3 Tips to Protect Your Portfolio From Downside

Description

It’s inevitable that your net worth will fluctuate if you hold a portion of your assets in stocks. If your stocks make up a big part of your investment portfolio, it can be scary in a downturn. Here are three tips to protect your stock portfolio’s downside.

When the market is high, hold more cash

When the market is high, you’ll notice that there will be fewer opportunities on the market. So, it makes sense to hold more cash than usual and wait for stocks to pull back to better valuations before buying.

The S&P 500 currently trades at a price-to-earnings ratio of 19.2, which is fully valued at best. The index’s 16-year normal multiple is 17.3. So, the market actually looks to be a tad expensive.

However, it’d be unwise to sell all of your stocks to wait for a pullback because the market can go irrationally higher for a long time.

So, currently, it’s probably good to accumulate more cash than usual, whether it’s from your paycheques or from dividends. It also isn’t a bad idea to take some profits in fully valued stocks if that works with your temperament.

By delaying purchases when the market has few buying opportunities, investors avoid concentration risk and buying high. With cash on hand ready to deploy in a downturn, when there are more attractive buying opportunities, investors can take advantage of a downturn.

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Require a greater margin of safety before investing in risky stocks

Risky stocks have higher earnings unpredictability. Companies whose earnings rely on commodity prices are risky stocks. They include the likes of **Barrick Gold Corp.** (TSX:ABX)(NYSE:ABX), which trades higher if prices go higher; the opposite is also true.

For a greater margin of safety, interested investors should wait for Barrick Gold to trade below its book value before considering investing in it.

Since the stock trades at 2.5 times its book value at $21.50 per share, in my opinion, it’s far from trading at a margin of safety, and I’d avoid it because of that.

By buying at a significant margin of safety, investors can reduce the downside caused by the earnings fluctuations in risky stocks.

Buy stocks with *relatively* predictable earnings

Companies with a lower chance of earnings surprises tend to have lower volatility in their share prices. These companies can help protect your portfolio from downside. Additionally, they tend to be consistent dividend payers. They include utilities, which are needed products and services in any economic environment.

Fortis Inc. (TSX:FTS)(NYSE:FTS) is a prime example. The North American leading utility has been profitable for decades. Even though it has experienced negative earnings-per-share growth four times in the last decade, it has never once stopped increasing its dividend. In fact, it’s one of the top dividend-growth companies in Canada; it’s hiked its payout for 44 consecutive years!

The takeaway

To protect your portfolio from downside, hold more cash than usual when there are few attractive opportunities on the market.

If you must invest in stocks with above-average risk, look for a greater margin of safety before buying.

Lastly, anchor your portfolio with dividend payers that earn relatively predictable earnings.

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kayng