Blue Chip Blues

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It's that time again. After a healthy rally on the share market, pundits are saying the easy gains are over and it's time to sharpen your pencils and start narrowing your portfolio down to a few tried and tested "blue chips".

The notion behind this sort of commentary[1] is that "high quality" or "top shelf" stocks will hold their own in any pullback, while the "junk" or "flotsam and jetsam" that floated to the top in the initial rally will quickly sink from favour.

Missing from this analysis is any way for investors to work out whether the information they hold about these stocks — the solid and dependable or the flaky and speculative - is better than what is already in the price.

Blue chips often are defined as established companies dominating their particular markets, with stable earnings, consistent dividends, strong balance sheets and which are highly regarded in financial circles.

If you build a concentrated portfolio around a few of these blue chips, the story goes, you are protecting yourself against the sort of wild volatility and precipitous price declines we saw in 2008 and early 2009.

Of course, this overlooks the fact that some of the worst performers in the recent downturn were the banks and property companies that were frequently cited as likely to be solid, reliable performers in any market cycle.

The fact is that companies with "blue chip" status can fall quickly from grace, sometimes spectacularly so. It doesn't matter whether they dominate their markets, that there is huge public demand for their shares, that they have high-profile backers or that brokers love their business model — stuff can happen that undermines them.

The only remedy for these company-specific risks is diversification — owning shares in lots of companies in different industries and different countries; small company shares and large company shares, high-profile and little-known companies. Some will be stars, some won't. But owning lots reduces the chances of idiosyncratic risks upending your portfolio.

While we ponder that thought, let's recall for posterity a few former Australian "blue chip" names:

Pasminco

"Rarely does a mining company have an opportunity to fulfil strategic and value-adding objectives on such a large scale and in a single deal."

Quote attributed to a resource analyst, 'Zinc Puts Cream on Pasminco', The Australian, Jan 11 1997, after Pasminco bought the Century and Dugald River zinc deposits from CRA.

Pasminco was once considered a blue-chip miner. Formed in the late '80s from the zinc and lead operations of CRA and North Broken Hill Peko, Pasminco grew to become the world's largest zinc miner. It collapsed in 2001 due to disastrous currency hedging strategies.

HIH Insurance

"The offer received widespread support from retail and institutional investors, who recognised…a company with a strong market position and a demonstrated record of growth and profitability."

Winterthur chief executive officer Thomas Wellauere quoted by Reuters on the company's public offering,, 'HIH Winterthur Offer Prices at $2.58/shr, Reuters, Aug 3, 1998

HIH was for a time Australia's second largest general insurer. Its shares were keenly sought by local investors when its Swiss parent Winterthur offloaded its 51 per cent stake in 1998. Less than three years later, HIH became Australia's largest corporate collapse, with losses of more than $5 billion. An inquiry led to the conviction and imprisonment of several executives.

Babcock & Brown

"We believe that Babcock's earnings outlook appears robust."

A quote from UBS analysts in a report which doubled their share price estimate for investment bank Babcock & Brown, The Australian, Nov 22, 2004

Shares in global investment firm Babcock & Brown, a company touted as "the next Macquarie", soared 60 per cent above their issue price on debut in October 2004. At its peak, B & B had a market value of around $10 billion. Less than five years after its float, it was placed in liquidation under the orders of bankers owed more than $3 billion.

One.Tel

"They're young, male and rich, and now they have banded together to create Australia's 'coolest' mobile phone company."

Journalist describing the Sydney eastern suburbs glamour team behind telco One.Tel, 'Meet the One.Tel Gang', The Australian, March 8, 1997

One.Tel was a youth-oriented mobile phone company formed in 1995. It floated in 1997 and by late 1999, as the nation's fourth largest telco, was one of the top 30 companies on the Australian market with a market capitalisation of more than $5 billion. But despite high-profile backing from the Murdoch and Packer families, it collapsed in 2001. Years of litigation followed.

[1]Randall W. Forsyth, 'Blue Chips for the Long Run', Barron's, Jan 26, 2010

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