The Five Biggest Mistakes Investors Make

MISTAKE # 1

HOLDING CASH

Anyone remember the Aesop's fable about the ant and the grasshopper? Put briefly, the ant worked hard all summer storing up food. The grasshopper just sang happily at leisure and did no work. Guess who had enough to make it through? To paraphrase pop artist Donna Summer, you work hard for your money. In return, your money should work hard for you.

Although we probably use a plastic card or even an app on our phone to represent it, cash is what we use to pay our common expenses. Beyond the food, clothes, transportation, entertainment and the mortgage that we budget for monthly, it's a good idea to have an emergency fund of cash on hand to pay for the unexpected car repair, new furnace or medical bill. Depending on your expectation of income stability, that emergency fund could be anywhere from 3-6 months' income coverage. But once you've got that secure, stashing more in cash is actually a bad idea.

There is a common misperception that cash is safe in the sense of protecting your principal. If I have $50,000 in the bank today and I don't spend it, I'll have $50,000 next year and $50,000 twenty years from now. The problem is just that. While I will have the same amount of money in nominal terms, my twenty-years-from-now $50,000 will not buy the same thing that my $50,000 will buy today, due to the erosive power of inflation. In fact, at just 2%-per-year average inflation, my future $50,000 will only buy the equivalent of less than $34,000 of goods and services. If you leave a significant portion of your retirement funds in cash or cash equivalents like marginal-return bank CD's, inflation is going to erode your purchasing power over time.

Some people hold on to too much cash because they fear the market. Some people have analysis paralysis and are always looking and waiting for the non-existent perfect investment. Either way, by holding cash, you are losing money.

MISTAKE # 2

FAILING TO CONSIDER **FEES**

If some people overthink the kind of investment to make, many people underthink the question of fees. There is a whole debate about actively managed versus passively managed mutual funds out there. Active funds pay one or (usually) more fund managers to determine their fund's mandate, conduct research, and buy and sell stocks according to which they expect to perform best within that mandate.

In addition to the cost of paying the managers, there are the transaction costs for buying and selling the stocks. Passive funds are designed to mirror an index and simply purchase the same stocks that comprise the index in the same proportions. No one is paid to do research or make decisions, and since index composition changes rarely, transaction costs are low.

The debate hinges on two questions:

- Do active managers chose better stocks for their funds, causing the funds to generate higher returns?
- Do the higher fees that result from paying the managers and making more transactions effectively obliterate the higher returns?

The answers are not consistent from year to year or across different fund comparisons. However, historical performance demonstrates that active management only generates excess returns—that is, returns beyond what a comparative index generates--in SOME years. Despite this, as an investor, you are still assessed the higher fees EVERY year. So, the probability of getting higher returns from your active investments varies from year to year, but the probability of paying higher fees on those investments is 100% every year. I'll let you draw your own conclusions.

MISTAKE # 2

FAILING TO CONSIDER FEES

Admittedly, reading a mutual fund prospectus can be less easily enlightening than reading your auto manual, but happily, Morningstar and other reporting services put fees and other information on the Internet. Or, you can just ask your financial professional for a one-pager on each fund.

If your money is managed or advised by someone other than you, you also have to consider management fees. Money management is a service and you should pay something for it since it frees up your time to get paid to do something else. But make sure you are getting something in return for the fee. Compare rates and services. Do not confuse investment or money management with financial planning. Investment management is a process of selecting a portfolio of investments that are suitable for you and advising you when to buy or sell parts of that portfolio, based largely on external circumstances. Financial planning is a much more comprehensive process of defining multiple and often interdependent financial goals and developing, implementing and monitoring strategies to reach them, according to both your personal circumstances and external circumstances. Make sure you know which one you are paying for and which one you are getting.

For those who invest in individual stocks and bonds, the question there comes down to transaction costs. Go with a low-cost brokerage. Although these days, competing companies are bidding each other down, so this is less and less of an issue.

MISTAKE # 3

TIMING THE MARKET

Regardless of whether your advisor is a money manager or a financial planner, and regardless of the nature of that person's compensation, one of your advisor's tasks should be preventing you from trying to time the market.

I say "trying" because no one is actually able to do it.

Timing the market means buying just before the market rises and/or selling right before it declines.

