An Empirical Examination of Industry Returns for Evidence of Cyclical Performance

A thesis presented in partial fulfillment of the requirements for the degree

Doctor of Philosophy

at

School of Economics and Finance

Massey University, Albany

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2012

Abstract

This dissertation provides three empirical studies of industry performance related to different financial market cycles. Popular belief holds that industries provide systematic cyclical performance. Such systematic performance would present a challenge to basic assumptions of market efficiency. The three industry cycles investigated are sentiment cycles, political cycles, and business cycles.

The first study investigates the interaction between three popular investor-sentiment measures and industry performance. Investor sentiment has a widespread and systematic effect on industry performance. Similar to prior market studies, investor sentiment predicts short-term industry mispricing. Predictable long-term industry reversals are weaker. Moreover, the effect of investor sentiment is widespread, with limited evidence of cross-sectional industry differences. Unlike prior market studies, there is no evidence of a relationship between investor sentiment and industry characteristics that serve as a proxy for valuation uncertainty. Lastly, an industry rotation strategy based on investor sentiment generates marginal outperformance, which turnover and transaction costs would consume. Results generally show that investor sentiment has a market-wide effect, questioning its usefulness in timing industry investments.

The second study examines industry returns for presidential election cycles. Risk-adjusted industry returns provide no evidence of political cycles previously documented in the U.S. stock market. In spite of the existence of market-wide effects, realized industry returns exhibit neither systematic nor persistent outperformance related to a president's political affiliation or the year of a president's term. Expected industry performance is equally unaffected by political cycles, exhibiting no systematic response to presidential elections and indicating that the market does not systematically price a president's political affiliation in industry returns. The study's results question the popular belief that certain industries systematically perform better under Democrats or Republicans and provide evidence that political cycles are solely a market-wide phenomenon best explained at a macroeconomic level.

The third study investigates industry returns for systematic business-cycle performance. Popular guidance holds that sectors/industries provide systematic performance and that business-cycle rotation strategies generate excess market performance. The study tests these two fundamental assumptions of popular rotation strategies. Initially, the study assumes investors can perfectly anticipate business cycles and implement conventional sector rotation. However, there is no evidence of systematic sector performance where popular belief anticipates it will occur. At best, conventional sector rotation generates 2.3 percent annual excess returns. This performance quickly diminishes after an allowance for transaction costs and incorrectly timing business cycles. An examination of all sectors across all business-cycle stages produces evidence of in-sample systematic sector performance, but an out-of-sample alternative rotation strategy fails to generate excess performance. Overall, the study documents unsystematic sector performance across business cycles, questioning the popularity of sector rotation as a viable investment strategy.

Acknowledgements

Embarking on a PhD is not so much about the destination as the journey. Most importantly, it is about the people you encounter on the way. Many people helped me on my journey. I would like to thank them now. My greatest appreciation goes to my supervisors, Associate Professor John Pinfold and Professor Martin Young. Thank you for your faith. I am especially indebted to Professor Larry Rose. Your door was always open. Heartfelt thanks also go to Professor Henk Berkman. Your friendship and inspiration guided this journey, more than you know. Special thanks go to Dr. Peren Arin, Catherine Beaumont, Mary Dawkins, Sharon Henderson, Rochelle Hughes, Liz Stewart, and Dr. Bill Wilson, for being friends.

I dedicate this PhD to the spirit of *Nabelle*. Isabelle and Nathan, this journey will define your childhood memories. Thanks for understanding all of those missed weekends and summer vacations. To Loren, my wife, you are the guardian of the spirit. We did this together, as everything. The journey would not have been bearable without you. Lastly, to Liz, my mother, the spirit of *Nabelle* emanates from you. You are life's ultimate traveler and made this journey possible, in so many ways.

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