Sankala Group

Credit: *Thomas Denkenberger*

Counter-Cyclical Businesses

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Executive Summary

Stocks can be divided into three types depending upon their relationship with the business cycle: Cyclical, Non-Cyclical, and Counter-Cyclical. This letter focuses on Counter-Cyclical stocks. In particular, we examine where we are in the business cycle, the origin of the Counter-Cyclical idea, the economic logic of Counter-Cyclical stocks, a case study, and what role Counter-Cyclical stocks play in a portfolio. We find that the U.S. is likely nearing the end of the current economic expansion; the trend towards zero interest rates will ultimately decrease the attractiveness of long term high quality bonds which have historically been the best hedge against a recession; Counter-Cyclical stocks provide the lowest cost option or a product/service that is needed more during hard economic times; Walmart is the quintessential example of a Counter-Cyclical business; and that Counter-Cyclical stocks are particularly important to add to a portfolio near the end of a business expansion as a way to maintain equity exposure while reducing downside risk during the ensuing recession.

Where do we stand in the business cycle?

The economy of the United States is currently in its 11th year of expansion since the last recession ended in 2009. We have now surpassed the previous longest expansion of 10 years, set during the 1990's. Based on this simple data point, it appears likely that we are closer to the end of this expansion, than to the beginning. To sharpen our resolution, we note that 5 of the 10 leading economic indicators tracked by the Conference Board Leading Economic Index turned negative in the most recent monthly reading: average weekly initial state unemployment insurance claims, ISM new orders index, S&P 500, interest rate spread of the 10-year Treasury bond less federal funds, and average consumer expectations for business conditions.

Importantly, the most predictive of these, the inversion of the yield curve, has firmly sent its warning signal by maintaining an inversion of the 3 month Treasury yield versus the 10 year Treasury yield for more than 90 days. The 90 day mark was reached on August 22nd of this year so the historical precedent is that a recession will occur within 6 to 24 months from that date. Over the coming months it is likely that more leading indicators will start to turn negative which will increase the accuracy and precision of our recession forecast, but for now it is reasonable to conclude that we are near the end of the expansion phase of this business cycle and that a recession is likely to start within 5 to 23 months.

Genesis of the Counter-Cyclical Idea

For the past year and a half we have been searching for investments that go up during a recession. The primary and most robust finding has been that long term high credit quality bonds are the only major asset class that goes up during a recession. While U.S. long term Treasury bonds are the most well known example, others include long term Japanese, German, and Swiss government bonds. By early summer this year these long term international bonds reached interest rates near zero. While U.S. Treasuries were still above 2% at the time, it made us realize that our long term interest rates could possibly head towards and perhaps reach zero. If this were to occur, our investment in long Treasuries would do very well between now and then, but ultimately we would be left in a dire situation: our only major asset class that goes up in a recession would have zero expected return and a huge amount of interest rate risk. How could we continue to protect against a recession and have a chance of a positive return?

This led to the simple search, "What stocks went up in 2008?" During the crescendo of the recession, 475 of the 500 stocks in the S&P 500 went down, while only 25 went up. Of the 5% that went up, some were random winners like drug companies that happened

to release a new drug, but the rest had an understandable reason why they should make more money during a recession.

What are the characteristics of a Counter-Cyclical business?

For context, there are three types of companies in terms of how they relate to the business cycle: Cyclical, Non-Cyclical, and Counter-Cyclical.

Cyclical businesses generally sell a non-essential, discretionary product or service. During the expansion phase of the business cycle, these businesses make a lot of money and their share price goes up quickly. But during a recession, consumers tighten their belts and rein in their discretionary spending, which leads to a drop in revenue and profits for Cyclical businesses, which in turn leads to a significant drop in share price.

Non-Cyclical businesses provide essential products and services, such as food, healthcare, and energy for homes. Because these products and services are always needed, the stage of the business cycle has little effect on these companies. In a severe recession, people slightly cut back their spending on food, healthcare, and utilities, but the demand reduction is much smaller than for Cyclical businesses. Thus, Non-Cyclical stocks usually go sideways through a mild recession and go down moderately during a severe recession.

