Add the Best Materials Stocks to Your Portfolio: Sector Analysis 1Q15

The Materials sector ranks sixth out of the 10 sectors in the first quarter of 2015 and receives our Neutral rating. The Materials sector as a whole underperformed the S&P 500 in 2014 rising almost 6% to the S&P's 12%. It was the third worst performing sector last year, beating out only the Telecom and Energy sectors.

The average positive return on invested capital (ROIC) in this sector is 8%, one of the lowest of all sectors and below the average positive ROIC of about 13%. Speculation has driven up stock prices in this sector, with the average positive price to economic book value ratio (PEBV) in the sector standing at 5.0. A low return in a generally overvalued sector means having the research on individual stocks is important if you want to add exposure to the Materials sector.

Stock Picking is Paramount to Success

Materials companies can often be a gamble as investments. China Gengsheng Minerals (CHGS) performed with incredible volatility as it climbed 164% in the first two months of 2014, only to see its value eroded by a 96% decline from its original price. CHGS earned our Dangerous rating not only for its fundamentals that included a negative ROIC and a negative free cash flow (FCF) yield, but also may be at risk for fraudulent reporting. Gambling can be fun, but when it's your clients' money or your retirement savings, you may think twice before you choose to lose.

With generally low returns on investment, the Materials sector will only offer great returns for investors with the right research. There are 18 Materials stocks that receive our Attractive or Very Attractive ratings.

The following are some of our favorite stocks in the Materials sector. Investors looking for the best stock picks in this sector should look no further than the following:

1. **Fuel That Really Drives Returns — FutureFuel Corp. (FF)**

FutureFuel Corp. manufactures and distributes chemicals and biofuels for North American companies. FF earns our Very Attractive rating, and was added to the January Most Attractive stocks list. Over the last six months of 2014, FF's stock price fell about 30%. Although this may scare some investors who seek out momentum stocks, this price drop now presents a cheap valuation for a company with strong fundamentals.

FutureFuel's impressive ROIC of 27% and its 9.2% free cash flow yield imply strong future growth that is not captured in the company's current valuation. In addition, FutureFuel's after-tax operating (NOPAT) margins of 13% and a three-year annualized revenue growth rate of 13% may reverse the direction in which this stock is headed.

The two major risks of investing with FF are its concentrated revenue streams and its participation in energy related products. 43% of all revenues in 2013 were derived from two customers with 30% of total revenues coming from a single customer. However, this may simplify forecasting the stability of FutureFuel's revenue streams in this volatile energy market. Any stock related to the energy markets should be purchased with caution.

Overall, FutureFuel Corp. gets a nod as one of our top materials stocks thanks to its strong fundamentals and its cheap valuation.

2. **Containers That Carry A Punch — Ball Corporation (BLL)**

The original manufacturer of the Ball Mason Jar (now a product owned by the Jarden (JAH)) has more to offer investors than at first glance. BLL earns our Attractive rating.

BLL outperformed the S&P 500 last year and earned an almost 30% return for investors. Past performance does not determine future performance, but Ball's strong fundamentals indicate this stock still has room to grow.

Ball's current ROIC of 12% and FCF yield of 9.8% indicate strong future performance, which should keep the stock's momentum going through 2015.

The major risk with the Ball Corporation is that its stock performance occurred in spite of declining top line revenue. However, this company's excellent profitability has kept it's stock climbing. BLL appears to be a stock where its past will mirror its future, and this company is primed for a run through 2015.

3. **Fertilizers That Grow Your Portfolio — CF Industries Holdings (CF)**

CF Industries Holdings, one of the largest nitrogen fertilizer producers in North America, earns our Very Attractive rating. A history of positive cash flows and strong margins makes this one of the most attractive companies in the Materials sector.

CF's stock climbed about 21% over the course of 2014, beating the S&P 500 by almost 10 percentage points. In spite of its somewhat choppy revenue, CF has continued to perform well as an investment because of high NOPAT margins of 35%.

