

Evaluating the SELECT Strategy Amid Volatility

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In the [previous quarterly newsletter](#), we introduced four [sectors of the S&P 500](#) we focus on within our SELECT strategy: consumer discretionary, technology, finance and healthcare. We looked at the attractive features of the consumer discretionary and technology sectors. In this commentary, we will review the remaining two sectors – finance and healthcare.

Finance: While [financials](#) initially lagged the market recovery that [started in 2009](#), this sector has been gaining momentum over the past three years and is likely to continue to do so. Within the group, we prefer three key subsectors:

- **Banks:** There are several important factors we consider when allocating funds to banks. First, we look at their most important business – lending. Loan growth has recently been [expanding at a sound pace](#), providing a platform for future earnings growth. Second, we consider the profitability of that business. Although net interest margins on loans have [been restrained by low interest rates](#), we believe they are staged to recover as the Federal Reserve Board gradually returns the federal funds rate to more normal levels. Finally, unlike in past cycles, banks have been disciplined about their employment growth in the current recovery, keeping that key cost variable at a level that will boost profitability. Overall, we believe the outlook for U.S. banks is brighter than it's been since before the financial crisis. These factors have led us to include PNC Financial (PNC) and U.S. Bancorp (USB) on our SELECT List.
- **Asset management/custody banks:** These companies are known for the investments they manage or hold in custody for other large institutional investors. Their business is generally driven by security valuations. Until the recent [stock market correction](#), they've been the beneficiary of rising prices. We've participated in these companies throughout the bull market and continue to believe they will do well. As industry leaders, they benefit from financial leverage related to their size. They've also adjusted their business models to benefit from changing trends within the asset management industry. To take advantage of these benefits, we have included BlackRock (BLK), T. Rowe Price (TROW) and State Street (STT) in our SELECT strategy.



- Financial information providers: This is a growing group of companies that provide information to financial institutions. These organizations have learned to harness “[big data](#),” now available through high powered computing, and provide it to a large group of customers. These specialized data services can be consistently profitable for the firms that supply them. SELECT recommendations include McGraw Hill Financial (MHFI) and Verisk Analytics (VRSK).

Healthcare: Healthcare is defensive by nature because people will always need the tools and facilities included in this sector. We focus on these three categories that have recently [outperformed the market](#):

- Pharmaceutical: We invest in companies that treat complex diseases, such as diabetes or certain types of cancer, because drugs for these treatments are sold at a premium price, thus increasing profit margins. Additionally, companies secure patents for these drugs, making them hard to replicate and giving these companies a competitive advantage. When choosing companies to invest in, we look at the track records and capabilities of the management team for producing, launching and finding innovative and profitable uses for new drugs. SELECT List choices are Abbvie (ABBV) and iShares Global Health Care (IXJ).
- Medical devices: We expect the utilization rate of this subsector to increase in the next decade due to two factors: the aging population and the [Affordable Care Act](#) (ACA). Ten thousand people in the U.S. are [turning 65 every day](#) and will eventually need to use a hospital or other healthcare facility. Additionally, the ACA gives more individuals access to insurance, thus encouraging them to take advantage of these facilities. Abbott Labs (ABT) and iShares Medical Devices (IHI) are on the SELECT List.
- Integrated healthcare services providers: This subsector is able to reduce expenses for the whole healthcare system. For example, CVS Health is able to offer cheap generic drugs due to economies of scale, resulting in cost savings for their patients. We added CVS Health to our portfolios during the recent downturn to increase our weight in the healthcare sector.

It is hard to quantify exactly where the markets stand amid recent volatility and it’s equally hard to predict what will happen moving forward. However, the four sectors we focus on with our SELECT strategy – consumer discretionary, technology, finance, and healthcare – [have performed quite well](#) year-to-date compared to the S&P.



Sources:

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