Counter-Cyclical companies occupy a special niche in which demand for their product or service actually increases during the contraction phase of the business cycle. Because their revenue and profits go up during a recession, these special stocks have a reasonable chance of going sideways or even appreciating while almost all other stocks are falling.

Our research has found two main classes of Counter-Cyclical stocks: deep discount stores, and businesses that provide a product or service that is needed more during hard economic times.

Deep discount stores offer the lowest cost option for consumers with limited resources. During good times, some consumers will trade up from these stores, but during hard times, these stores will make more money as consumers trade down in an effort to make their dollar go as far as possible. Some of the best examples of deep discount stores which thrived during the last two recessions are Walmart, Dollar General, Dollar Tree, and Ross Dress for Less.

Businesses that provide a product or service that is needed more during hard economic times are a fascinating example of the chain of events that occur during a recession. For example, imagine you are a person who is scared of losing your job during a recession and your car is having problems. You probably won't go out and buy a new car. Instead, you would be more likely than normal to walk into a retail auto parts store to try to find the parts and advice you need to fix your car yourself. Again, not everyone will do this, but at the margin, if more people than normal do this during a recession, the auto parts company will grow revenue while most other businesses are losing revenue. During the last two recessions, AutoZone, O'Reilly Auto Parts, and Advance Auto Parts all grew revenue and their share prices appreciated.

Bankruptcy service providers are another example of businesses that provide a service that becomes in higher demand as financial conditions deteriorate. Such companies help with insolvency, restructuring, and business rescue options for companies, professional advisors and financial institutions.

Case Study: Walmart

"It is hard for me to remember a time when I have been so mindful of the reason my Dad founded Wal-Mart. He knew that every day – and especially in today's tough economy – the world needs a retailer that saves people money so they can live better. He really built Wal-Mart for these times." - Rob Walton, 2009 Walmart Annual Report

This quote perfectly describes what it means to be a Counter-Cyclical business. Walmart doesn't merely survive during a recession; it thrives. While company annual reports are usually positive, Walmart's 2009 report was ecstatic. And this enthusiasm wasn't just wishful thinking, it was based on hard business facts. In a year when the revenue growth of the S&P 500 was -12.9%, Walmart's revenue growth was +7.3%.

Here's how Eduard Castro-Wright, Walmart Vice Chairman, put it in the 2009 Annual Report:

"Consumers faced increasing challenges and uncertainties throughout the year. Our commitment to price leadership helped them save money when they needed it the most, which drove significant increases in store traffic. More people shopped at Walmart U.S. this year than ever before."

This sort of growth does not go unnoticed by Wall Street. During the bear market and recession that accompanied the Financial Crisis, the S&P 500 went down 56% from October 9, 2007 to March 9, 2009; over the same time period, Walmart went up 9%.

Looking back to the previous bear market, the S&P 500 went down 49% from August 31, 2000 to October 9, 2002; during the same time, Walmart went up 7%. Thus, in the past two bear markets, Walmart has outperformed the S&P 500 by an average of 60.5%. While past performance is no guarantee of future results, the economic forces which drove more consumers to shop at Walmart during the past two recessions seem likely to drive similar consumers to Walmart in the next recession. The Walmart name is still synonymous with low prices, and during hard times, consumers will look for the lowest price option.

To see the Counter-Cyclical nature of Walmart's business more clearly over time, it is helpful to strip away as many variables as possible. While stock price movements are ultimately what matters most to investors, there are many confounding factors which can cloud the picture that they paint. Total revenue growth is also very important, but it is strongly influenced by how many new stores a company opens. By looking just at the change in same store sales growth, we can see clearly whether more or fewer people are shopping at their local Walmart from year to year. This can be compared to the sales growth of the companies in the S&P 500 to see if people spend more or less money at Walmart relative to how much they spend at the other 499 companies (See Fig. 1).

