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Two steps back

Commentary: Low-profile financials, chemical and drug makers look solid

By Alan Lancz

TOLEDO, Ohio (MarketWatch) -- The old adage about selling in May and going away was all but forgotten back in May 2007 as the global equity markets were coming off five consecutive summers of gains.

In fact, exactly three years ago, a reporter called us to ask if "sell in May and go away" was old school and no longer something investors should consider.

We have always had reservations about such all encompassing, blanket type statements, but we did tell the reporter that just when investors give up on such a statement, it may be the best time to revisit it.

Going into 2010, we expected a two-steps-forward, one-step-back type market, with volatility in both directions coming back on the table. Investors experienced their first significant correction since the March 2009 low in the middle of January, which pulled valuations down a little more than 9%.

This was actually a positive for the long-term health of equity markets, but after eight straight weeks of gains (the longest such stretch since 2004), how should investors position themselves now?

First of all, it is critical to lessen risk as valuations rise, which has been the basis of most of our tactical strategies over the past few weeks. After the huge advances in our two favorites for 2009 (Goldman Sachs Group Inc. (NYSE:GS) and J.P. Morgan Chase & Co. (NYSE:JPM)), we have recommended taking full profits in Goldman Sachs and partial profits in J.P. Morgan.
Just as important as taking profits, it is important not to chase stocks as valuations rise and rather look for new, unrecognized bargains. In terms of the financials, which face financial regulatory reform and rising interest rates, we feel investors are better off buying Western Union Co. (NYSE:WU) and H&R Block Inc.(NYSE:HRB) at current depressed valuations rather than buying many of the banks that have already soared threefold or fourfold (or more) over the past 12 to 18 months.

Flexible approach needed

As the global equity markets continue to advance, investors should become more defensive. Investors who do not capitalize on the two-steps-forward (take partial profits, become more defensive) and one-step-back (add to risk and selectively buy) will be destined to take on too much risk at exactly the wrong time.

To lessen risk as valuations rise, investors should look at companies that are not only paying solid dividends which are consistently increased to keep pace with upcoming inflation risk, but also companies that are aggressively buying back shares, which should reduce downside during those one step back market phases. The added benefit is that some of these companies are trading near new lows, despite the fact that the markets are reaching levels not seen in more than 18 months.

Qualcomm Inc. (NASDAQ:QCOM) , Monsanto Co. (NYSE:MON) and Baxter International (NYSE:BAX) are companies facing short-term difficulties that have presented opportunity for the patient investor seeking total return.

Continuous risk management

It is critical to find companies that can participate in the segments of the markets we still find attractive, such as technology and commodities, but to do so without chasing our past winners which have already soared in price. As much as we like Apple Inc. (NASDAQ:AAPL) and Google Inc. (NASDAQ:GOOG) , two of our largest growth positions within our money management firm, we would not buy either at current levels.
It is still important to participate in this market, but we would rather do it within a barbell approach of buying defensive, income generators as core holdings at current levels while selectively adding pure growth companies on the other end of the risk spectrum to complement our core positions. This, along with holding many of our favorites which we added to when investors were panicking out (Apple, Caterpillar Inc., (NYSE:CAT) , J.P. Morgan, Suncor Energy Inc.(NYSE:SU) , ICICI Bank (NYSE:IBN) , etc.) should allow investors to keep pace with this global rally while taking less risk.
In addition to lessening risk as valuations continue to rise with this impressive rally, utilizing strategies outside the realm of conventional and "herd" type thinking is highly recommended. At the start of the new year, we suggested that investors utilize depressed grocery store chains, such as Kroger Co.(NYSE:KR) and Supervalu Inc. (NYSE:SVU) as a long term inflation hedge rather than the conventional Treasury Inflation Protected Securities (TIPS).
The inflation hedging component of TIPS was already overstated, and the depressed values and low expectations at the time in the grocery space presented a total return opportunity. TIPS have disappointed with a meager return of less than 1.5% year to date, while our two grocery store companies returned 16% to 26% year to date, respectively.

Considering our disciplined and continuous risk management approach, it is too late to buy either Kroger or Supervalu, but rest assured that the markets will give the smart investor other select opportunities, even within this steadily rising market.

Alan B. Lancz is president of Alan B. Lancz and Associates, Inc. and director of independent research institute LanczGlobal, LLC. Alan B. Lancz, Alan B. Lancz and Associates, Inc. clients and family members own all companies mentioned in this article with the exception of Goldman Sachs, where full profit taking has already occurred. Alan B. Lancz & Associates Inc. is an investment adviser registered with the U.S. Securities and Exchange Commission and this update is only for informational and educational purposes.

May S&P 500 Statistics (from 1950 to 2009)

Total Up Years: 35
Total Down Years: 25
Largest Gain: 9.20% (1990)
Largest Loss: -8.60% (1962)
Average Gain: 2.83%
Average Loss: -3.01%
Consecutive Up Years: 13 (1985-1997)
Consecutive Down Years: 4 (1981-1984)
Cumulative Return All Months: 0.40%

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