

Buying a defensive share portfolio

When any given asset class outperforms and such performance is unlikely to continue, most asset consultants will recommend a switch to more defensive asset classes. Ian Murdoch and Jamie Nemtsas, directors of Investstone Wealth Management, take a look at an alternative option.

Instead of reducing your overall exposure to an asset class in favor of another, what about re-aligning the holdings within the particular asset class so that investments with more defensive characteristics are retained?

No-one is going to argue with the importance of asset allocation. However, asset allocation only tells half the story - each and every one of us is managing investments within asset classes. Therefore, how we spend the money we allocate to a particular asset class becomes just as important as making sure our overall weighting to that asset class is appropriate. Take for example a portfolio that has 50% of its capital allocated to Australian shares. The portfolio could have one, ten or a whole index worth of different shares and their asset allocation would be the same - 50% allocated to Australian shares - no mention of sectors, growth or value profiles, valuation etc. Another example that illustrates the short comings of blinkered asset allocation would be looking at holding just one share and comparing the associated risks.

If we compare the risks associated with holding Wesfarmers (diversified group with strong earnings and a reasonable valuation, very strong management) to holding just ERG (expensive at current prices, sector specific, volatile earnings outlook). Despite the differences between these two companies, the asset allocation would still be the same percentage allocation to shares.

But how does an investor build a defensive position within a particular asset class? As the title of this article suggests, the asset class we are considering is Australian equities, more specifically, the direct component of a portfolio's Australian share exposure. So, how do we define a 'defensive' share? Well the word 'cheap' pretty much sums it up. By holding companies that are valued at a reasonable price, the thinking is that these shares are less likely to suffer than most other shares in a market downturn or slump.

One of the reasons for this resilience is that a key measure in assessing relative cheapness is dividend yield. By holding companies with high dividends (25% greater than the market average dividend yield), this income stream (if sustainable), should underpin returns in times of downward price pressure.

At the height of the technology boom (March 2000), Investing Times, (originally Donnelly's Investing Times) explored this concept further and built an Australian share portfolio, aptly

named: 'Defensive Share Portfolio'. It is such a portfolio that we will explore further in this article.

How does the portfolio work? - the buy side

The portfolio is based on three quantitative criteria, the criteria are dividend yield, dividend cover and return on equity.

- Dividend yield greater than 7.5% gross.
- Dividend cover of at least 1.25 times. and
- Return on equity of greater than 10%.

Dividend Yield - this measure is used for two reasons; firstly, to compare the company to the rest of the market. A general rule of thumb is to buy companies that are yielding 25% higher than the average market dividend (7.5% gross) or, if you like, the shares are 30% cheaper than the rest of the market - on dividend yield anyway. Secondly, if you are obtaining over 7.5% in dividends, then the growth in the share price only has to be around 3% or equal to CPI to obtain a double digit total return.

Dividend Cover - The dividend cover is really used to verify if the dividend will be covered by the company's current earnings. Some companies pay out high dividends - however, they don't have the earnings to back it up and thus are distributing capital to the shareholder. Also, if the company has a short term profit downgrade, a company with a high dividend cover can sustain its dividend, rather than cut the dividend. The market typically deals harshly with the share price of any company that cuts its dividend. A dividend cover of 1.25 is generally sufficient to satisfy this criteria.

Return on Equity - This is used typically to assess the company's internal ability to generate a return on shareholder funds after any costs of finance. A return on equity of over 10% would be one of the indicators that a company is utilising shareholder capital wisely.

No other factors are considered. No personal preferences, no favorites, no black box computer programs, no six figure analyst's opinion, just these three numbers. Simple!

Too many individual shares

So far, so good. However, we have found that the portfolio has grown in size, and in fact since inception in March 2000, the portfolio has often held more than 37 individual hold-

ings at various times and currently holds 26. For anyone that does the administration on their own portfolio, the paperwork alone on 37 shareholdings could fill every weekend!

Currently the portfolio is down to 26 individual companies. It is still quite large, however it is important to remember that the principles applied to building the portfolio are quantitative and are likely to differ to those of a personal investor. This is also true of some of the companies that have been removed, as outlined above - not necessarily prudent actions for a personal investor.

The sell side

It is amazing how many DIY investors, advisers and even professional fund managers for that matter, fall in love with individual companies. The company might have provided enormous returns and increased their personal wealth substantially, making the decision to sell that much harder.

Conversely, people decide to hold capital in companies that have blown up, gone wrong, or substantially fallen in price. They might have lost a lot of capital however they maintain their holding on the premise that one day the shares will return to their glory days.

