Protecting a portfolio in difficult markets: CHALLENGING YOUR ASSUMPTIONS

- Investors may need to reassess long-held beliefs on portfolio protection.
- Larger, high growth companies with predictable dividends may not be more consistent.
- Investors need to be more nuanced in their approach.

Investors have enjoyed benign stock markets for much of the past decade. It is clear that this is changing. In a new, more fragile, environment, investors may want to build greater resilience in their portfolios. However, they may also need to reassess long-held beliefs on how to protect a portfolio.

The old rules suggest that tricky times called for 'defensive' companies, those with predictable revenues and cashflows, plus consistent dividends. While some of these qualities will still be important today, we believe it is important to take a more nuanced view.

For example, there is a long-held view that larger companies will prove more resilient in a tricky climate. Certainly, large companies are often more diversified, but if a company is in a difficult area, or poorly managed, its size will provide little defence. In reality, we see little correlation between a company's size and its resilience. The right companies with the right characteristics can be found across the market capitalisation spectrum. In recent years, we have been moving the FTSE 250 and SmallCap holdings in the Dunedin Income Growth Trust a little higher – to 30% from 17%.

Equally, consistent dividends are important, meaning investors are paid to wait out any market volatility. However, it is not enough on its own. It is important not to neglect the potential for growth in dividends, for example, not least because those companies growing their dividends are often delivering stronger capital growth as well. Over the past three years, we have raised the amount of companies growing their dividend at more than 5% per year from 21%, to 44%.

Companies that can grow their revenues in difficult market conditions are often seen as more defensive. We are looking for companies with non-discretionary demand, with sticky customers and recurring earnings, such as healthcare or software providers. However, again, this is not enough on its own. Recently investors have overlooked high share prices as long as a company appears to be delivering strong earnings. In our view, a company ceases to have defensive qualities if investors pay too much for it. In the same vein, the importance of proper governance is often underestimated.

Within the portfolio, this leads us to companies such as Just Eat. Its online platform is uniquely positioned and it has many more restaurants on its books than its competitors. Aveva is a software company selling to the oil and gas industry. It is a structurally-growing area as the industry becomes increasingly digital.

We maintain an underweight to domestic UK companies, not because we believe the UK domestic economy is likely to be weak, but a recognition that areas such as emerging markets are growing more quickly. A side effect of this positioning should be that the portfolio will be more resilient if the Brexit situation does not achieve resolution.

In building a portfolio fit to withstand more troubled markets, investors cannot rely on old rules of thumb. Sticking to a portfolio of large cap, expensive growth companies may not protect against volatile markets. Quality is important, but it must come at a reasonable price. ■

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