Fight Market Malaise with These Four Sector Strategies

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Markets are proving challenging in 2016. Divergent monetary policies among the world's central banks, a bull market that's quite long in the tooth, and full valuations on domestic stocks frustrate.

Catalysts to jump start growth are scarce. Headwinds include weak corporate earnings, low energy prices affecting the energy patch and related industries, and a strong Dollar making exports less competitive, depreciating the value of overseas profits.

The S&P 500 is quite fully valued, at around 17 times this year's earnings. Yet, with yields on Government debt still below the average stock dividend, investors remain very incented to look for undervalued equity opportunities. Consider these four sectors:

Small Caps

The S&P 500 consists of the biggest 500 stocks in the US, out of the approximately 5000 equity issues that trade here. Historically, small and midsize stocks, those with smaller market capitalizations than the top 500, have outperformed their larger brethren. From 1928 to 2014, smaller firms outpaced larger ones by 3.5% annually.

Smaller companies, although more volatile, have potentially greater growth trajectories, because their market shares are typically quite small. In addition, they are potentially bait for larger companies, providing investors a potential windfall should they be bought out.

Yet, despite the long term outperformance of the small fry, they have been big underperformers in recent years. Vanguard's small index fund has returned on average 3% less relative to the S&P 500 over the last five years, with a surprisingly large 9.5% shortfall in just the last 12 months. This despite many proclamations that due to lesser international exposure smaller firms should have superior fundamentals relative to the big multinationals, struggling to overcome Dollar strength and flailing overseas economies.

To incorporate them in your portfolio, consider simply using an indexed portfolio class, for example **Fidelity's Spartan Small Cap Index Fund (FSSVX)**. To gain access in a discounted manner via a closed end fund, try the **Royce Microcap Fund (RMT)**. Despite outperforming the

S&P 500 by 2.5% annually over the last 15 years, its last 12 months have seen it lagging by nearly 20%. Its portfolio can be bought at a 16% discount to net asset value.

Many individual names offer outstanding value, including community banks, frequently trading at or below book value. Be sure to invest in a passel, so as to dampen the inevitable volatility and to insulate from a bad apple.

International Plays

Overseas stocks outpaced domestic stocks for the first decade of this century, gaining 31% versus a drop of nearly 11%, even including dividends, for the S&P 500. However, since then the S&P has doubled versus a meager 14% international return.

Part of the challenge has been the different composition of the domestic economy versus overseas economies. The lion's share of technology and healthcare is positioned Stateside, and those sectors have garnered much recent attention.

Overseas economies, by contrast, have much greater weighting in finance, industrial, basic materials, and the energy industries. As these industries have struggled with a sluggish rebound from 2008-9's Great Recession, overseas stocks have become laggards. Another factor has been the strong US Dollar pushing down the value of overseas assets and profits.

Change may be afoot. While our central bank is tightening monetary policies, most overseas monetary authorities are loosening. Interest rates in some cases are negative, theoretically justifying equity valuations of infinity.

Inflation may yet be on the horizon, giving a boost to energy and raw materials, the bulwark of many international economies. If interest rates are poised to rise over the next five years, financials, the centerpiece of many foreign bourses, could be in the sweet spot. Overseas stocks typically trade at cheaper valuations, with more generous dividends, than is the case Stateside.

Index funds again, particularly for a smaller portfolio, may be an economical and simple way to obtain exposure. Consider Fidelity's **Spartan International Index Fund (FSIIX)**.

There are closed ends that allow you to invest in international portfolios at steep discounts from their net asset value: **Lazard World Dividend & Income (LOR)** and **Voya Global Equity Dividend & Premium Opportunity (IGD)** trade at 17% and 12% discounts, respectively, and offer generous payouts.

Many international stalwarts trade Stateside. There is no American company that dominates the planet's packaged food business like **Nestles (NSRGY).** It boasts a 3.1% yield and trades 8% off it recent high; growth opportunities are enhanced by its emerging market initiatives.

London based **Vodafone (VOD)** trades on the NYSE, offers a play on the communications needs of Europe and other continents, and pays out a generous dividend. Meanwhile, Detroit's Big Three automakers pale in comparison to their foreign competition. **Toyota (TM)** and **Volkswagen (VLKAY)** sell many more vehicles, although VW stock sells at less than half the price of Toyota. VW faces actions over failures to meet emission standards; however, its luxury brands including Porsche and Audi are arguable worth more than the entire parent company at the current quote.

Healthcare Plays

Pummeled over fears of the potential effects of the Affordable Care Act, the sector soared when it turned out that there'd simply be more customers, but without any reduction in prices.

Fast forward to 2016, a year of politics and concern over costs, exacerbated by the likes of Martin Shkreli, the poster child for outlandish price hikes with no R&D to justify them. Healthcare stocks have plunged.

Many of these companies remain high quality, with productive R&D pipelines and long tails for existing patents. Americans, indeed the entire world, are desperate for solutions for better health.

While you can play the sector via exchanged traded funds dedicated to this area (**Healthcare Select Sector SPDR (XLV)**), we prefer to pick out individual stocks that have unusual appeal.

Allergan (AGN) sports a diversified portfolio of proprietary drugs and biosimilars, including the best known compound on the planet, Botox. Liquidity will be enhanced following the planned sale of its generic portfolio to Teva. The kicker is that the company has agreed to be acquired by Pfizer, at a premium of over 22% to the current stock price.

Generic plays have also sold off hard, and seem to make sense as long term investments as societies strive to reduce costs. Largest of the generics is **Teva (TEVA)**, whose stock is down by a third since summer. Aggressive generic **Mylan (MYL)** is down over 40% but we believe has a bright future.

Energy Bargains

Both crude oil and natural gas prices have crashed by two thirds over the last several years. Low cost US fracking technologies coupled with war torn Middle Eastern countries resuming production have increased supply just as a global economic slowdown depressed demand.

Now, the laws of economics are kicking in. Energy related capital expenditures have declined for two years in a row, not previously seen in modern times. The oil rig count has dropped to 474, down from nearly 2000 in late 2014. Energy prices will rise.

The obvious play is **Exxon (XOM)**. Its geographic and operational reach, from upstream exploration to mid-stream transport to downstream refining and chemical production, assures it will do well even if commodity prices stay volatile.

More aggressive investors can venture into energy services, which provide drilling and other support for the big guys. The field is dominated by **Schlumberger (SLB)**. In an effort to compete better, numbers two and three, **Halliburton (HAL)** and **Baker Hughes (BHI)**, have agreed to merge, with Haliburton offering its shares and cash as consideration. The package is worth over 31% more than the value of the Baker Hughes being given up. Bottom line, Baker Hughes is an attractive way into the energy patch, with a big premium if its planned merger with Halliburton occurs.

In Sum

Despite full valuations and slowing earnings growth, low interest rates make the search for better returning equities imperative. Consider these four asset classes to boost your portfolio.