There is a myriad of factors that cause market movement. Some are rational, some are not. Some can be analyzed to a certain extent, and some cannot. However, NONE can be predicted with frequent-enough accuracy for market timing to succeed more than it fails. In addition to the likelihood that you will "miss the window" to time the market, attempting to do it will generate unnecessary transaction costs. Particularly with the growing volume of robo-trading, engineered by super-computes, the market frequently moves too fast. Once you notice the direction, it's often too late to benefit from following it.

Over the long run, the stock market will go up. In the short run, it will have varying degrees of up-and-down volatility. Buy-and-hold, as tired as it seems, really is the most efficient way to go. Periodic rebalancing will keep your portfolio mix in suitable proportion, but the rebalancing should take place according to pre-set considerations rather than the market's bull or bear sentiment.

MISTAKE # 4

IGNORING LIQUIDITY

Probably every financial professional has had the client that either comes with investments that are not commonly traded securities (stocks and bonds or mutual/index/exchange-traded funds comprising stocks and bonds) or expresses a strong interest in them. Such investments include everything from real estate to energy sources to livestock and commodities to crypto-currencies (such as Bitcoin) to antiques, collectibles and art.

Unless you or your advisor happens to have professional experience in the relevant industry, it can be very difficult to accurately assess these investments in terms of risk versus reward—in other words, are the possible returns you might get on this investment a good trade off for what you could lose from this investment? One criteria, though, is very easy to investigate and ought to play an enormous part in the decision to purchase any investment. That is: Liquidity.

Suppose you have two children. You don't like or trust the stock market, but you have a fondness for real estate. So, you purchase two investment properties. Your plan is to sell the properties as each of your children approaches college age, and to use the properties to fund their higher education. The potential pitfall to this strategy is not just that the local real estate market might take a downturn. The same thing could happen with the stock market. But in the event of a downturn, real estate can be much more difficult to sell than securities. Even in a good market, it can take months to sell a highly desirable property after inspections and showings. And although you can liquidate a security portfolio gradually, giving the market at least some chance to recover, you generally cannot sell just part of a building.

Many of us have had the experience of purchasing collectibles—coins, figurines, stamps, baseball or Pokémon cards, porcelain dolls, vintage toys or Beanie Babies® to name a few—with the expectation that the price will rise and that there will always be a ready market, only to find the popularity of and interest in the item dropping off a cliff and prospective buyers vanishing into thin air. An investment is only valuable if someone is willing to buy it from you for the cash you need to pay for you children's education or your own retirement or long-term care. Ebay and Amazon can greatly broaden your potential customer base, but even these sites cannot create a market, and liquidity, for something that no one wants anymore.

MISTAKE # 5

FAILING TO UNDERSTAND THE PRODUCT

Annuities are a lot like certain sports teams or politicians in that many people either love them or hate them with either emotion taken to the extreme, so I'm using this as my product example. There probably are some really bad annuities out there. But for the most part, annuities are not intrinsically good or bad. What they ARE is misunderstood. Annuities are basically an investment wrapped in insurance. To the best of its corporate ability, an insurance company guarantees you, the annuity owner, some aspect of your investment; for example, how much it will earn, how long it will last, or the maximum that it can decline. Your homeowners, auto, health and life insurance are not free. So, neither is this insurance on your investment. Annuities do certain things that other investments don't or can't.

If you want to make sure your money lasts a long as you do, an annuity can do that. If you want to make sure that your principal will stay intact or that your heirs will get a certain amount of money, an annuity can do that. If you want to find a way to defer taxes after you've maxed out your retirement plans, an annuity can do that too. However, there is a charge for each of these features. And generally, there's a charge for not holding the annuity for a certain minimum period. Annuities are not truly liquidity-challenged as discussed above. You can get your money out at any time, but you may pay a hefty charge to do so.

MISTAKE # 5

FAILING TO UNDERSTAND THE PRODUCT

Annuities, permanent life insurance, financial derivatives (options, swaps, collateralized debt and the like) and Master Limited Partnerships (MLPs) are just some of the more complicated investments available. Each of them serves a kind of need and sometimes the need is the kind you have.

To avoid mistakes you need to be sure:

- What the investment does.
- Whether you need or can benefit from what the investment does.
- How much it will cost you to meet that need or obtain that benefit.

Another of Aesop's fables is "Belling the Cat". Certainly, if you are a mouse, tying the bell on the cat represents an excellent investment. But what is the cost of approaching the cat to tie the bell...?