The 6 Most Common Portfolio Protection Strategies

By Will Ashworth

The key to successful long-term investing is the preservation of capital. Warren Buffett, arguably the world's greatest investor, has one rule when investing - never lose money. This doesn't mean you should sell your investment holdings the moment they enter losing territory, but you should remain keenly aware of your portfolio and the losses you're willing to endure in an effort to increase your wealth. While it's impossible to avoid risk entirely when investing in the markets, these five strategies can help protect your portfolio.

Diversification
One of the cornerstones of Modern Portfolio Theory (MPT) is diversification. In a market downturn, MPT disciples believe a well-diversified portfolio will outperform a concentrated one. Investors create deeper and more broadly diversified portfolios by owning a large number of investments in more than one asset class, thus reducing unsystematic risk. This is the risk that comes with investing in a particular company as opposed to systematic risk, which is the risk associated with investing in the markets generally.

Non-Correlating Assets
According to some financial experts, stock portfolios that include 12, 18 or even 30 stocks can eliminate most, if not all, unsystematic risk. Unfortunately, systematic risk is always present and can't be diversified away. However, by adding non-correlating asset classes such as bonds, commodities, currencies and real estate to a group of stocks, the end-result is often lower volatility and reduced systematic risk due to the fact that non-correlating assets react differently to changes in the markets compared to stocks; when one asset is down, another is up.

Ultimately, the use of non-correlating assets eliminates the highs and lows in performance, providing more balanced returns. At least that's the theory. In recent years, however, evidence suggests that assets that were once non-correlating now mimic each other, thereby reducing the strategy's effectiveness. (See why investors today still follow this old set of principles that reduce risk and increase returns through diversification. Check out *Modern Portfolio Theory: Why It's Still Hip*.)

Leap Puts and Other Option Strategies
Between 1926 and 2009, the S&P 500 declined 24 out of 84 years, or more than 25% of the time. Investors generally protect upside gains by taking profits off the table. Sometimes this is a wise choice. However, it's often the case that winning stocks are simply taking a rest before continuing higher. In this instance, you don't want to sell but you do want to lock-in some of your gains. How does one do this?

There are several methods available. The most common is to buy put options, which is a bet that the underlying stock will go down in price. Different from shorting stock, the put gives you the option to sell at a certain price at a specific point in the future. For example, let's assume you own 100 shares of Company A and it has risen by 80% in a single year and trades at $100. You're convinced that its future is excellent but that the stock has risen too quickly and likely will decline in value in the near term. To protect your profits, you buy one put option of Company A with an expiration date six months in the future at a strike price of $105, or slightly in the money. The cost to buy this option is $600 or $6 per share, which gives you the right to sell 100 shares of Company A at $105 sometime prior to its expiry in six months. If the stock drops to $90, the cost to buy the put option will have risen significantly. At this point, you sell the option for a profit to offset the decline in the stock price. Investors looking for longer-term protection can buy long-term equity anticipation securities (LEAPS) with terms as long as three years. (Learn more in *Long-Term Equity Anticipation Securities: When To Take The "LEAP"?*)

It's important to remember that you're not necessarily trying to make money off the options but are instead trying to ensure your unrealized profits don't become losses. Investors interested in protecting their entire portfolios instead of a particular stock can buy index LEAPS that work in the same manner.

Stop Losses
Stop losses protect against falling share prices. Hard stops involve triggering the sale of a stock at a fixed price that doesn't change. For example, when you buy Company A's stock for $10 per share with a hard stop of $8, the stock is automatically sold if the price drops to $8.

A trailing stop is different in that it moves with the stock price and can be set in terms of dollars or percentages. Using the previous example, let's suppose you set a trailing stop of 10%. If the stock goes up $2, the trailing stop will move from the original $9 to $10.80. If the stock then drops to $10.50, using a hard stop of $9, you will still own the stock. In the case of the trailing stop, your shares will be sold at $10.80. What happens next determines which is more advantageous. If the stock price then drops to $9 from $10.50, the trailing stop is the winner. However, if it moves up to $15, the hard stop is the better call.

Proponents of stop losses believe that they protect you from rapidly changing markets. Opponents suggest that both hard and trailing stops make temporary losses permanent. It's for this reason that stops of any kind need to be well planned. (A stop loss is a simple but powerful tool to help you implement your stock-investment strategy. Find out how; see *The Stop-Loss Order - Make Sure You Use It*.)

