The Top 10 Mistakes Investors Make

And How To Avoid Them

SPECIAL REPORT

By Dan Kiley

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Money Masters
INVESTMENT PORTFOLIOS

Most people invest in the hope of achieving strong, long-term returns. So why put those potential returns at risk by making common investment mistakes? Here are 10 of the most common investment errors—along with some tips on how to avoid them:

Mistake #1.
Not having a plan to guide your investment decisions.

You wouldn't drive from city to city in a foreign country without a road map to guide you. If you tried it, you could quickly find yourself hopelessly lost. If you invest without a detailed written plan to guide you, you could also find yourself lost and possibly making decisions that often are completely wrong for you.

To invest wisely, you need a plan that lays out why you're saving money and when you plan to spend it. You'd invest one way if you were putting aside money to make a down payment on a home in the next year, and another way if you're saving for retirement and won't need to draw income from that money for 20 years or more.

You should be in a position to take more risk with your money if you won't need it for years to come. The market may have some losing years over that time but, over the long term, your money should grow. With a long time horizon before you need to actually sell your investments, you should invest with a growth objective so you'll have the nest egg you need to pay for your retirement.

So make a plan before you make major investment decisions. Think through what you are saving for and when you will need the money. Then make investment decisions that are matched appropriately to your time horizon.

Mistake #2.
Selecting the wrong asset allocation.

When it comes to asset allocation, the well-known rule is: Don't keep all your eggs in one basket. Each investment has its own unique characteristics.

Stocks offer the potential for growth, while bonds are attractive because they deliver a steady stream of income. Money invested in Treasury bills is super-safe, but doesn't offer much protection against inflation. You can take advantage of the special characteristics of each asset class by spreading your money among them, rather than sticking to only one class.

How important is asset allocation to your investment success? Studies maintain that 80 percent of investment success can be attributed to having the right asset allocation—and only 20 percent to picking the right individual securities within those asset classes.

You shouldn't pick one asset allocation mix for the rest of your life. Your asset allocation mix should favor growth investments when you have lots of time until retirement, and safer income-oriented investments as retirement draws near.

Mistake #3.
Not having enough diversification.

It isn't enough just to divide your money among stocks and bonds and cash. You should also diversify within each major asset class.

Picking just a single stock fund—say one that invests only in large U.S. stocks—wouldn't give you enough diversification.

To be properly diversified, you should spread your money across several funds that invest in medium sized and smaller U.S. companies, as well as funds that invest in foreign markets.

The more you spread your money over investments, the greater the likelihood that you will always have some winning investments each year.

Bonds might rally in a year when the U.S. stock market is down. Smaller stocks might rally in a year when investors are avoiding the blue chip stocks of corporate giants. And foreign markets might rally even though U.S. stocks are depressed.

Mistake #4.
Having too much diversification.

Although one fund might not be enough for adequate diversification, it is possible to spread your money over too many funds or stocks.

For instance, the more funds you own, the less your investment account will benefit when one particular fund has a stand-out year. Research done by Morningstar, the mutual fund rating company, showed that owning only one fund could be risky—but that adding more could reduce that risk.

More important than the number of funds is how diverse they are. Check out each fund's investments to make certain your choices are as diversified as you think they are.

"Don't obsess over the number of securities you own," says Morningstar. "Instead, concentrate on their diversity."

Mistake #5.
Having unrealistic expectations.

Back in the high flying stock market days of the late 1990s, polls showed that investors expected to earn 30 percent per year or more on their investments. At that rate of return, even a small amount invested each year would quickly build your savings into a great deal of wealth.

However, as we all now know, reality intruded and the stock market slumped for three straight years—putting an end to those overblown expectations of how much gain their investments might return.

The stock market trend over longer periods of time is still positive. Over a 10-year period, there's a very good chance that money invested in stock funds will appreciate—just not at 30 percent a year.

Based on market performance going back to 1926, stocks have returned an average 10 percent a year, bonds an average 6 percent a year, and cash (invested in Treasury bills) 3 percent a year. You can expect to do better than that some years—but worse in others.

To keep your expectations realistic, assume that a diversified portfolio of stocks and bonds and cash will return roughly 8 percent a year over time, and you probably won't be disappointed.

Mistake #6.
Following the crowd.

