

93/09-What Goes Around...

One of the keys to Magellan's success was buying cyclical stocks in the early '80s. Is it time to buy cyclicals again?

By Peter Lynch

At Magellan, I loaded up on cyclical stocks during the 1981-1982 economic slump. This strategy was one of the keys to Magellan's success. It occurs to me that we may now be in a similar situation, one in which cyclical stocks will do well.

While the stock market overall has been stuck in the tightest trading range in 40 years, we've already seen some exciting advances in cyclicals. "Seen" may be the wrong verb, because many people seem not to have noticed the upturn, which is occurring, as usual, as we come out of the latest recession.

At the end of the glorious decade, the 1980s, the consumer growth stocks (Merck, Gillette, < wam-co NYSE:KO>Coca-Cola, Wal-Mart, < wam-co NYSE:HD>Home Depot__you know the names) continued to wax while the cyclicals waned, but this couldn't continue indefinitely. On Wall Street, what waxes today may wane tomorrow, as many of these growth stocks have, since 1991. Meanwhile, the cyclicals were due for a rebound.

Sure enough, the 30 companies included in Morgan Stanley's Cyclical Index turned in a 23 percent gain in 1992, when the S&P 500 rose just 4.5 percent. In the first half of 1993, cyclicals once again have outpaced the average stock. One leader, Standard Products, which makes plastic and rubber gizmos for the transportation industry, has tripled off its 1990 bottom.

For those of you who haven't already heard, a cyclical is a company that will prosper in good times and suffer in bad. That's because it makes or sells expensive products or luxury items that customers can put off buying when they are short on cash. People continue to buy deodorant, dental floss, Big Macs, and headache pills no matter what, which is why drugstores and fast-food restaurants are not cyclicals.

Usually when people think of cyclicals, they think of the industrial giants, such as the steels, the aluminums, and the autos. But industrial giants no longer dominate the financial landscape the way they did in, say, the 1950s. The folks at Dow Jones have had to fill out the Dow Jones Industrials with such unlikely industrials as McDonald's and Disney. If more people realized that McDonald's was a Dow Jones Industrial, the Big Mac might not be so popular.

While the smokestack cyclicals have declined in number, there are other kinds of cyclicals, including some that are not recognized as such. Hotels are cyclical, since more rooms are sold, and at higher prices, in a strong economy. Expensive restaurants are cyclical, since they cater to a prosperous clientele, people who can retreat to the neighborhood bistro as soon as they feel the pinch of recession.

Machinery in general is cyclical, and so are the homebuilders, the appliance companies, and the furniture manufacturers. IBM turned into a cyclical when the mainframe computer became its most important product. Waste-management companies are cyclical__although when these clean-up stocks were widely touted some years ago, investors, unfortunately, did not recognize that fact. Many bought at the wrong time, only to see the cleanup stocks get clobbered in the recession. When business is slow, there's less waste to clean up.

Liner board, which we call cardboard, is cyclical; when nothing is selling, the stores don't need boxes to ship it in. Then there are the airlines. I regard United as the ultimate cyclical. One year it earns \$15 a share, and another year it loses \$15 a share. So it's a \$15-a- share operation, no matter what.

If you're ever in doubt as to whether a certain company is a cyclical, the easiest way to tell is to look at its chart in Value Line, or in one of the chart books published by the Securities Research Company and available in libraries or in a broker's office. One of the lines on a stock chart is the earnings line, and here a picture is worth a thousand numbers. When the earnings line has a steady upward slope, the way Merck's does, you're dealing with a growth stock. When it wobbles up and down, as Alcoa's does, you're probably dealing with a cyclical.

The best time to get involved with cyclicals is when the economy is at its weakest, earnings are at their lowest, and public sentiment is at its bleakest. The staff at Standard & Poor's weekly newsletter, "The Outlook," once reviewed the eight recessions since World War II to find out what happened to the prices of key cyclical stocks after the stock market hit bottom. In every instance, the cyclical groups gained 50 percent or better in five months, more than double the advance of the S& P 500.