Dividends
Investing in dividend-paying stocks is probably the least known way to protect your portfolio. Historically, dividends account for a significant portion of a stock's total return. In some cases, it can represent the entire amount. Owning stable companies that pay dividends is a proven method for delivering above-average returns. When markets are declining, the cushion dividends provide is important to risk-averse investors and usually results in lower volatility. In addition to the investment income, studies show that companies that pay generous dividends tend to grow earnings faster than those that don't. Faster growth often leads to higher share prices which, in turn, generates higher capital gains.

In addition to providing a cushion when stock prices are falling, dividends are a good hedge against inflation. By investing in blue chip companies that both pay dividends and possess pricing power, you provide your portfolio with protection that fixed income investments, with the exception of Treasury inflation-protected securities (TIPS), can't match. Furthermore, if you invest in "dividend aristocrats", those companies that have been increasing dividends for 25 consecutive years, you can be virtually certain that these companies will up the yearly payout while bond payouts remain the same. If you are nearing retirement, the last thing you need is a period of high inflation to destroy your purchasing power. (For more insight, read *Why Dividends Matter*.)

Principal-Protected Investments

Investors who are worried about protecting their principal might want to consider principal-protected notes with equity participation rights. They are similar to bonds in that your principal is usually protected if you hold the investment until maturity. However, where they differ is the equity participation that exists alongside the guarantee of principal.

For example, let's say you wanted to buy $1,000 in principal-protected notes tied to the S&P 500. These notes will mature in five years. The issuer would buy zero coupon bonds that are maturing around the same time as the notes at a discount to face value. The bonds would pay no interest until maturity when they are redeemed at face value. In this example, the $1,000 in zero-coupon bonds is purchased for $800, and the remaining $200 is invested in S&P 500 call options.

The bonds would mature and, depending on the participation rate, profits would be distributed at maturity. If the index gained 20% over this period and the participation rate is 90%, you would receive your original investment of $1,000 plus $180 in profits. If it loses 20%, you would still receive your original investment of $1,000 while a direct investment in the index would lose $200. You are forfeiting $20 in profits in return for the guarantee of principal.

Risk-averse investors will find principal-protected notes attractive. Before jumping on board, however, it's important to determine the strength of the bank guaranteeing the principal, the underlying investment of the notes and the fees associated with buying them. (To learn more about principal protected notes, check out *Principal-Protected Notes: Hedge Funds For Everyday Investors*.)

The Bottom Line

Each of the five strategies described herein can help you protect your portfolio from the inevitable volatility that exists when investing in stocks and bonds. Choosing between them is depends on your individual financial situation.

Protecting your investment portfolio

By Laura Bruce • Bankrate.com

Highlights

It's a mistake to think SIPC coverage is as strong and broad as the FDIC's.
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When people fall victim to a scam and lose their investments, 20/20 hindsight often has the rest of us scratching our heads and wondering, "How the heck did they fall for that?"

We all have our circles, and when one person in that circle trusts someone, it becomes easier for the rest of us to trust that person. We assume that someone we know did the due diligence and now we don't have to. Let's hope that after being inundated with news about Bernie Madoff's alleged $50 billion Ponzi scheme -- perhaps the scam of the our lifetimes -- we're a little less smug about who falls for a scam and who doesn't.

Keep your eyes wide open

Each person who hands money to an adviser or a firm to invest must do so with his eyes wide open. Check out the adviser's credentials, get references, use a search engine or news service to see if anything's been reported or blogged about the adviser. Make sure the adviser understands your goals and financial needs. Know how your money will be invested and get it in writing.

But if your best efforts aren't enough and you learn that some or all of your money is gone either through fraud, bad advice, inappropriate investments or a bankrupt brokerage, you may find yourself relying on various agencies to recover your funds.

SIPC gives limited protection

Just as the Federal Deposit Insurance Corp., or FDIC, protects the money you have in deposit accounts in member banks and savings institutions, the Securities Investor Protection Corp., or SIPC, affords some protection for cash, stocks and bonds in your brokerage account. But it's a mistake for investors to think that SIPC coverage is as strong and broad as FDIC coverage.

