

>: Limit Your Risk

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My goodness, this market strength is something, isn't it? One of the strange paradoxes of the market is that the stronger it gets, the riskier it becomes. In fact, the absolute riskiest time to invest in stocks is when you have zero fear of owning them. Equally as bizarre, the lowest risk time to buy stocks is when nobody wants them and when the TV talking heads are bemoaning the death of stocks.

The market we find ourselves in right now is very overbought BUT is still very much in an uptrend, and the technical readings that I follow counsel continued long exposure to the market. So, how do we reconcile our desire to participate in stocks and our desire to not lose money in a clearly overbought market?

Here's the deal: it's not a question of IF this market will come in; it's purely a question of when. So one of the strategies I use at times like this is that I eliminate my use of margin. This is a very useful risk management tool when faced with an overbought market. Yes, you will give up a measure of your upside performance, but remember that when markets crack, they usually do so violently and with very little warning.

Like the mortgage credit cycle I explained a couple of weeks ago, the best time to be highly levered to the stock market is early in the cycle, not late in the cycle. Money can still be made later on in the bull cycle, but you don't have the same capital protection cushion that early cycle valuations provide.

Another strategy that I will enact in this portion of the bull cycle is to keep an eagle eye on the relative strength performance of all market sectors. I want to see how each sector is performing in relation to each other. This can give me early clues to a potential breakdown in the future if I begin to see a former leadership group begin to lag.

One such group that is currently exhibiting signs of fatigue is the Wall Street/Brokerage sector. This is a group that has led the way for many months now and is on the verge of posting a very meaningful point and figure sell signal. This could very well be the first warning shot across the bow.

The dust cloud of the approaching bear party army is visible on the horizon, but it's too early to go full bore bear yet. Expect some border skirmishes here and there, but the full war, if there is to be one, will probably not descend upon us until Spring.

So make money on the long side while you can, restrict your margin buying, exercise discipline on your position sizing, and you'll have the unique opportunity to catch this market both coming and going.



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