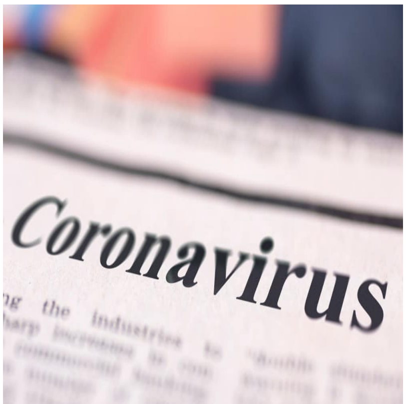

COVID-19 Wave 2.0: Here's How to Prepare Your TFSA

Description

The stock markets are in turmoil once again, with the **S&P 500** flirting with correction territory on fears of a second COVID-19 wave that could spark reopening rollbacks and another round of shutdowns. To many prepared TFSA investors, this sell-off should come as no surprise. There was a tonne of speculative froth on the pandemic-resilient first-half-of-the-year winners, with unprecedented amounts of liquidity being pumped into this market.

I think this September sell-off is precisely what the doctor ordered. While there's no telling when this sell-off will come to an end, I still think it makes sense to keep your TFSA's COVID-19 risks in check if you've yet to strike a balance with a barbell portfolio, so you'll be well equipped to navigate a second (or even a third) wave of COVID-19 outbreaks.

Will your TFSA hold up in another round of COVID-19 lockdowns?

At this juncture, many health experts see a safe and effective vaccine arriving at some point next year.

While you could maximize your upside by overweighting your TFSA across the hardest-hit, financially strapped companies that have been hurting most amid the pandemic (think names like **Cineplex**) with the assumption the vaccine will land at some point in the first half of 2021, you must also acknowledge that your portfolio could get crushed if this pandemic drags on longer than expected, possibly through 2022 and beyond. And the financially hit firms that saw their revenues collapse in the first wave could be at risk of insolvency if future waves were to hit. In a bear-case scenario, you'd be in a spot to lose your shirt if you've overweighted your TFSA in battered firms that are bleeding cash. Worse, you may not be in a position to recover once the pandemic does end.

Financially unfit COVID-hit plays look more like options amid the COVID-19 crisis

Now, I'm not suggesting that you assume this pandemic will last forever and avoid names at ground zero of the crisis (financials and energy). Rather, you should balance COVID-19 risks with a barbell approach, so you'll be in a position to do relatively well, regardless of when this pandemic ends or how many further waves we'll experience.

In a highly uncertain environment like this, it's wiser to be more conservative with your COVID-19 risk allocation than aggressive. Why? Firms battered by COVID-19 appear more like options than stocks. They depend on the outcome of a contingent event (the advent of an effective vaccine) to do well. And if such an event doesn't happen within some time frame, the stock could cause you to lose most, if not all, your investment. On the flip side, if the contingent event does happen, you could have a multitude of upside.

Foolish takeaway

If you wouldn't overweight your portfolio in options with all-or-nothing propositions, it doesn't make sense to overweight your portfolio in financially strapped firms that have seen their cash flows decimated by the COVID-19 crisis in the face of further lockdowns. It does, however, make sense to incorporate such COVID-hit stocks with options-like traits to hedge the rest of your otherwise well-diversified TFSA portfolio.

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Date
2025/08/30
Date Created
2020/09/24

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