How to Reduce the Risks of Investing in Stocks: Part 2

Description

Investing in stocks historically gives higher returns than placing money in bonds, GICs, or savings accounts. With higher returns comes higher risks. Here I will talk about two risks that come with investing in stocks and how to reduce those risks. In part one, I discussed two risks of investing in stocks, capital loss and volatility. In this article I will discuss other risks that come with investing in stocks.

Valuation risk

It doesn't matter if you're investing for growth or income, overpaying for a company will not only reduce your returns, but also increase your risk. For example, back in January **Fortis Inc.** (TSX:FTS) reached an all-time high of $42 with a price-to-earnings ratio (P/E) of close to 23. Historically, the utility has never traded at that multiple before.

On the contrary, over the past 15 years or so the company has traded at a normal P/E of 18, and in the past decade, a P/E of 20. At about $38 per share, it trades just under a P/E of 20. So at best, the company is fully valued.

Some investors may argue that Fortis's dividend is high quality because the company has paid a growing dividend for over 40 years with a sustainable payout ratio of 85%. Even though that's on the high side, Fortis's long track record of paying dividends makes up for it.

Further, Fortis has an S&P credit rating of A-, and sustainable debt levels with a debt-to-cap ratio of 51%.

Overvalued companies will inevitably either decline in price or trade sideways until earnings catch up. In Fortis's case, its price has retreated from the overvalued P/E of 23 to a more reasonable valuation of under 20 today.

How to reduce the valuation risk

The only way to reduce the valuation risk is to buy stocks at reasonable valuations, if not at a discount. The other side of the equation requires estimating the earnings-per-share (EPS) growth rate going forward. A higher growth rate supports a higher P/E and a lower growth rate warrants a lower P/E.

For example, **Starbucks Corporation** (NASDAQ:SBUX) has a high P/E of over 36, but its EPS is expected to grow more than 16% per year. The tricky part is the estimation is an educated guess based on company or analyst forecasts.

The risk of unforeseen market crashes

Most people did not see the financial crisis coming in 2008-09. Other events that could cause market crashes include wars, epidemics, and bursting of bubbles, such as the Internet bubble and the housing bubble.

How to reduce the risk of unforeseen market crashes

There are multiple ways to reduce this kind of risk.

First, you should avoid emotional buying and selling by focusing on company fundamentals and buying at reasonable valuations. If you're buying quality businesses such as Fortis and Starbucks at reasonable valuations relative to the respective businesses, you shouldn't worry about market crashes. It will just take time for the price of the stock to recover when it declines with the rest of the market.

Second, you should diversify your portfolio across different sectors and companies with stable earnings. Sectors that come to mind include consumer staples, healthcare, utilities, and real estate investment trusts.

Third, set aside a cash position you're comfortable with. As a market crash is playing out, you'll feel the pain. Remember not to panic and sell at a loss, but instead, put cash to work by buying the top quality stocks on your watch list at different points in time. This is the classic strategy of dollar-cost averaging.

In conclusion

You reduce your portfolio risk when you buy high-quality businesses at proper valuations. Diversifying your portfolio across different stable industries will reduce your portfolio risk and volatility. Further, maintain a large enough cash position for your comfort, so that you can add to top quality companies as dips bring companies to your pre-set buy range based on reasonable valuations.

CATEGORY

1. Dividend Stocks
2. Investing
3. Stocks for Beginners

POST TAG

1. Editor's Choice

TICKERS GLOBAL

1. NASDAQ:SBUX (Starbucks Corporation)
2. TSX:FTS (Fortis Inc.)

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