Weekly Market Commentary

July 8, 2013

The Right Recipe for Stocks

Jeffrey Kleintop, CFA
Chief Market Strategist
LPL Financial

Highlights

The recipe for stock market investing success may be as simple as taking the S&P 500 and adding the characteristics provided by company share buybacks as the market heats up in the second half of the year.

The summer means cookouts. The recipe for success is usually simple: take a basic ingredient, add some characteristic flavors, and apply some heat. The recipe for stock market investing success may be as simple as taking the S&P 500 and adding the characteristics provided by buybacks as the market heats up in the second half of the year.

Some characteristics to consider for a good core U.S. stock portfolio for the second half include:

- **Market-like risk exposure –** We expect stock market gains to be accompanied by more volatility than experienced in the first half of the year. As a result, a good U.S. stock portfolio should not be more cautious than the overall stock market, nor should it be much more aggressive, since that would likely result in wide swings and a very bumpy ride. In other words, a "beta" of around one makes sense (since beta is the tendency of a portfolio to respond to moves in the market, and a beta of less than one means the portfolio moves less than the overall market; more than one means the portfolio moves more than the overall market).
- **Fewer mega-sized companies –** Less of a focus on very large globally exposed companies than the major indexes may be a positive due to weak overseas demand and the rising dollar, translating into weaker dollar-based export gains.
- **Favor consumer discretionary and health care –** These domestically focused and consumer-driven sectors of the stock market may fare better due to a relatively brighter U.S. economic growth and employment outlook and a rising dollar.
- **Favor financials –** Financials may benefit as the rise in longer-term interest rates widens profit margins on lending as business loan demand improves.
- **Avoid materials and energy –** These commodity-based sectors may not do well, as they suffer from overcapacity and weak global demand.
- **Avoid utilities and telecommunication services –** These bond-like, yield-sensitive sectors would likely underperform as bond yields rise and prices fall.

The biggest buyers of stocks this year have been the companies themselves.

The characteristics are detailed, but, fortunately, the recipe is simple. These characteristics can be found by simply screening for the companies in the S&P 500 buying back their own shares. An easy way to see this is to simply take a look at the S&P 500 Buyback Index that focuses on the 100 companies in the S&P 500 that are doing the most buybacks. Using this

LPL Financial

1 Buybacks Provide the Right Characteristics

S&P 500 Buyback Index and S&P 500 Index Characteristics

	Buybacks	S&P 500
Beta	0.97	1.00
Average Market Cap	$23.3B	$30.4B
Consumer Discretionary	25.8%	17.9%
Financials	19.7%	16.7%
Information Technology	17.7%	17.9%
Health Care	14.4%	12.7%
Industrials	13.2%	10.1%
Consumer Staples	5.8%	10.4%
Materials	0.9%	3.3%
Telecom	0.9%	2.8%
Utilities	0.8%	3.2%
Energy	0.8%	10.6%

Source: Standard and Poor's 07/05/13

The buyback recipe has worked well so far this year with the S&P 500 Buyback Index posting a total return of 25.4% compared to 15.7% for the S&P 500.

The S&P 500 Buyback Index provides exposure to the 100 constituent companies in the S&P 500® with the highest buyback ratio in the last 12 months. At each rebalancing reference date, the buyback ratio is defined as the monetary amount of cash paid for common shares buyback in the last four calendar quarters with interim reports available divided by the total market capitalization of common shares at the beginning of the buyback period. Constituents are equally weighted and the index is rebalanced quarterly. The rebalancing reference dates are the last trading day of March, June, September, and December. Index rebalancings are effective after market close on the third Friday of the month following the reference date.

S&P Indices are unmanaged and cannot be invested into directly. Unmanaged index returns do not reflect fees, expenses, or sales charges. Index performance is not indicative of the performance of any investment. Past performance is no guarantee of future results.

index as a representation of the characteristics of a buyback-driven core U.S. stock portfolio, we can see that buybacks make an almost perfect recipe for the characteristics we outlined above:

- Market-like risk exposure with a beta of 0.97, a nearly perfect 1 beta.
- Fewer mega-sized companies – The S&P 500 Buyback Index has a mean market cap of $23.3 billion compared to the $30.4 billion of the S&P 500 Index. The median market cap is similar at $12.5 for the buybacks and $14.7 for the S&P 500, reflecting fewer mega-cap companies in the buyback index.
- Overweight consumer discretionary and health care sectors by a combined 10 percentage points. This combined 40% of the portfolio more than offsets the 5% underweight to the high-yielding consumer staples sector that is more vulnerable to rising interest rates.
- A modest overweight to the financials sector by 3 percentage points.
- Very little energy or materials sector exposure with a 12 percentage point underweight.
- Almost no telecommunication services or utilities sector exposure.

There is another reason to focus on companies doing buybacks. The biggest buyers of stocks this year have been the companies themselves. After reducing purchases during the financial crisis in 2008 and 2009 as companies were focused on hoarding their capital, corporations have returned to near-record levels of net share repurchases. New buyback announcements have surged this year. Corporations have been aggressively buying back shares, adding up to hundreds of billions in purchases each quarter. Buybacks are likely to continue at a strong pace due to strong cash positions and the fact that shrinking the number of outstanding shares is a way to drive earnings per share growth in a weak global revenue growth environment.

