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Kim Inglis, BCom, CIM

Don't forget exit points

When you bring your cash back in, remember when to get out

The extreme market excursions of 2008 have carried into 2009, with investors witnessing the worst crash since the Great Depression followed by a remarkable rally. The MSCI World Index was up 19% in the May to August period; the steepest advance for that period since the Index was created in 1970. This has led to debate over the near-term future of the markets.

Industry heavyweights Goldman Sachs and Morgan Stanley are completely at odds. Goldman Sachs' analyst David Kostin predicts a sustained rally for the S&P 500 Index, forecasting the steepest second-half rally since 1982 with a target of 1,060. Morgan Stanley's strategist Jason Todd sees the S&P 500 hitting 1,100 but he says the levels are unsustainable and recommends investors sell into the rally.

Options traders have further fueled speculation by betting the S&P 500 Index will drop in September. According to Bloomberg, traders are betting the VIX will increase 13% in the next five weeks. This would bring the volatility index to its biggest spread since August 2008, with last summer being the turning point.

While I believe the markets are due for a correction, I also think it will be short-lived. According to the Investment Company Institute there's a staggering US$5.8 trillion worldwide sitting on the sidelines in money market funds. With inflation nibbling at already low rates of return, many people have grown weary of their cash being eroded and are eager to get back into the markets. If they worry that they've already missed the boat, they'll likely act on a correction.

As that cash starts to be deployed, the markets will respond. Investors must be ready to move but it's critical to define a strategy first, because a rise may not mean the end to volatility. Whether they are fully invested and are unsure of their positions, or sitting on the sidelines eagerly awaiting a buying opportunity, investors should be prepared for near-term market movements, such as we have seen recently. Volatility can be embraced, but only by adhering strictly to a well-defined strategy.

Developing the right strategy begins with reassessing risk tolerance and rebalancing risky portfolios. The last bull market saw a lot of otherwise risk-averse investors opt for increased equity exposure that ultimately led to the demise of their portfolios in 2008. Reviewing asset allocation is integral to this process.

To protect against corrections, investors should set pre-defined exit points or trailing stop losses. When market conditions deteriorate, such discipline will help protect profits. As well, a properly defined mandate helps lock-in current gains if the markets continue to climb. Investors should also research new buying opportunities should they get stopped out on their positions.

Consider Teck Resources Ltd., which has increased over 700% from its annual low. Numerous analysts have raised their targets for the company but it is not impervious to decline. If the stock follows analyst predictions, investors with trailing stop losses will continue to benefit as they lock-in their profits. If it takes a turn for the worse, investors will be comforted knowing their pre-defined exit points limit their downside.

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Those presently sitting on the sidelines and assembling game plans should be looking for high quality businesses and the right buying opportunities. Just as those who are fully invested should have pre-defined exit points, investors on the sidelines should set pre-defined entry points. This will reduce the urge to chase a stock or stray from discipline.

No matter what the future holds, a clear and properly executed strategy is imperative.

Kim Inglis, BCom, CIM is an Investment Advisor. The views in this column are solely those of the author. www.kiminglis.ca

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