"SIPC is very tight with the dollar. They operate almost like a private-sector insurance company in terms of not wanting to pay claims," says Mark Maddox, a securities and investment fraud attorney with Maddox Hargett & Caruso in Indianapolis.

Maddox, a former Indiana securities commissioner, says that when you look into the SIPC you'll see it's nothing like the FDIC.

The FDIC and SIPC both protect you when an institution fails. If the money you have in a deposit account -- checking, savings, CDs, money market account -- is within the FDIC coverage limits, you'll receive your money promptly, no questions asked.

Stingy with the payout

The SIPC protects cash, stocks and bonds up to $500,000 per customer at member brokerages. That includes a $100,000 limit on cash. Mutual funds are not covered by the SIPC.

"SIPC always has been a tough place to get money out of," Maddox says. They'll deny claims. They'll say you don't qualify for this reason or that reason. They'll put investors through a gauntlet, and only those people who have the time and energy and resources to survive the gauntlet will get any money out of SIPC.

"You're at the mercy of people who are making insurance-type decisions. You're often involved in litigation and then one or two levels of appeals. Very often you'll need to employ an attorney on a one-third contingency fee to help you through the process. Then at some point you're really just trying to cut your losses."

No protection against fraud

From its inception in 1970 through December 2007, the SIPC paid investors only $508 million from its reserve fund. SIPC coverage comes into play only when an institution fails and assets are missing from an investor's account. If a brokerage is in business and you believe assets are missing from your account due to fraud, the SIPC will not help you. You'll have to hope that the brokerage can determine what happened and reimburse your account, or perhaps you'll need to turn to the Securities and Exchange Commission.

"In the past I've always said that, all things being equal, (an investor) is better off with a large firm, a major name, than a small firm," says Stuart Meissner, a securities arbitration attorney in New York and former prosecutor with the New York State Attorney General's Office.

"Usually, the supervision is much better as far as overseeing brokers and the enforcement of compliance standards. Secondly, if there is a problem and you need to file a claim, generally you can be confident that the firm will be around to pursue a claim against. That enables you to get an attorney to take on your case. When you have a no-name firm, you may not even get to the point of seeing if the firm can pay. However, in the past year and a half, that has somewhat gone out the window with Lehman Brothers."

Excess coverage from brokerage

Most large brokerages have what's called "excess SIPC" coverage and will reimburse customer accounts when it is determined that funds were removed from your account through unauthorized transaction through no fault of your own. Often the coverage extends into the millions of dollars. Fidelity, for example, has no limit on its stock and bonds coverage, although there is a $1.9 million cap on cash.

Meissner advises investors who opt for small brokerages that don’t have excess SIPC to make sure the firm is covered by errors-and-omissions insurance. This is comparable to malpractice insurance. If you end up suing the brokerage, you want to know that there is money to pay your claim.

"A lot of small firms talk about SIPC, and that's misleading -- it (can) give a false sense of comfort to investors. Ask the firm if they have errors-and-omissions insurance, and ask to see a copy of the policy. If they don't want to tell you or they don't know, it may be a sign to go elsewhere."

Get your plan in writing

Meissner also says having an investment plan in writing is crucial.

"There's a distinction between an investment advisory firm and a brokerage firm. The advisory firm isn't covered by SIPC. With anyone you deal with, ask for a plan, in writing, that shows how they are going to invest your funds and how the plan meets your objectives. Later, down the road, if they don't do what was in the plan, it's a pretty straightforward case of comparing what was in the plan and what happened -- or looking at the plan in the beginning and saying this isn't suitable for your needs."

As mentioned, the SIPC doesn't cover mutual funds, but that doesn't mean you should shy away from them in your investment account. Vanguard, the giant mutual fund company, carries a fidelity bond to cover its funds, says spokeswoman Rebecca Cohen.

"We have a fidelity bond that covers in excess of SIPC on the brokerage side of the business, and we have a fidelity bond on the mutual fund side of the business that covers fraud and illegal acts, but our funds also have insurance against negligence and pricing errors. Most of the errors we see are clerical and can be easily remedied."

Attached are profiles of four entities, the FDIC, the SIPC, the SEC and the Financial Industry Regulatory Authority, or FINRA, that every saver and investor should know about. Knowing what protections are afforded you is just as important as being vigilant about your accounts on a routine basis.