Should You Choose Cyclical or Defensive Stocks?

Description

Stocks can be classified in two ways: cyclical or defensive, depending on how they react to business cycles. You shouldn't invest in only one of these, as cyclical stocks will sometimes outperform defensive stocks, and sometimes the reverse will happen.

Let's look at the best moment to invest in cyclical stocks and the best time to pick defensive stocks.

Cyclical stocks

As the name suggests, cyclical stocks are cyclical; that is, they tend to follow the movements of the economic cycles. The sectors that are cyclical are consumer discretionary, energy, financials, health care, industrials, information technology, materials, and telecommunication services.

When confidence in the economy is high, people tend to buy items that are considered non-essential, like cars and phones.

Resource and energy stocks are considered the most sensitive to the business cycle. When the business cycle is in its rising phase, resource demand expands faster than resource supply, so it will push up the price of resource stocks. Resource stocks are also a good hedge against inflation.

On the other hand, when the economy is slowing down, cyclical stocks may fall more sharply than defensive stocks. Cyclical stocks are thus more volatile than defensive stocks, and as such, they can experience wide and unpredictable swings. They usually have a beta higher than 1, which means they move more than the market does.

Hudbay Minerals Inc. (TSX:HBM)(NYSE:HBM) has a beta of 5, which means that this stock moves 500% more than the market when the latter is rising. With a PEG of only 0.14, this stock is very cheap relative to its growth prospects, so it should outperform in the months to come.

To have success with cyclical stocks, you should buy them when the economy is in a rising phase. You should therefore pick cyclical stocks that are strong financially with the best growth prospects in their sector.

Defensive stocks

As the name suggests, defensive stocks are defensive; that is, they can defend your portfolio during an economic downturn. Consumer staples and utilities are defensive stocks.

The consumer sector is considered the most defensive. The companies that are part of this sector generate regular sales regardless of the economic cycle. Even if your budget is tight, you still have to buy toothpaste and shampoo.

Therefore, defensive stocks provide protection during a market downturn because they are far less sensitive to the ups and downs of the economic cycle than are cyclical stocks. They usually have a beta lower than 1, meaning that they move less than the market.

Metro Inc. (TSX:MRU) is a great defensive stock. After all, people still have to buy food, even during a recession. With a beta of only 0.10, it is much less volatile than the market and it will fall less during a market downturn.

Bottom line

To have a well-balanced portfolio, you should own stocks in most of the sectors, but it can be profitable to overweight or underweight some sectors depending on the business cycle. If you have a low tolerance for risk, however, you may prefer to be concentrated in defensive stocks, as they are less volatile than cyclical stocks. However, by not owning cyclical stocks in a bull market, you may forego some great growth opportunities.

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Date
2025/08/27
Date Created
2018/04/27
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