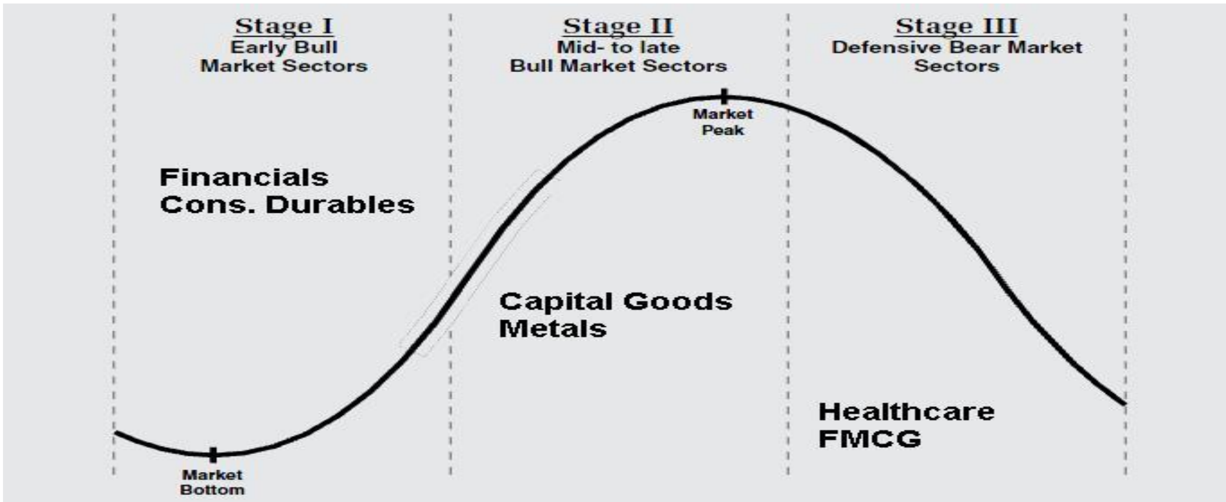
Cyclical and Defensive Sectors



- Sectors perform differently during an economic and market cycle. On this basis, the sectors can be broadly grouped as cyclical or defensive sector.

What is cyclical sector?

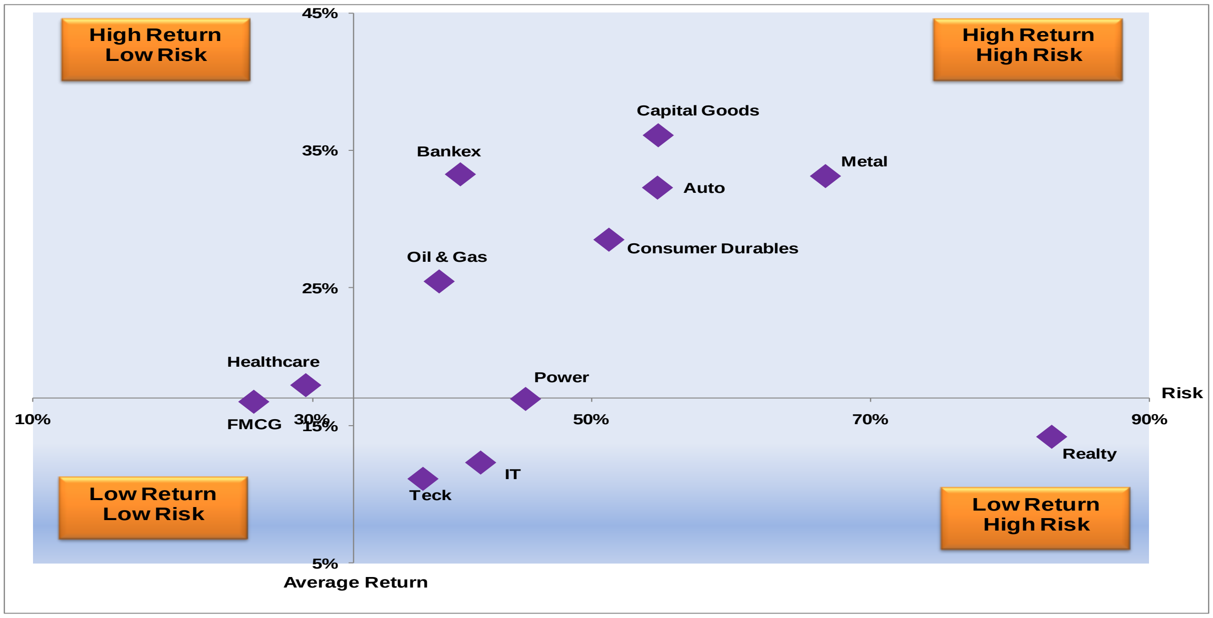
- Cyclical sectors are those sectors which are highly correlated with the economic cycle. These sectors move in line with the economy.
- Cyclical sectors are affected by economic indicators like interest rates, inflation etc.
- Sectors which are cyclical in nature include Auto, Capital Goods, Financial, Metals, service industries like Tourism, Hotel etc.
- Cyclical sectors being highly correlated with the economy outperform when the economy is booming and underperform during recession.
- When economy is on an upswing, consumer's discretionary spending increases resulting an increase in demand of goods and services of these sectors. This in turns leads to capacity expansion for the companies, which result the sectors to outperform.
- Cyclical sectors movement being in line with economy tends to have beta more than 1.

