

# **The Top 10 Investor Mistakes And How To Avoid Them**

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**THE MDE GROUP, INC.**

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## Introduction

With the New Year now upon us, investors and investment advisors alike are inundated with “Top Ten” lists of almost every stripe attempting to foretell the events of the coming year. As we know from past experience, these lists generally tend to make good cocktail party conversation, but tend to add little strategic value since most advisors’ crystal balls tend to be a little rusty after much reveling during the holiday season. Our goal in writing this “Top Ten” list is not to add to the clutter and noise manufactured by the others. Rather, our goal is to provide a level of insight into investor psychology that may lead to some serious introspection by both investors and their advisors as to how they emotionally react to external events in making investment decisions. Our hope is that this introspection leads to some change in investor psychology that in turns leads to a more rational investment process.

After decades of blindly following so called “efficient market” investment models, the financial establishment only recently has begun to formally acknowledge what many investors have always known. Namely, a wealth management model based on the assumptions of perfect market and investor rationality often does a poor job meeting the needs of clients. Over the past few years, the trend has accelerated triggered by the findings of a relatively new school of thought known as behavioral finance or investor psychology. Perhaps the ultimate imprimatur related to behavioral finance occurred in 2002, when the Nobel Memorial Prize in Economic Sciences was co-awarded to Daniel Kahneman, of Princeton University, for his pioneering work in investor psychology.

World-class wealth management is a two-way street. Both client and firm must work hand-in-hand to achieve the client’s goals. The behavioral finance literature documents a number of investor biases or mistakes that investors repeatedly make. As wealth management advisors, it is our responsibility to correct our own mistakes and to educate our clients of their own biases. For example, over the past five years The MDE Group, Inc. has moved away from the highly rigid and backward looking Harry Markowitz who inspired the Efficient Frontier model that quantitatively tries to maximize returns for a given level of risk. Although the approach may make sense in a purely rational world, it often breaks down during times of market distress. This is precisely the time when our clients need it to work the most – where emotion rules over logic. Instead, The MDE Group has evolved into a forward thinking and backward mindful organization that combines various quantitative risk metrics with the collective wisdom of our six-person Investment Committee.

There have been dozens, if not hundreds, of investor mistakes or biases documented in the behavioral finance literature. Below, we list ten mistakes that we believe are particularly common and important. Our goal in reviewing these mistakes is to formulate a logical and consistent approach to wealth management grounded in reality and one that can withstand market shocks often exacerbated by irrationality, fear, and panic.

**10. Holding Losing Investments Too Long:** Many investors refuse to sell a losing investment to avoid turning a mistake into a realized loss. In most cases, realizing capital losses is the wise thing to do.

**9. Selling Winning Investments Too Soon:** Imagine purchasing Microsoft in 1986 only to sell it in 1987 for a moderate gain. As long as the fundamentals and news flow remains positive it generally pays to hold the investment and defer the capital gains tax.

**8. Hindsight (Is 20/20) Bias:** Consider the following portfolio culled from *Fortune’s* 1999 “Most Admired American Companies” list: Enron, WorldCom, Lucent, Tyco, Merck, Schering Plough, Rubbermaid. Investing in a portfolio of these “admired” companies would have turned out to be a disastrous investment in subsequent years.

The key point is that making an investment decision in a real-time setting is difficult, but many investors assume, after the fact, that an investment outcome (e.g. growth and crash of Internet stocks) was obvious at the time the decision was made.

7. **Confusing Price With Value:** Many investors assume that if an investment is down sharply from its fifty-two week or all-time high then it must be a good value. Due to changing fundamentals or investor irrational exuberance, many investments may never return to their prior heights. Each investment should be re-evaluated on a regular basis to ensure that the reasons for initial purchase remain valid.

6. **Fooled By Framing:** Investors often have problems seeing the “net” result of an investment and are often fooled or distracted by its components. A common example is many investors believe the coupon rate on a bond is its expected return while in actuality the “yield to worst,” (i.e. the lower of yield to call or yield to maturity) on the bond is the better estimate of future returns.

5. **Chasing Performance Or The “Hot Hand” Fallacy:** Statisticians will tell you it takes many years to distinguish luck from skill. Nevertheless, many investors are swayed by a short-term track record. In all likelihood, truly outstanding performance is difficult to replicate since the conditions that helped generate that performance rarely repeat themselves.

4. **Overreacting To Short-Term Events:** Many investors talk long-term, but act short-term. The end result is often damage to the integrity of a long-term financial plan and the purchase or sale of an investment at the worst possible time.

3. **Focusing On Pre-Tax, Not After-Tax Returns:** Taxes are the highest transaction cost for high net worth investors. It is not what you make, but rather what you *keep* that matters most.

2. **Failure To Consider A Holistic Financial Plan:** Many investors consider each investment account (e.g. 401k, trusts, family partnerships) in isolation while a holistic plan may reduce risk, maximize after-tax returns, and stand the test of time.

1. **Desiring Absolute Returns During Bear Markets And Relative Returns During Bull Markets:** Although it would be wonderful to find a manager who always outperforms and never loses money, in reality a compromise must be reached. Managers that deliver consistent returns with low risk often cannot compete with the market averages when they are up in excess of 20% per year. In contrast, it may be unrealistic to expect a manager to return 40% during a bull market and to lose nothing during a bear market. A combination of both types of managers may be the best solution for most client portfolios.

## Conclusion

If you recognize some of these traits in your investing approach then you are far from alone. Our goal at The MDE Group, Inc. is to build customized wealth management strategies for our clients that stand the test of time. Accordingly, knowledge of the latest research on investor psychology helps us build value added and durable strategic plans for the real world, while much of the industry continues to cling to an outdated approach developed in an ivory tower.