What Cyclical Stocks Can Really Do for Investors

Description

In an article earlier this week, I explained defensive stocks.

On the flip side of defensive, consistent, dividend-paying securities, investors have the opportunity to purchase shares in more volatile companies in the cyclical category. While defensive securities are characterized by lower volatility and lower variance in revenues and profits, the opposite is true of cyclical stocks. Cyclical stocks can experience explosive growth in revenues and profits depending on the economic cycle or the specific demand for a certain product or service.

The reason investors sometimes prefer cyclical securities to defensive ones is because of the expectations of a higher profit. Due to the cyclical nature of certain businesses that are prone to boom-and-bust cycles, there can be either a lot of money made (when buying at the bottom) or potentially a lot of money lost (if held during a pullback).

Teck Resources Ltd. (TSX:TECK.B)(NYSE:TECK) is involved in mining a number of resources including coal, copper, and zinc, all of which experience price changes and fluctuations in demand throughout the year and the economic cycle.

During a financial boom, the demand for resources and metals increases dramatically as more goods are produced and buildings are built to accommodate business expansions. The large increase in demand drastically increases revenues for Teck Resources, leading to much higher profits and an explosive stock price (this is the breakout). Over the past 52 weeks, shares of the company have traded in a range between $12.08 and $35.67. Investors could have almost tripled their money had they been lucky enough to buy at the right price.

Currently trading near $25 per share, the company has declined in value by close to 30% from the 52-week high, and things could continue downwards from here.

The challenge investors face is the uncertainty with respect to the revenues, profits, and, of course, dividends paid during a full economic cycle. While the increase in the share price is usually very exciting and lucrative for investors, the ride back down is most often not as much fun.

Another example of a cyclical company is **Toromont Industries Ltd.** (TSX:TIH), a seller of heavy machinery used in construction and farming. While the company has paid and raised the dividend for a number of years, the country has not had a recession for quite some time. Should there be another major downturn in the economy (which is inevitable), there is always a danger that shares will decline significantly and the dividend could be cut as a result of the larger-than-average decline in revenues and profits.

While investors accepting additional risk should be compensated with additional returns, the truth is that buying a cyclical stock while the economy is in full swing may not be the best option. Much too often, shares have already run up too far, and the next breakout is often on the downside.

The “higher” returns come when investors buy at the bottom of the cycle (prior to the breakout).

CATEGORY

1. Investing
2. Metals and Mining Stocks

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