CF Industries' current ROIC of 21% and FCF yield of 10.5% demonstrate efficiency in capital management and operations, pointing toward strong future performance for this stock.

The major risk with CF Industries is declining sales that may indicate eroding future performance if not managed correctly.. If CF Industries is unable to make smart decisions about capital management in the face of sales declines, this trend could potentially end its run. However, CF's history of cash flows, its high NOPAT margin, and strong ROIC all point to another great year for the fertilizer king.

The Best & Worst Materials ETFs and Mutual Funds

Not the type to buy individual stocks? We also cover 26 ETFs and mutual funds in this sector. We rate these ETFs and mutual funds based on their holdings as well as their total annual costs (TAC).

The following are the top three ETFs or mutual funds in this sector. The Materials sector can be especially difficult to profit from due to its generally low returns, and these funds offer investors the opportunity to easily diversify among the best companies in the sector at a low cost:

1. **Fidelity Select Chemicals Portfolio (FSCHX) — Attractive**

Quick Take: FSCHX's holdings are almost 100% basic materials with less than 1% of energy related materials firms — good news in current markets. FSCHX has Neutral total annual costs of 1.13%.

2. **Vanguard Materials Sector ETF (VAW) — Neutral**

Quick Take: VAW's holdings consist mostly of basic materials companies, though it does have about 12% of holdings in consumer cyclical materials. In addition, there is minimal exposure to energy materials. This fund has Very Attractive total annual costs of 0.13%.

3. **State Street SPDR Materials Select Sector Fund (XLB) — Neutral**

Quick Take: XLB's holdings are fairly similar to VAW's, but this ETF has no exposure to energy materials and is more heavily concentrated in large firms for lower risk. This fund has Very Attractive total annual costs of 0.18%.

Figures 1 ranks the best and worst ETFs in the Materials sector. Figure 2 below list the five best and worst rated ETFs and mutual funds in the Materials sector.

Figure 1: ETFs with the Best & Worst Ratings – Top 5

	Allocation of ETF Holdings			
Ticker	**Attractive-or-better Stocks**	**Neutral Stocks**	**Dangerous-or-worse Stocks**	**Predictive Rating**
Best ETFs (only 3)				
VAW	11%	48%	38%	**Neutral**
XLB	13%	52%	32%	**Neutral**
IYM	11%	49%	38%	**Neutral**
Worst ETFs				
FXZ	10%	41%	45%	**Neutral**
IGE	16%	35%	38%	**Neutral**
PYZ	9%	34%	57%	**Neutral**
PSCM	8%	18%	70%	**Dangerous**
XME	7%	18%	71%	**Very Dangerous**

Source: New Constructs, LLC and company filings

Figure 2: Mutual Funds with the Best & Worst Ratings – Top 5

	Allocation of Mutual Fund Holdings			
Ticker	**Attractive-or-better Stocks**	**Neutral Stocks**	**Dangerous-or-worse Stocks**	**Predictive Rating**
Best Mutual Funds				
FSCHX	13%	51%	30%	**Attractive**
VMIAX	10%	47%	40%	**Neutral**
FMFEX	13%	41%	39%	**Neutral**
FSDPX	13%	41%	39%	**Neutral**
FMFCX	13%	41%	39%	**Neutral**
Worst Mutual Funds				
FMFBX	13%	41%	39%	**Dangerous**
FMFAX	13%	41%	39%	**Dangerous**
RYBCX	14%	37%	38%	**Very Dangerous**
ICBAX	11%	37%	46%	**Very Dangerous**
RYBMX	14%	37%	38%	**Very Dangerous**

* Best ETFs exclude ETFs with TNAs less than $100 million for inadequate liquidity.

Sources: New Constructs, LLC and company filings

Disclosure: David Trainer and Hunter Gray receive no compensation to write about any specific stock, style, or theme.

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2. Standard for all companies.
3. A more accurate representation of the true underlying cash flows of the business.

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