How to Protect Your Portfolio From Speculative Investments

Description

The easiest way to protect your stock portfolio from speculative investments is to avoid them altogether. However, they can be lucrative at times. If you must invest in them, you can maintain a limited allocation to them to manage risk.

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Here are some examples of speculative investments.

Home Capital Group

After **Home Capital Group Inc.** (TSX:HCG) had a situation similar to a bank run, its shares fell more than 80% from the recent $30-per-share level to as low as $5! At that point, it was a speculative investment. Investors who'd invested then had a belief that the company would turn around, but no one knew for sure that it will.

However, when **Berkshire Hathaway** swooped in to save the day by buying a significant stake in the company and providing a $2 billion line of credit, investors could have argued that was the inflection point of the turnaround. At that point, Home Capital went from being a speculative investment to being a turnaround investment.

Shopify

Shopify Inc.'s (TSX:SHOP)(NYSE:SHOP) simple, unified, multi-channel platform allows merchants, particularly small- to medium-sized businesses, to sell their products online.

It's one thing to believe in the mega-trend of e-commerce. It's another thing to invest in Shopify. Sure, the company has had tremendous sales growth. From 2013 to 2016, its revenue increased at a compound annual growth rate of 98%. However, its net income remains in the negative. The company hasn't turned a profit yet.

Amazon.com, Inc. (NASDAQ:AMZN) showed that a stock can be a great investment even if it has little earnings. It currently trades at a price-to-earnings ratio of about 170, which is way overvalued in any interpretation of value investing.

However, Amazon proves that it can grow its operating cash flow at a high pace — about 43% per year on a per-share basis for the last three years.

Shopify hasn't even achieved consistent operating cash flow growth yet, which means it's a more speculative investment than Amazon.

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Investor takeaway

Speculative investments can be lucrative for investors. Even if investors didn't catch the $5 bottom of Home Capital and bought at, say, $7.50, they would still have doubled their investment in about three months!

The share prices of high-growth stocks such as Amazon and Shopify can rise a lot before earnings and cash flows follow. In 10 years, Amazon shares have appreciated more than 1,200%! And its earnings still haven't caught up yet (even though it's experiencing high earnings growth). Shopify shares have climbed nearly 180% in the last 12 months, but the company hasn't turned a profit yet.

Speculative investments can boost growth for a diversified portfolio. Timing is important for stocks that fall a lot in a short time like Home Capital, while it's not as important for Amazon and Shopify.

In either case, investors can reduce their risk in investing in speculative stocks by spreading their cash around in multiple stocks and limiting them to, say, no more than 5-10% of the portfolio.

CATEGORY

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2. NYSE:SHOP (Shopify Inc.)
3. TSX:HCG (Home Capital Group)
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