Part I

Why Some Succeed and Many Fail

Chapter ONE

Why Investors Fail

If you don't profit from your mistakes, someone else will.

—Yale Hirsch

Investing isn't terribly difficult, but it's a specialized area that requires careful navigation. A huge industry has evolved to use a multitude of clever ways to separate people from part of their retirement savings without necessarily providing much benefit in return. In simple terms, this means that neither your broker nor any of the array of experts on Wall Street is necessarily your friend or even on your side.

Think of investing as a journey. You start at one place and head for another. If you want to drive from California to Michigan quickly and painlessly, there are relatively few choices that make sense. Most will probably draw heavily on the interstate highways. But imagine how hard it would be to plan such a trip if sales forces for several hundred competing highways were giving you tantalizing promises, saying they could get you there better and faster if you would just choose their routes.

Investing is a little bit like that: The best route may be efficient but boring. But along the way there are hundreds of distractions and opportunities to get you off the track. Most investors have a tough time making good investment decisions. They don't have the training or the knowledge. The difficulty of understanding all the options sometimes appears greater than the benefits of doing so. As a result, somewhere along the way almost every investor makes at least one serious mistake. Some never seem to stop making mistakes.

In this chapter we'll look at some of the more serious ways that typical investors work against their own interests. Investors procrastinate or remain passive when the circumstances call for action. They ignore the effects of taxes and expenses. They don't think about their long-term and short-term goals in a clear, organized way. They don't have a written plan for how to get from where they are to where they're going. (Think of it as a road map. If you leave it at home, it's no help.)

Most investors occasionally take way too much risk. Sometimes they don't take nearly as much risk as they should. Investors pay too much of their hard-earned savings to other people who are not necessarily on their side. Too many investors act as if they think smiling salespeople are their friends. They put too much faith in institutions, as if they believe big companies are organized for their customers' benefit. They put too much faith in what they see on financial television, hear on the radio, and read in financial publications. In doing this, they fail to distinguish between facts (which can be very useful) and interpretation, persuasion, and marketing.

Without getting any particular benefit in return, too many investors give up liquidity, making it costly and inconvenient to get their money back when they need it. They have unrealistic expectations and treat investing as a competitive sport. They take investment advice or tips from strangers or amateurs. They invest in ways that fill their emotional needs instead of their financial ones. Thus, they give in to fear and greed, arguably the two most powerful forces on Wall Street. They put their money into investments they don't understand, leading to grief, loss, and disillusionment that sometimes prompts them to give up altogether.

Collectively, that's the bad news. Whew!

The good news is that investing does not have to be that hard. This book will show you precisely how to overcome all those hurdles and how to draw up a road map that's right for you. You'll learn how to implement that plan so that good investment decisions become automatic—instead of random events that happen by luck.

Investing is about taking risks. When you risk your capital, you are entitled to expect a fair return commensurate with the level of risk you take. But if you're not careful, your own mistakes can prevent you from achieving the return that should be yours.

When I meet with a new client, one of the first things we talk about is risk. It's a topic that most of the industry (and most investors) would be happy to avoid altogether. But investors who don't understand risk cannot understand the choices they must make as investors. You'll find numerous references to risks in this book, because it is a critical topic.

Imagine you are in a bank applying for a loan. Suddenly you realize that right at the next desk, Bill Gates is also applying for a loan. Who do you think the bank would rather lend money to? Bill, of course! Don't take it personally, but the bank would always rather lend its money to Bill than to you because there is simply no question about his ability to pay the money back. He's as close to a risk-free, perfect borrower as the bank could wish for. But it's not quite that simple. Bill Gates is not the sort of person who would hesitate to take advantage of his position. If he told the bank he wouldn't pay more than 5 percent interest, and if you were willing to pay 10 percent interest, what do you think the bank would do?

In this case, the bank is in the same position as an investor. It can lend money to Bill and earn 5 percent in a risk-free transaction. Or it can lend money to you and collect twice as much. Obviously the bank would like the extra interest, but how reliable are you? Here's the rub, because the bank can't ever know for sure.

Therefore, the bank must decide if that extra return is worth the extra risk. And that is exactly the challenge that investors face. If you were the banker and you could make only one of those two loans, you'd have to tell your boss either "I turned down Bill Gates for a loan," or "I turned down an opportunity to make twice as much money." Which one would you choose? Would you make that decision on your own without consulting your boss? Probably not!

In real life, bankers have the benefit of institutional and personal experience. They have policies and committees and mentors. They don't have to make decisions like that by the seat of their pants. But much too often, individual investors make variations of this exact same decision without understanding the nature of what they are doing: taking risks that have real consequences.

I usually start my investing workshops by discussing a dozen or so common traps that investors get themselves into. Almost every investor makes at least a few of these mistakes, and I hope you won't feel there's anything wrong with you if some of them sound painfully familiar.