Figure 1: Walmart same store sales growth and S&P 500 sales growth

We can see that Walmart's same store sales growth generally declines while sales growth is rising for the S&P 500, but it spikes up in 2002 and 2009 when sales growth in the S&P 500 turns sharply negative. Even during less extreme times, we see Walmart sales rise in 2012, 2013, and 2015; all years when sales growth slowed in the S&P 500.

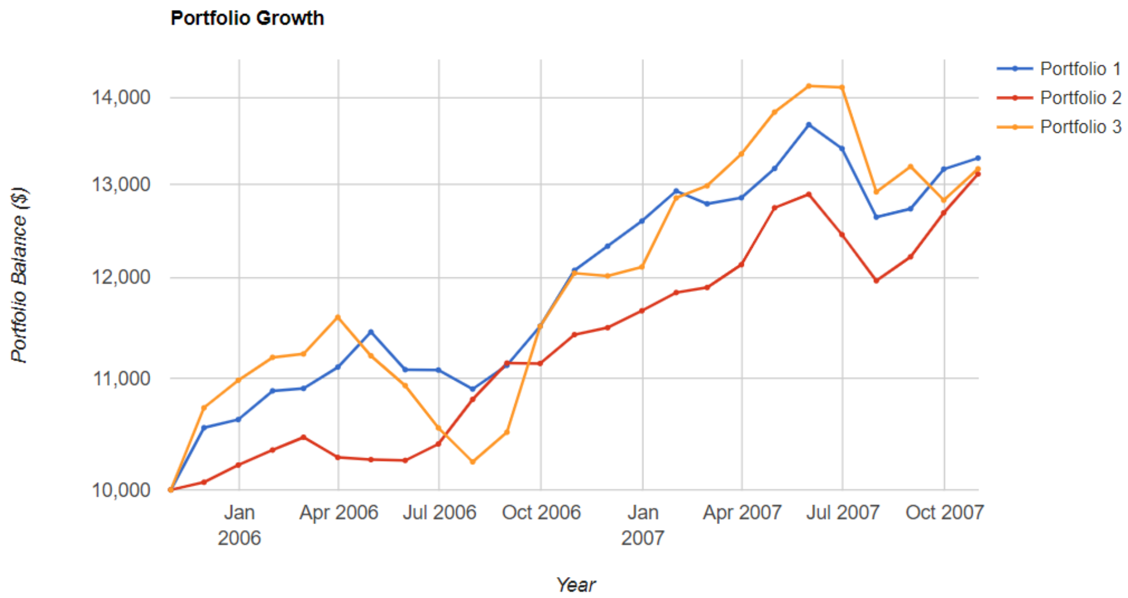
"The fact is, Wal-Mart's performance last year would be considered strong at any time and for any retailer, and certainly during one of the most difficult global economies in decades." - Michael T. Duke, Walmart President and CEO, 2009 Annual Report

Counter-Cyclical Stock Performance

Individual Counter-Cyclical stocks have volatility and uncertainty similar to any normal stock. Thus, for the purpose of analyzing their performance as an asset class, it is appropriate to look at a basket of them to smooth out company specific volatility. This basket was selected by filtering for companies that had positive revenue growth and share price appreciation from the start to the finish of the last recession excluding "one hit wonders," such has biotech stocks that happened to release a breakthrough drug during that time. The stocks in the Counter-Cyclical basket are: Walmart, Dollar Tree, Ross Dress for Less, McDonald's, AutoZone, O'Reilly Auto Parts, and Advance Auto Parts.

