Use These 3 Strategies to Protect Your Gains in Cannabis Stocks

Description

For many people invested in the cannabis space who have made a lot of money recently, I know that this is going to be a tough sell. But it has to be said: don't invest in the cannabis space, unless you are willing to lose everything you put into it. The sector is on fire, but rockets that go up in a hurry can also come back to Earth just as fast.

Two prime examples of these stocks are **Canopy Growth** (TSX:WEED)(NYSE:CGC) and **Aphria** (TSX:APH). These two companies have generated incredible capital gains over the past year, but have also been highly volatile and trade at expensive, speculative valuations. For example, Aphria trades at a multiple of around 90 times earnings. And while both of these companies have experienced significant revenue growth and have positive future prospects, including partnerships with various companies, their valuations are still extremely high and set the stage for significant downside risk.

If you did buy some of these stocks, you need to be very careful. You need strategies to protect your capital while you ride these crazy stocks, hopefully upwards.

Capital preservation strategy #1: Sell half your position when it doubles

This strategy is a mainstay of career gamblers, so it aptly applies to marijuana stock speculation. The strategy is actually quite simple. Whenever the stock doubles, you sell half and lock in the gain. In addition to getting your money back, you are able to "play with the house's money" and let it ride. Once you get back your original investment, it is easier to stomach the wild ride of stock speculation.

A further benefit of this strategy is that it is tax efficient. In Canada, capital gains are taxed at a much more favourable rate than in the United States, leaving more cash in your pockets.

Capital preservation strategy #2: Use a trailing stop

As your marijuana stock moves upwards, using a trailing stop can be beneficial to make sure you capture as much of the gains as possible. Each day, you can set the stop at a certain distance, say 10%, below the stock's current price. If the stock falls, you may sell your position, so you have to be prepared to exit if the market turns down.

With this strategy, you have to be careful. If the stock falls too rapidly, as these hot stocks tend to do, the stock may fall through your stop, leaving you with all of your shares unprotected. For this reason, a trailing stop is best used with strategy #1. Start using trailing stops after you've sold half your position and you have your original investment back. This leaves the remaining cash somewhat protected, and you will not feel quite so terrible if the stocks fall through your trailing stop.

Capital preservation strategy #3 (advanced): Buy a protective put option

This strategy is a little more complicated, but it can greatly reduce your downside if your stocks turn downwards. In order to buy options, you must first be approved by your broker. Because buying options is a relatively safe strategy, being approved should not be an issue. In my experience, the best way to buy protective puts is to buy them at around 10-20% below the current stock price. Buying options at a strike price below the stock price, or out of the money in options parlance, allows you to purchase the option for cheaper than if you were to buy them at the current price.

The biggest risk of buying options is the very real possibility that the stock will go up and you will lose the premium. This loss will certainly cut into your profits. But consider the fact that the marijuana stocks have massive downside risk due to their valuations. If the stocks fall quickly, these options will also quickly rise in value as insurance becomes more valuable. And if you combine the options strategy with a trailing stop, you may very well lock in your gains at a high level and gain on the put as well. Besides, even if the option does expire worthless, you can write it off as a tax loss against the capital gain on the stock.

Key takeaways

If you are going to engage in high-risk speculation on high-valuation stocks, you should be aware of capital-protection strategies. Using one, or all, of these strategies, should help protect you against capital loss if the stocks turn south. Since these strategies also have tax implications, remember to check with your accountant about whether these strategies are appropriate for you.

Happy trading!

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