

## INVESTMENTS

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# NO MORE INVESTING MISTAKES

Don't fret about daily ups and downs — and be sure to diversify

BY RUSSEL KINNEL

I talk with investors almost every day, and over time the same themes emerge. Although they cover the gamut of sophistication levels, I hear the same mistakes over and over again. So, to help save you from repeating the same mistakes and losing a lot of money, I've jotted down 20 of the most common investing mistakes.

## MISTAKE 1: Reacting to short-term returns

Every day, people go to their online 401(k) accounts and sell the fund with the worst one-year returns and buy the one with the best one-year returns. It makes them feel better, and they will tell you that the new fund is ahead of the curve and run by a smart manager, and the old one has lost its touch. What they won't say is that they are buying high and selling low. Nor will they say that short-term returns are just noise. You are better off buying funds with lagging short-term performance than those with top-quartile returns.

## MISTAKE 2: Basing sell decision on cost basis

You bought fund A at \$10 and now its net asset value is at \$5. You bought fund B at \$10 and now it's at \$20. Which should you hold, and which should you sell? I have no idea. The amount you paid is relevant only to tax planning. What matters is which will have better returns over your investment horizon. If the answer is fund B, then sell fund A (you'll have a tax benefit if it's in a taxable account) and put the proceeds in fund B. The problem is that people have an emotional attachment to the price. Some are afraid to book losses, and others are too anxious to sell a winner for fear that they'll miss out on gains. What matters is whether the funds have strong fundamentals.

## MISTAKE 3: Selling after the market falls

The short-term direction of the stock market is unpredictable, yet selling in reaction to market moves implies that you can predict short-term moves. What we fail to account for is that the market's price in the same news that we are hearing — often before we hear it. The markets are not perfectly efficient from minute to minute, but they quickly reflect a best guess based on new information. Fear is one of the greatest enemies of successful investing. When you're worried about your money, you want to make it safe. However, you risk missing out on the next rally, and you might not even keep pace with inflation. From a long-term perspective, cash is very risky and stocks are low risk.

## MISTAKE 4: Accumulating too many niche funds

We get mailings all the time telling

us about hot new investments. In 2007, commodity funds and BRIC (Brazil, Russia, India and China) funds were the rage and the timing turned out to be terrible. These specialist funds are exciting and fun to buy, but they will mess up your portfolio if you let them. Most niche funds charge more than more-diversified funds, and they typically have third-tier managers and less analyst support. Yet you can get the same exposure to sectors and regions through more-diversified funds. Niche funds drive up your costs, add extra volatility and make managing your portfolio more difficult.

## MISTAKE 5: Failing to build an overall plan

This is a biggie. Spend a little time to spell out your goals, how you'll meet them and the role of each investment. This is an enormous help in figuring out how to get to your goals and how to adapt along the way. Make a little plan, and your day-to-day investment decisions will become easier and less stressful.

## MISTAKE 6: Failing to write down your reasons for buying and selling

Once you've got your plan, spell out why you own each investment and what would lead you to sell. For example, you could say that you own a focused equity fund as a long-term 20-year investment for its manager and its moderate costs. You'd sell if the manager left, costs were raised or asset bloat forced a change in strategy. If you have doubts about the fund in the future, you can turn to that document when you may well have forgotten what the draw was in the first place.

## MISTAKE 7: Ignoring costs

Expense ratios matter across the board. Most of the best managers work for low-cost funds. So, don't listen to the siren song of a high-cost mutual fund or hedge fund. Results won't live up to expectations. Expense ratios are the best predictor of future performance.

## MISTAKE 8: Making things needlessly complex

Wall Street works overtime to sell the message that investing is complicated, messy stuff that you couldn't possibly undertake on your own. Is it any wonder that so many investors are paralyzed with fear and indecision? There are a handful of investors who have delivered tremendous returns by using swashbuckling investment strategies and zooming in and out of arcane investments. For the rest of us mortals, though, buying and holding a portfolio composed of plain vanilla stocks and bonds — with perhaps a dash of a "diversifier" such as commodities or real estate — is more than adequate to help us reach our goals.

