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the ten biggest mistakes in investing.

BY BILL SPITZ
Director

My career in investing has been guided by the principle that the key to success is not losing. In other words, given that markets generally provide positive returns, things will turn out fine if you simply avoid catastrophic mistakes. Avoiding mistakes is easier said than done because we are all subject to the classic emotions of fear and greed which are the source of most problems. Since we are all human, I can't provide an infallible method for avoiding mistakes. But, by making you aware of ten of the most common and serious errors, I hope to increase the odds of a good outcome. This discussion is applicable to both individual and institutional investors. A paper devoted to investing mistakes could easily come across as "preachy," so let me state at the outset that I have been guilty of each of them at one time or another.

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MISTAKE 1 inattention to cycles.

In the world of investing, cycles are inevitable, and they often are longer and more extreme than anyone could imagine. Given that reality, more adventurous investors may choose to try to take advantage of temporary dislocations caused by extreme greed and fear. While certainly not easy, capturing these opportunities creates the potential for significant value added and it represents a component of our overall investment process at Diversified Trust Company. But, I am more concerned about playing defense; in other words, avoiding the possibility that cycles wreak havoc on your portfolio. This happens in two ways. First, many people extrapolate recent trends and or returns. This tendency frequently results in jumping on the bandwagon ***after*** an investment has performed well. It is easy to be seduced by media or cocktail party chatter regarding the killing someone is allegedly making in the latest hot investment. And, Wall Street is an excellent marketing machine that will simply fan the flames. Second, it is very common to abandon a sensible investment strategy at just the wrong time; typically, at the bottom of a market cycle. There are two keys to avoiding these traps. First, every investor should develop a formal investment policy that includes a sensible asset mix and appropriate risk controls. And, even though it may be emotionally difficult at times, it is critical to stay within the approved guidelines. Second, when contemplating any changes in a portfolio, you should try to evaluate whether the assets in question are early or late in their cycle. Of course, you won't get it exactly right, but this awareness should prevent the most destructive timing decisions.

MISTAKE 2 analysis paralysis.

I have noted a tendency for particularly intelligent, well informed individuals, to become paralyzed by too much attention to politics, world affairs, the economic outlook, and so on. Yes, these are important. But, they should only influence your decisions if you can convince yourself that you know something that the market does not. Some people avoid investing until they see more clarity in the outlook. In fact, the outlook is never really very clear, and there are always conflicting forecasts and opinions. And, by the way, if the outlook were ever clear, the markets would have long since reflected it. Once again, the best way to avoid this mistake is to set up your portfolio intelligently, rebalance periodically, and do your best to tune out all of the noise generated by the financial world.

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MISTAKE 3 failure to evaluate the impact of extreme events.

As we all discovered in 2008-09, extreme events do occur in the capital markets, and they occur more often than simple statistical models would suggest. In a global meltdown of this sort, diversification doesn't seem to help very much and operational problems, bankruptcies, and frauds rear their ugly heads. Of course, it is difficult to forecast one of these events. But, you can attempt to evaluate the impact of one should it actually occur. There are sophisticated models that analysts use to "stress test" portfolios. But, a simpler approach is to simply ask the question: "what would be the impact on my finances of a large decline (Say 20%) in the value of my investment portfolio?" If the result is catastrophic either financially or psychologically, then you need a different portfolio. Second, the key to survival in tough times is liquidity so every investor needs to make sure that she has sufficient liquid assets to meet one to two years of budget needs.

MISTAKE 4 excessive conservatism.

The previous mistake focused on having a portfolio that was sufficiently conservative to ensure survival. But, many take that too far. Because markets do go up on average, the real enemy for most investors is inflation rather than a temporary decline in market value. In the interest of "prudence," some investors have very conservative asset mixes and overly restrictive investment guidelines. Similarly, they totally avoid or minimize their exposure to illiquid investments. All of these are likely to lead to lower returns and they may not actually significantly change the risk profile of the portfolio. The key to avoiding this mistake is to truly understand the risk tolerance of the investor, create a portfolio strategy that is consistent with it, and stick to that strategy over time.

MISTAKE 5 lack of attention to current income.

Over longer periods of time, current income (dividends and interest) has accounted for virtually all of fixed income returns and about 45% of stock returns. Current income is much more stable than capital gains which are both uncertain and highly variable. And, current cash flow prevents forced selling to meet budget needs in down markets. I find that these virtues are under-appreciated because many investors are enamored of capital gains. Of course, this is driven in part by the tax code as well as the fact that both stocks and intermediate US Treasury bonds currently yield about 2%. But, income will once again have its day so it makes sense to ensure that your portfolio is designed to generate at least a moderate level of current cash flow.

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MISTAKE 6 inattention to the cost of investing.

