How to Build a Defensive Stock Portfolio

Description

Here are the characteristics of a defensive portfolio. The portfolio falls less in a down market and keeps up with the market in good times. The portfolio sticks to safety, aims to avoid big losers, and generates good income. A defensive stock portfolio should allow you to do well overall, while reducing the risk and volatility you'll experience.

Here are some tips for choosing the stocks for your defensive portfolio.

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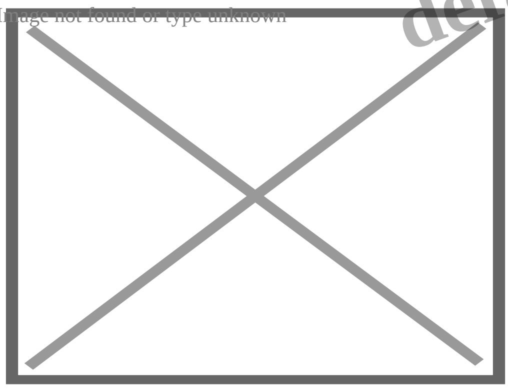

Choose stocks from no-lose industries

By no-lose industries, I mean industries in which companies are profitable in good times and bad. Sure, the companies might experience dips in earnings or cash flow from time to time, but they'll still be profitable. As well, their earnings or cash flow will recover after experiencing dips. You'll find that the earnings or cash flow of these companies will be in a long-term uptrend.

The Big Five Canadian banks, including **Royal Bank of Canada** (TSX:RY)(NYSE:RY) and **Toronto-Dominion Bank** (TSX:TD)(NYSE:TD), are some of the safest banks in the world. In the last recession in 2008-2009, triggered by a financial crisis, these banks managed to maintain their dividends.

All but one of the banks had negative return on equity (ROE) in 2008. And that bank's ROE quickly bounced back to positive territory in the following year. The Big Five's recent ROE was 13% or higher.

Investors can pretty much expect long-term returns of ~10% if they pay a fair valuation on the banks.

Valuation

Utilities is also generally a no-lose industry, particularly utilities that have largely regulated assets, such as **Fortis Inc.** (TSX:FTS)(NYSE:FTS) and **Emera Inc.** (TSX:EMA).

Other than focusing on defensive businesses, investors should also strive to buy stocks at a margin of safety. Buying stocks at a discount will add another layer of defence to your portfolio, not to mention getting higher yields from safe dividend stocks at a presumed lower price.

Of the mentioned companies, the analyst consensus from **Thomson Reuters** thinks Emera is the best value right now with 20% upside potential in the next 12 months. Moreover, Emera offers a juicy 5.4% yield.

Growth

One common goal of investing is to outpace inflation so as to maintain your purchasing power. So, a defensive stock portfolio should offer growth that beats inflation. Let's be conservative and say that the long-term rate of inflation is 4% (instead of 3%). If so, then aiming for at least a return of 8% is a reasonable target.

An 8% rate of return can be made up of, say, 3% dividends and 5% earnings growth. Again, investors need to keep in mind that they should not overpay for stocks when they invest with the goal of an 8% minimum rate of return.

Investor takeaway

Aiming to buy businesses that are profitable in good times and bad from different sectors at undervalued prices, as well as getting returns of at least 8%, is a defensive way to invest. What will your defensive stock portfolio look like?

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TICKERS GLOBAL

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2. NYSE:RY (Royal Bank of Canada)
3. NYSE:TD (The Toronto-Dominion Bank)
4. TSX:EMA (Emera Incorporated)
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