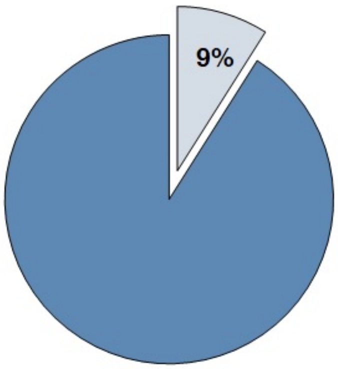
Investing in the Industrial Sector

INDUSTRIAL SECTOR REPORT

Rec. Equity Weight for Industrials: 9%



Buy-rated companies mentioned in this report:

Capital Goods:
- **Ametek** (AME - $122.43)
- **Boeing** (BA - $139.24)
- **Deere & Co.** (DE - $362.91)
- **Raytheon Technologies** (RTX - $97.21)
- **Snap-On** (SNA - $221.56)

Transportation:
- **Southwest Airlines** (LUV - $44.42)
- **Union Pacific** (UNP - $225.17)
- **United Parcel Service** (UPS - $187.11)

Prices as of market close 6/6/22 and are subject to change. Source: Reuters.

For more information:

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The industrial sector spans a broad array of companies across aerospace and defense, heavy machinery, transportation, and commercial services. While it is diverse, the companies within the sector share common traits and have leverage to several broad themes that we think make industrials an important part of the equity portion of a broadly diversified portfolio.

The overarching theme across the industrial sector is its sensitivity to economic growth. Demand for industrial products and services tends to be driven by large-ticket capital investments, and typically improves with general economic conditions. Because of this economic sensitivity, we view the sector as "offense," meaning it tends to outperform in rising markets and underperform in falling markets.

The COVID-19 pandemic significantly impacted the sector, including the disruption of operations due to supply and labor shortages. It also had a negative effect on demand, as companies deferred investments in their businesses. Over the last year, the industrial economy has demonstrated improving demand trends. While we expect the recovery to continue, near-term uncertainties that could impact growth for the sector include potential slowing of economic growth due to central banks unwinding accommodative policy, further supply-chain challenges, and new COVID-19 variants. Consistent with our view that the sector is "offense," industrials can be expected to be volatile with changing market outlooks.

In addition to general economic activity, other key trends and drivers of growth for industrials include
- Construction and infrastructure investment;
- Manufacturing and factory automation;
- Increasing regulation for energy and fuel efficiency;
- Growth in developing countries such as India, Russia, China, and Brazil; and
- Global population growth with a rising middle class.

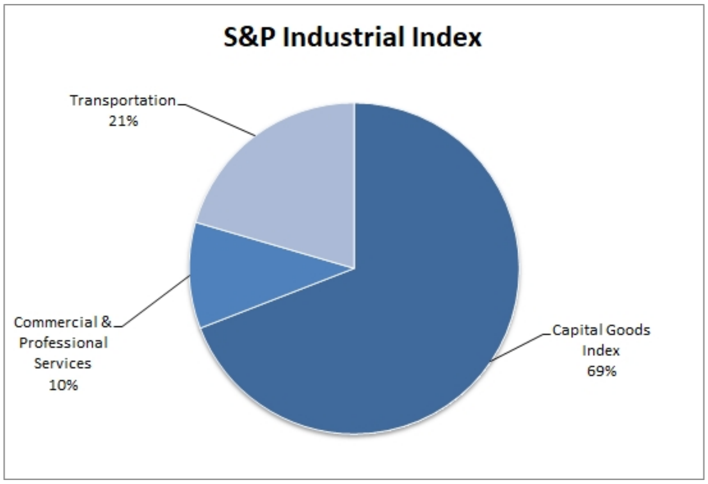
We recommend a 9% equity sector allocation toward industrials, and we believe portfolio diversification can be further improved by making sure that the 9% weighting is further broken down into each of the three subsectors within industrials: capital goods, transportation and commercial services. Capital goods is the largest subsector **(Figure 1)**, and we recommend starting with this subsector before allocating funds toward the smaller transportation and commercial services subsectors.

Analyst: Jeff Windau, CFA
Analyst: Matt Arnold, CFA

Please see important disclosures and analyst certification on page 4 of the report.

Industrials are categorized in three broad segments, including capital goods, transportation, and commercial services.

