Warren Buffett: How to Prepare for a Market Crash

Description

The stock market has been on an epic run these past few months. Such a rally makes savvy investors rich but also cautious. Experienced investors know a rally can't be sustained forever and a market crash is always lurking around the corner. No one knows this better than the most successful investor of them all, Warren Buffett.

Buffett's reputation as a pragmatic and cautious investor is unimpeachable. Over his long career, he's faced down multiple market crashes and come out the other end richer than before. Buffett's ability to survive market crashes is potentially the key reason he's been one of the richest men in the world for decades.

With that in mind, here are some key lessons from the Oracle about anticipating and avoiding market crashes.

Buffett Indicator

Buffett's favourite metric for tracking stock market valuations is a simple ratio. He simply divides the value of the total stock market by the country's total annual gross domestic product. The logic is that stocks should not be worth more than the entire country generates in revenue. Thus, a market-to-GDP ratio above one is a sign of overvaluation.

Right now, the Canadian stock market is collectively worth nearly $2.95 trillion. Meanwhile, the national GDP is $2.38 trillion. That means the market-to-GDP ratio is 124%. That's slightly overvalued.

This doesn't necessarily mean a market crash is imminent. The ratio could shoot much higher in 2021 and the market could become far more overvalued. The ratio in the U.S., for instance, is 189.8%. What does Buffett do in this situation?

What to do in a bubble

Warren Buffett readily admits that there's plenty of things he doesn't know. He and his partner have said that they cannot say how long a stock market bubble lasts or when or how it will ever end. Instead, they focus on things they *do know.*

For example, we know for sure that stocks are overvalued since the Buffett Indicator suggests it. We also know that stocks in some sectors (technology, biotech, and financials) are trading at historically high valuations. We can assume that other sectors are being overlooked or shunned by investors and some of these provide essential services.

Fortis (TSX:FTS)(NYSE:FTS) is a great example of this. Investors simply aren't excited about an electric utility the way they're obsessed with Bitcoin and Elon Musk at the moment. That means Fortis's stock valuation isn't absurd. It's trading at just 19.2 times earnings per share and offers a 4% dividend.

Fortis is also relatively immune to the market and economic cycle. Canadians will pay their utility bills, even if the stock market crashes or we dip into another recession. That makes the company's cash flows remarkably stable.

Buffett has been cutting his stake in several holdings over the past year. Instead, he's added exposure to the most essential sector of the economy: pharma and healthcare. Buffett would invest in a fairly valued safe-haven stock like Fortis when the market becomes absurd. This is why this stock should be on your watch list for 2021.

Bottom line

Warren Buffett's favourite indicator is signaling a market crash soon. Reliable stocks like Fortis could get you through it.

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