The buyback recipe has worked well so far this year with the S&P 500 Buyback Index posting a total return of 25.4% compared to 15.7% for the S&P 500, and we expect it to outperform in the second half as well. But even the best cookouts come with risks, ranging from the always-threatening fire and smoke, to the unpredictable weather and even food-borne illness. Besides the ever-present dangers of stock market investing, the risks unique to a buyback-focused portfolio include:

- In a fear-driven market sell-off, the buyback portfolio might underperform the S&P 500 if investors favor the largest, most well-known companies since the portfolio is underweight mega-sized companies relative to the S&P 500 Index.
- Given the large overweight to the consumer discretionary sector and underweight to the energy sector, if higher oil prices drive energy stocks higher and consumer stocks sell off as a result of the negative impact on consumer discretionary spending, then the buyback-focused portfolio would likely underperform. So it may pay to watch out for a

Investors seeking an enduring recipe for success in the changing environment of the second half of the year may find it in share buybacks.

further escalation of geopolitical events and the upcoming hurricane season — either of which could add more upside pressure to oil prices.

Stocks' modest gains in the second half of the year (driven by mid-single-digit earnings growth, aided by record-breaking share buybacks, wide profit margins, and contained labor costs) may come with more ups and downs. This is because the second half of the year holds many changes for the markets:

- Federal Reserve policy will change as the aggressive stimulus of the past five years begins to fade;
- Fiscal policy deliberations re-emerge as the debt ceiling comes back into focus;
- The government shrinks as a portion of the U.S. economy to the lowest levels in a decade;
- The economic drag from higher taxes and spending cuts implemented in the first half of 2013 starts to diminish; and
- Europe holds key elections that will define its next steps.

Investors seeking an enduring recipe for success in the changing environment of the second half of the year may find it in share buybacks. ■

Earnings per share (EPS) is the portion of a company's profit allocated to each outstanding share of common stock. EPS serves as an indicator of a company's profitability. Earnings per share is generally considered to be the single most important variable in determining a share's price. It is also a major component used to calculate the price-to-earnings valuation ratio.

Consumer Discretionary Sector: Companies that tend to be the most sensitive to economic cycles. Its manufacturing segment includes automotive, household durable goods, textiles and apparel, and leisure equipment. The service segment includes hotels, restaurants and other leisure facilities, media production and services, consumer retailing and services, and education services.

Consumer Staples Sector: Companies whose businesses are less sensitive to economic cycles. It includes manufacturers and distributors of food, beverages and tobacco, and producers of non-durable household goods and personal products. It also includes food and drug retailing companies.

Energy Sector: Companies whose businesses are dominated by either of the following activities: The construction or provision of oil rigs, drilling equipment and other energy-related service and equipment, including seismic data collection. The exploration, production, marketing, refining and/or transportation of oil and gas products, coal, and consumable fuels.

Financials Sector: Companies involved in activities such as banking, consumer finance, investment banking and brokerage, asset management, insurance and investment, and real estate, including REITs.

Health Care Sector: Companies are in two main industry groups — health care equipment and supplies or companies that provide health care-related services, including distributors of health care products, providers of basic health care services, and owners and operators of health care facilities and organizations. Companies primarily involved in the research, development, production, and marketing of pharmaceuticals and biotechnology products.

Industrials Sector: Companies whose businesses manufacture and distribute capital goods, including aerospace and defense, construction, engineering and building products, electrical equipment and industrial machinery. Also, companies that provide commercial services and supplies, including printing, employment, environmental and office services, or provide transportation services, including airlines, couriers, marine, road and rail, and transportation infrastructure.

Manufacturing Sector: Companies engaged in chemical, mechanical, or physical transformation of materials, substances, or components into consumer or industrial goods.

Materials Sector: Companies that are engaged in a wide range of commodity-related manufacturing. Included in this sector are companies that manufacture chemicals, construction materials, glass, paper, forest products and related packaging products, metals, minerals, and mining companies, including producers of steel.

Technology Software & Services Sector: Includes companies that primarily develop software in various fields such as the internet, applications, systems and/or database management and companies that provide information technology consulting and services; technology hardware & equipment, including manufacturers and distributors of communications equipment, computers and peripherals, electronic equipment and related instruments, and semiconductor equipment and products.

Telecommunications Services Sector: Companies that provide communications services primarily through a fixed line, cellular, wireless, high bandwidth and/or fiber-optic cable network.

Utilities Sector: Companies considered electric, gas or water utilities, or companies that operate as independent producers and/or distributors of power.

INDEX DESCRIPTIONS

The Standard & Poor's 500 Index is a capitalization-weighted index of 500 stocks designed to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries.

The S&P 500 Buyback Index provides exposure to the 100 constituent companies in the S&P 500® with the highest buyback ratio in the last 12 months. At each rebalancing reference date, the buyback ratio is defined as the monetary amount of cash paid for common shares buyback in the last four calendar quarters with interim reports available divided by the total market capitalization of common shares at the beginning of the buyback period. Constituents are equally weighted and the index is rebalanced quarterly. The rebalancing reference dates are the last trading day of March, June, September, and December. Index rebalancings are effective after market close on the third Friday of the month following the reference date.

S&P Indices are unmanaged and cannot be invested into directly. Unmanaged index returns do not reflect fees, expenses, or sales charges. Index performance is not indicative of the performance of any investment. Past performance is no guarantee of future results.

RES 4238 0713
Tracking #1-181508 (Exp. 07/14)