Defensive Investing Strategies

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The stock market keeps going up despite the Delta variant wave of Covid-19 and the bull market that has been going on since the depths of the Financial Crisis continues. But, as investors keep driving the S&P 500, NASDAQ, and DOW to new records, many are employing defensive investing strategies. Defensive investing strategies are not so much meant to grow your portfolio as to prevent losing what you have gained over the years. Common defensive investing strategies include blue chip dividend stocks, short term US Treasuries, AAA Bonds, diversification across countries and market sectors, and keeping a portion of your assets as cash. Additional measures include trading options to hedge investment risk.

Investing in Dividend Stocks

Companies that have been paying dividends for decades and even more than a century are typically secure investments. When the economy sours, the stock market falls, and investors look for safety they typically buy companies that sell consumer staples, are in the health sector, or have amazingly strong balance sheets. These companies commonly pay dividends as well. If you have put part of your portfolio into a strong dividend stock before a market correction or crash you will typically see a bit of appreciation as other investors pile in later.

Investing with Treasuries and Corporate Bonds

US Treasuries are generally considered to be the most secure interest-bearing investment vehicles followed by AAA corporate bonds. A problem with this approach is that with increasing inflation and interest rates as low as they are today, you are saving with negative real interest rates. Your choices are to use long term treasuries or bonds to get higher interest rates or go very short term and accept extremely low rates. With this approach you will protect your dollars but not necessarily your purchasing power over time. The good part is that if the market does crash, you will have cash to pick up bargains as the market bottoms out.

Portfolio Diversification as a Defensive Investing Strategy

Many investors put their money into several US market sectors as well as abroad in order to benefit from where the growth is. Many also diversify in this manner so that investing mistakes in one sector are hopefully offset by growth in another. The best way to do this for most investors is to put your money into one or more ETFs that track the S&P 500, one or more of its sectors, and foreign markets. A problem for the average investor is that they have a “day job” that takes up the majority of their work day. This makes it difficult to adequately follow more than five or so investments. The ETF approach makes this less of a chore.

Defensive Options Trading Strategies

An approach used by professional investors, as well as options traders, to protect stock positions is to buy puts. A put is an option contract that gives the buyer the right to sell a stock at its contract price (strike price) at any time during the duration of the contract. The buyer is essentially purchasing insurance against the stock (or ETF) being taken down in a correction or crash. If the bottom does fall out of the stock price, the put buyer can execute the contract and sell the stock at the strike price even though it may have fallen ten or twenty percent. Alternatively, they can sell the contract to exit and get cash.

Three Versions of Defensive Puts

The basic defensive put strategy is to buy one more put contracts on the stock that you want to protect. Each contract is for 100 shares. Depending on how much of a loss you are willing to accept before having the put kick in, you can pay quite a bit for the contract or not very much. Assuming that you hold a lot of the stock and that you set your strike price rather high, this can get to be expensive if you continually roll over the contracts to continue the protection. There are two approaches that make this less expensive.

Synthetic Short Stock

If you are certain that your stock is going to fall in price, you can use a synthetic short stock approach. In this case, you buy a put but also sell a call. While the put you sold gives you the right to purchase the stock, the call contract gives the buyer the right to buy the stock from you at the strike price of the contract. You set this up with the same strike price for the puts and calls and the same expiration date. The premium that you receive for selling the call contract will reduce your cost for the trade and may even leave you with a small credit. If the price goes down you can treat this strategy like a protective put and if it goes up the buyer will execute the contract and you will sell the stock for the strike price. Although this approach is cheaper than a simple put, there are a couple of issues.

Protective Collar

This approach is the same as the synthetic short stock route but it has two advantages. First, it is cheaper and second, it protects you from selling your stock due to normal market fluctuation. A protective collar sets the put and call strike prices at different levels. The put is much lower than the current stock price and the call is much higher. Since the put and call are out-of-the-money, they are cheap. Thus you can use this approach over the long term if you choose to. And, because you set the strike prices far enough apart, you will not end up selling the stock just because the market fluctuates a little and then see the market stabilize.

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