What It Means for a Stock to Be Recession Proof

Description

Market crashes and recessions are often lumped together in a single discussion. Indeed, recessions tend to lead to down markets. A decade ago, the last market crash, which observed stocks falling 50% from peak to trough, was caused by a recession triggered by a financial crisis.

Let me be crystal clear: in a market crash, no stock is immune from big slashes in their trading prices, because investors are worried about losing money in their stocks in an unstable economic environment. The stock market is swayed by emotions all the time, especially when there are big headlines ushering investors to sell.

If all stocks will get major price cuts in a recession, then what does it mean for a stock to be recession proof? How can investors protect their wealth?

Example of a recession-proof stock

A reader questioned my point of view on **MTY Food Group** (TSX:MTY) being a recession-proof stock. He argued that it is a consumer discretionary stock so it can't possibly be recession proof, and that in a recession, consumer spending decreases and so does discretionary spending. I agree with his general trail of thought, but perhaps our definitions of a recession-proof stock are different.

In my book, a recession-proof stock's earnings or cash flow stay more or less intact in a recession. For stocks that pay dividends, the dividend is at least maintained, if not increased — healthily — from earnings or cash flow. Notice that not once did I mention the stock price.

Before the stock market was in existence, the focus was on businesses. Today, investors (or traders) are bombarded with real-time news and changes in stock prices. If you have a business with a history of posting higher and higher profits year after year, wouldn't you love to continue owning the business? As a business owner, you shouldn't care what its stock price is. Only traders worry about short-term price movements.

In the last recession, MTY Food Group's stock fell about 47% from peak to trough. However, as I pointed out earlier, all stocks fall in a market crash. What makes MTY Food Group a recession-proof stock was that its earnings per share *increased* in fiscal 2008 and 2009 by 8% and 23%, respectively.

MTY Food Group's persistent earnings growth is what has been driving the stock higher over time. Even if you bought the growth stock at the peak of 2007, you'd still have netted respectable returns of 13.3% per year that beat the market!

Yes, MTY is a consumer discretionary stock; consumers can choose to eat at the food courts (or not). Thankfully, because grabbing a bite at the food court is a cheaper option versus eating out at a restaurant, where it's the convention to pay tips, during a recession, MTY's range of low-cost options at the food courts should appeal to consumers feeling tight in the wallet.

Investor's Foolish takeaway

In a market crash, all stocks fall — it's just a matter of magnitude. In the last recession, MTY stock felt a similar magnitude of price cut as the market. However, MTY's earnings were much stronger than many other businesses out there.

Its earnings continued to increase through and after the recession. As a result, the stock has delivered extraordinary returns of more than 21% per year since the trough.

Investors should seek recession-proof businesses — those that keep their earnings (and dividends) intact even in recessions — and see their portfolios fly to new heights as the economy recovers after future recessions.

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