



Marijuana Investors: 1 Easy Way to Protect Yourself From Tanking Pot Stocks

Description

It has not been a good few months for Canada's top marijuana companies. Shares have tanked as investors have suddenly turned bearish on the sector.

There are a few things that are conspiring against pot stocks to keep them down. Many analysts are saying a [wave of oversupply](#) is on the verge of hitting the market, which will drive down prices for marijuana growers. Black market pot dealers are undercutting legal sources in an attempt to keep market share. And investors are frustrated that many of Canada's top pot companies are nowhere close to profitable. They're starting to lose patience, something that is exasperated by the poor performance in these names.

The carnage in the sector has been pretty painful. Shares of **Canopy Growth** ([TSX:WEED](#))(NYSE:CGC) peaked at approximately \$76 each back in April. Shares now trade hands for just over \$26 each on the TSX. That's a haircut of some 70% in just six months.

What's a long-term believer to do? Some analysts say the sector is primed for recovery, but others remain bearish. If these companies can't become profitable then there's still plenty of downside potential. But at the same time, there's still long-term opportunity here.

Nobody can really predict where the top pot stocks will end up. But there is at least a way for investors to gain exposure to the sector while protecting themselves on the downside. Let's take a closer look at how you can do that.

Using the option market

Writing covered calls is a well-known strategy primarily used by dividend investors who are looking to coax a little more income from their underlying portfolio. It tends to work pretty well. I just profiled a way investors can use [covered calls](#) in their TFSA to generate safe yields of up to 10% using common dividend stocks.

The same concepts can be useful for marijuana investors who are looking to protect themselves

against further price drops.

Here's how it works. The first step is to buy shares of whichever pot stock you choose. I'll use Canopy Growth as an example because it is largest by market cap, it has some interesting growth avenues overseas, and it's likely one of the safer choices in the sector.

The next step is to sell a call option, a move that generates income immediately in exchange for creating a sell obligation at a certain date for a certain price.

Let's look at a real-life example. If you sell the December 20th \$30 Canopy call option, you'll generate \$1.15 per share in income today in exchange for agreeing to sell your shares at \$30 each on the expiry date.

This trade has two potential outcomes. The first is Canopy shares soar and you have to sell at \$30. This would be a profit of more than \$5 per share counting the capital gain and the income from the covered call trade, all in just over a month. That's a fantastic result, even if you might be giving up some upside if shares go higher than \$30.

The other outcome is if shares fall. If that happens, you've helped insulate yourself from that loss by pocketing the option premium. You're then free to write another covered call on Canopy shares, which would generate even more income. You'd still have a paper loss on the stock, but the option premium would offset this.

If your Canopy shares stay the same or keep grinding lower over the longer-term, this strategy lets you really minimize any losses. You can get more income by writing options closer to the current price, but this limits upside if the stock shoots higher.

The bottom line

There's no free lunch in investing. The downside to this strategy is you will give up some of the upside potential on Canopy shares. For investors who have been hurt by the recent decline, but who still want exposure to marijuana, this hedging strategy can help them sleep much better at night.

Much of investing is all about minimizing losses. Remember that and you'll be ahead of 90% of other investors.

CATEGORY

1. Cannabis Stocks
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POST TAG

1. Cannabis

TICKERS GLOBAL

1. NASDAQ:CGC (Canopy Growth)
2. TSX:WEED (Canopy Growth)

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