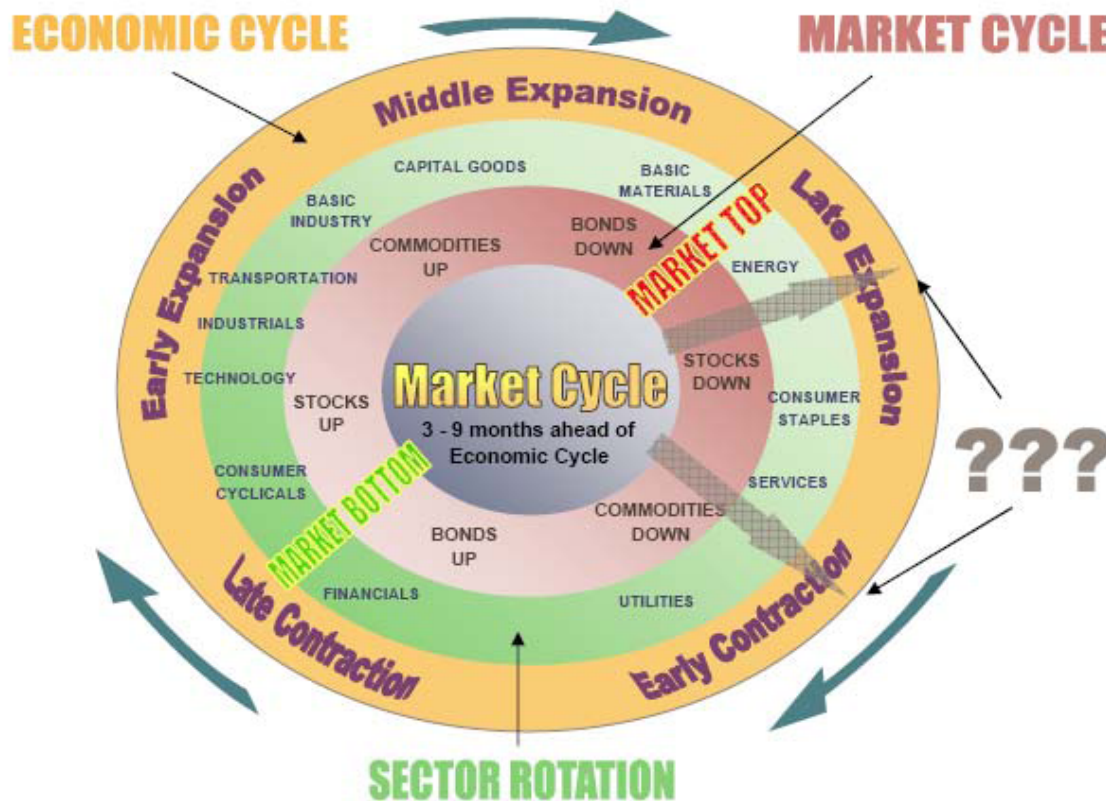


The Investor's Wheel of Fortune

One of the great comforts of monitoring the seemingly endless supply of financial pundits via the internet or on TV is their almost instantaneous explanation for every market movement. A Yahoo! Finance headline touting "Markets up as oil prices fall" or an MSNBC update from an on-the-scene reporter that "bonds are rallying in anticipation of a Fed rate cut" serve to ease investors' anxiety over the unknown. **And even though we may intuitively know that the purported market relationship is oversimplified, or may be irrelevant or just plain wrong, having an explanation in hand still makes us "feel better."**

However soothing this streaming commentary may be, **reacting to the "news" without evaluating the information within a broader economic and market framework can place an investor at high risk.** As part of our on-going educational process, we are providing such a framework in the form of a "typical" business cycle and the accompanying stock sector performance based on a Standard and Poor's study encompassing ten complete economic cycles from December 1945 to December 1995.



Original Source: Matt Blackman, the EquiTrend Weekly Market Watch

Keys to the Economic Cycle

1. Consumer Non-Cyclicals

Because consumer non-cyclicals (food) and consumer growth industries (tobacco, beverages, cosmetics) are less sensitive to changes in the business cycle due to more consistent demand, they are particularly attractive as defensive holdings when the economic cycle has matured or is in the early stages of contraction.

2. Consumer Cyclicals

Both durable (automotive) and non-durable (clothing) consumer cyclicals are sensitive to interest rates as well as the business cycle. Accordingly, investors find these categories attractive when the economy is in the late stages of contraction in anticipation of declining rates and economic expansion.

3. Healthcare

The healthcare sector has historically been dominated by the large pharmaceutical firms. Similar to the consumer non-cyclicals, the category was considered immune to economic fluctuations and was therefore classified as defensive in nature. Non-market considerations such as FDA approvals, patent lives and company R&D pipelines are making the sector less predictable in the business cycle.

4. Financials

Interest-sensitive financials such as housing-related lenders become investment targets as interest rates peak toward the late stages of an economic contraction. Non-mortgage-dependent banks rely more on commercial and consumer loan growth, showing strength throughout the expansion cycle.

5. Technology

Because technology stocks (hardware and software) depend on capital spending and business or consumer demand, they are usually popular during the early to mid stages of an economic expansion.

6. Basic Materials

Profits in basic materials companies (steel, lumber, chemicals) are driven by strong market demand for products and high utilization of capacity. The development of a solid supply/demand structure generally leads to attractiveness later in the economic expansion.

7. Capital Goods

Capital goods (agricultural equipment, industrial machinery, machine tools) spending increases as the economy is expanding with greater demand for products. The need for increases in production capacity normally occurs midway through the business cycle. The global economic cycle is also important as this sector relies heavily on the export markets.

