Forget Gold. I'd Follow These 3 Steps to Capitalise on a Stock Market Rally

Description

A stock market rally can never be guaranteed. The past performance of indexes such as the FTSE 100 and S&P 500 shows that they have experienced significant volatility and periods of decline. As such, defensive assets such as gold have proved to be popular among risk averse investors.

However, the stock market has delivered high single-digit annual total returns over recent decades, despite its periods of decline.

Therefore, a long-term investment horizon that seeks to purchase a diverse range of cheap, high-quality businesses could be relatively profitable compared to holding other mainstream assets.

Diversifying in a stock market rally

While risk reduction may not be the foremost thought for all investors when deciding how to capitalise on a stock market rally, it could be the most important aspect of investing. After all, it is all too easy to lose money from poor performances from a small number of holdings that can negatively impact on a portfolio's prospects.

As such, buying a wide range of stocks that operate in different industries and geographies could be a sound move. It may mean lower company-specific risk, which is the threat of one holding dragging down the performance of an entire portfolio. It may also lead to a broader range of growth opportunities being present within a portfolio that enhances its returns in a rising stock market.

Buying high-quality businesses

Purchasing high-quality businesses may also be a logical move in a stock market rally. Clearly, deciding what are attractive companies is open to debate. However, companies with sound financial positions and wide economic moats could be a good starting point. They may be able to deliver relatively strong profit growth that enables them to command higher valuations than their peers.

Furthermore, financially-sound companies may be better placed to survive a period of volatile economic and stock market performance. As the last year's events regarding coronavirus have shown, the future performance of the world economy is very unpredictable. This makes holding higher-quality companies even more important.

Purchasing cheap shares

Buying expensive shares in a stock market rally may mean limited scope for capital gains. Of course, even highly-valued companies can become even more expensive. However, the past performance of the stock market suggests that many companies (but not all) revert to their average valuations over the long run. This means that buying stocks with low valuations may provide greater scope for capital appreciation versus purchasing highly-rated businesses.

Of course, this strategy is not guaranteed to succeed. Growth stocks, for example, can rise to exceptionally high ratings that are difficult to justify based on previous averages or profitability. However, through buying an asset for less than its intrinsic value, it is possible to obtain relatively high returns in a long-term stock market rally.

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