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COVER STORY

ON THE DEFENSIVE

Investors should heed storm warnings and seek weatherproof shares, writes

John Synnott

THE share market has snapped back after the August credit crunch, but the doomsayers predict more trouble this month.

September-October traditionally brings tough times for shares, and investors have been warned to be prepared.

So financial pundits have been assembling beauty parades of defensive shares that can be relied on to survive further turmoil.

They can be a useful guide for the short-term investor who wants to be in the market.

It will boil down to your investment horizon, and how you think the market is travelling in the overall scheme of things.

If you consider shares overvalued now, or there's worse to come from the US credit crunch or other major external threats looming, it makes sense to run for cover.

"Short-term investors should stay sidelined," says ABN AMRO Morgans retail strategy manager Rebecca Sullivan, who has advised investors to be defensive.

Medium-to-long-term investors can sit through the volatility with quality stocks. There is an opportunity to pick up shares cheaply and get a dividend, which should provide some buffer to the price volatility, she says.

ABN AMRO likes shares including BHP, Westpac, ANZ, QBE Insurance, Toll Holdings, Woolworths and AMP.

Smaller plays with mining and infrastructure exposures include Transfield, Macmahon Holdings, Cardno, Ausenco and Queensland Gas.

An investment portfolio is supposed to be diversified across asset classes for the long term to smooth rough patches.

A short-term strategy is to use a defensive tilt in your portfolio to ride out the dip in share prices, and when the dust settles after a few months, rotate into other shares that have been hardest hit.

For investors looking 12 months ahead, it depends on what is foreseen.

Optimists such as Shane Oliver, head of investment strategy and chief economist at AMP Capital Investors, think investors can sit tight. He believes the market is not overvalued, and not ripe for a fall.

"The recent correction was like a summer storm, which blew in to clean up and carry away the rubbish, and set up the market for a brighter time ahead," he says.

US growth will slow — but that will take pressure off interest rates there and allow the Federal Reserve to cut interest rates, setting up the share market for stronger growth.

In recent weeks, companies have been reporting their annual results and giving investors guidance on the year ahead — and the news has generally been positive.

Companies have done well and are cautiously optimistic, even with the turmoil in financial markets, says CommSec chief equities economist Craig James.

"We have seen the share market spring back in a big way. I don't think it is a defensive environment."

Nevertheless, utilities (AGL Energy), property trusts (Westfield), banks and Telstra head his defensive list.

Another strategy is to go for low-beta stocks that move less than the general share market, such as infrastructure and media stocks.

Macquarie Research Equities is less optimistic, viewing the market as better after the correction, but still overvalued.

"Our analysis now suggests a total market return of 8 per cent over the next year," the broker says in a note.

"This is the long-term minimum requirement.

"In the current risk-averse environment, a return in excess of 10 per cent is needed, suggesting a further 5 per cent drop."

The broker warns investors to be careful about picking up shares that have suffered the greatest price falls. These stocks have underperformed because of earnings risks.

The low PER (price/earnings ratio) is usually illusory.

If gearing is low, cash-flow generation is strong and earnings have low risk, then there is no real need to access debt-funding. The risk to the share price is relatively low, even if the PER is high, Macquarie Research Equities says. If, however, net debt to equity is high (100 per cent or greater), and more debt is needed to cover a cashflow shortfall or to meet dividends, then the PER is irrelevant.

"The experience of the 1987 crash highlighted that buying low single-digit PER stocks (such as Bell Group, Bond Corp) did not protect the investor.

"On the other hand, the share prices of stocks with sound cash flows and balance sheets regained their pre-crash highs within the next year, despite the index still being well down," the Macquarie analysts said.

The same applies today. Cheap-looking garbage is still garbage. Buy quality and you will get returns.

Macquarie sees industrials and listed property trusts as expensive.

Yet banks and resources are both offering attractive growth-value trade-offs, and valuations either at or below key market metrics.

The current environment could prove beneficial for the major banks as their competitors in the lending market struggle to maintain margins and market share.