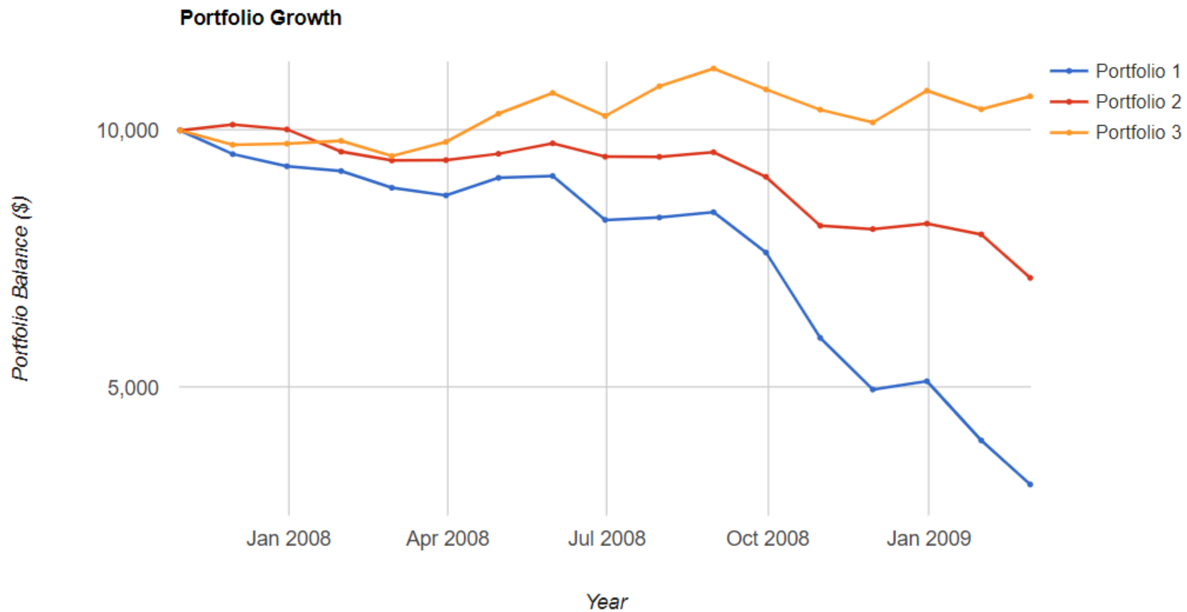
For this analysis, we look at how Cyclical, Non-Cyclical, and Counter-Cyclical stocks performed before, during, and after the Financial Crisis of 2007-2009. The Cyclical stocks are represented by an equally weighted basket of three ETFs: Materials Select Sector SPDR (XLB), Consumer Discretionary Select Sector SPDR (XLY), and Financial Select Sector SPDR (XLF). The Non-Cyclical stocks are represented by an equally weighted basket of three ETFs: Consumer Staples Select Sector SPDR (XLP), Health Care Select Sector SPDR (XLV), and Utilities Select Sector SPDR (XLU). Finally, the Counter-Cyclical stocks are represented by an equally weighted basket of Walmart, Dollar Tree, Ross Dress for Less, McDonald's, AutoZone, O'Reilly Auto Parts, and Advance Auto Parts. Specifically, we examine the performance of these portfolios during the two years prior to the previous stock market peak (Fig. 2), during the entire bear market from peak to trough (Fig. 3), during the two years after the bottom of the market (Fig. 4), and during the entire time period from two years before the peak to two years after the bottom (Fig. 5)

Figure 2: Performance of Cyclical stocks (Portfolio 1) vs. Non-Cyclical stocks (Portfolio 2) vs. Counter-Cyclical stocks (Portfolio 3) *in the two years before the start of the last bear market*:



