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Share portfolio killers – stocks to avoid in this climate

Mark Story - July 24, 2008

Piling back into a falling sharemarket on the pretext that all under-valued stocks look attractive would be akin to saying to a surfer on P-plates – there's a tsunami coming in – why don't you go and ride it? With the average portfolio down 5-10% over the last month, trader Alan Hull says only those brokers looking to turn a commission on trades should be comfortable with clients buying more shares right now.

With the sharemarket currently enduring a one-in-20-year transitional phase, he says the only real safeguard against share portfolio dilution is to remain in cash until the market stops falling. "When you buy into a falling market you're buying a falling dagger," says Hull. "What's indicative of a true market-bottom is that it consolidates on its lows, and we haven't seen that yet."

While the market might be close to bottom, he says investors who buy stocks on the strength of an expectant pre-Christmas correction risk further losses. According to chart followers, if the S&P/ASX 200 slips much below 4940 points the market stands to lose another 10% before it finds the next support-level at around 4400 points. Instead of buying falling daggers, Hull says investors would be better served protecting their share portfolios from further losses.

Given that the market lost 16% in 2007, he says share portfolios that are breaking-even are doing well. And if you've only lost bank interest, count yourself lucky - you can make that up within a year.

Instead of buying stocks in falling markets where the surprises to the downside are greater, he says investors should cull non-performing deadwood from their share portfolios. But first, adds Hull they must identify what they were trying to achieve when they bought a stock, and whether that criteria still stacks up.

To ensure investors measure their shares on the right criteria, he also recommends dividing their portfolio into two distinct groups - income and growth. In other words, there's little point selling-off good yield-plays unfairly beaten-down by the market if they're chasing income.

That's why he says investors shouldn't be spooked into shedding stocks like Qantas just because the share price has been dragged down mercilessly by negative market sentiment. "Qantas pays a 10% dividend and 100% franking credits, so with the yield looking better as the share price falls, there's also a strong argument for dollar cost averaging into more shares," Hull says.

So what are the hallmarks of share portfolio killers? Within a market forced to refocus on fundamentals, Hull says it's important to find businesses that can generate solid earnings. One of the first places to look for deadwood, he adds is amongst the small-caps, (typically under a $1/share) which struggle to recover lost ground once markets correct. “When the speculative money goes out of the market, it’s the bottom-end that suffers badly,” he says. “It’s not a time to be speculating, the balance of probability suggests you’ll get whacked in the head.”

With the price of funding going up, Hull also warns against stocks carrying over 30% debt-to-equity. Ironically, he says many investors who thought they were safely diversified away from resources have also been slugged. He cites listed property trusts, once perceived as defensive stocks as a case in point.

Other share portfolio wreckers identified by Hull include, uranium stocks which he says look questionable given the current operating environment. And due to the strength of the A$, he’s also wary of anything doing its accounting in US$.

So if you want to mitigate downside shocks from the growth-side of your share portfolio, what stocks act as the best safeguard? While the market continues to be driven by fear, Chris Hall investment executive with Argo Investments says investors should to divide between cash and safe, mainstream defensive stocks underpinned by solid fundamentals.

That means sticking to renowned large-cap brands within the ASX top 100 stocks, especially those with strong earnings based on essential services, like banks and diversified financials. Valuations, balance-sheet and cash-flow aside, he says investors need to scrutinize stocks according to a critical check-list.

Firstly, Hall says investors need to question the quality of the board and its management line-up. Secondly, he says they need to check where a company sits within its industry and whether changes to industry structure have left it vulnerable to set-back. “Both resources and property are undergoing structural changes (or similar). While the former is based on underlying demand from China and India, the latter is witnessing a move from rental to fund manager income and this will require some unwinding,” says Hall.

Telstra, adds Hull is a case in point, he says while its copper network represents a competitive advantage, this won’t always be the case. “Now’s not a time to be looking for value, wait until the market turns and you’ll be in the box seat,” urges Hull. “Share portfolio accidents happen when people who have been in cash too long suddenly become impatient.”

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