

The Importance of Sector Allocation

By Don Freeman

May 22, 2011

In this newsletter we will focus on sector allocation in your portfolio. Before we jump in though, we should take a moment to define exactly what it is, and why it is so important to a successful investing strategy.

Sector allocation is practice of including securities in different industries in your portfolio. This is an easy way to avoid systemic risk that can come with certain situations, such as general meltdowns in specific areas of the economy. For example, there might be major issues in the financial sector and as a result the major banks sell off. This won't necessarily have an impact on healthcare stocks. If you have shares in both industries, the losses in the financial stocks should be counterbalanced by the healthcare stocks. At the very least, the healthcare stocks won't normally lose as much as the financials in a situation like that. That is the basic idea of sector allocation.



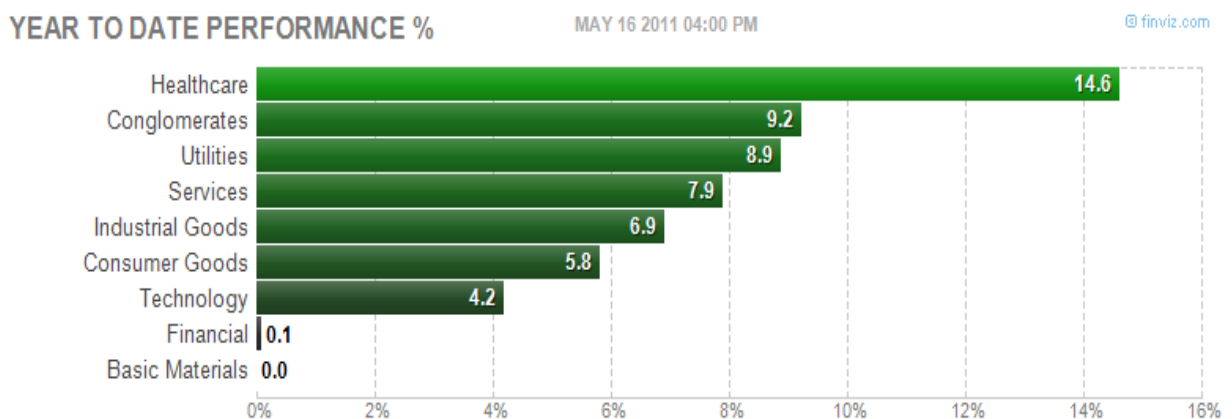
The long-term investor should practice sector allocation in order to smooth out the performance of their portfolio. This allows them the freedom to take advantage of the good times in certain sectors, while weathering the storm in others. If you think about the last twenty years, you can see that almost everything has risen in value since then. But when you think about it, certain areas have grown at different rates and times than others. This is in essence my job, to make sure the balance is always kept in your sector allocation. For example, look at Apple and how it has grown. Think about how much money you would have made if you owned the stock just ten years ago.

Looking beyond Apple, you can see that the entire sector has had several ups and downs over the years, but in general has risen. Often in times that technology falls, other sectors that are considered "safe havens" will rise in value. One great example is healthcare, as it is a service that people always need – no matter what the economy is

doing. This makes it a safe play for investors over the long-term as there is always demand for the companies.

Sector allocation can also include various countries as well. For example, you might have a balanced portfolio of country-specific ETFs from around the world. This makes sense as not all areas around the world are growing at equal rates all of the time. In fact, some will fall as others rise, but as a general rule: the world is getting more and more prosperous over time. So while your South Korean ETF is gaining 12% this year, you may find your Chinese fund falling a few percent. But the overall outlook for both is higher prices over time as the world advances.