Nevertheless, capital is capital. A decision should be made on the capital basis of the equation, ie. is my capital best allocated to a company that has lost me 50% in the last 2 years with a questionable chance of recovery, or should I realise what is left and make an informed decision on where to place the proceeds? The answer is relatively straight forward, although emotions often get in the way.

In deciding what sell criteria could be established, we look to remove companies with the opposite characteristics or the ones that look expensive e.g. unsustainable payout ratios, low yield and a poor return on shareholder funds. We therefore can use the same three criteria in reverse:

- Dividend Yield less than 4.7% gross.
- A dividend covers of less than 1.1 times
- ROE of less than 8%.

Similar to the buy side, when evaluating companies it is important to look at estimates of 2005-06 ratios, as you should be holding shares because you have a view on what they can provide to you going forward, not what they have done in the past.

It is also interesting to note that a book that was reviewed in the February 2006 issue of "The Investing Times" - 'The Little Book That Beats The Market' - also uses some very similar characteristics in the US market, with quite remarkable results.

The performance of the Defensive Share Portfolio (DSP) since inception in March 2000

The last 12 months has seen resources rally rapidly, investment banks double in value and high PE stocks get even higher. Not really a market for a conservative defensive oriented portfolio of Australian shares like Investing Times' Defensive Share Portfolio (DSP)! In these types of market conditions you would not expect the portfolio to perform anywhere near the benchmark, therefore it is of much surprise that the DSP actually outperformed the All Ordinaries index for the year ended to 31st December 2005. The DSP returned 26%, compared to the All Ordinaries that returned 22% - a 3.3% out performance.

The portfolio performed very well across the board with only a handful of stocks that recorded a negative income and growth return for the year.

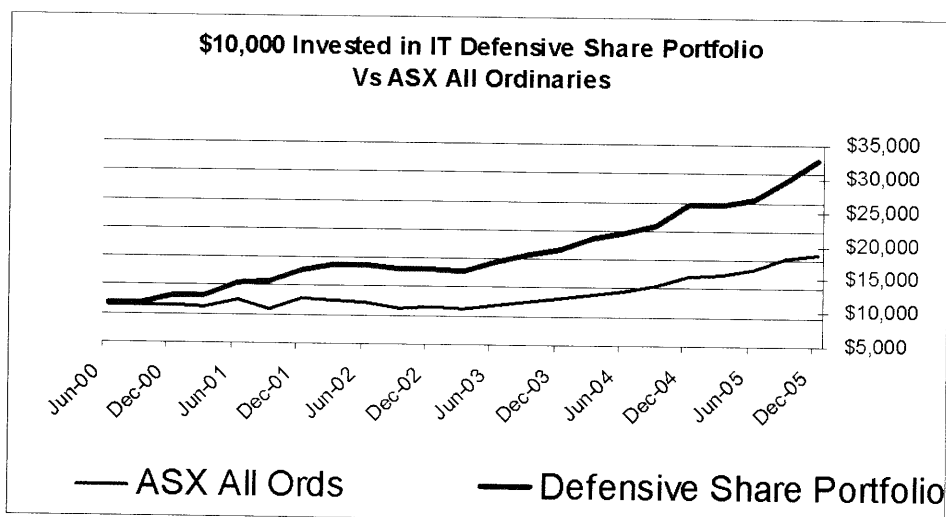
The best performing stock was Santos, returning near 50% over the year, closely followed by the Commonwealth Bank of Australia (CBA), CSR and Adelaide Bank (ADB). The portfolio return from inception annualised, now sits at 20%. This return is without franking credits, so you could add approximately another 1.5%. The index has returned 12% pa over the same period.

Given we have been going on about the real performance of this portfolio for the last couple of years, we thought that it may be better to show it graphically. As you can see from the chart below the return of the portfolio compared to the All Ordinaries is quite amazing, if not sobering.

Using the three basic criteria and a handful of other investment portfolio rules, the DSP has added a lot of value. For example, if you had invested \$10,000 in the All Ordinaries in March 2000, you would now have around \$19,000. If you followed the DSP mechanism of selecting stocks then you would have over \$32,000.

Once per year the portfolio is critically analysed and rebalanced.

