Safer Than Gold: 3 Ways to Protect the Downside of Your Portfolio

Description

Any investor living through the financial market price action this year knows the importance of protecting the downside of one's investment portfolio. Rising interest rates have triggered a sell-off in stocks and bonds. And more rate hikes are likely ahead. Here are some ways that may help you better protect the downside of your portfolio.

XIU data by YCharts

Portfolio diversification

[Portfolio diversification]() – aiming to hold assets with little correlation amongst them – can reduce downside risk. For example, you might have assets allocated to guaranteed investment certificates (GICs), bonds, stocks, real estate (such as your home), and gold with different betas, a relative measure of risk. A low beta under 1 of, say, bonds or utility stocks would offset the high beta above 1 of, say, REITs.

Within your stock portfolio, you could diversify across quality names in different sectors such as tech stocks, real estate stocks like real estate investment trusts (REITs), and utilities.

For gold exposure, instead of holding the bullion, investing in precious metals streamers or royalty companies could lead to better results.

For example, **Franco-Nevada** (TSX:FNV) has partnered with operators like **Glencore**, **Teck Resources**, and **Barrick Gold**, helping them finance exploration projects and in return receive precious metal royalties or streams.

Because Franco-Nevada doesn't explore or operate any mines, it has limited exposure to the cost of inflation. FNV stock also provides a dividend. It has increased its dividend for about 14 years with a 10-year dividend growth rate of 11.5%.

Its business model dictates high margins and free cash flow generation. For the trailing 12 months (TTM), FNV reported net income of US$756.5 million with a high net margin of 57%. Its *free* cash flow generation was US$963.5 million.

Low-beta stocks

Low-beta or low-volatility stocks can also help protect your downside. Focus on businesses that have durable and stable earnings. For example, as a regulated utility, **Emera** (TSX:EMA) stock provides reliable earnings. It's a Canadian Dividend Aristocrat with a 10-year dividend growth rate of 7%. According to Yahoo Finance, its recent beta is 0.26, which is way lower than the market's beta of 1.0.

Emera has total assets of approximately $34 billion. Through 2025, it has an $8-9 billion capital plan to grow its rate base by 7-8%. Management believes it can support dividend growth of 4-5% per year in the period.

According to the 12-month analyst consensus price target, the stock is 12% undervalued. At $51.25 per share, its dividend yields 5.4%. Combining its yield and dividend growth prospects, the stock can potentially deliver total returns of about 10% through 2025 without any valuation expansion.

Valuation

By aiming to buy stocks at discounts, investors can further protect the downside of their investment portfolios. The tricky part is that stock valuations change all the time. For example, when a business does well, the valuation of the underlying stock can expand resulting in a higher stock price. Conversely, rising interest rates compress stock valuations, as we've seen this year.

The Foolish investor takeaway

Smart investors first plan out a solid portfolio that's diversified across quality businesses, including a meaningful percentage in low-beta, dividend stocks that have stable and durable earnings growth. More conservative investors would have a higher percentage. Then, aim to buy the stocks on your watch list when they're trading at discounts. Doing the above should greatly protect the downside of your overall portfolio.

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