

## **Capital Preservation – The Market Beating Stocks Approach**

### **What is Capital Preservation and Why is That Important**

We think of Capital Preservation in the context of portfolio management and minimizing the risk of loss to the overall portfolio. Market Beating Stocks employs strategies to limit losses on individual investments in such a way as to minimize the overall risk of loss to the portfolio. Minimizing portfolio losses is just as important as maximizing gains. By way of example, let's assume your \$100,000 portfolio grows 100% in one year to \$200,000. Then let's assume your portfolio loses 50%, and now you are back to where you started with a portfolio of \$100,000. The important point is that you need earn twice as much gain in order to compensate for the loss incurred. If your portfolio loses 20%, you need to subsequently earn 40% just to break even! That is why minimizing losses is so important, you have to work twice as hard just to breakeven when you experience a loss. By minimizing loss, investors stand to make much more over the long term. Capital preservation is critical to building long term wealth. Market Beating Stocks uses several strategies to preserve capital which we describe below.

### **Remember Diversification**

Diversification is one component of Capital Preservation. Investors that carry a well diversified portfolio will improve their chances of preserving capital. We have outlined our diversification approach in detail in another article (to learn more see our article on Portfolio Management – Diversification). Suffice it to say, that diversification across asset classes and within those asset classes is important. As for stock portfolios, we will spread our capital across at least 10 stocks.

### **Cutting Losses**

The ability to cut losses on investments is absolutely critical to investors. Some professionals would say that investors who cannot cut losses should not be trading in the stock market. Emotionally, cutting losses is extremely hard to do. There have been many studies where research shows that most investors fail when it comes to cutting losses.

Are there strategies to help cut losses? Market Beating Stocks understands the effect of emotion and human behavior on cutting losses. We try to remove emotion by setting up specific sell rules that if hit, automatically trigger sale of the investment. Make no mistake this is still not easy, but if you establish an exit plan when you enter the position, you have a better chance of sticking to your plan. We also implement automated controls where we can to help force liquidation. For example, setting stop loss and trailing stop orders will automatically trigger sales when limits are hit. Of course, there is no guarantee that the stock will execute at the target price, but it does remove emotion from the decision.

### **Techniques for Cutting Losses**

Market Beating Stocks employs these techniques:

1. Set stop loss order – this allows us to minimize the overall risk of loss on the position based on our purchase price.

2. Set trailing percentage stop – a sell order is executed when the set percentage loss is incurred when measured from a stock's price high. For example, a 10% trailing percentage stop will execute once the current price falls below 10% from its trading high since the time the stop was set. This allows the stop price to rise as the stock moves up in price.
3. Buy an option against the security in order to lock in gains. This is the only sure way to ensure losses are capped, but is also more costly due to the option premium expense. With stop loss and trailing stops, there is no guarantee that the sale will execute at the stop target and there can be slippage when a stock is undergoing heavy volatility.

### **Market Beating Stocks Likes Trailing % Stops**

Market Beating Stocks primarily uses stop loss limits and trailing stops on stocks that we buy. There are more complex trading strategies for managing losses, but we try to keep it simple in light of time and money concerns. We set the stop loss target usually 15% below our purchase price. Sometimes we tweak this target depending on the trading behavior of the stock, but usually the maximum loss is set around 15%. As the stock moves up in price, we change the stop order to a 15% trailing percentage stop. That way, our stop loss level will move up as the stock rises in price. We may end up selling a stock for a 1% gain over our purchase price, after it has dropped 15% from its recent high. For our strategy, trailing percentage stops are very effective. Once a stock loses its momentum, we want to move on to a better investment that is already starting to move up in price. We find that 15% trailing stops are a good barometer for when stocks lose momentum. However, some stocks need more room to run as they carry higher volatility, but on average this tends to be a good stop. Evaluating the range of price movements on a particular stock can also help you set stop targets. We also gradually reduce our trailing percentage stop as the stock rises in price over time. By doing so, this allows us to lock in more of our stock price gains.

### **Other Part of the Equation is Weight**

In terms of Capital Preservation, we like to set a target such that no investment will risk or lose more than 1.5% of our overall stock portfolio. That is, even if the stock loses money, we will not lose more than 1.5% of our portfolio value in any one position. That is a pretty low number, which means you can have some losses and still not crush your portfolio. But earlier we said we set stop loss targets at 15% not 1.5%. That is correct as the other part of the equation is the portfolio weight of the investment. For example, if we set a stop loss target of 15% and the investment represents 10% of our portfolio, our risk of portfolio loss is 1.5% ( $15\% * 10\%$ ). That is, we setting a capital preservation target, you need to consider the stop loss target of the investment, as well as the size of the investment in the portfolio. Let's take another example. If you choose to invest 20% of your portfolio into one investment, you need to set a loss target on the investment of 7.5% to ensure ( $7.5\% * 20\%$ ) to ensure you don't exceed your overall target capital loss. This concept is important, because the investment weight will ultimately drive the stop loss target you need to set depending on your capital preservation goal.

### **Parameters From Market Beating Stocks**

In terms of capital preservation, Market Beating Stocks usually sets the following parameters for stock investments. We set capital preservation targets for each stock investment at 1.5% loss. We usually invest 10% of our portfolio into each stock, and therefore set the initial stop loss target at 15%. That combination meets our targeted capital preservation loss rate of 1.5%. As the stock moves up in price, we change the sell order to a trailing stop percentage of 15% to lock in gains as the price rises.

For options, the math is the same with respect to the investment loss percentage and the portfolio weight. However, due to the higher risk reward ratio on options, we set our capital preservation loss rate target at 3% in our options portfolio. The higher rate is necessary to accommodate the higher volatility inherent with options trading. Setting the loss target too narrow will force too many inadvertent sales.

### **The Key – Protect Your Capital**

Our investment success vastly improved once we began to set and apply loss limits. The math is clear, when you lose money it takes twice the gain to just breakeven from where you were. Focus on overall portfolio target for gains and losses by setting capital preservation loss rates on each investment. That approach gives you the flexibility to adjust your stop loss points and investment weights as needed depending on the investment risk and return profile. For example, if you have a very risky investment where the stop loss needs to be higher, giving the investment a smaller portfolio weight will allow you to maintain your capital preservation loss target. Protecting your capital is critical to building long term wealth.