The following is a summary of the quantitative parameters that the portfolio uses as a framework to make its investment decisions.



| Criteria | to include a new share | to sell a share |
|------------------------|------------------------|-----------------|
| Gross Dividend Yield | >7.5% | <4.7% |
| Return on Equity (ROE) | >10.0% | <8.0% |
| Dividend Cover (times) | >1.25 | <1.10 |

Take the emotion out of the decision

Our intention in sharing the defensive portfolio with you is not to show-off any stock picking prowess or to promote "The Investing Times" newsletter and the firm. What we want readers to take away is that to manage an Australian share portfolio, you need some kind of framework to make decisions with, a framework beyond asset allocation.

Many of us can attest to creating wealth by taking no action at all, for example on any banking stock in the last ten years you would have increased your capital four fold. However, it is easy to say that most of these assets have increased substantially because the government under-estimated what the true value of the individual companies really were.

Going forward, free rides like the ones that were available in the 1990's may not be around and review rules and decision making tools may be more crucial in building a successful portfolio than ever before.

rules that allow you to take the emotion out of investment selection and review. Also avoiding the tendency to subordinate the logic of investing to any one principle, be it asset allocation, diversification or investment horizon, will put you in good stead. By building a portfolio in this manner you are holding today's winners, not yesterday's heroes, or tomorrow's dreamers.

A Defensive Share Portfolio for today

Using the above criteria in the current market we have put together a portfolio of stocks that could be purchased. Some are in "Investing Times" newsletter's long term core share portfolio already. A number of new additions have been made and will be put into the defensive share portfolio from this issue onwards. Not all the recommendations strictly make all three criteria however we have reviewed each stock and are satisfied that overall they fit the defensive characteristic of this portfolio as a whole.

Which stocks are out?

| Company Name | Franking 06 (%) | ROE 06 (%) | Yield 06 (%) | Market Cap. (\$M) | Div Cov (%) |
|------------------|-----------------|------------|--------------|-------------------|-------------|
| Telstra (TLS) | 100 | 24.2 | 9.2 | 46,005.00 | 0.79 |
| Wesfarmers (WES) | 100 | 32.1 | 7.0 | 13,696.5 | 1.08 |

Both Telstra and Wesfarmers fail on dividend cover. We state that a dividend cover of 1.1 must be obtained. Even though we like both of these companies, and both are core holdings in the long term share portfolio in "The Investing Times", we are sticking to the rules and selling both at market prices.

So, to sum this all up, building a defensive position does not have to be a complicated task and yet it can be very rewarding. A magic ball or gifted stock picking ability is not required.

What will help is a set of simple, logical

Which stocks are in?

Five new companies have come up on the radar of the defensive share portfolio and

all five are going to be added. ALS only narrowly makes one field ie. dividend cover, nevertheless it covers all three criteria. It's interesting to note that we have five different companies in five different sectors. Their inclusion in the portfolios will add further diversity to the current make up of the defensive share portfolio.

Profiles of the five new investments

1. Alesco Corporation Limited (ALS) - formerly Atkins Carlyle Ltd

Alesco is a wholesale distribution company with leading positions in niche markets operating in four business units - Building & Renovations, Construction & Mining, Scientific & Testing and Garage Doors & Openers. The company's long-term Industrial Consumables division was sold along with the Atkins Carlyle name to Howard Smith (Blackwoods) in late March 2001. The company has made several acquisitions over the past few years. These include Parbury, Biolab, Robinson Industries, B&D Garage Doors & Openers and Dominator International.

2. Bluescope (BSL)

Bluescope is Australia's largest steel producer, and also has NZ, Asian and US manufacturing operations. It is Australia's only flat products producer, accounting for 80% of the local market. The purchase of pre-engineered building maker Butler has further enhanced BSL's downstream operations, and boosted its presence in both the US and China. BSL's strong balance sheet and its evolving Asian-based growth strategy are attractions. However, it's image has been hurt by some recent profit downgrades.

3. Great Southern Plantations (GTP)

Great Southern is an investment manager, specialising in the agribusiness sector. The company's primary interests are in the Australian plantation timber industry. GTP is involved in forestry activities, which will, for some years yet, account for the bulk of total revenues. GTP has also diversified into the viticulture business, organic olives and the company has recently taken over the management of a beef cattle managed investment scheme, although these interests are quite small compared to the plantation business. A point of difference with GTP is that they own all the property that they

run the plantations on, eventually providing a huge land bank.

4. Insurance Australia Group (IAG)

IAG is the largest general insurance group in Australia and New Zealand. More than 60% of premium revenue is derived from its Australian personal insurance business, with motor, home and contents being the main product lines. The group's Australian insurance brands include NRMA (NSW), SGIO (WA), SGIC (SA) and CGU. Its New Zealand brands include State Insurance, NZI and Circle.