Mistake No. 1: *No written plan*

According to every study I have seen, people with written plans for their investments wind up with much more money during retirement than those who don't have written plans.

This important document should spell out your main assumptions about inflation, future investment returns, how much you'll save before you retire, when you will retire, the amount of money you'll count on from fixed sources such as pensions, Social Security, and perhaps part-time employment, as well as the amount that you'll need to withdraw from your portfolio in retirement. Your written plan should specify how you will make asset allocation choices and where you'll get professional help when you need it.

By the time you finish this book, you'll know the most important things that should be in your written plan. And to give you more specific help, we've put two articles on the web site for this book. One is called "Don't Have an Investment Plan? Start here." Another, written by Rachele Cawaring, is called "Make Your Life Easier with a Written Investment Policy."

Mistake No. 2: *Procrastination*

If you wait for the "right time" to get your investments organized or reorganized, the wait could ruin your results over a lifetime. Procrastination takes many forms. Some people don't start saving for retirement until it's nearly on top of them. Other people know they should review their investments yet always give priority to other things.

Some investors are sure they will catch up later. The irony is that the longer they wait, the less time they have. And time, as anybody who has studied compound interest tables knows, is an investor's best friend. Once you know what you need to do, every day you delay is a day of opportunity that you can never get back.

Mistake No. 3: *Taking too much risk*

In the late 1990s, some relatively inexperienced investors began to act as if they believed investment risk had become only a theoretical concept. But the three-year bear market of 2000 through 2002 was a rude wake-up call to all investors.

Most people understand at least in general that higher risks go along with higher returns. But too many investors act as if they are immune to risk. Or perhaps they believe they will somehow know when it's time to sell a risky investment they bought. Investors typically don't make any up-front effort to understand the nature of the risks they are taking when they make an investment. And they rarely have a plan for what they will do if things don't turn out the way they planned. People who take too much risk often wind up being speculators rather than investors. Savvy investors, on the other hand, pay a lot of attention to limiting and managing risks. If they speculate, they do so with money they know they can afford to lose.

Mistake No. 4: *Taking too little risk*

Some people are paranoid about losing any money at all. They want things nailed down, secure, guaranteed. The majority of money in 401(k) plans, at least until the great bull market of the late 1900s, was invested in guaranteed interest contracts, bonds, money market funds, and similar low-risk securities. Those choices give investors the illusion of short-term security—but in the long run, it's only an illusion.

Especially after the bear market of 2000 to 2002, it may seem important to avoid losses. But that risk is tiny compared with the gains you are likely to give up by avoiding equities. Very-low-risk investments always come packaged with low returns. If your emergency money is in a bank account paying 2 percent interest, you may think there's no risk. But in fact, you are taking the very real risk (in the long term it's a virtual certainty) that inflation and taxes will rob your money of some of its purchasing power.

If you're saving for retirement 25 years down the road, and you opt for a very conservative mix of investments that is expected to return 7 percent annually instead of an all-equity portfolio with an expected annual return of 12 percent, you may be massively short-changing yourself. After 25 years of contributions of $3,000 a year, a 7 percent portfolio will grow to $203,029. But invest the same capital at 12 percent and you will have more than twice as much: $448,002.

Mistake No. 5: *Trusting institutions*

I often ask participants in my workshops if they trust their banks. Most of them answer with a pretty firm "No!" Yet most of us still habitually act as if we believe our banks will tell us if we should move our money in some way that would be more beneficial to us.

You and your bank have a classic conflict of interest. Your best interests are served by an account that pays the highest interest along with penalty-free access to your money whenever you need it. Your bank's best interests are served by accounts that pay you little or no interest. Your bank also wants you to buy products on which it can earn sales commissions, like load mutual funds and various types of insurance.

It's even worse than that. Perhaps the single most profitable thing that banks do is bounce checks on overdrawn accounts. Bankers who work in branches (and thus deal with customers face to face) will be happy to help you manage your money so that you don't bounce checks. But if every checking account customer were bounce-free for a year, billions of dollars in profits would vanish—and some executives in bank headquarters would find themselves looking for jobs.

Because of these conflicts, it's a mistake to rely on a bank to tell you what's in your best interest. The same is true of brokerage houses and insurance companies, too.

Mistake No. 6: *Believing the media*

The headlines on the covers of financial magazines are often predictable: "The Six Best New Funds." "Found: The Next Microsoft." "Everyone's Getting Rich; Here's How to Get Your Share." (Those are actual examples.) The purpose of those headlines is to get you to dive into the contents enough so you'll buy the magazine and see the advertising within. We'll discuss this in more detail in Chapter 4. Here are a couple of high points.