## MISTAKE 9: Not understanding the risks

Narrowly focusing on recent returns can blind investors to risks. If a fund has a long track record, you can easily get

a handle on risk by looking at annual returns. In a bad year, the stock market can lose 30 percent or more. In a bad three-year period, it can lose 60 percent. It's reasonable to assume that nearly any stock fund can do at least that badly. This is why stocks are for 10- or 20-year time horizons or longer. If you know that going in, you stand a much better chance of earning a healthy return. Most bond funds can lose 5 percent or 10 percent in a year. If they have long maturity or own mostly junk-quality bonds, you can double those losses or more.

## MISTAKE 10: Not diversifying properly

The 2008 bear market punished financials the most, while energy fared best. Large growth got crushed in 2000–02, and small-value stocks as well as bonds held up like champs. Every down period is different, so be sure to diversify between stocks and bonds, between foreign and domestic and among sectors. The key is to have meaningful exposure to a lot of areas and to build up your core.

## MISTAKE 11: Not saving enough

I'd encourage you to preach the benefits of early saving to relatives and friends in their 20s or 30s. If they make regular contributions to their 401(k) and IRA accounts, reaching their goals will be quite manageable. If they don't, they better make a killing or they'll be behind the eight ball.

## MISTAKE 12: Failing to rebalance

My 401(k) plan has a tool that automatically rebalances my investments for me. When the markets really move, your portfolio can go off-kilter and mess up your nicely laid plan. Rebalance yearly so that you'll be buying low and selling high.

## MISTAKE 13: Failing to factor taxes into portfolio decisions

Like expenses, taxes play a huge role in your long-term success, but they're no fun. So a lot of people ignore them with the hope that their funds will make such big returns that taxes won't matter. There's a better way to think about it. Simply putting less-efficient investments in tax-sheltered accounts and more-efficient ones in taxable accounts will pay off in a big way. In addition, when you're shopping for a new fund for a taxable account be sure to look for those that should be efficient, such as tax-managed funds, index funds, low-turn-over actively managed funds and, of course, municipal-bond funds.

## MISTAKE 14: Not building up a sufficient money market position

Morningstar managers recommend that you have six to 12 months' worth of living expenses in a money market or other cash-type account. There's no substitute for money market funds. This emergency stash is vital in case you lose your job or have another emergency, such as unexpected home repairs. In addition, it will make market downturns less stressful.

## MISTAKE 15: Ignoring costs in money market funds

When interest rates rise, many fund companies will resume charging high expenses on money market funds because investors don't pay attention. So, go with Vanguard, Fidelity or someone else who charges low costs to manage your cash

## MISTAKE 16: Failing to look at the big picture across accounts

Economist Roger Ibbotson, chairman and CIO of Zebra Capital Management, argues: Investors tend to view each investment and each account — 401(k), IRA, college-savings account, etc. — in isolation rather than in aggregate. Trying to make every investment a winner can throw off the overarching asset allocation. It also can lead an investor to chase hot stocks, trade excessively and sell at the wrong time. If all of an investor's accounts and individual investments are up at the same time, he should be alarmed. It's a sign that he may be under-diversified and taking on too much risk.

## MISTAKE 17: Misreading your own abilities

People who treat gambling addicts say that it's the big winning bet that hooks gamblers. Fund investors can be a little like that. They remember that one time they accurately called the direction of the market or picked a sector fund, and they forget all the times their calls were off. Go back over your past investments. See what went well and figure out a solution for the areas where you didn't do well.

## MISTAKE 18: Focusing on the fund instead of the manager

The fact that previous managers did well or poorly is rarely relevant unless it reflects institutional strength or weakness. Examine the current manager's record.

## MISTAKE 19: Ignoring the fund company behind the fund

You may like a fund, but if the fund company has mostly lousy investors, a record of sticking it to fundholders, or both, you may pay the price in the end. Over a long time horizon, bad things happen to good funds at bad fund companies and mediocre funds at the best fund companies are more likely to turn things around.

## MISTAKE 20: Worrying about daily ups and downs

Don't get stressed watching business TV or tracking the market online. Those activities are exciting and often informative but not always helpful for long-term investors. All those ups and downs have no bearing on your long-term goals. Warren Buffett, one of the most successful investors of all time, advocates buying stocks you feel so strongly about that you wouldn't care if the stock market took a two-year holiday. The same goes for funds. Buy them and tune out the noise.

Russel Kinnel is director of manager research for Morningstar and editor of Morningstar FundInvestor, a monthly newsletter.