How to Save Yourself From a Bear Market

Description

The stock market rally has slowed, as the optimism around the reopening of the economy fades. The market rallied in April and May, as investors priced in their expectations that the COVID-19 curve would flatten and demand would return in June. But the second wave of coronavirus has already hit the metropolitan cities of South Korea and China. South Korea expected the second wave to come in the fall or winter. Although the second wave has not yet hit the western countries, global leaders are on the alert. Investors have slowed their buying activity over the fears of another market crash. What should you do in the next bear market?

A two-step approach can save you from the bear market

There is a reason why it is called a bear market; the steps to save yourself from a bear attack and a bear market are similar. There is a two-step safety guide when you face a bear attack. Firstly, don't run when you see a bear. Bears are faster than you. Secondly, drop to the ground and play dead, as bears will stop attacking you if they feel you are no longer a threat. The same two rules apply to the stock market.

A bear market occurs when investors are in a sell mode. The first thing to do is, don't sell in a bear market. The prices will fall faster than you think, and you may not get a reasonable price for your stocks. **Air Canada** stock dropped 28% on March 16 alone. As there were more sellers than buyers, sellers sold the stock at any price that the buyers offered. If you have a weak stock like airlines, wait for the panic to subside and the market to stabilize. When more buyers appear, sell such shares at the market price, even if you are making a loss. Your money will be safer in your hand than invested in a weak stock.

The second thing is to drop to the ground and play dead if you own quality stocks that are resilient toan economic downturn and have the potential to grow in the future. Even quality stocks like **Descartes Systems** fall during a panic sell-off. In such circumstances, let the good stock hit the bottom. Don't sell in panic. Once the sell-off is over, the quality stock will recover as the panic fades, and investors will be able to make informed decisions.

What qualifies as a quality stock?

How do you identify a quality stock? The first trait of a quality company is a healthy cash reserve and lower debt compared to its peers. The second trait is stable free cash flows, which come from recurring revenue and higher profit margins. The third trait is a higher revenue-growth rate than peers and the ability to tap future growth. The last trait is its return on equity (ROE).

None of the above four traits should be viewed in isolation, as every industry has different fundamentals. For instance, airlines are capital intensive, so they have a higher debt and lower margins. But an airline stock with better fundamentals than its peers tends to perform well.

Beat the bear with these stocks

In the current market, **Constellation Software** (TSX:CSU) is among the quality stocks. It acquires small companies that offer mission-critical software to niche markets and generate high cash flows. It reinvests these cash inflows to make new acquisitions. This strategy has helped it increase its ROE from 10% in 2009 to 43% in 2019, which is way above its rival **Enghouse Systems's** ROE of 19%.

Constellation has increased its revenue at a CAGR of 13.7% in the 2015-2019 period, almost double Enghouse's CAGR of 6.7%. Constellation's 69% revenue is recurring in nature as against Enghouse's 57%. The former has net cash of US$216 million and undrawn credit facility of US$700 million, which it can use to pursue acquisitions, even in the economic crisis.

Constellation is a large-cap stock with a market capitalization of over $30 billion, which makes it a safer stock than the mid-cap Enghouse with $3.9 billion in market capitalization. Constellation is a quality stock that can keep your investments safe in the bear market.

CATEGORY

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1. Editor's Choice

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pujatayal