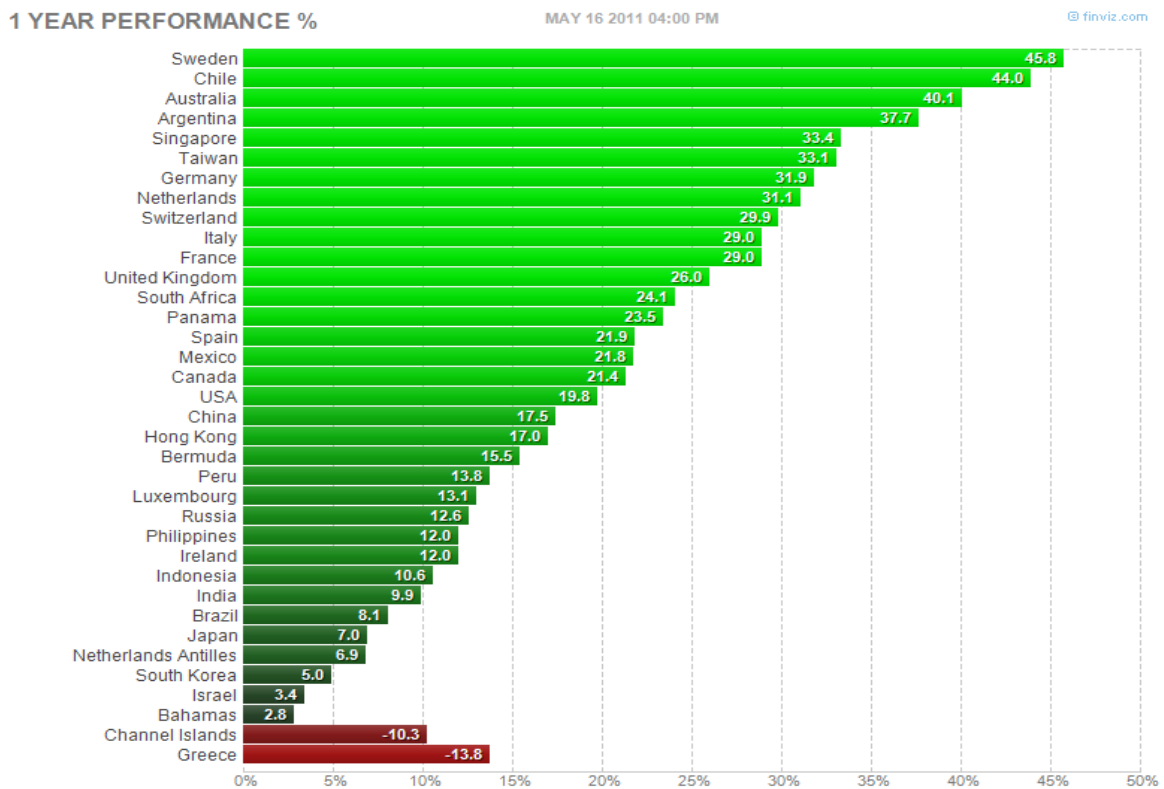
Looking at sector performance over the last 12 months, you can see how the healthcare sector is gaining rapidly. This signifies that the markets could be entering a cautious period, and as such looks to buy “needed” companies over those that supply wants. Contrast that with the financial sector, which has barely made a return at all, bringing in just 0.1% over the last year.



The reasons for this makes sense, as the average investor is understandably shell shocked from the financial crisis, and they are more likely to invest in something they understand like hospitals and radiological equipment. Also, this shows that the market may be getting a little more nervous, and this makes sense as the ride up from the market lows has been so relentless. There are a lot of potential headwinds coming out of Europe, and this makes investors look to the traditional “safe havens.”

It should also be noted that the financials at the bottom of the graph make sense to be weak in the short term as they are still weighed down by the housing markets in the US and developed nations, and the Greek debt is owned mainly by banks. The US government is also currently ramping up regulations as well, and this kind of uncertainty never sits well with someone wanting to invest their money.

Looking at country specific performance in the stock markets can give you a great view of which country specific ETFs are going to perform well over the longer term (6-35 months). As you can see on the chart below, some of the strongest countries have been Sweden, Chile, Australia, and Singapore. This makes sense because of the strong financial position Sweden finds itself in after already dealing with its own financial crisis a few years ago. This gives it strong banks and financial companies. It is also well-known for being a hub for technology as well.



Going onto the countries of Chile and Australia, they certainly benefit from the commodity trade. Although we are currently seeing volatility in the commodities, the fact remains that the rest of the world needs the copper Chile produces, as well as the gold, iron, and copper that Australia exports. This won't change anytime soon as the Chinese are expanding so rapidly, pushing prices up by their ravenous buying of all things commodity related. Singapore is an important financial hub for Asia, one of the strongest areas of growth in the world right now. It certainly makes sense for it to be ranked so high. The Greeks are at the bottom, and with their debt crisis, it shouldn't be very difficult to understand why investors aren't buying into their markets.



Country Specific ETFs

Conclusion

As you can see, there are many different countries you could have invested in over the last year. If you owned the Japanese, Russian, and Chilean ETFs, your Chilean one would have certainly help the portfolio out as the Japanese one gained “only” 7%. By practicing sector allocation, you were able to capture the profits of the explosive ones, adding to your overall returns. Also, if you did own the Greek ETF: The Chilean one would cover those losses.

As you can see sector allocation is something that can be very important for your long-term prospects. By balancing your portfolio with the various sectors, I can take advantage of explosive moves as they happen, and can even help protect against other positions that are going through pullbacks.

About Freeman Capital Management, LLC

Don Freeman is Managing Director of Freeman Capital Management, a Registered Investment Advisor with the U.S. Securities Exchange Commission (SEC). He provides personal financial planning and investment advice to expatriates and teaches financial courses throughout SE Asia and the United States.

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