THE SPECTATOR

Investment Special: On the defensive

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A guide to safer stock-picking in difficult times

These are dark days for investors. Interest rates squat at historic all-time lows in order that the Bank of England can continue to bail out our errant banks and government. Western economies toil under a monumental burden of public and private-sector debt, to which austerity is merely the latest desperate political response. Securities and currency markets are all being manipulated by extraordinary and highly inflationary monetary stimulus. Safe havens, anyone?

The situation is doubly challenging for anyone in or approaching retirement. By artificially suppressing the yields available on UK government bonds or gilts, and therefore annuities, through its absurd policy of quantitative easing (a.k.a. money printing), the Bank of England has done an excellent job of further enriching the banking lobby whilst impoverishing those least able to add to their investment pot.

But the kneejerk response to the challenges of our time should not simply be to plunge without reservation into the stock market and hope for the best. Stocks play a role within a balanced portfolio for any investor — as do high quality bonds and real assets — but the prudent course is surely to concentrate on the most defensive stocks available. Happily, there are a number of time-honoured strategies that can help us identify some of the most appropriate candidates.

The imposing-sounding Altman Z-score is a particular favourite of mine. I will spare you the maths, but the Altman score for any quoted company indicates the probability of that business going bankrupt within the next two years. It is calculated by using a weighted mixture of a company's working capital, retained earnings, market value, liabilities and tangible assets. A bulletproof business with strong earnings and little or no debt will score highly; a debt-laden basket case with puny revenues and a dodgy business model will earn a score of little or nothing. Anything scoring above 3, by the reckoning of Professor Edward Altman of New York University's Stern School of Business, is almost certainly 'safe'.

That would include FTSE350 stalwarts such as Reckitt Benckiser, Renishaw and Domino's Pizza, all of which score above 7. Not to kick stocks when they're down, but Altman might look askance at the likes of Enterprise Inns, Trinity Mirror or Vodafone, all of which score less than 1. The Altman Score cannot be computed for financial stocks, but in my opinion nobody in their right mind should be buying them anyway.

Another tried and tested value metric is the price/earnings or p/e ratio. This is simply a company's share price divided by its earnings per share, and it tells you how many pounds you are paying in share price terms for each pound in earnings. For explicit value investors, the lower the p/e the better. In the go-go days of the dotcom boom of the late 1990s (which, as Alex Brummer observes on page 16, seems to have returned) companies would routinely float on the stock market with p/e ratios either grotesquely high or at infinite levels — because while those companies had a share price, they didn't have any earnings — and the rest is painful history.

These days, despite the machinations of quantitative easing and other manipulative market stimuli, good quality businesses can still be found with modest p/e ratios and the comparable allure of a high dividend yield. Among them are AstraZeneca (Altman Score of 4.6; p/e of 6; gross dividend yield of 7 per cent) and Royal Dutch Shell (Altman Score of 3.3; p/e of 7; gross dividend yield of 5 per cent). To put those dividend yields into perspective, ten-year UK gilts yield 2 per cent and offer no protection whatsoever against the prospect of sustained inflation. You be the judge.

A less scientific but equally valid approach would simply be to favour those sectors of the market that have a reputation for solidly stodgy earnings and generally defensive attributes. Such sectors would include tobacco, utilities, healthcare, and consumer staples. Fund managers have a metric for safety in this respect too — what they term beta, which is simply the historic price volatility of a stock relative to that of the broader market. A stock with a beta of 1 can be expected to move hand in hand with the most relevant market index. A stock with a beta well below 1 can be expected to fall much less than the market when the market falls. British American Tobacco, for example, has a beta of just 0.6; Barclays, on the other hand, has a beta of 1.8. You have been warned.

David Fuller, market strategist at the excellent Fullermoney.com investment website, offers another way to assess interesting stocks. He calls the most promising ones 'the autonomies': multinational companies that operate globally and can be considered stateless, ideally with many of the attributes above (low p/e ratios, for example, and high dividend yields) and with quasi-monopoly status in their individual sectors. Many of these so-called autonomies are US-based but international in scope: think Microsoft, Johnson & Johnson, McDonald's. The one wrinkle in this argument is that cash-strapped governments, when they need money, will go after those entities that have it. The autonomies represent a highly visible tax target for depleted treasuries.

There are other useful portfolio diversifiers worthy of consideration for any investor concerned about the state-sanctioned inflationism that stalks the western world. Gold and silver, the monetary metals, represent one of the best forms of currency protection at a time when the printing presses are running 24 hours a day. But for the nervous investor, a portfolio of high quality defensive stocks represents a practical way of being in the market without being entirely at the mercy of the market.

Despite the best efforts of smooth-talking 'strategists' to persuade us otherwise, the business of investing is not an exact science. Unanticipated risks lurk around every corner. But many of those risks are in plain sight: bankrupt governments; debt defaults; crippled banks; the likelihood of soft economic growth for some time to come in the west, combined with varyingly intense attempts at national austerity. If that doesn't argue in favour of defensive investing, I don't know what does.

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