

Ten classic investing mistakes

I've come to the conclusion that investing is a bit like golf – if you stay out of the rough, the bunkers, and the water, you'll probably have a fairly respectable round. Golfers end up in hazards because they don't know what they're doing, or by trying too hard, either of which increase the chances of making a mistake. And trying too hard when they don't know what they're doing is a recipe for real disaster.

Often, after the first mistake, the only way a golfer feels he can get back on terms is to try harder, increasing further the chances of errors.

For the golfers among you, how would you like to play all the championship golf courses in the world and hit par? In the same way that golf has its classic errors – slicing, hooking, lifting the head, and so on – so too has investing. While not guaranteeing a future of positive performance, avoiding the following pitfalls will greatly help your investment experience.



Basing decisions on emotions

Investments tend to run in cycles. In boom times, investors feel good about themselves and their investments, and tend to go into the market; conversely, in bad times, the despairing investor hunkers down or even bails out. Making investment decisions based on hope and fear, or even worse, greed and panic, destroys wealth, by causing investors to buy in at a high price and sell cheaply. Which is exactly the reverse of the dictates of common sense.

Timing the market

Investors will say, but I'll come out of the market before bad times, and go back in for good times. That sounds like a sensible plan, except that it is next to impossible to achieve in practice. The flow of information is so lightning-fast nowadays, that news is priced into the market almost instantly; certainly before ordinary mortals can react. And getting it wrong can be very painful. A person invested in the UK stockmarket for the 20 years to December 2005 would have seen £1,000 turn into £8,814¹. Missing the best single day would have reduced that by £500 to £8,326; missing the 25 best days would have reduced that to £3,358, which is less than would have been generated simply by holding cash. Time, not timing, is the secret in investing.

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Investing in the “flavour of the month”

This is a function of the emotional investing and panic buying described elsewhere. When an asset or investment is doing really well, there is a lot of pressure to conform. A simple picture tells the story of how foolish such a strategy usually is – the chart depicts a range of asset classes, year-by-year, in

common sense as stated in the old proverb, Don’t put all your eggs in one basket. But it can also be demonstrated to be unwise mathematically. Investing in different assets that move up and down in different ways reduces the overall risk in a portfolio without necessarily having a commensurate effect on performance. The technical term for this is diversification, and the