5. Macarthur Coal Limited (MCC)

Macarthur is a coal mining, processing, exploration and development company, primarily focused on the production at the Coppabella and Moorvale coal mines, located near Moranbah in Queensland's Bowen Basin. All of the company's projects are exclusively located in Queensland. Like any resource company, the underlying profitability will depend on the spot price of coal, year to year.

All in all the portfolio has had another stellar year. With some tilting here and there we are set for another exciting year.

The portfolio has a little bit of everything, from the Banking Sector, to Diversified Industrials. The average yield achieved from investing in this portfolio is a huge 8.32% gross per year which is very attractive when interest rates are only around 5.5%. ●

Notes:

1. All figures are based on forecast ROE, Gross Yield and Dividend Cover.
2. The above information may prove to be incorrect at a later date.

This article was written by Ian Murdoch and Jamie Nemtsas, directors of Investstone Wealth Management who is the publisher of the investment newsletter "The Investing Times": www.investingtimes.com.au

DISCLAIMER: This article provides general information only. It is not intended as investment advice and must not be relied upon as such. You should obtain professional investment advice tailored to your specific circumstances and needs prior to making any investment decisions.

| Company Name | ROE 06 (%) | Franking 06 (%) | Yield 06 (%) | Market Cap. (\$M) | Div Cov (%) |
|---------------------------------|------------|-----------------|--------------|-------------------|-------------|
| Alesco (ALS) | 14.54 | 100 | 6.01 | 689.97 | 1.264 |
| BlueScope Steel (BSL) | 15.66 | 100 | 5.85 | 5,257.91 | 1.704 |
| Gr. South Plantations (GTP) | 27.94 | 100 | 6.90 | 1,525.71 | 1.924 |
| Insurance Australia Group (IAG) | 20.35 | 100 | 5.59 | 8,565.15 | 1.728 |
| Macarthur Coal Ltd (MCC) | 44.10 | 100 | 7.65 | 977.50 | 2.037 |

Figures are forecasted for 2006

CURRENT DEFENSIVE SHARE PORTFOLIO

| Security Name | ROE | Gross Yield | Div/Cov |
|--|-------|-------------|---------|
| Alesco - ALS - new | 14.54 | 8.66 | 1.26 |
| Adelaide Bank Limited - ADB | 14.90 | 6.39 | 1.50 |
| ANZ Banking Group Ltd - ANZ | 18.80 | 6.31 | 1.54 |
| AWB Limited - AWB | 11.50 | 10.06 | 1.42 |
| Bluescope Steel Limited - BSL - new | 15.66 | 8.30 | 2.24 |
| Boral Limited - BLD | 15.10 | 5.68 | 1.88 |
| Coates Hire Limited - COA | 17.10 | 4.54 | 2.01 |
| Commonwealth Bank of Australia Ltd - CBA | 19.90 | 6.90 | 1.35 |
| Crane Group Limited - CRG | 9.90 | 7.67 | 1.23 |
| CSR Limited - CSR | 21.80 | 4.54 | 1.88 |
| David Jones Limited - DJS | 21.60 | 6.81 | 1.29 |
| G.U.D. Holdings Limited - GUD | 30.30 | 11.21 | 1.17 |
| Great Southern Plantations Limited - GTP - new | 27.90 | 9.79 | 1.92 |
| Insurance Australia Group Limited - IAG - new | 20.35 | 7.93 | 1.73 |
| Just Group Limited - JST | 64.50 | 6.53 | 1.73 |
| Leighton Holdings Limited - LEI | 25.40 | 4.05 | 1.58 |
| Macarthur Coal Limited - MCC - new | 44.10 | 10.86 | 2.04 |
| National Australia Bank Limited - NAB | 14.80 | 6.22 | 1.41 |
| Qantas Airways Limited - QAN | 11.20 | 8.52 | 1.34 |
| Santos Limited - STO | 22.30 | 4.87 | 2.84 |
| SIMS Group Limited - SGM | 16.70 | 5.11 | 2.85 |
| Spotless Group Limited - SPT | 15.8 | 6.95 | 1.13 |
| St. George Bank Limited - SGB | 22.20 | 7.31 | 1.31 |
| Suncorp-Metway Limited - SUN | 20.70 | 7.10 | 1.61 |
| Tabcorp Holdings Limited - TAH | 15.80 | 8.36 | 1.17 |
| Westpac Banking Corporation - WBC | 21.60 | 6.67 | 1.55 |