A large number of academic papers and financial publications have noted that a majority of professional investment managers under-perform their respective market indices. These managers are smart, well informed, have lots of resources and work very hard. So, what's the problem? While some managers certainly do add value, as a group, they simply cannot overcome the cost of hiring them. The cost of investing includes manager fees, mutual fund sales loads, administrative costs, taxes, and transaction costs. Unfortunately, there are hidden fees in some investment vehicles and transaction costs are both substantial and frequently unmeasured and under-discussed. The cost of investing is particularly high for "alternative" investments such as hedge funds, private equity, and real estate. What should you do about costs? First, understand the true costs involved in any investment. Second, you should be somewhat skeptical of higher cost vehicles and only invest in them when there is a clear benefit that overcomes the cost hurdle.

MISTAKE 7 placing too much trust in others.

In global capital markets with a large number of investment categories, it is virtually impossible to "do it yourself" which means most investors must rely on others. Unfortunately, there are many reasons to be extremely cautious and somewhat cynical in your choice of investment products or services. First, the investment business is full of conflicts of interest and incentives are often misaligned. Disclosure can be incomplete if not misleading and frauds are not uncommon. Finally, as previously mentioned, most professional investors do not earn their keep. What can you do about all of this? First, it is critical for every investor, either individual or institutional, to take ownership of key decisions. Of course, you can marshal all of the resources that are available to you including databases, consultants, investment advisors, and so on. But, in the end, you must be comfortable with the level of risk chosen for your portfolio, the asset allocation and spending rate that are consistent with it, the implementation of your investment program, and the safety and security of your assets. This requires at least a moderate level of knowledge and a reasonable level of due diligence.

MISTAKE 8 placing too much emphasis on outperforming peers/ market indices.

In recent years, I have noted an unhealthy focus on investment performance. Of course, investment results are important and we all have our competitive streaks. But, excessive focus on relative performance can lead to destructive behavior. First, in an effort to "keep up with the Joneses," many people dial up the risk in their portfolio to a level that is inconsistent with their actual level of risk tolerance. Second, some investors attempt to copy the investment strategies of others even though

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they may not have the expertise or resources to implement them successfully. (Many institutions have attempted to implement portfolios similar to those of Harvard, Yale, and other large endowments even though these portfolios are both complex and very labor intensive). A related problem is that many invest in things that they really don't understand because they are in vogue. Finally, many chase performance by frequently hiring and firing investment managers, an activity that is both costly and frequently non-productive. How should you think about performance? The most basic question, which many fail to ask, is "are we accomplishing our basic mission?" Beyond that, performance should be measured against truly relevant market indices and manager peer groups and over a reasonable time period. And, when contemplating a change in managers due to performance, you should be somewhat skeptical of the likelihood that the new manager will outperform the one being replaced.

MISTAKE 9 managing money via a committee with poor dynamics.

Most institutions as well as many families govern the management of their money via a committee, and many are unfortunately quite dysfunctional. In particular, large committees find it hard to be either daring or creative which leads to collegial, "middle of the road" investment decisions and mediocre results. In some cases, a committee can be dominated by a forceful, outspoken person. It is also very difficult for individuals to separate their personal investment strategy/risk tolerance from that which is truly appropriate for the institution or family and no one wants a problem on their watch. Finally, in larger organizations, there is frequently tension between the committee and professional staff. I believe the solution is to operate with small committees composed of knowledgeable individuals who leave their egos at the door. The committee should accept responsibility for major decisions and results while carefully delineating the separation of duties between committee members and staff.

MISTAKE 10 failure to take a global view.

The world's economies and capital markets are increasingly integrated yet many investors are guilty of what is known as the "home country bias." In other words, too much of their portfolio is confined to investments in their home

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IMPORTANT NOTES AND DISCLOSURES

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markets. Roughly 50% of the world's stock market is now located outside of the US. Additionally, growth rates are much higher in emerging economies than in the industrialized world. Finally, global markets do not move exactly in tandem which means that there is a diversification benefit to exposure to other markets. The message is straightforward, take a global view of your portfolio and each of its components.

conclusion.

I attempted to provide some direction as to how to avoid each of the ten mistakes discussed in this paper. But, if you flip back through the text, you will find that there are several recurring themes. Every investor needs to do a good job of understanding her financial and psychological makeup which should lead to a decision as to the appropriate level of portfolio risk. Having established this parameter, the next step is to design a portfolio structure and investment guidelines that are consistent with it. And, this structure should take into account the expertise of the investor and the resources available to her. Once in place, it is important to stick with the program and any changes should be made only after careful consideration and with an eye to investment cycles. Finally, it is ever important to evaluate results correctly and to avoid chasing performance. ■

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