What Defensive Really Means to Investors

Description

The dream for most investors is to find investments in the low-risk, high-reward category. Buying these investments at a low price and selling at a higher price is, of course, part of the investment process. The challenge sometimes faced by investors (especially new investors) is understanding the risk/reward proposition of a security.

With investing, we know the more risk a security carries, the greater the potential reward there should be. Unfortunately, this is not always the case as both defensive and cyclical stocks react differently during the market cycle. Looking first at defensive stocks, investors must reset their expectations and be willing to accept lower returns when compared to cyclical stocks if holding for a long period of time.

Defensive stocks are characterized as experiencing minor fluctuations in revenues and earnings during boom or bust markets. Put another way, the consumers of certain products are significantly less effected by a decline or financial increase in their paycheques. An obvious example of this is grocery stores. Using **North West Company Inc.** (TSX:NWC) as an example, we notice a few important things.

The first obvious thing is that the company has a very low beta in comparison to the market. The beta metric is used to compare how volatile a company is in comparison to the overall stock market. No matter how volatile the stock market is, the market's volatility is what sets the bar at one. Stocks which are more volatile than the overall market will have a beta in excess of one, while stocks with a beta of less than one are clearly less volatile than the market. In the case of North West Company, the beta is approximately 0.13, signalling a very low amount of volatility.

Given that the company operates grocery stores in remote parts of Canada and Alaska, the revenues and expenses are very consistent. The population's income and mobility are both very stable in these communities.

Another fantastic example of a defensive security is any one of Canada's biggest banks. With **Toronto-Dominion Bank** (TSX:TD)(NYSE:TD), booming economic times will often lead to higher amounts of money being put on deposit and subsequently invested into longer-term products. During recessions, however, the credit products may be more highly used by Canadians, leading to an offset in the investment products. Additionally, Toronto-Dominion Bank has a very large footprint in the United States, further reducing the exposure to any one economy.

While there may be substantially less risk with defensive securities, it is important to note the rarity of a major breakout leading to a 50% return in any one year with either of these securities. While average Canadians may use certain goods or services on a regular basis, “rain or shine,” we so rarely hear individuals talk about how they stocked up on banking services during good times or bad.

Explosive earnings are exceedingly rare in the case of defensive stocks.

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