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How to Avoid Three Common Investment Mistakes

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Fewer retirees than in the past will have the luxury of a guaranteed pension plan where the onus of responsibility for providing retirement income is on the company or municipality. There will be a few fortunate retirees who will have enough money that they can “live on the dividends” from their portfolios, but they will be the exception rather than the rule. For most future retirees, their investment portfolios will have to provide capital appreciation as well as dividend income so that they will not outlive their assets.

In this paper, we will not discuss important investment topics such as asset allocation or passive vs. active investing. These and other “investment topics” are adequately covered by other communications. Instead, the purpose of this paper is to alert the investor to three common pitfalls that can derail a Wealth Management Plan and negatively impact retirement income. In my long career as a Financial Advisor, I have seen many people fall prey to the three challenges described in this paper, and recent research in the field of behavioral finance/economics has demonstrated scientifically that the issues described are real, widespread, and often difficult to overcome. Unfortunately, one's level of formal education is often not a good predictor of the likelihood of making the three common investment mistakes described. These mistakes are widespread because the human brain seems to be wired in a way where it is very easy to behave irrationally in making investment and other important life decisions. Avoiding the three common investment mistakes described below will not guarantee that one will become an outstanding investor, but avoiding these pitfalls will likely help the investor avoid doing very poorly.

The three common mistakes that we have seen over the years are:

"Overestimating One's Investment Skills: The Transferability Fallacy"

A common mistake often made by people who are very accomplished in a particular field is to assume that they have far more knowledge in an unrelated field than their real level of expertise. With access to the internet, every person with a computer can supposedly read what the "experts" have to say. The problem is that unless one really is an expert, they will not be able to differentiate the worthwhile information from the worthless information.

Overestimating one's skills in a new or unrelated field is an example of the transferability fallacy. That is, high general intelligence and expertise in one field does not usually transfer to expertise in investing without considerable training and years of experience. The transferability fallacy is likely true not only for investing, but for many fields. A sometimes amusing example of the transferability fallacy is when the wealthy and successful owner of a professional sports team, who may not have played or coached the sport at any level beyond age 12, tries to micromanage the franchise. The interference from the smart and successful owner usually sets the franchise back for years.

In our experience, the clients who do best are good at providing us with relevant information about their situation, ask clarifying questions, and make intelligent choices about options presented. Those clients who insist that with a little reading they can become very knowledgeable about investing, although experts in their own field, usually have disappointing results.

<u>“Failing To Be Patient”</u>

Experienced Wealth Advisors often look at their job as preventing the client from self destructing. That is, if one is patient and allows the markets to produce the long-term returns that virtually always occur in 30 year periods, a successful outcome will be achieved. The mistake that investors often make is that they become enamored by an investment strategy that has done well the last few years and want to abandon a strategy that has recently underperformed. Unfortunately, failing to have enough patience is not a problem limited to individual investors, but sometimes can plague so-called sophisticated investors who handle endowment or pension money.

The reason why buying the “hot” strategy or manager is almost always doomed to failure and buying the “cold” manager or strategy with a good long-term record almost always provides above average returns over the next few years, is a mathematical concept called “regression towards the mean”.

Without becoming mathematical, an easy way to understand the concept of "regression towards the mean" (the mean is the arithmetic average) is the following. Everyone has a long-term performance level that over many trials will be reached. If, over a short time period, one's performance differs significantly from their true skill level, then it is to be expected that going forward their performance will "regress" up or down towards their true skill level. This seems to be true for investment managers as well as types of investments. An example might be where the "growth style" of investing in stocks is significantly outperforming the "value style" of investing, even though their long-term performance is about the same. Typically, investors want to go with a winner by firing "value" managers and hiring "growth" managers, but this is exactly the opposite of what is usually best because of "regression towards the mean".

"Failing To See That Many Factors Affect Markets"

Over the years, clients have often asked us what we thought about the direction of the stock market, bond market, economy, interest rates, etc. Trying to predict the direction of any of these items over anything but a long period of time is very difficult to do consistently and is an inefficient use of time for most people. The reason why it is so difficult to predict the markets accurately is that there are a multitude of factors, some known and some unknown, that could affect the direction of any of these markets. At any given point in time, some issues which affect a market have a higher chance of occurring than some other issues, but it is unknown whether the highly probable factors or the highly unlikely factors will determine the eventual movement of a market.

Because there are many factors that could determine the short-term movement of a market, predicting the direction and magnitude of those movements is extremely problematic.

A more reasonable approach is to determine what factors have a high probability of occurring and would also likely have a large negative effect on one's investments. Therefore, if a preponderance of factors indicated that interest sensitive investments were overpriced by historical averages, then it would make sense to lower a portfolio's exposure to investments that would be hurt by a rise in interest rates. Bonds, for example, are often affected negatively by rising interest rates but may also be affected by such factors as credit quality and currency fluctuation. A bond portfolio could be changed to reduce interest sensitivity and increase credit and/or currency sensitivity, without changing the proportion of the portfolio invested in bonds.

In our experience, investors often have difficulty thinking in terms of the probability of various risks to their portfolio. They seem to be psychologically more comfortable making a "market call" and then making a major shift in a portfolio based on that "market call". However, a much more prudent way of managing one's investments is to think in terms of the likelihood of events that could negatively affect a portfolio and then making changes to the areas that are most potentially harmful. Making changes in small sequential steps usually works much better than making "market calls".

Summary

In this paper, we have explored three common mistakes made by investors. The mistakes are: (1) Overestimating One's Investment Skills: The Transferability Fallacy, (2) Failing To Be Patient, and (3) Failing To See That Many Factors Affect Markets. These are not the only investment mistakes that we have observed that can derail a Wealth Management

Plan, but if these common mistakes can be avoided, one can likely greatly improve the chance of meeting long-term investment goals.