What is defensive sector?

- Defensive sectors also known as non-cyclical are those sectors which are not correlated with the economic cycle.
- Defensive sectors are not affected by economic indicators and do not depend on consumer's discretionary spending.
- These sectors produce goods and services needed by consumers in their daily life and include sectors like FMCG, Healthcare, Utilities like power, oil & gas etc.
- Defensive sectors not being correlated to the economy outperform during recession and underperform during economy upswing.
- When there is recession, defensive sectors outperform as demand doesn't decrease because it represents the daily need of consumers and do not depend on their discretionary spending. However during economic boom it underperforms the market as demand doesn't increase in comparison to capacity expansion.
- Defensive sectors not being affected by economy tends to have beta less than 1.

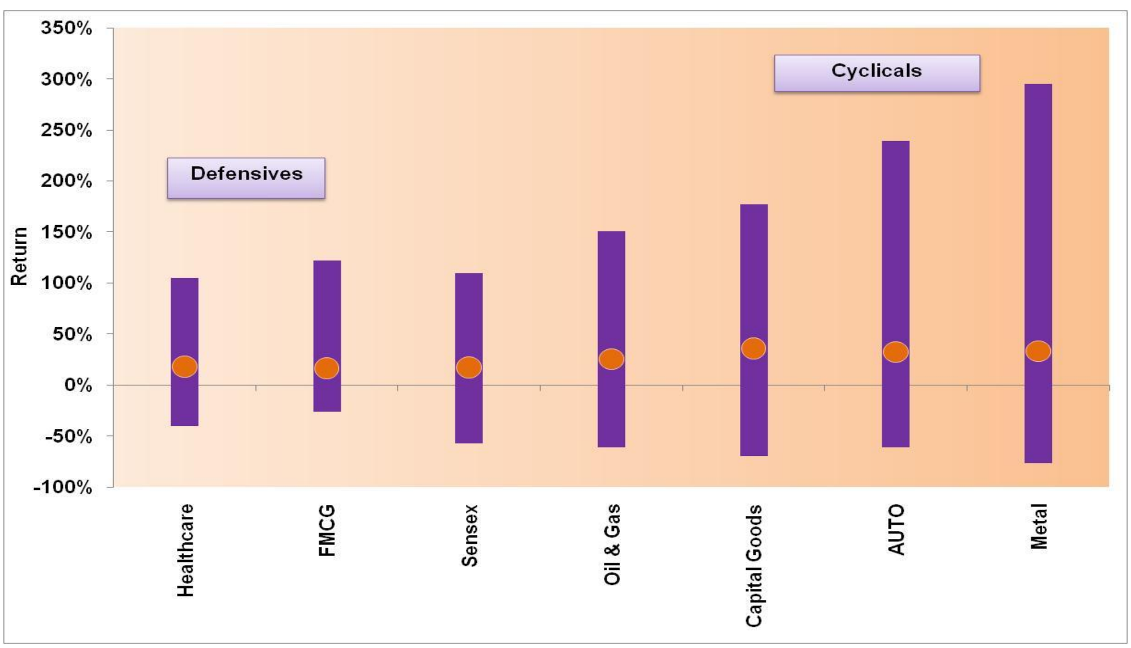
Re W I S E

- Chart below shows the risk[1] and return[2] of different BSE sectors plotted against the Sensex having return of 17.2% and risk of 33.3%.



Source: BSE

- From the above chart, it's observed that cyclical sectors like auto, capital goods, realty, and metal are more volatile in comparison to defensive sectors like fmcg, healthcare.
- Chart below shows minimum, maximum and average returns for Sensex, defensive and cyclical sectors.



- From the above chart, we can observe that defensive sectors show lower variation while cyclical sectors show higher variation.

