Which Industry Groups Are Closet Indexers?

The Financials, Materials and Energy Prove Their "Risk-On" Nature

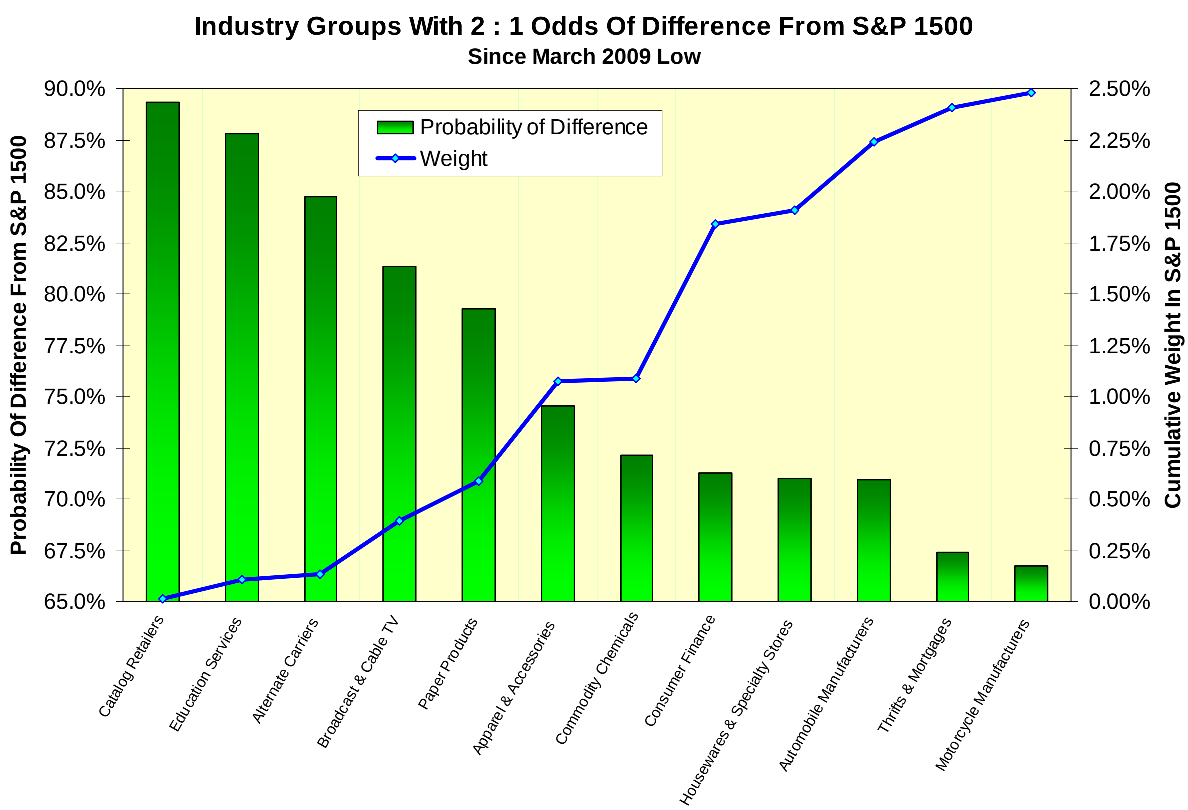
Those who say statistical analysis is all that separates us from the beasts probably need to spend a little more time out in nature, but it is quite clear the only thing that should count in market analysis is the willingness and indeed the ability to crunch a few numbers every now and then.

One of the things we have heard over and over in 2011 is the high level of correlation amongst stocks and amongst indices. It is just a fact of life in a market dominated by algorithmic trading, index and basket trading for ETF creation and redemption and the use of stock index futures to equitize and de-equitize cash. It is neither good nor bad per se, and one of the things I pointed out in October's Implied Correlation Has Led to High Stock Market Returns is sometimes high correlation, of volatility in this case, can lead to higher returns. Moreover, high intraday correlation does not mean diversification is impossible to achieve, as I noted in Investors, Take Note: Diversification Arrives With Time.

