3 Ways to Prepare for the Next Market Crash

Description

From the lows of the financial crisis of 2008-09, the **iShares S&P/TSX 60 Index Fund** has risen over 75% and the **SPDR S&P 500 ETF Trust** has increased over 200%. I view these as general market returns representative of returns from Canada and the United States.

We're in the seventh year of a bull market. The horrendous experience of the 50% drop from 2008 highs to 2009 lows may be at the back of investors' minds, but it's essential to look back and learn from the experience. Here are some ways to prepare for any market crash.

1. Buy quality at a discount

Make sure you're buying market leaders that do better than competitors in all market environments. **Royal Bank of Canada** (TSX:RY)(NYSE:RY) and **Bank of Nova Scotia** (TSX:BNS)(NYSE:BNS) come to mind. They pay out nice yields over 4% and have grown at least 6% in the past few years. These great businesses are priced at a fairly in my opinion.

My choice of pipeline leader has to be **Enbridge Inc.** (TSX:ENB)(NYSE:ENB). Its total return has generally outperformed **TransCanada Corporation**. Based on the price-to-cash flow ratio, Enbridge is priced at a discount over 10%.

All companies mentioned are high quality with S&P credit ratings of A- or better. They're unlikely to default, but very likely to continue generating income for their shareholders.

2. Visualize a 50% decline of your portfolio

No matter how big or small your portfolio is, it's not fun when it declines. In the financial crisis, it scared a lot of people out of the market. It fell fast and hard. One way we can prepare for it is to visualize our portfolios dropping 50%.

Let's say I had a $50,000 portfolio. I visualize it dropping to $25,000. What's more, for individual holdings, I visualize each dropping 50% and how it would look afterwards. Are you still confident in holding that company after that drop? If not, you should consider selling out of that position at a favourable price.

Remember, price drops don't necessarily imply earnings or cash flow deterioration of the business. A fast fall in price often has fear attached to it.

3. Diversify

Starting with high-quality businesses that generate increasing earnings and cash flows over the long term is a safe way to invest compared with investing in high-flying stocks that have just had their initial public offering.

After you've built your foundation portfolio and have remaining "play" money, you can use up to 10% of your portfolio to buy high-flying companies that you believe have a bright future.

At the same time, it's essential to diversify your portfolio by buying leaders from different sectors. With limited capital from Canada, you might choose to invest in the top bank, the top pipeline, the top energy company, the top utility, and the top telecom.

Then diversify into the sectors found in the United States that are lacking in Canada. The healthcare, IT, consumer staples, and consumer discretionary sectors come to mind.

Bonus: Dollar-cost averaging

Never buy in a lump sum. Instead, dollar-cost average in to your positions over time. Downturns can last months. It took the market 9-10 months to go from the highs of 2008 to the lows of 2009. And don't try to catch the bottom because it's impossible to do so.

In conclusion

When you stick with high-quality businesses that you buy at a fair price, or even better, at a discount, you do not need to worry about market crashes. The leaders are the ones that bounce back first and come out stronger when the economy improves.

The only thing we need to keep in check is our fear. To prepare for that, visualize all your holdings dropping 50%. For long-term investment success, staying the course and buying at proper valuations is essential.

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TICKERS GLOBAL

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2. NYSE:ENB (Enbridge Inc.)
3. NYSE:RY (Royal Bank of Canada)
4. TSX:BNS (Bank Of Nova Scotia)
5. TSX:ENB (Enbridge Inc.)
6. TSX:RY (Royal Bank of Canada)

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