

So the answer, suggests *Investing Times'* editor Ian Murdoch, might be to realign shareholdings into more defensible stocks. He says asset allocation only tells half the story. How people allocate within an asset class like shares can become just as important as the overall asset allocation model.

He says the way to take a defensive approach to shares is pretty well summed up by the word "cheap". The theory is that holding shares that are reasonably valued means they are less likely to suffer than "dearer" stocks in a market downturn.

This generally means shares in companies that are well-established and unlikely to fail, let alone reduce their dividends.

There are several approaches to selecting such shares but they all usually involve some combination of a value approach to investing.

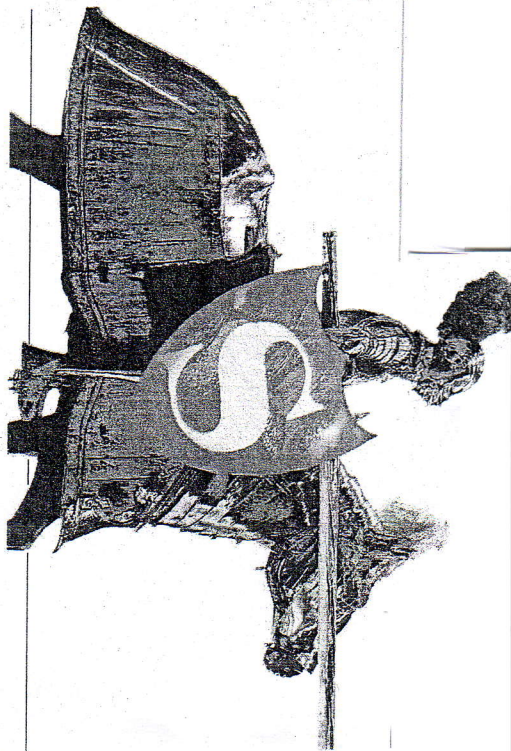
This means concentrating on companies that are paying (and can pay in the future) dividends and produce good returns on capital and which are selling at low, rather than high, price-earnings ratios.

In general, value investors have tended to do better in the long term, especially when the stockmarket is running on momentum. Value stocks in these circumstances tend to be the forlorn to the growth hares.

Murdoch's group, Investstone Wealth Management, has been running a defensive share portfolio for more than seven years and it has comfortably outperformed the S&P/ASX 200 Index in that time by more than 47 per cent while it has beaten the All Ordinaries index by 58 per cent.

Another advisory group that emphasises investment fundamentals, Lincoln Indicators, is running funds based on its measure of a company's corporate health and this, too, has produced top-quartile performance.

Murdoch's teams select stocks for the portfolio from the S&P/ASX 200 Index that satisfy minimum key criteria and then removes stocks when they fail to meet them.



The three key points are dividend return (a yield of more than 7.5 per cent gross allowing for dividend imputation credits), dividend cover (of at least 1.25 times) and return on equity (of more than 10 per cent).

The dividend yield is used first to compare the stock to the rest of the market. The general rule of thumb is to buy companies yielding at least 25 per cent more than the average market dividend.

The added benefit, says Murdoch, is that if you are getting 7.5 per cent in dividends, then share price growth need only be

Cash has been the worst-performing asset class in the past two decades (barely matching inflation after tax) and only makes sense as a short-term defensive strategy.

3 per cent (about equal to the consumer price index) to get a double-digit return.

The dividend cover simply verifies if the company's current earnings can cover the payout; a company with a high dividend cover can sustain its payment (rather than cut the rate) in a short-term downturn.

The return on equity is used to assess the company's ability to generate a return on shareholders'

funds: a 10 per cent return on equity indicates a company is using investors' capital wisely.

Murdoch says no other factors are considered: "no personal preferences, no favourites, no black box computer programs, no six-figure analysts' opinions - just these three numbers".

Stocks are removed from the portfolio when the dividend yield falls to less than 4.7 per cent, when the dividend cover declines to 1.1 times or when return on equity is less than 8 per cent.

Although the stocks are selected for their defensive qualities, it has still outperformed the S&P/ASX 200 Index in the past three and five years, and by 20.54 per cent a year to 13.92 per cent for the index since inception. But, with its defensive characteristics, it has underperformed in the past six and 12 months, not helped by the inclusion of AWB and Santos.

In its March review, Investstone has made three changes: removing Qantas (because of the takeover offer) and including Telecom NZ and Zinifex.

It now contains the following stocks: Adelaide Bank, Alesco Corporation, Australia and New Zealand Banking Group, AWB, BlueScope Steel, Boral, Coates Hire, Commonwealth Bank of Australia, Crane Group, CSR, David Jones, GUD Holdings, Great Southern Plantations, IAG, Just Group, Leighton, Macarthur Coal, NAB, Santos, SIMS Group, Spotless, St George Bank, Suncorp, Tabcorp, Telecom NZ, Westpac and Zinifex.

SHIELDED Defensive share portfolio

Company name	Return on equity (%)	Gross yield (%)	Dividend cover
Adelaide Bank	15.60	7.37	1.44
Alesco Corporation	17.40	8.31	1.20
ANZ Banking Group	20.30	7.24	1.57
AWB Limited	10.94	11.57	1.38
BlueScope Steel	19.50	7.38	2.03
Boral	12.00	6.25	1.65
Coates Hire	16.10	6.59	2.23
Commonwealth Bank	20.80	7.67	1.37
Crane Group	12.40	5.65	1.47
CSR	23.10	6.67	1.87
David Jones	22.80	6.42	1.19
GUD Holdings	8.00	10.86	1.12
Great Southern Plantations	23.00	11.36	3.33
Insurance Australia Group	16.90	7.67	1.41
Just Group	51.00	6.65	1.54
Leighton Holdings	32.70	4.69	1.46
Macarthur Coal	13.80	6.05	2.04
National Australia Bank	17.30	6.67	1.52
Santos	15.60	6.25	2.35
Sims Group	19.40	8.24	1.54
Spotless Group	17.50	6.80	1.27
St George Bank	22.00	7.67	1.30
Suncorp	12.00	7.81	1.40
Tabcorp Holdings	15.10	8.09	1.11
Telecom NZ	46.91	9.16	1.33
Westpac	22.60	7.53	1.44
Zinifex	36.85	10.48	2.27

Source: Investstone Wealth Management