Randomness of Returns

Annual: 01/1993 - 12/2008; Default Currency: GBP

	12/1993	12/1994	12/1995	12/1996	12/1997	12/1998	12/1999	12/2000	12/2001	12/2002	12/2003	12/2004	12/2005	12/2006	12/2007	12/2008
Highest Return	78.90	5.24	23.79	18.36	26.19	24.24	71.41	15.56	5.04	3.95	45.27	18.81	50.14	25.38	37.49	4.44
	50.36	2.06	23.46	16.68	23.54	15.31	53.48	10.14	3.02	-15.03	40.88	17.44	25.12	22.87	7.91	-14.33
	38.07	0.72	22.83	13.28	20.38	13.77	33.66	6.91	0.19	-19.01	40.53	17.37	23.63	16.75	5.76	-15.31
	37.42	-1.17	22.41	6.03	20.15	7.38	30.63	6.00	-12.61	-22.67	34.64	13.07	23.12	16.50	5.32	-15.96
	33.32	-1.64	17.73	2.79	8.80	2.97	27.33	-5.12	-13.28	-27.75	24.75	12.84	22.04	9.81	2.77	-29.93
	28.44	-2.53	15.83	2.63	6.79	2.24	24.21	-5.91	-14.62	-27.77	20.86	10.56	19.77	5.73	2.28	-35.08
	25.82	-5.86	6.61	1.83	6.05	-9.72	21.04	-6.05	-15.48	-27.79	20.50	6.98	18.96	4.96	1.50	-40.80
	5.72	-12.33	-4.34	-4.12	-7.89	-26.16	5.30	-24.96	-15.69	-29.29	3.67	4.53	4.82	4.85	-17.92	-48.32
Lowest Return	5.72	-12.33	-4.34	-4.12	-7.89	-26.16	5.30	-24.96	-15.69	-29.29	3.67	4.53	4.82	4.85	-17.92	-48.32
FTSE All-Share Index	28.44	-5.86	23.79	16.68	23.54	13.77	24.21	-5.91	-13.28	-22.67	20.86	12.84	22.04	16.75	5.32	-29.93
FTSE Small Cap ex	38.07	-2.53	15.83	18.36	8.80	-9.72	53.48	6.91	-15.48	-27.77	40.88	13.07	18.96	22.87	-17.92	-48.32
Investment Trusts Index																
MSCI Emerging Markets Index (gross div.)	78.90	-12.33	-4.34	-4.12	-7.89	-26.16	71.41	-24.96	0.19	-15.03	40.53	17.44	50.14	16.50	37.49	-35.08
MSCI World ex UK Index (gross div.)	25.82	0.72	22.41	1.83	20.38	24.24	30.63	-6.05	-14.62	-27.75	20.50	6.98	23.12	4.96	7.91	-15.96
MSCI World ex UK Value Index (gross div.)	33.32	2.06	22.83	2.63	20.15	15.31	21.04	10.14	-12.61	-27.79	24.75	10.56	23.63	9.81	2.77	-15.31
Fama/French UK Value Index	50.36	-1.64	23.46	13.28	26.19	2.24	27.33	15.56	-15.69	-29.29	34.64	18.81	19.77	25.38	1.50	-40.80
International Small ex UK (with US) Composite Index	37.42	-1.17	17.73	2.79	6.05	2.97	33.66	-5.12	3.02	-19.01	45.27	17.37	25.12	5.73	2.28	-14.33
UK One-Month Treasury Bills	5.72	5.24	6.61	6.03	6.79	7.38	5.30	6.00	5.04	3.95	3.67	4.53	4.82	4.85	5.76	4.44

order of performance. It demonstrates very vividly that this year’s high-performing asset class is not a consistent predictor of next year’s star. Investing is not like ice-cream; stay away from flavour of the month and stick to tutti-frutti. And when someone speaks to you about this month’s flavour, treat them as you would have your children a stranger who offered them sweets – just say, No!

Concentration

The temptation, once one starts down the slippery slope of investing in a particular favoured asset, is to pile more of one’s wealth into it than is wise. After all, the logic runs, if it’s the best asset to be in, why would one invest in anything else? Time and again I come across investors with pretty much all their wealth in one or two investments which they – or more likely a previous adviser – particularly favoured at one time. This flies in the face of

father of modern investing, Nobel Laureate Harry Markowitz, called it the “nearest thing to a free lunch”. And by the way, owning three different with-profits bonds, or four UK equity funds, does not constitute diversification – the assets must be significantly different in nature for diversification to work its magic.

Panic buying

Herd instinct is a dangerous thing in investing. Investing in a particular asset just because “everybody’s getting into it” means buying at or near the top of the cycle, when asset prices are inflated because of the weight of money chasing them. Investment guru Warren Buffett speaks about weighing assets and counting them: counting them is today’s price; weighing them is what they are really worth. Common sense suggests that one should buy something for no more than it is really

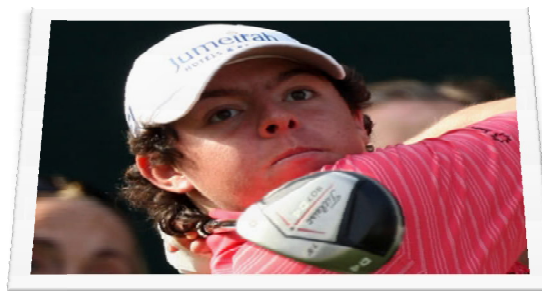
worth, and ideally for less than it is worth, especially in the long run. Because panic buying inflates prices, investors end up paying more than the assets are really worth. Without wishing to insult taxi-drivers, when your taxi-driver tells you he's "getting into" property, technology shares, or whatever, that is not a good time to buy. The late Sir James Goldsmith's quip is very apposite, "When you see a bandwagon, it's too late!"