8. Transportation

Railroads and other surface carriers are one of the early beneficiaries to a pickup in the economy, and perform best during the early expansion phase. While airlines also benefit from increases in demand tied to an expanding economy, they are also subject to cyclical fuel costs.

9. Energy

The energy sector includes three distinct subcategories including large integrated international oil companies, domestic exploration companies and energy service companies. Although there are timing differences, all three sectors are driven by the global demand for energy and are most attractive late in the business cycle. Political events have historically had significant short-term impacts.

10. Utilities

The traditional electric utilities have historically been sensitive to interest rates because of their high leverage and the interest rate sensitivity of their dividend stream. Thus, they have performed best in an environment of declining interest rates or in the early stages of an economic contraction. The telephone and telecommunication companies have been more growth oriented, performing better during economic expansions.

11. Precious Metals

Precious metals and the companies that mine and process them have historically been utilized as a hedge against inflationary pressure. Investors tend to shift to this category as rates are peaking late in the expansion cycle.

Beyond these noted business cycle factors, **one must also consider factors outside the business cycle and their impact on markets.** Without attempting to expound on each such factor, **a short list would include domestic government policies, international economic, trade, currency and regulatory conditions, technological innovation and global political events.**

Bull and Bear Market Characteristics

In addition to the characteristic behavior of market sectors are the signals that typically define the peaks and valleys of the entire stock market. For example, **a business-cycle peak is normally at hand when earnings are high and unemployment is low.** When prices for raw materials rise and inventories start to increase, a downturn often follows. **The bull market rise to such a peak is characterized by rising price-to-earnings (P/E) ratios and falling yields.** In its late stages, a bull market may see high initial public offering (IPO) activity, rampant speculative buying, and leadership from the more volatile small-cap stocks. Because the stock market usually anticipates the business cycle, it may begin to slip even as good earnings are still being reported.

At the opposite end of the spectrum, **a bear market is characterized by rising yields, falling P/E ratios, and sharp declines with abnormally high trading volumes.** The business-cycle trough is usually characterized by low earnings and high unemployment. Again, the market will anticipate the business cycle and, just as earnings bottom and investors are most pessimistic, it may be poised for its first up-tick.

Where, Oh Where Will The Two Cycles Meet?

As with all targets, the highest value is achieved by hitting the bullseye. Note that in Blackman's model, **this bullseye states that the Market Cycle is 3-9 months ahead of the Economic Cycle – a half-year variance in the point where the decision-making takes place.** What this translates to in our illustration is that, **while the outer Economic Cycle has historically been more predictable in its rotation, the inner Market Cycle is more like a pinwheel that not only moves, but also changes speeds.** This raises the logical questions; **“Where are we in Blackman's cycle and how do we apply this information to our investing?”** One way to answer this question is to look at the leading and lagging

market sectors as published by Investors Business Daily, or listed at Barchart.com. Of the top 10 performing sectors, four are in the food industry (Consumer staples) while the bottom 10 are dominated by Building/Housing (Industrial Goods). Based upon this criteria, **one would conclude that we are somewhere between 3 and 5 o'clock on our Market Cycle clock.**

Turning Economic Cycles Into Investment Strategies

How one uses this information depends upon your investment discipline and strategy. **If you are an ultra-patient investor who buys unloved, “out of favor” companies, then you should find industrials, technology, and transportation comparatively cheap.** As an example, famed Legg Mason Value fund manager Bill Miller has reportedly been accumulating homebuilders after their recent swoon. Though clearly cheap compared to their highs, the timeframe for their return to favor is uncertain. **If you are a “value” player with somewhat less patience, buying utilities and financials would appear to be just ahead of the crowd and in line to lead the market as the economic cycle progresses.** Finally, **momentum players and short-term traders would be attempting to take advantage of the current favorites in the services and consumer staples categories with an eye to quickly rotating into the next hot sector.**

Obviously, each of these investment approaches involves different levels of risk. **The momentum player will have to stomach the greatest volatility as he is “buying high” with the hope of selling higher. The risks of loss are greater as the timing of a stampede out of one sector and into the next are often more emotional than fundamental.** The deep value player incurs two basic risks in that he must first distinguish between “out of favor” companies and “just plain dogs” and second, endure the sometimes excruciating wait for a turnaround.

The basic investment discipline employed by Grant/GrossMendelsohn includes a broad diversification among equity categories to ensure exposure to all market capitalizations (large, mid and small cap) and both “growth” and “value” styles. This guarantees participation in the top performing categories, even if that proves to be a “surprise” to the experts. The allocation weightings among the various categories are based on relative strength measures including economic cycle considerations. Limited specialty sector selections are made based upon a “value” approach, with new funds added as the initial signs of developing strength appear, and exits triggered as the strength wanes and better opportunities are uncovered. **This discipline has been successful in capturing both general market and sector returns while avoiding the high risks of short-term trading strategies.**

One of the most important “value added” strategies utilized by GGM is the inclusion of “hedged” and market neutral funds. **These selections have been particularly effective during market corrections or actual bear markets when traditional equity strategies have suffered.** Some of the funds employed include Gateway (7.5% YTD), Merger (8.7% YTD), Diamond Hill Long-Short (7.7% YTD), Laudos Ros US Long/Short (3.2% YTD) and Calamos Market Neutral (6% YTD).

A number of telltale economic signs combined with weakening performance in several fund categories recently led us to modestly “carve back” exposure in the most volatile categories. By targeting a substantial portion of the proceeds for reinvestment in the market neutral sector, **we have elected to reduce the risk profile of our portfolios without materially impacting performance potential.** **Despite the new highs in the Dow Industrials, we believe we are closer to 4 o'clock than 10 o'clock on our Economic/Market Cycle clock.**

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