



Ruminations on Investment Mistakes

Be aware of the following common investment mistakes (in no particular order):

1. Selecting investments without an overall plan. Most people have accumulated a hodge-podge of funds and individual securities without considering how they fit together. They have a collection rather than a portfolio. The individual investment selection (within the same asset class) is one of the *least* important parts of the process. This is confusing because it looks *very* important. It is true that selecting superior investments would make a huge difference to your results, but research shows that to be nearly impossible. Because the market is a fantastic clearinghouse of information, securities are generally priced “correctly” leaving no opportunities to profit from superior investment selection. In other words, markets work. The following factors, even though they may seem extraneous, are just a few of those that should be considered in structuring a portfolio:

- Projected cash flows (when money will flow into or out of the portfolio)
- Capital markets assumptions (the expected return, risk, and correlations of the investments available in the market)
- Tax possibilities and probabilities
- Human capital (the value of future labor income, and the level of certainty)
- Debt (*ceteris paribus* more debt should be balanced by a more conservative portfolio)
- Pensions, including Social Security (the funding/risk level, the survivor benefits, whether there are COLAs, etc.)
- Inflation possibilities and probabilities

2. Not being properly diversified. In general, you are rewarded for taking risk with higher returns. However, this does *not* apply to diversifiable risk. In other words, stocks are riskier than cash, and one stock is more risky than owning a portfolio of many stocks. However, you get rewarded (with higher expected return) for owning stocks over cash but *not* for only owning one stock. Why? Because you can easily mitigate that risk by owning many stocks. The worst form of this mistake is also the most typical. People frequently accumulate large amounts of their employer’s stock. This is a very risky strategy, not only from an investment portfolio perspective, but also because in the event of a problem in their company or industry, they could find themselves both without a job and with a diminished investment portfolio simultaneously. It is almost impossible to have a properly diversified portfolio (technically defined as eliminating non-systematic risk) using individual securities. Mutual funds or exchange-traded funds are the appropriate vehicle for building a diversified portfolio for the typical investor.

3. Not staying with the plan. Consider a simple situation where you have determined having 60% of your investments in stocks and 40% in bonds is optimal. Suppose the stock market then goes up dramatically so the allocation is no longer 60/40. What should you do? Many people, happy to see their stocks soaring, plow more into those investments (remember the late 90’s in stocks? 2006 in real estate?). Conversely, suppose that stocks plummet (as in 2008). Many people want to move money from stocks to something safer. Both of these reactions are wrong, but *not* for the reason most people think.

Academic research has shown there is little serial correlation in the capital markets in the short run (either positive or negative). In non-technical language, that means what *has* happened has little or no short-term predictive power over what *will* happen (again despite what you hear in the media).

The fact that stocks go down does not indicate they will continue down or that they “must” come back. If stocks (or any other asset classes) go up, that does *not* mean they will come down.

The reason to rebalance the portfolio (keeping transaction costs and taxes in mind) is that the 60/40 allocation has the risk/return profile with the highest probability of meeting your long-term financial goals. The losses incurred from missed opportunities or increased risks from trying to outsmart the market can be significant.

4. Ignoring costs. Many people focus on obvious costs like commissions and fees (which average about one percent of your investments annually for professional help), but completely ignore hidden costs. For example, most people (and advisors) overtrade because they feel a high need to “do something” even if it is wrong. The advisor frequently does this not out of malice but due to overconfidence in trading ability or to justify his or her existence. It is difficult to charge fees for inactivity; however, inactivity is generally called for. Making a change is not free. Transaction costs, ranging from the bid/ask spread to commissions to market impact costs, must be overcome before making a profit on each trade. Insurance products (for investing), separately managed accounts, hedge funds, etc. are all products that tend to have excessive costs.

Another cost is taxes. Reducing turnover, actively harvesting tax losses from a taxable account, and paying attention to asset location (locating tax-inefficient holdings in tax-sheltered accounts and tax-efficient holdings in taxable accounts) may add from one-half up to one percent to the annual return. Obviously, individual situations can vary a great deal. Many advisors and investors do not harvest tax losses effectively because they believe in negative serial correlation (because it went down it must “come back” – see number three above) and because it is difficult emotionally to admit being wrong (though investing shouldn’t be about emotion), and selling something that has declined seems like admitting error.

An opposite error is occasionally made by focusing excessively on taxes. The objective is to maximize after-tax return not to reduce taxes. An example of this mistake would be holding municipal bonds when your tax bracket is too low for that to make sense. Generally, the best way to reduce costs is to use index funds or exchange-traded funds and a “tax aware” advisor.

5. Ignoring conflicts of interest. The financial media, while not wishing you ill, have a primary goal of attracting an audience. “10 Stocks to Buy Now!!!” does just that. A discussion of buying and holding boring index funds and treasury bonds does not. Stockbrokers charging commissions have an incentive to overtrade. Investment advisors charging fees (e.g. us) have incentives to keep you leveraged to increase assets under management (i.e. don’t pay off the mortgage).

Also, many advisors get higher pay (directly or indirectly) for selling “in-house” products, though they generally have poor relative performance and higher costs. Some firms have fee schedules that give the advisor huge incentives to tilt an asset allocation toward more risk. (One of the largest firms pays its advisors as much as 60% more for using stocks over bonds). I believe most advisors *do* have good intentions, but often compensation issues can cloud judgment.

There are obviously many other mistakes people can make in their investments, but in our view, these are the main ones.

Notes:

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