Panic selling

OK – so markets have gone down, and our hypothetical investor is sitting on losses. At this stage, they are only paper losses, although nonetheless painful for that. What we are currently experiencing is a banking crisis, and you will not be surprised to learn that this is not the first time such a phenomenon has occurred. A recent studyⁱⁱ into four serious banking crises in the last 40 years shows some common (albeit not universal) patterns. Among these were a variable time for recovery, meaning that spotting the bottom of the market is very difficult; and very high stock-market returns within a short period of time once the recovery began. By selling after experiencing a sharp drop in equity values, the investor is very likely to give up the opportunity to earn these high returns. So not only has he lost on the downside, he also loses on the upside by not being there to enjoy it.

Chasing performance

There is at least one area where investing does not mimic golf: practice does not always improve one's game. Study after studyⁱⁱⁱ has shown that good past performance is not a reliable indicator of the future. It takes 16 years of results to determine with any statistical accuracy whether a fund manager's good performance is down to skill, or just luck. By which time, he or she has probably moved on; the number of fund managers staying with one investment house for 16 years is negligible. Better to remove the guesswork and the extra risk by replicating the desired asset class as closely and cost-effectively as possible.



Ignoring costs

Costs have a very real effect on investment returns, especially compounded over the long term. The average Total Expense Ratio (TER) of a UK actively managed equity investment is currently 1.62%^{iv}. This may not sound like much in isolation, but, just as holding an investment for the long term allows one to enjoy the year-on-year effect of compound growth, so, too, can the damaging effect of costs best be seen in the context of the long view. This insignificant-looking TER compounds to 8.4% over five years, and to a truly terrifying 49.4% over 25 years (not an untypical length of time for a person aged 40 to be investing in a pension). And as we've seen, actively managed investment funds do not, in general, deliver consistently better performance, so paying these high costs is, largely, a waste of money. Better to control costs and drive down the middle of the fairway.

Too much activity

This comes under the same heading as the golfer trying too hard. A recent study into the UK equity fund management industry^v showed that, as you would expect from the above information on costs, the average equity fund underperformed the FTSE-All Share Index by just over 2% per annum in the 12 years to December 2003. But that's not all – the average investor, already losing out because of costs, lopped a further 2.08% off the annual return, simply by trying (and failing, obviously) to time the market, in and out. Using the example of a lump sum investment of £100,000 made at the beginning of 1992, this sum would have grown to only £178,000 against an index fund final value of £264,000 – an eye-watering shortfall of 32.6%.

Ignoring other risks

Investors tend to concentrate on the risk to their capital. This is natural and right, but to do so in isolation leaves one prey to other risks. Consider the retired person, with £100,000 in the bank,

relying on the income to supplement his pension. If interest rates fall, so too will his income. He may even have to dip into capital to supplement the lost interest, so the interest rate risk becomes a capital risk anyway. Consider, too, that same £100,000 and think about its purchasing power. Today, there is no risk to the purchasing power – our hypothetical investor can go out and buy £100,000 of goods and services if he chooses. Can he buy the same goods and services for £100,000 next year? No, because inflation will have raised their price. And the longer the time horizon, the greater the risk to purchasing power. This is in direct contrast to capital risk,

which is very high in the short term, but reduces as one extends the time, arguably to zero; there has never been a ten-year period where UK shares have finished up below where they started.^{vi}

Conclusion

In the same way that the lucky golfer sometimes sees his risky shot fly over the bunker and drop within six inches of the hole, so too can extra investment risk pay off.

But with golf, tomorrow is another round; in life, you only get one shot at the course!

ⁱ FTSE data from Financial Express.

ⁱⁱ Lee, I & Quigley G. *What can we learn from past financial turmoil?* December 2008.

ⁱⁱⁱ Rhodes, Mark. *Past imperfect? The performance of UK managed funds.* FSA Occasional Paper 9. 2000. As noted in the main text, there are many studies, but because of the FSA connection this is perhaps the most influential.

^{iv} Source: Financial Express. UK All Companies sector, excluding trackers and index funds

^v Schneider, Lukas. *Are UK investors achieving fund rates of return?* July 2007

^{vi} Source: FTSE-All Share index 02/1955 to 01/2009

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