Figure 1



The S&P 500 Index is based on the average performance of 500 widely held common stocks. The S&P Industrials Index consists of 71 industrial companies within the S&P 500 Index. These are unmanaged indexes and cannot be invested in directly.

Capital Goods (69% of the Industrial Sector)
Capital goods companies are responsible for manufacturing and/or distributing products. These products are typically sold to other businesses (not directly to consumers) and can often be large and expensive (airplanes, tractors, excavators).

- Aerospace & Defense: Companies in this area focus on the production of commercial planes and a wide range of defense products, including jets and missile-defense systems. Air travel has begun to improve with the rollout of vaccines and the reopening of travel destinations. While it could take months or even years for travel to fully recover, we believe airlines will be increasing the number of flights and will continue to plan for new planes in the coming years. Given that there is limited competition in the market, we feel there will be growth opportunities for **Boeing (BA)** as market conditions improve. We have a positive view on defense companies given the solid level of defense budgets and the number of geopolitical issues. **Raytheon Technologies (RTX)** is on the Edward Jones Stock Focus List.
- Machinery: These companies manufacture large pieces of equipment or provide parts and services. Examples of products include bulldozers, excavators, tractors, tools and large mining trucks. Currently, we favor machinery companies focused on agriculture given our positive growth outlook and positive view of the replacement cycle for large tractors and combines. **Deere & Company (DE)** and **Snap-on (SNA)** are on the Edward Jones Stock Focus List.
- Diversified Industrials: Companies in this group are composed of multiple businesses covering a wide variety of end-markets. This diversification can help to smooth out results, as positive trends in one segment can help offset pressures in another part of the business. Our outlook varies for each diversified industrial company based on the specific end-market exposure and the outlook for the company. **Ametek (AME)** is on the Edward Jones Stock Focus List.

Transportation (21% of the Industrial Sector)
Transportation companies tend to be involved with the movement of people or cargo. They could also be involved with planning the logistics of shipping goods. The products can be moved by rail, truck, ship or plane, or may use a combination of those methods.

- Rails: The railroads haul freight over their vast rail networks. The volume of goods to haul has been increasing with the improvements in the economy. Over the past several years, the rail industry has focused on improving efficiency and reducing the costs of the business. This focus on efficiency is known as Precision Scheduled Railroading (PSR). Our outlook on the companies considers the mix of products being hauled, the level of implementation of PSR, and the expectations for improvements. **Union Pacific (UNP)** is on the Edward Jones Stock Focus List.
- Airlines: Companies in this group operate planes to haul passengers. We have limited coverage in this space, given the cyclical nature of the business, the high costs of doing business, and the fact that most companies in the space are noninvestment grade. Airline travel has been improving since the coronavirus lows, with leisure and domestic being the drivers. While there could be near-term volatility due to the coronavirus and rising fuel costs, we believe long-term demand for travel will provide growth opportunities. We have a Buy rating on **Southwest Airlines (LUV)** and look favorably on the company's solid financial position and low-cost focus. **Southwest Airlines (LUV)** is on the Edward Jones Stock Focus List.
- Freight and Parcel Carriers: These companies are focused on moving packages for businesses and consumers around the world. The growth of e-commerce and the resulting package-shipping

requirements has been a positive factor in this segment. Our outlook for the companies considers the efficiency of the shipping network, ongoing investments being made, and the potential for rising competition. We have a Buy rating on **United Parcel Service (UPS)**.

Commercial Services (10% of the Industrial Sector) Commercial Services companies provide support activities, such as cleaning, security and equipment rental. This is a broad group of companies with a range of services provided. Given the relatively small weighting of commercial services within the broader industrial sector, our coverage in this segment is limited. However, we would tend to favor companies that have competitive advantages and provide services that are more technical in nature. We do not currently have any Buy-rated names within commercial services.