It is consumers who lead the way out of a recession, with their car buying and home buying and replacing of old appliances, all of which then creates a revival in the businesses up the line__lumber mills, steel plants, capital goods manufacturers, the advertisers, the newspapers that sell space to the advertisers, and so on.

Yet even though the cyclicals have rebounded in the same fashion eight times since World War II, buying them in the early stages of an economic recovery is never easy. Every recession brings out the skeptics who doubt that we will ever come out of it, and who predict that we will soon fall into a depression, when new cars will sit unsold in the showrooms forever and houses will stand empty, and the country will go bankrupt. If there's any time not to own cyclical stocks, it's in a depression.

"This one is different," is the doomsayer's litany, and, in fact, every recession is different, but that doesn't mean it's going to ruin us. In order not to get sucked into the gloom, I always remind myself that although we once suffered from chronic depressions leading to the Great Depression of 1929 (in fact, that one was no "greater" than several others), we are no longer the same economy.

Today 17 percent of Americans work for federal, state, or local governments, and millions more get Social Security benefits, unemployment compensation, and/or pension payments, so there are enough steady paychecks being cashed every week to keep the economy from slowing to a halt. We have a huge college industry and a huge health- care industry, both of which are immune from recession__colleges do better in recessions. There are many other stabilizing factors__the Fed, deposit insurance, and so forth__that we've all heard about.

This brings us to the ninth recession since World War II, which began in 1990. As usual, the skeptics said that this recession was different from other recessions, and that we might never recover from it. Now that we're two years into the recovery, some people are still doubting that we'll ever recover. Meanwhile, Europe is still in the depths of recession and Japan is sluggish, and the inevitable revival in both places will stimulate our economy.

While some cyclicals have produced impressive gains already, others have yet to turn, and if the experience of 1982 is any guide, the cyclicals have several good years ahead of them. Although Chrysler </wam-co> has quadrupled in price since its 1990 low, and Ford has doubled, both stocks have barely reached the levels at which they sold before the Great Correction of 1987.

As business goes from lousy to mediocre, investors in cyclicals can make money; as it goes from mediocre to good, they can make money; from good to excellent, they may make a little more money, though not as much as before. It's when business goes from excellent back to good that investors begin to lose; from good to mediocre, they lose more; and from mediocre to lousy, they're back where they started.

So, you have to know where we are in the cycle, and right now, most companies are somewhere between lousy and mediocre. But it's not quite as simple as it sounds. Investing in cyclicals has become a game of anticipation, as large institutions try to get a jump on their competitors by buying cyclical companies before they've shown any signs of recovery. This can lead to false starts, when stock prices run up and then fall back with each contradictory statistic (we're recovering, we're not recovering) that is released.

To succeed at investing in cyclicals, you have to have some way of tracking the fundamentals of the industry and the company involved. This is where the Investor's Edge comes in. Of the 110 million Americans who have jobs, at least 50 million are involved in cyclical industries, where they are in a position to see a business turn before the news reaches Wall Street. People who build houses or sell houses, make cars or sell cars or parts of cars, work in a chemical plant or install aluminum siding, work in the airlines or the travel agencies, have a front-row seat from which they can watch the prices, the inventories, and the sales go up or down. Employees in the temporary-help agencies are the first to know which companies have more work than they can handle, a sure sign that business is getting better.

This is the sort of "inside information" that can be put to profitable use, although most people fail to take advantage of it. Even if you decide it's too late to buy your favorite cyclical in the current recovery, in the next five years, ten years, or 15 years there will be another down cycle, and another buying opportunity. Cyclicals are very forgiving. They always give you a second chance.

Peter Lynch writes the Investor's Edge column monthly. From 1977 through 1990 he managed the Magellan Fund, the best-performing of all mutual funds over a 15-year period, and he is now vice-chairman of Fidelity Management and Research Co. His latest book, *Beating the Street*, is published by Simon & Schuster.

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