It was hard, in the late 1990s, to avoid all the hype about technology and the Internet. Investors paid higher and higher prices for dot-com companies with no history, no earnings, and very little chance of long-term survival.

However, the investors who managed to steer clear of the dot-com craze generally did better than those who blindly followed the crowd.

The best time to invest is before the crowd has started to move. Managers of value funds specialize in finding promising investments before they have attracted the crowd.

Tune out the crowd.

Buy only because an investment makes long-term sense for you—not because you have seen it in headlines or heard it touted at a cocktail party.

The reason these investments are called “hot tips” is because most people end up getting burned!

Mistake #7.
Buying or selling on emotion.

Have a reason for buying an investment and a reason for selling—rather than reacting to the heat of the moment. Even the best long-term investments will have down periods.

The most successful investors, over time, are those who buy carefully and then hold for the longer term.

Therefore, buy only after careful consideration. No matter how much you may want to own a particular investment, give yourself enough time to think it over before you buy. No matter how poorly an investment has performed, don't sell until you have had time to review the facts and the circumstances leading to those poor results.

If you had a sound reason for buying, and all those reasons that attracted you in the first place still exist, give the fund enough time to recover from what may turn out to be a short-term drop.

Always compare the performance of a fund with that of its peers. If you own a large-company growth fund and all large-company growth funds are performing poorly, your fund manager probably isn't at fault.

Mistake #8.
Staying anchored when you should be moving.

When it comes to investing, you are anchored when you won't sell a losing fund, no matter how poor its prospects have become, until it returns to the price you paid for it.

For example, you paid $25 a share for the XYZ Advanced Technology Fund. Many of the fund's investments have turned sour and now the fund sells for only $15 a share. You made a mistake when you bought the fund. But instead of acknowledging your mistake and moving on to something more promising, you hang onto the shares, waiting for them to again touch $25.

Not every investment decision you make will pay off.

When you do make a mistake, acknowledge the error, sell the shares, and invest in something more promising.

The longer you stay anchored, the more money you will have tied up in assets that may never return what you originally paid for them.

Mistake #9.
Having no knowledge of what you actually invested your money in.

Many buyers of dot-com stocks in the 1990s had no idea what the companies they were investing in actually did.

If you were asked to choose between a foreign stock fund and a global fund, would you know the difference? (Foreign funds invest only overseas, while global funds can invest anywhere—including the U.S.)

One of the worst mistakes you can make is putting money into investments you don't understand. When you do so, you are investing without a clear understanding of the risks involved—and without a clear understanding of what returns you can expect for taking those risks.

Always read the fund's prospectus before you buy. If there is anything you don't understand, keep asking questions until the confusion has been cleared away.

Over the past twenty years, in working with hundreds of individual investors, I've learned that knowledge builds confidence, and that confidence builds comfort. Isn't that what most of us are searching for with our retirement nest egg?

Mistake #10.
Giving too much of your money away.

What would you think of a merchant who gave you credit for only 96 cents of each $1 you spent? The rest, the merchant explains, is his fee for being there to serve you. Chances are you would quickly go to another store where your dollar bought a dollar's worth of goods.

If you aren't careful, a big chunk of each dollar you invest might be taken away from you because of various commissions and expenses.

Some mutual funds charge an upfront sales commission of 4 percent on each dollar you invest. That means only 96 cents is actually invested into stocks or bonds.

All funds charge a fee to cover the normal expenses of running the fund, but the size of this ongoing expense can vary widely.

Make sure you understand all the costs connected with your investment.

The more you pay in fees and expenses, the less money your manager has left to put to work on your behalf.

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Mr. Kiley is Chairman and Chief Compliance Officer of the Retirement Corporation of America. Since founding the company in 1985, Dan and RCA have helped hundreds of client families live a richer retirement. He is responsible for creating Money Masters Investment Portfolios and for managing the company's disciplined investment process.

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For more information about Dan Kiley
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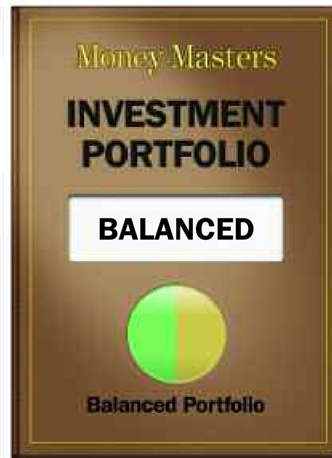

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