Industrials are Economically Sensitive

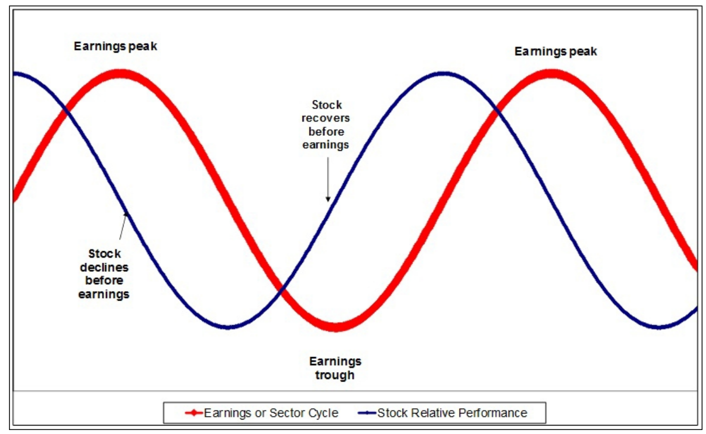
Given the sensitivity of the industrial sector to economic growth, the COVID-19 pandemic had a significant impact on the sector early in 2020, including disruption of operations due to supply and labor shortages, as well as a negative effect on demand as companies deferred investments in their businesses. While the impact was broad-based across industrials, we note that airlines and aerospace companies with exposure to commercial aircraft were heavily impacted due to the weakening in travel demand. Through 2021 and into 2022, improving trends have been noted in the industrial economy. While we expect the recovery to continue, near-term uncertainties that could impact growth for the sector include potential slowing of economic growth due to central banks unwinding accommodative policy, further supply chain challenges, and new COVID-19 variants. However, consistent with our view the sector is "offense" (i.e., outperforming in rising markets and underperforming in falling markets), we would expect industrials to outperform in an environment of improving economic sentiment.

Industrial Cycles and Building Portfolios

Many industrial companies are cyclical, meaning they go through ups and downs as the fundamentals of the industries they serve change. Within industrials, each company may be facing a different stage of its business cycle. As a result, we believe investors can improve diversification by owning stocks from more than one subsector of industrials and selecting companies that serve different industries.

Figure 2 is a simplistic chart that illustrates the typical progression of a business cycle and how stock prices typically lead earnings recoveries off the trough.

Figure 2



Source: Edward Jones

Based on this typical progression, we think that the best time to buy a cyclical stock is when the news is still pessimistic. On the other hand, buying when the news "feels good" is likely an inopportune time.

Environmental, Social and Governance (ESG) Considerations

Industrial companies tend to have manufacturing operations that build products, control the transportation of goods, or provide services such as those delivered by construction and engineering firms. Therefore, ESG risks in the industrials sector primarily consist of labor issues along with product safety and quality, such as product recalls. During economic slowdowns, industrial companies frequently resort to layoffs to lower costs, but cutting costs too far can negatively impact employee morale and the companies' ability to attract talent. While the financial impact of product liabilities is less meaningful for a larger company, reputational risk can exist in high-profile product issues, and potential lawsuits can take many years to resolve. For example, Boeing's 737 Max crashes resulted in the loss of lives, the grounding of planes, and lawsuits that are still active in the court system. Most of the companies we recommend do a good job of managing these risks. Many of the companies we follow have sales to government agencies, which require detailed policies and procedures. Most of our industrial coverage has detailed ethics and anti-corruption policies in place, which results in favorable governance scores from the ESG ratings agencies.

Valuation

Methods we use to evaluate the attractiveness of industrial stocks include traditional ratios such as price to earnings (P/E) and price to sales (P/S), both on an absolute and relative basis, PEGY ratios (P/E vs. estimated growth and dividend yield), and discounted cash flow (DCF) analysis.

Risks

There are several risks associated with investing in industrial companies. In our view, one of the biggest risks facing them is a prolonged economic downturn. A recession or a sustained period of little to no economic growth will negatively impact performance. Increasing regulations or the further escalation of trade uncertainty could negatively impact global growth. Another risk will be an increasing number of competitors, especially from emerging markets such as China.

Recent Sector Performance

The S&P Industrial Index has underperformed the market over the past three years as a result of rising trade uncertainty, and more recently the economic impact of the coronavirus outbreak.

Please see the individual research reports for additional information, including disclosures, analyst certifications, valuation and risks specific to each company.

Figure 3

Source: Bloomberg. The S&P 500 Index is based on the average performance of 500 widely held common stocks. The S&P Industrials Index consists of 71 industrial companies within the S&P 500 Index. These are unmanaged indexes and cannot be invested in directly. Past performance is no guarantee of future results.

Analyst Certification

I certify that the views expressed in this research report accurately reflect my personal views about the subject securities and issuers; and no part of my compensation was, is, or will be directly or indirectly related to the specific recommendations or views contained in the research report.
Jeff Windau, CFA; Matt Arnold, CFA

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