Chasing The Mean

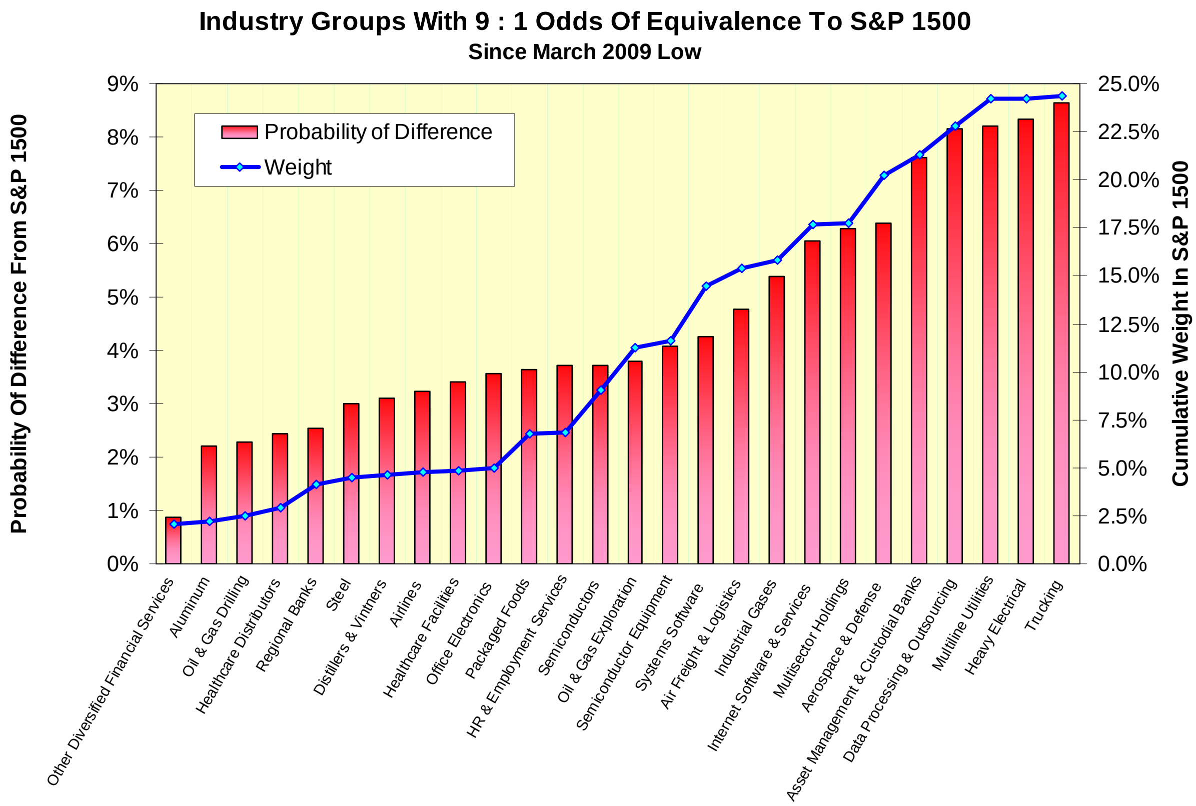
Calling an active fund manager a closer indexer is a slap in the face; it is equivalent to saying they are useless and provide no value for their fees. Heaven forbid. If you tilt your portfolio toward various industries, are you tilting toward the broad market mean or away from it? Let's use the same set of 147 industry groups used yesterday in assessing their psychological reserve and see which ones are statistically different from or virtually equivalent to the S&P 1500 itself. As before, the data sample will begin with the March 2009 low.

First, let's take the groups whose average returns are different from the broad market at a 66.7% or higher confidence interval; this is equivalent to 2:1 odds of being different. The list is surprisingly small, just 12 groups, and they combine for just under 2.50% of the Supercomposite by weight. I sniff.



If you are interested, and I cannot imagine otherwise, the most different group has been Catalog Retailers, otherwise known as HSN; you may call it Home Shopping Network. Put me down for the cubic zirconium.

Twenty-five groups accounting for 24.35% of the Supercomposite's capitalization are equivalent to the Supercomposite at a 90% or greater confidence level; this is equivalent to 9:1 odds of equivalence.



The list is dominated by financial, basic materials and energy sector firms and is headed up by Other Diversified Financial Services. These are the big banks such as Citigroup (C), Bank of American (BAC) and JP Morgan Chase (JPM).

Everywhere I have turned to in group and sector analysis has found these three sectors moving together in response to primal market factors such as energy prices, currencies and interest rates. They are the "risk-on" trio. If it has seemed to you they are the usual suspects on all of these big up and down days, the ones where 90% of stocks either rise or fall together, you are right. As the world moves more and more toward algorithmic trading where these factors are analyzed by machines to generate trades, their combined weight will accentuate these one-way movements.

This is just a fact of life. It will continue until someone gets too smart by half, bets too much and then gets clocked. If we have learned anything over the past quarter-century, this comeuppance is inevitable; when it will happen I have no way of knowing.