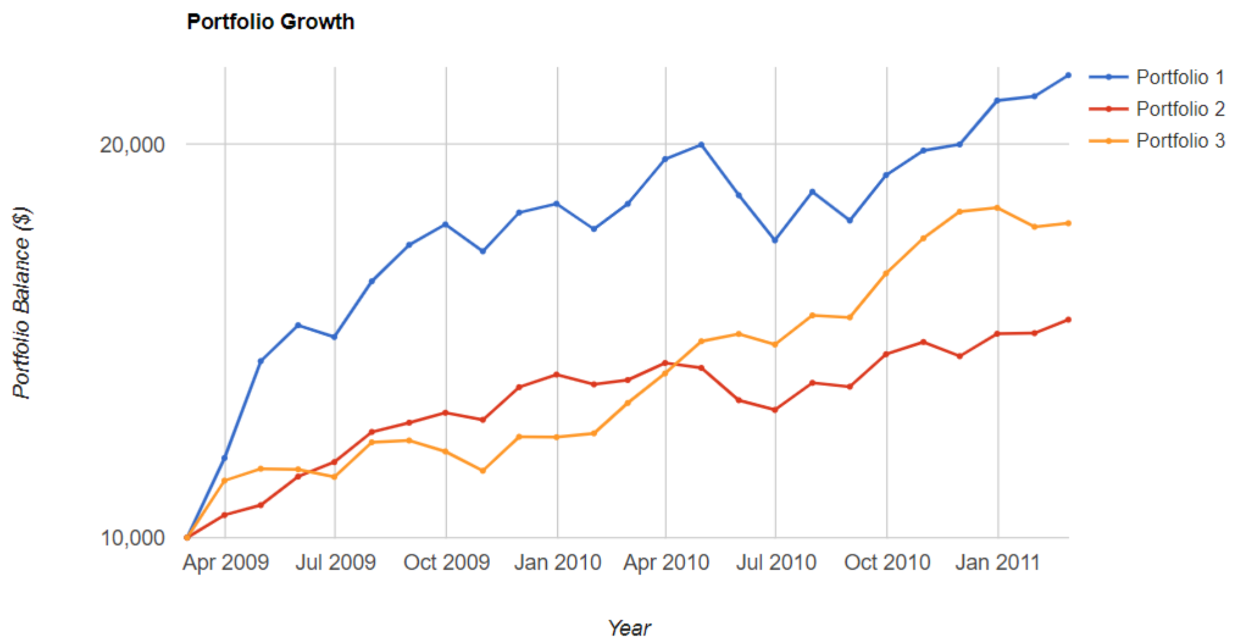
In the two years leading up to the stock market peak we see that a rising tide lifts all boats. The Counter-Cyclical stocks were more volatile, but the annualized rate of return for all three portfolios was +15 +/- 0.5%.

Figure 3: Performance of Cyclical stocks (Portfolio 1) vs. Non-Cyclical stocks (Portfolio 2) vs. Counter-Cyclical stocks (Portfolio 3) *from the peak to the trough of the last bear market*:



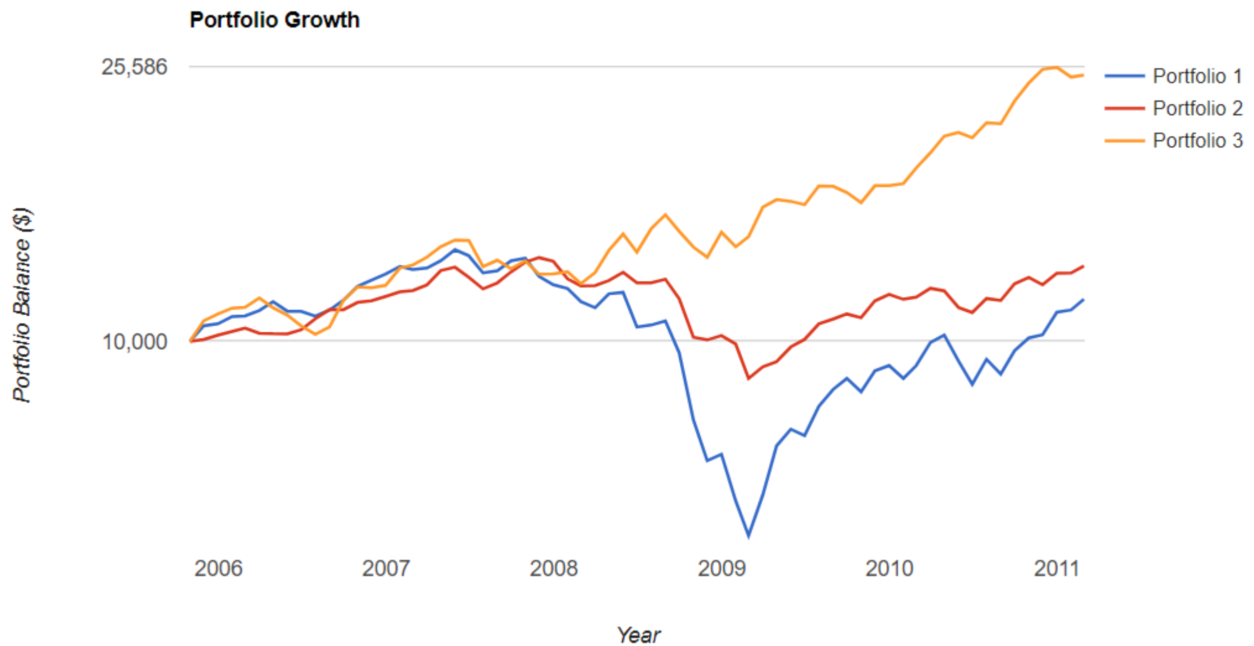
As Warren Buffett once said, “You only find out who is swimming naked when the tide goes out.” During the bear market the annualized rate of return for Cyclical stocks was a horrific -51.12% with a total drop of -61.50%. Non-Cyclical stocks held up much better, but still lost at an annualized rate of -25.78% for total loss of -33.80%. While the Counter-Cyclical stocks were not risk free, they appreciated at a +7.14% annualized rate for a total return of +9.6%.

