How Much Should You Pay to Protect Your Portfolio?

The stock market seems to have peaked and may be ready for a substantial correction. How much should you pay in terms of lost opportunity in order to protect your portfolio? *Bloomberg* writes that many investors are moving from **stocks to bonds** which they describe as a bear market signal.

> *Risks are stacking up for markets attempting to recover from the latest provocation by North Korea and the mounting damage of Tropical Storm Harvey.*
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> *Citigroup Inc. strategists including Jeremy Hale cite "worrying developments" that may signal the approach of a correction in stocks, while Commerzbank AG finds growing evidence of bearish sentiment in bond funds.*

They cite the increased number of puts versus calls in the options market, technical factors that typically precede market corrections and an increased appetite for bonds, especially government debt.

> *Equity investors are willing to pay more for protection against losses than gains. So-called equity implied volatility skews are above the 10-year average, according to the Commerzbank strategists. This implies they are willing to pay more for downside protection than upside potential compared to the last decade.*

Investors have stayed in an overpriced market because they believed that economic conditions would improve and because earnings kept improving for stocks like the FANG tech darlings. But there comes a time when enough is enough. And those who are willing to forego that last iota of opportunity in exchange for portfolio protection typically preserve their gains and can reenter the market looking for bargains after a correction plays out. How much should you pay in terms of lost opportunity to protect your portfolio?

Sectors at Risk

Who would have thought that Hurricane Harvey would rise to a category 4 as it hit shore and that it would park itself over the Texas coast dropping several feet of rain on some areas? In an overpriced market it only takes an isolated but significant event to hurt stocks. *The Los Angeles Times* notes that **insurers and energy stocks** have been hit by the storm.

> *Insurance companies and oil drillers stumbled while refineries rose along with gasoline prices.*
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> *Investors mostly focused on Harvey, initially a hurricane before becoming a tropical storm, which continues to hit parts of the Gulf Coast with historically heavy rains. Large parts of the energy and petrochemical industries are based there, and companies with a lot of stores in the area stand to lose business. Although gas-price spikes will be temporary, other effects of the storm will last years.*
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> *"There will be ripple effects that everyone is going to feel," said Jack Ablin, chief investment officer for BMO Capital Markets. He said that could include higher insurance premiums, as the storm is likely to cause tens of billions of dollars in flood damage. Ablin added that the storm might also affect interest rates, as the Federal Reserve might hesitate to raise rates if officials think the storm will slow the economy significantly.*

Investing in a rising market becomes self-sustaining. Stocks go up because they went up and new buyers expect more of the same. So long as earnings are reasonable this can go on until the market is overpriced by measures of **intrinsic stock value**. Considering an already overpriced market there are two options to protect your portfolio. One is to buy put options at increasing prices as everyone is doing that now. The other is to buy secure bonds before the prices go up due to increased buying by those fleeing a collapsing stock market.

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