How to Reduce Risk When You Invest in Stocks

Description

Warren Buffett's first rule of investing is to "never lose money." You can reduce your risk of losing money when investing in stocks by buying businesses that generate stable, growing earnings or cash flows, have strong balance sheets, and pay growing dividends.

Moreover, if you pay a fair or discounted price on such businesses, you'll further reduce your risk. Also, the longer your investment horizon, the less risky it will be.

Let's see how this might work in practice.

Stable, growing earnings or cash flow

Over the long term, **Toronto-Dominion Bank's** (TSX:TD)(NYSE:TD) earnings per share (EPS) have trended higher. In recent years, the only big drop was in fiscal 2008 during the Financial Crisis, in which the bank's EPS fell 15%. Its earnings recovered within two years. Since then, it hasn't experienced negative earnings growth in any year.

For companies with big depreciation expenses, it makes more sense to look at their cash flows instead of earnings.

Strong balance sheet

Companies that have excessive debt on their balance sheets have the risk of going bankrupt if things turn south.

One easy way investors can check a large company's financial strength is by looking up the credit rating given to it by credit agencies, such as S&P.

Toronto-Dominion Bank's S&P credit rating is AA-, which is three levels away from the highest level of AAA. An S&P credit rating of BBB- or higher is considered investment grade. So, any A-grade credit rating is pretty good.

Get income from growing dividends

Each time you get a dividend, you receive cash, which can be viewed as getting some of your investment back. So, a company that grows its dividend over time will allow you to get your investment back faster. And you can do this without having to sell your assets (the shares of the stocks you own — i.e., the pieces of the businesses you own).

Toronto-Dominion Bank has increased its dividend per share at a rate of 10.1% in the last three years, which is pretty impressive for a company that was founded more than 60 years ago.

How much is a stock worth?

A business can be performing well, but its stock can trade sideways or turn south if it was too expensive. Toronto-Dominion Bank's long-term normal multiple is 12.7. When the stock trades above or below this multiple, it'll revert to the mean. At $67.90, the stock trades at a multiple of ~12.4. So, the stock is within fair valuation.

Occasionally, under normal market environments, the stock has traded close to a multiple of 11, which implies a price of about $61, at which time the stock would be considered slightly discounted.

If the bank traded at a single-digit multiple, it'd be considered a bargain. During the Financial Crisis, it traded at a multiple of as low as 7.4! Essentially, the stock was on sale with a +40% discount. At such times, investors need to take control of their fears and recognize it as a great buying opportunity.

Investment horizon

Having a long investment horizon means you can sit back when there are market corrections without having to sell at a loss. So, make sure that you don't need the money that you invest anytime soon — certainly not within the year, because even if you invest in a discounted company, there's no telling when it will revert to the mean.

CATEGORY

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

POST TAG

1. Editor's Choice

TICKERS GLOBAL

1. NYSE:TD (The Toronto-Dominion Bank)
2. TSX:TD (The Toronto-Dominion Bank)

PARTNER-FEEDS

1. Msn
2. Newscred
3. Sharewise
4. Yahoo CA

Category

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

Tags

1. Editor's Choice

Date
2025/08/10
Date Created
2017/09/22
Author

kayng