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An Empirical Examination of Industry Returns for Evidence of Cyclical Performance

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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.

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