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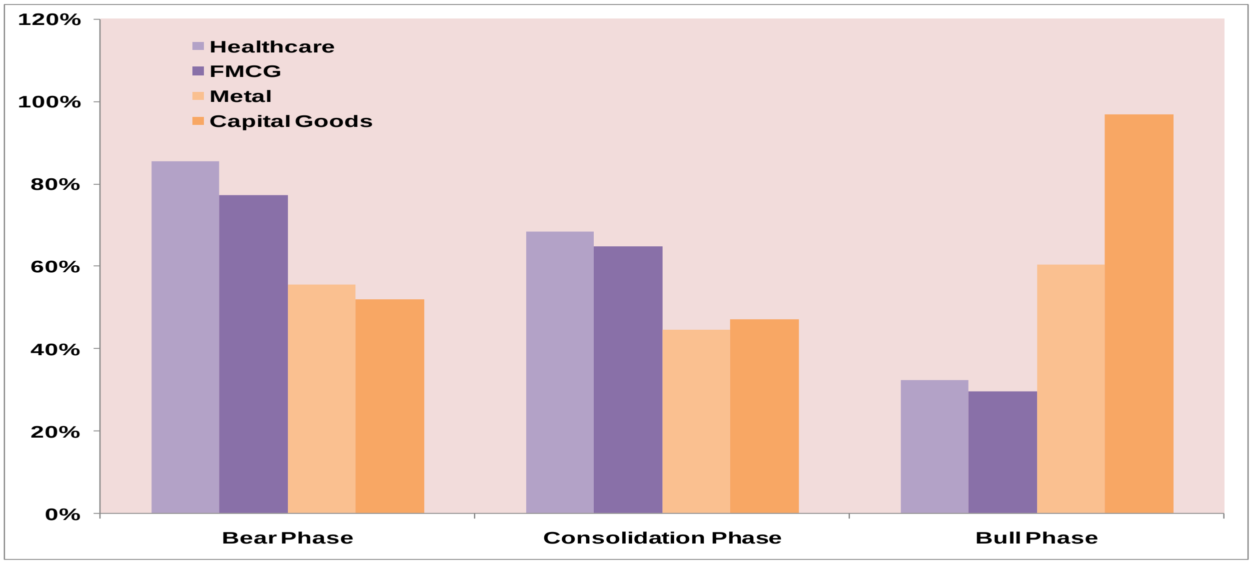
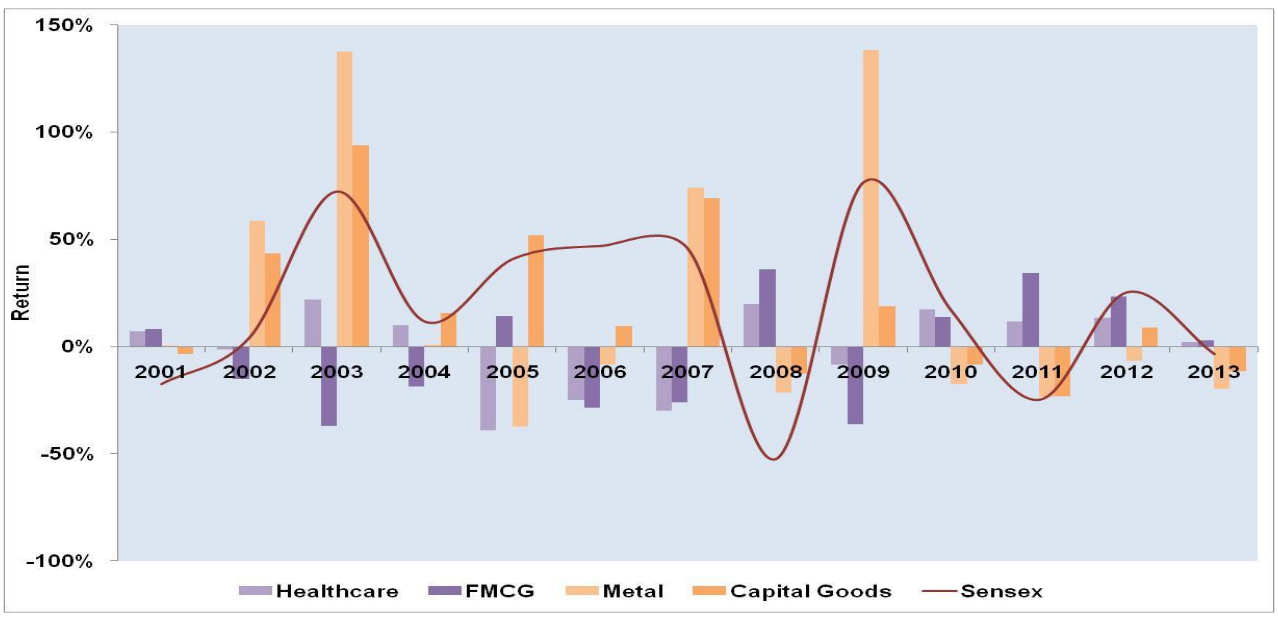
[1] Standard Deviation is used as measure of risk and calculated from Jan 2001 till 20th March 2013

[2] Return is average 1 year daily rolling return from Jan 2001 till 20th March 2013

- Chart below shows relative outperformance of the sectors compared to Sensex during different market phases[3].



- It's observed from the above chart that defensive sectors like fmcg, healthcare respectively outperform around 77% and 86% of the time during bear phase.
- Conversely, cyclical sectors like metal, capital goods respectively outperform around 60% and 97% of the time during a bull phase.
- This indicates that cyclical sectors outperform during bull phase and defensive sectors outperform during bear phase.
- In continuation to above, chart below shows annual relative returns for the above mentioned sectors and Sensex annual returns.



[3] Bear phase is when Sensex give negative returns, Consolidation phase is Sensex given returns between 0-25% and Bull phase when Sensex given returns above 25%.Returns are 1 year daily rolling returns from Jan 2001 till 20th March 2013