Don’t Make This Common Mistake During the Market Crash

Description

The financial markets have officially moved from choppy to full-bore, hurricane-force volatility of late. Many investors will now seek safety to a degree that they haven’t in more than a decade. Covered call strategies generally fall in the “safe” or low-risk bucket. Therefore, many investors may be enticed by such offerings. Here’s why I think a covered call strategy should be avoided by all investors at this particular time.

Call options in a sideways market

As many investors know, a covered call strategy consists of selling call options equivalent to a portfolio position (underlying stock holding), providing additional yield (proceeds of the sale of those options) to companies that are typically long-term holdings with an income aspect to them. In markets that trade sideways or slightly down, such portfolios tend to outperform. Investors are then able to earn a higher yield than they would otherwise.

Call options in a down market

The case is very different in severe down markets, like the one we’ve had recently. Various covered call exchange-traded funds (ETFs) like the **BMO Covered Call Utilities ETF** (TSX:ZWU) move generally in line with the broader utilities index. (This is not good). Overall, losses are slightly lower due to the aforementioned options premium one receives. That said, the key problem coming out of a severe down market for those investing in such products is that the call options essentially act as a ceiling on the amount of upside one receives. If you expect to take advantage of a recovery, in other words, covered calls are a terrible place to be.

So what should you do?

Having a pure-play investment approach is riskier. A pure-play investment strategy includes avoiding hedges, options, etc. There is indeed a higher potential for losses with this type of strategy. That said, unhedged portfolios also outperform in bull markets. So one has to weigh the overall risk by keeping a few things in mind.

One one hand, you will lose a little more money, as markets can only go down so far. On the other hand, you may not realize maximum value from stock market advances, which in my view is a larger long-term risk than most investors recognize.

Bottom line

Staying invested and continuing to add to positions, where possible, should be the choice for investors in this climate. The stomach-churning volatility and losses will be difficult to stomach short term, but should pay off over the longer term. Focusing on large-cap companies with rock solid balance sheets, little debt, and high-quality earnings will help ensure long-term stability in short-lived market catastrophes and recessions, like the one we're now in. Read about my three top picks to invest in right now, from my recently published article "3 Winners to Invest in During the Mayhem."

Cooler heads will eventually prevail. So don't give away your upside, even if that means more potential downside in the near term.

Stay Foolish, my friends.

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chrismacdonald