

TNT: Explosive Ideas for Successful Security Selection

By Alan Segars, CFA, Chief Investment Officer

TNT, or Trinitrotoluene, is best known as an explosive material, originally adopted by German armed forces to fill artillery shells in 1902. The TNT we have in mind is not the manufacture of explosive materials but the generation of explosive ideas through Tilts N' Themes. Tilts involve overweighting or emphasizing a particular sector or industry based on a positive fundamental outlook and/or compelling valuation. An example of a tilt would be the biotechnology industry, which is benefiting from substantial research & development (R&D) investment, drug innovation, and new drug demand from large pharmaceutical companies. An example of a theme is disruption, wherein a company gains a competitive advantage through innovation or some other means. (Please see Beacon Trust Market Monitor, "When Disruption is a Positive," dated December 20, 2013.) In essence, the line between Tilts N' Themes is a bit blurred. For instance, we might tilt toward the biotechnology industry because of its high R&D expenditures but also because it is a disruptive force.

TNT ideas can often emanate from economic, monetary or financial trends. Ironically and contrary to popular belief, broad economic trends do a poor job of forecasting the stock market. Coincidentally, while preparing this commentary, we came across an article on the Seeking Alpha Web site that argued for a strong relationship between real GDP and the S&P 500 based on a chart showing a trend line comparison between dollar GDP and the S&P price from 2004 to mid-February 2014. Our regression analysis of these two variables in percentage terms (not dollars) during the same period resulted in a correlation coefficient of 33%. In other words, real GDP explained only a third of the change in the stock market. Would you invest in a situation where the odds of being right were much less than 50%? So, from our vantage point, the belief that broad economic data can be used to forecast the stock market or to select specific securities is a myth. What does help with birthing explosive ideas for security selection is analyzing the merits of sector/industry trends or themes and their influence on specific securities. This endeavor takes on added significance in the current market environment for a variety of reasons, such as:

- Increased relevance of stock picking/security selection as fewer stocks and asset classes move in lock-step (lower correlations)
- Fewer bargains as the stock market reaches historic highs
- Increased market volatility reflecting the death of quantitative easing (QE) in the US and geopolitical risk and other concerns in emerging markets
- Low returns from safe assets such as bonds

We introduced several TNT ideas in 2013 including housing, defense, business investment/capital spending (capex), biotechnology, and valuation. We update our outlook for business investment and biotechnology on the following page.



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Market of Relevance: Equities

- 1) Nonresidential fixed investment grew 8.6% in 4Q13 following consecutive 6% gains in the second and third quarters
- 2) The Policy Uncertainty Index declined by 30%, on average, during the 12 months ended January 2014

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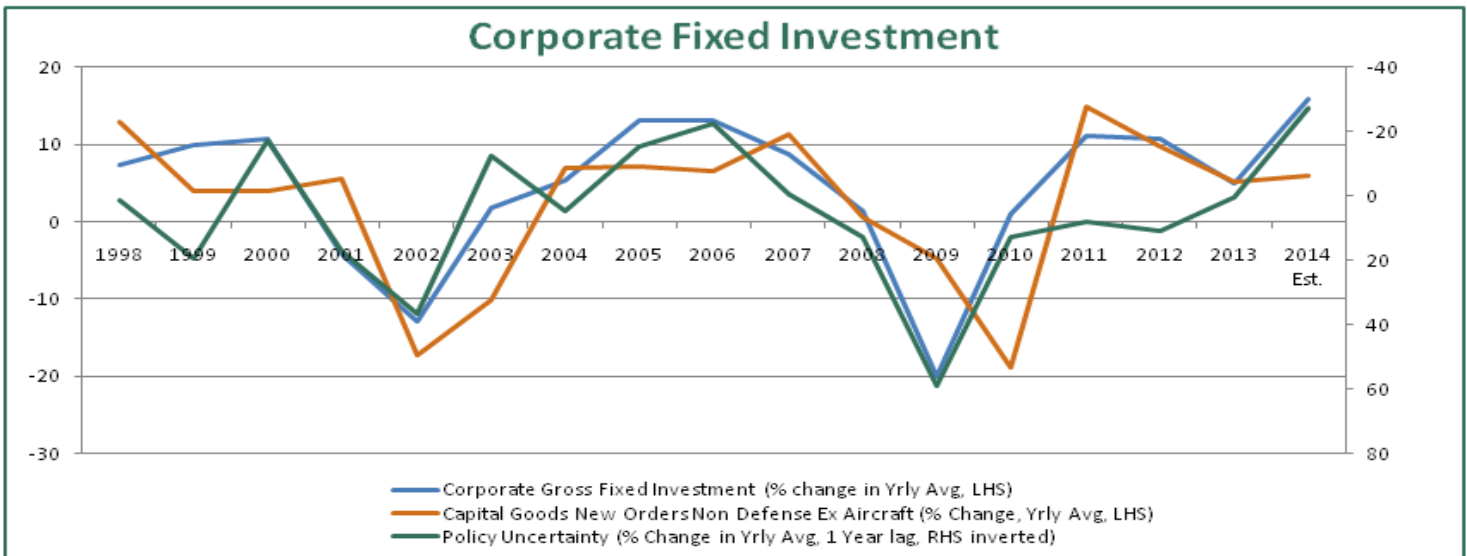
Corporate Fixed Investment

In the September 2013 Market Monitor, we predicted that corporate fixed investment was due for a comeback akin to the stock market's recovery during the last five years. The underpinnings of this prediction were reduced policy uncertainty, giving corporations the confidence to invest in their businesses, and signs of escape velocity in key economic barometers such as nondefense capital goods orders ex aircraft. Despite rumblings of social unrest in several emerging market countries, Washington, DC dysfunction is receding. As such, Stanford University's Policy Uncertainty Index¹ declined by 30% for the 12 months ended January 2014. Nondefense capital goods orders rose by 7% on average during the second half of last year. Other positive indicators include the new orders index from the Institute of Supply Management, which is approaching its pre-financial crisis highs. In the GDP accounts, nonresidential fixed investment, which encompasses capex and R&D, grew 8.6% in 4Q13 following consecutive 6% gains in the second and third quarters, a not

too shabby performance. We continue to believe that fixed investment will accelerate to a mid-double digit rate during 2014. The accompanying chart shows our forecast based on trends in Policy Uncertainty and nondefense capital goods orders.

So what does this mean for specific sectors/industries and stocks? We continue to view prospects for biotech stocks and ETFs quite favorably, despite a 17% total return for the NASDAQ Biotechnology index during the year's first two months. From a longer-term perspective the industry should benefit from hefty R&D expenditures and new drugs. Accelerated business investment will facilitate the emergence of a manufacturing renaissance in the US. This in turn will give rise to additional TNT investment opportunities.

Please stay tuned for updates on existing as well as new TNT ideas.



R²=81%

Source: Federal Reserve; U.S. Census Bureau; Economic Policy Uncertainty

¹The Policy Uncertainty Index consists of three components: 1) Newspaper coverage of policy-related economic uncertainty; 2) The number of federal tax code provisions set to expire in future years; and 3) Disagreement among economic forecasters. The index correlates inversely with corporate fixed investment, meaning, investment spending goes up when policy uncertainty goes down and vice versa.

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