beat LV...