feature

Cash Flow Portfolios

Making sense of a new reality

Break out the champagne: 2011 is drawing to a close. This year's seesaw market left many questioning their investment process. Looking in the rear-view mirror, the Japanese tsunami was a major surprise, but the United States and European debt debacles really shouldn't have been.

As the steward of the world's reserve currency, the U.S. government has been less than responsible. Just 50 years ago, the United States was a manufacturing powerhouse and the world's largest creditor, boasting the highest standard of living built upon a productive economy and strong currency. Since then, the U.S. has gradually raised its debt ceiling 74 consecutive times, to where it is now the most indebted nation on the planet, with a struggling economy and a recently downgraded currency.

The U.S. response to the latest recession was not uncommon. Most of the influential governments around the world acted in concert. They slashed their interest rates and created massive amounts of money in an effort to stimulate their lacklustre economies. However, they now find themselves even further in debt and still with severe economic challenges. This nonsensical approach attempts to solve a debt and easy money problem with more debt and more easy money.

This type of government intervention has made it tough for investors to understand and take actions that make sense in an insane world.

How should investors position their portfolios in this new reality of low interest rates, low growth, high volatility and high uncertainty? Since the majority of investment decisions are based on emotion, uncertain times call for some certainty. This is the precise reason my articles of the past few years have focused squarely on the need to create a defensive portfolio built on "cash flow."

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Cash flow portfolios own investments that pay you for the use of your money. A properly designed portfolio should be purposefully created to generate a stream of recurring income, through some combination of interest, dependable dividends and other payments.

Cash flow portfolios often include both companies that *pay* dividends and companies that *grow* their dividends. This is critical to portfolio outperformance. For the past 25 years, companies that paid dividends provided a 10.5 per cent annual return, while companies that consistently grew their dividends returned 12.2 per cent per year. Compare these to a non-cash-flow portfolio, which returned only 1.6 per cent.

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