How to Reduce the Risks of Investing in Stocks: Part 1

Description

Investing in stocks historically gives higher returns than placing money in bonds, GICs, or savings accounts. With higher return comes higher risk. Here I will talk about two risks that come with investing in stocks and how to reduce those risks.

1. Risk of capital loss

You can buy and sell stocks on major exchanges easily through your bank or through a trading platform. However, the flip side of this liquidity is that it's also very easy to sell at a loss. Some people make better investors in real estate because it is less liquid, even though one usually needs to get a loan to buy a property because the investment is much bigger.

When investing in a stock, there's a chance that the company could go bankrupt. However, the odds are in your favour if you invest only in quality companies. So, the more likely risk scenario is selling at a loss emotionally after the price of a stock goes down.

For example, many investors sold their **Silver Wheaton Corp.** shares when they found out the company might need to pay more taxes. Of course, gold and silver prices heading downwards doesn't help either.

If you happened to sell a stock at a loss, then you need to ask yourself why you did it. Did you no longer believe in the company you chose? Did something change after you made your purchase? Or was it due to emotion?

Ways to reduce the risk of capital loss

- Record why you bought a company in the first place.
- If it's for a short-term trade, decide the holding period and at what price range you plan to sell. Do that ahead of time without being emotional.
- Know yourself. That is, know your temperament, risk level, time horizon, experience, and test the waters by buying bite-sized pieces if you have to.
- Buy at reasonable valuations.

- Have an investment plan and update the plan as needed.

2. Volatility Risk

Stocks go up and down all the time. For example, **Bank of Nova Scotia** (TSX:BNS)(NYSE:BNS) was at a high of $73 in July 2014. Today it sits at $65, so your investment declined by 11%. And actually, within that year, it went as low as $61, a drop of over 16%. New investors might not be able to stomach that kind of volatility. Investing in stocks is a much different experience than putting money in a savings account.

Ways to reduce the volatility risk

- Buy stocks at reasonable valuations, if not at a discount.
- Invest for the long term. The longer you stay in the market, the higher the chance you'll come out with positive returns. If you invest in dividend stocks, you'll get a positive return even in a down market, given the company continues to pay a dividend.
- Train yourself to ignore short-term ups and downs. It's common for companies to go up or down 1-3% in a day. During earnings report season, it's not uncommon for companies to go up or down 7-10%. Mentally prepare yourself by writing down how your investment would look if it went up or down 10%.
- Build a portfolio of quality stocks to reduce the overall volatility of your portfolio.

In conclusion

Investors need to be patient to buy at the proper price, and have the patience to hold on. Investors also should be prepared to increase their knowledge in investing, and be willing to update their investment plan as their experience grows. Emotions can be contained if investors know why they invested in a company.

CATEGORY

1. Dividend Stocks
2. Investing

TICKERS GLOBAL

1. NYSE:BNS (The Bank of Nova Scotia)
2. TSX:BNS (Bank Of Nova Scotia)

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