Why Staying Invested Is Important

Description

As the **Toronto Stock Exchange** (TSX) hits new highs seemingly on a weekly basis, many investors understandably are considering pulling their money out of the market and waiting for a correction before jumping back in. In this article, I'm going to discuss why staying invested no matter what is the best long-term move for all investors, even with clouds on the horizon.

With everything from inverted yield curves to rock bottom government bond yields and risk-seeking behaviour everywhere in the markets, it's reasonable to have serious concern.

I'm going to touch on a few hedging options that everyday investors can use to protect against said downside risk while remaining exposed to the markets.

The main reasons for this are twofold: first, we don't know precisely when the next downturn will begin, and many of the drivers of the market that have driven stock prices higher have not abated, and second, missing out on the biggest up days in the market is far worse than missing out on the worst days.

Short Selling

Perhaps the easiest hedging strategy to understand is that of short-selling a portion of a portfolio, preferably an index, to gain value when the market drops and recoup some of the losses one would otherwise see.

Selling anything short is not a preference of mine, as this strategy incurs borrowing costs, and losses are potentially unlimited if the stock market keeps rising.

This strategy would need to be confined to a specific stop-loss level, and should only be taken when one has reached maximum bearishness on the market.

That said, long-short strategies (i.e., long Enbridge, short Baytex) are very useful ways of taking advantage of relative value between two comparable companies in the same sector.

Using Options

There are a variety of ways to use options to protect one's portfolio from a downward slide in stock prices you may have heard of. I prefer using options to hedge, as these do not have any recurring borrowing costs, and the cost of these options are limited to the bid-spread gap determined by the underlying volatility of said stock or index.

One option is to use a covered call strategy, which involves selling call options of an owned stock, and pocketing the premium. If the stock price goes up, you make money on the long equity position, but lose money on the call options, which lowers your upside potential.

If the stock goes down or trades sideways, however, your losses are lessens by the premium you received from the calls.

Another option is to simply buy put options on a stock you own and pay a premium for these. If the stock goes up, you make the upside on your long equity position less the premium you paid for the puts.

If the stock falls below the strike price of your puts, your profit on puts should help offset your losses on your long position.

Stay Foolish, my friends.

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