Figure 4: Performance of Cyclical stocks (Portfolio 1) vs. Non-Cyclical stocks (Portfolio 2) vs. Counter-Cyclical stocks (Portfolio 3) from the trough of the last bear market through the next two years:



In the two years following the bear market bottom, we see a tremendous rebound across all three portfolios, with Cyclical stocks leading the way with a breathtaking +50.37% annualized rate of return which produced a total return of 126.11%! Non-Cyclicals did well at 21.20% annualized for a cumulative return of 46.89%. Interestingly, while the Counter-Cyclicals lagged behind during the first year, they made up ground in the second year to earn an annualized return of 31.96% for a total return of 74%.

Figure 5: Performance of Cyclical stocks (Portfolio 1) vs. Non-Cyclical stocks (Portfolio 2) vs. Counter-Cyclical stocks (Portfolio 3) from two years before the peak of the market through two years after the bottom of the market:



Putting it all together, we see that Counter-Cyclical stocks win by not losing. Over the entire time period, their maximum drawdown was -13.87% and the previous high was surpassed within 11 months. 3 years and 9 months after the peak of Cyclical stocks, they were still 15.5% below their high water mark. Non-Cyclicals fared better, but were still 2.8% below their high water mark set 3 years and 3 months earlier.

What role do Counter-Cyclical businesses play in a portfolio?

Counter-Cyclical stocks play an important role in a diversified portfolio, especially when leading economic indicators begin to point towards a recession. Because Counter-Cyclical stocks have risk and uncertainty like all stocks, their background expected return should be approximately equal to the standard equity risk premium. But unlike normal stocks, which exhibit above average returns in good times and below average returns in hard times, Counter-Cyclical stocks display below average returns in good times and above average returns in hard times. As a form of recession insurance, it would be prudent to have a slight overweight to Counter-Cyclical stocks by mid expansion. When leading economic indicators point to a recession within a year or two, it is time to significantly overweight Counter-Cyclical stocks as a way to prudently maintain equity exposure while simultaneously reducing a portfolio's downside recession risk. After a recession has dramatically reduced the valuations of Cyclical stocks, it is time to carefully

sell down Counter-Cyclical stock exposure to move money into Cyclical stocks in anticipation of the coming recovery.

Conclusion

Publicly traded Counter-Cyclical businesses are not numerous, but their investment characteristics are worth the extra effort required to find them. With the United States currently in the longest economic expansion in the history of the country, now is a particularly good time to think about how to wisely invest for a coming recession. While the vast majority of stocks go down during a recession, a small number of truly Counter-Cyclical stocks actually earn more revenue and stand a reasonable chance of going up.

This property is extremely valuable when constructing a risk/reward optimized portfolio. By replacing part of our normal (Cyclical and Non-Cyclical) stock holdings with Counter-Cyclical stocks, we can maintain similar exposure to the long term equity return premium, while significantly reducing our maximum drawdown risk during the next recession.

Best,

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