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The Four Best Stock Sectors Now (and the Three Worst)

Investors often focus on the ups and downs of the overall stock market or a few individual stocks. But there is a better way to gauge where the most attractive opportunities and the biggest dangers lie. It involves concentrating on sectors—the industry categories that help investors determine which companies are benefiting the most and the least from economic and other trends.

Over the past year through July 25, technology and health-care stocks soared the most of the 10 major sectors, gaining 30% or more. But in the first half of this year, utilities and energy stocks led the way. As investors grow nervous about whether the stock market can continue to push ahead, which sectors will hold up best?

We asked sector specialist Sam Subramanian, PhD, to forecast what lies ahead and what it could mean for investors...

SECTOR TRENDS

When large numbers of investors rotate into a sector, the sector typically outperforms the broad market for the next one to three years. That doesn't necessarily mean that investors should plunge heavily into a sector that looks hot. But interpreting the trends correctly can help investors seize opportunities and avoid dangers at a time like this, when many stocks seem fully valued. Your best chance of outperforming the market is to have a great deal of exposure to fast-growing, undervalued sectors.

I look at three main factors in evaluating sectors...

The sector must have attractive valuations from a historical perspective. The sector should typically have a price-to-earnings ratio (P/E) that is at or below its five-year average.

It must have strong momentum relative to the Standard & Poor's 500 stock index. I like to see a sector that is beginning to pick up momentum, outperforming the index's returns over the last three to six months.

It should have "favorable catalysts." That means economic and business trends that clearly can benefit the sector.

FAVORITE SECTORS

The following sectors have strong growth prospects, and most are considerably undervalued, having underperformed the S&P 500 over the past three years. You can gain exposure to these sectors through individual stocks or—my preference—sector funds, which make it easier to gauge and adjust your sector exposure over time. Exchange-traded funds (ETFs) offer a convenient, low-cost way to invest in specific sectors, but there also are attractive mutual funds focusing on sectors, including the Fidelity fund on page four. Conservative investors should consider limiting sector funds to no more than 10% of their overall portfolios because the funds can be volatile. *My favorite sectors now...* >>

Bottom Line/Personal interviewed Sam Subramanian, PhD, founder of AlphaProfit Investments, LLC, and editor in chief of the *AlphaProfit Sector Investors' Newsletter*, Sugar Land, Texas. The newsletter's ETF Focus model portfolio gained 40% in 2013, compared with 32.4% for the S&P 500, and it has beaten the S&P 500 by an average of three percentage points a year since its inception in 2003. AlphaProfit.com

>> **AUTOS**

The NASDAQ OMX Global Auto Index gained 33% over the past three years (versus 58% for the S&P 500) as the automobile market recovered from the impact of the global financial crisis. Lower unemployment, easier car financing and strong pent-up demand will continue to push up auto-industry profits for the next several years.

US auto sales likely will total 16.4 million for 2014, the highest since 2006, and even car sales in Western Europe have rallied from a six-year slump, rising 6.2% in the first half of 2014. *Funds...*

The First Trust NASDAQ Global Auto ETF (CARZ) invests in about 40 stocks and focuses on global automotive manufacturers. *Performance:* 9.9%.*

*Performance figures are three-year average annualized returns through July 25, 2014.

Fidelity Select Automotive (FSAVX) is an actively managed mutual fund that offers exposure to smaller areas of the auto industry, such as tire manufacturers and aftermarket parts suppliers. *Performance:* 13.7%.

HEALTH CARE

The S&P Health Care Select Sector Index has trounced the S&P 500 over the past three years, gaining an annualized 23%, and with a P/E of 19, it is just slightly overvalued on a historical basis. A good deal of that outperformance was fueled by biotech stocks. Other subsectors of health care, such as the stocks of medical-device companies, have lagged and are significant bargains. Overall, growth prospects for this sector even without biotech are exciting. Companies are just starting to benefit from implementation of the Affordable Care Act, and they are sitting on record-high levels of cash, which increase the possibility of stock buybacks and mergers. *Fund...*

First Trust Health Care AlphaDEX Fund (FXH) takes a value-oriented approach, weighting stocks not by market capitalization but by sales growth, cash flow and other measures. The 75-stock portfolio is dominated by health-care providers, medical-device makers and pharmaceuticals. *Performance:* 22.3%.

CLEAN TECHNOLOGY

This alternative energy sector focuses on renewable energy sources such as wind and solar power and companies that specialize in providing technology such as water-filtration systems and energy-efficient lighting. Many of these stocks struggled after the 2007–2009 recession. But governments are taking a new interest in clean energy production and saving energy. Also, so-called green energy has become more affordable. The solar industry's global growth is expected to accelerate to 18% in 2014. *Fund...*

PowerShares Cleantech ETF (PZD) invests in about 60 stocks of green-technology firms. *Performance:* 5.4%.

NATURAL GAS

The ISE-Revere Natural Gas Index fell by 5% over the past three years because rising production of shale gas coupled with falling natural gas demand led to a supply glut and falling prices for the fuel. But several factors will push up this heavily undervalued sector for years. Gas producers have started to curtail production at the same time as electric plants and trucking companies are switching to natural gas from more costly coal and diesel fuel. This past winter's brutal weather has pushed US natural gas inventory below one trillion cubic feet for the first time since 2003. Foreign usage is driving demand as well. Last year, the US exported just 2.9 billion cubic feet of gas through liquid natural gas terminals, merely 0.2% of the country's production. But exports are expected to rise to 1.5 trillion cubic feet by 2020. *Fund...*

First Trust ISE-Revere Natural Gas Index (FCG) has about 30 stocks involved in exploration and production of natural gas. *Performance:* –1.5%. BLP

More from Sam Subramanian, PhD

The Worst Sectors

Right now, I'm avoiding three sectors, all of which are sporting overall valuations that are excessive and are facing economic and/or industry headwinds. While share prices in these sectors may continue to rise a while longer due to investor excitement, investing in these sectors has become more risky. You should not make new purchases in these sectors, and you should consider cashing in on profits for at least a portion of any holdings you have in these sectors.

In July, Federal Reserve Chair Janet Yellen, in a report to Congress, singled out two of these sectors—biotech and social media—saying their valuations were "substantially stretched."

Biotechnology: Biotech stocks have gained more than double the total return of the S&P 500 over the past three years. And the recent P/E of the Nasdaq Biotechnology Index was an unsustainable 80, compared with 19 for the S&P 500 (based on earnings for the trailing 12 months). This past March and April, the sector plunged 20% within a few weeks. Criticism of biotechs has been mounting over the costs of specialty drugs. A treatment for hepatitis C at $1,000 per pill has sparked calls in Congress for reform of medication pricing.

Internet stocks focused on social media and networking. This sector rose by 73% in 2013 even though many of the companies don't even have earnings or profits and still are trying to figure out how to capitalize on their vast user bases.

Utilities and other interest rate–sensitive sectors. Utility stocks were bid up over the past few years by yield-hungry investors, leaving only specific segments of the industry, such as small regional utilities in areas with strong economies, still bargain priced. Valuations in the overall utilities sector were recently 20% above their historical long-term averages, and growth forecasts have slowed. Moreover, rising interest rates are likely to make these defensive holdings less attractive to investors because their dividends become less attractive as yields on bonds increase.

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