Cash flow is seen as a security blanket in troubled times and the current environment favours sound balance sheets.

Macquarie suggests 11 standout stocks with low gearing, strong cash conversion rates and preferably strong growth valuation trade-offs (see table).

"These stocks have shown outperformance at this time," Macquarie analyst Tanya Branwhite says.

Large fund manager Colonial First State is not panicking because it trusts the fundamentals underpinning the economy and the market.

The big banks, the big miners and the big grocers should ride out the storm and grow with Australia, says

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Hans Kunnen, head of investment research at Colonial First State.

"People have not bought the China growth story fully, so the (share) price to earnings ratios of the large mining companies are very low," he says.

BHP and Rio should still repay medium-term buying.

Top-performing manager Prime Value Asset Management topped up holdings in BHP and Rio holdings when the price dipped recently.

Similarly, more money went to News Corporation (owner of *The Australian*), while allocations to companies with high gearing and small companies were reduced, because these traditionally do poorly in rough market conditions.

"An exception is small companies with highly tangible assets, such as large property holdings on their books, like Amalgamated Holdings," says Leanne Pan, senior portfolio manager at Prime Value Asset Management.

The manager is a bottom-up manager looking for good companies that can be expected to do better than most, whether the market is up or down. Another top performer, Pengana Emerging Companies Fund, adopts the same approach, ignoring the market.

"We have been in this game for nearly 13 years and try to keep our head and rigorously check a company's underlying cash flow. That keeps us away from the speculative end of the market," co-portfolio manager Steve Black says.

The small to medium company fund does not invest in resource companies, because they have been subject to volatile demand and pricing, but sees more defensive investing opportunities in mining services companies such as Mineral Resources, which has a four to five year contract with BHP to crush ore.

It also goes for good franchises without major debt, such as Cabcharge and MacMillan Shakespeare, the latter a leader in salary-packaging services.

The market jitters emanating from the international credit crunch have confirmed the scepticism about diversified financials, such as Macquarie Bank, for some.

"People who make profits by moving money around are not going to grow much more — now that the credit market has tightened we are more interested in meat and potato companies," van Eyk Three Pillars listed investment company portfolio manager Otto Rieth says.

He sees safety in direct infrastructure companies such as Leightons and Transfield Services.

"They have record levels of work and their margins have expanded, allowing them to be selective and not have to cut each other's throat," he says.

He prefers to avoid infrastructure vehicles, such as Transurban, Macquarie and Babcock and Brown.

The fund is overweight in resources and he prefers RIO at present.

It holds one pillar of blue chip stocks, one of growth stocks and a third of 12 special-situation or value stocks that promise a turnaround or takeover, such as Alumina.

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PICKS FOR JITTERY INVESTORS Defensive stocks

Company name	ASX code	Why liked
Commonwealth Bank	**CBA**	Preferred pick of banks which have met growth forecasts.
Westpac	**WBC**	New boss Gail Kelly. And, banks benefiting from mortgage competitors' margin pressure
ANZ Bank	**ANZ**	Value at 7% discount to peers and big four are relatively attractive
National Bank	**NAB**	Forecasts optimistic but scope for banks to win back market share
BHP Billiton	**BHP**	Global growth will sustain demand. Most diversified of the big miners.
Rio Tinto	**RIO**	Quality exposure to China, a story investors still haven't cottoned onto
Woodside Petroleum	**WPL**	Strong outlook despite concerns about oil project delivery

Source: Macquarie Research Equities

Company name	ASX code	Why liked
QBE Insurance	**QBE**	Strong result makes it our preferred general insurance stock
Singapore Telecom	**SGT**	An attractive low risk proxy to Asian telecom growth story.
Brambles	**BXB**	Expects strong earnings to continue next year.
Leightons	**LEI**	Big order book. Plenty of work for all players so margins fat
Origin Energy	**ORG**	Blends domestic growth projects and current guaranteed cashflows
Woolworths	**WOW**	Unique business model, favourable industry dynamics but expensive
Lend Lease	**LLC**	Strong global retail and communities development business with US ramp-up

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