Serious investors need textbooks more than hot ideas. But most people would rather have entertainment, and that's what broadcast outlets and financial publications provide. Writers and editors and publications follow fads. They write about what's in favor and what's in style. When the winds of popularity change, you can bet that they won't be far behind. The purpose of these articles is not to help you. The purpose of the articles is to get you to buy the publications.

The right way to read financial articles that tout specific mutual funds and stocks is to treat those articles as entertainment. The wrong way is to regard them as prescriptions for investment decisions you should make. If you remember that, you might easily save yourself 100 times the cover price of this book.

Mistake No. 7: *Failing to take small steps that can make big differences*

Far too many people fail to make their IRA contributions at the start of the calendar year. Others fail to make IRA contributions at all. They leave money in taxable accounts instead of sheltering it in retirement accounts. They don't maximize their opportunities for corporate matching money in 401(k) and similar plans. They have multiple small IRA accounts, paying annual fees for each one instead of consolidating these assets into a single account that can avoid such fees and make rebalancing easier.

Bank customers, spurred by laziness or inertia or thinking that it doesn't matter, don't move their money from checking accounts into money market deposit accounts. Others don't move their money from money market deposit accounts to nonbank money market funds where they can earn more interest. Each of these steps seems small by itself. Yet over a lifetime they can make a big difference—but only to people who act.

Mistake No. 8: *Buying illiquid financial products*

Liquidity is the ability to get your money back quickly without undue penalties. A stock is very liquid; you can turn it into cash whenever the market is open and you'll have your cash in a few days. Mutual funds are even more liquid, letting you have your cash the following day if you have set up electronic transfers into a bank account. Money market funds and many bond funds give you same-day access to your money by letting you write a check.

But liquidity is severely compromised when you invest in limited partnerships, for which there is often no market. Liquidity is also impaired with variable annuities and shares in load mutual funds that charge penalties for withdrawals made before certain waiting periods have expired.

Some people sink their rainy day savings into their homes by making extra principal payments on their mortgages. But when that rainy day comes along, the only way to "withdraw" that extra principal may be to refinance (a time-consuming, expensive process) or sell the home. (And if you're facing financial troubles, your refinancing prospects could be at a low point.)

Mistake No. 9: *Requiring perfection in order to be satisfied*

People who can't stand to have anything but "the best" solution seldom make successful investors. No matter where you put your money, there will always be something that's performing better than what you have. And if you're lucky enough to own the one fund that's doing better than everything else, you can be certain it won't remain that way for long. That's just the nature of this business.

Perfectionists often flit from one thing to the next, chasing elusive performance. In real life, you get a premium for risk only if you stay the course. If you demand perfect investments, you never will.

Mistake No. 10: *Accepting investment advice and referrals from amateurs*

If you had a serious illness, I hope you would consult a nurse or a doctor, not somebody on the street who happened to have an opinion or what you should do—or worse, somebody who had a product to sell you. I hope you would treat your life savings and your financial future with the same care as you'd treat your health. Sad to say, too many people make financial decisions based on things they hear casually. The lure of the "hot tip" is all but irresistible to some investors. But as painful as it is, there are no safe shortcuts to wealth.

A client once told me he had heard about a woman who "made a lot of money" for some of his friends. My client, normally a very conservative man, cashed in $250,000 of his portfolio and turned it over to this woman, who told him she would invest it in "a conservative strategy." Within two months, she had lost half his money. Only then did this client investigate enough to learn that she was not even licensed to do what she was doing. Her compensation was to be 20 percent of whatever profits he made. That gave her an incentive to generate big profits quickly. Unfortunately for my client, she had no disincentive to take big risks—because all the risks were his.

Mistake No. 11: *Letting emotions drive investment decisions*

The two most powerful forces that drive decisions on Wall Street are emotional: fear and greed. Think about this the next time you listen to a radio or television commentator explaining what's happening in the stock market. You'll hear echoes of fear and greed over and over.

Some investors fear rising interest rates; others fear falling interest rates. Some fear inflation while others welcome it. You name it, somebody's afraid of it. Fear is why so many investors bail out of carefully planned investment strategies when things look bleak. Investors sell en masse when prices are down; that reduces their profits or increases their losses.

Greed, likewise, blinds investors and makes them forget what they should know. In the last half of 1999 and the first half of 2000, greed prompted many investors to stuff their portfolios with high-flying technology stocks. But in the spring of 2000, most of those stocks plunged without warning. This quickly transformed many greedy investors into fearful investors.

The desire to make money is legitimate. But unless it is tempered with a healthy respect for risk, it turns into greed. Likewise, the desire to avoid or limit losses is legitimate. But when it is allowed to run amok, it turns into fear.

Mistake No 12: *Putting too much faith in short-term performance*

Many investors, especially inexperienced ones, spend far too much time and energy trying to forecast what essentially cannot be forecast: short-term performance. Worse, they give far too much credence to recent short-term performance. We tend to think that whatever just happened will continue to happen. Sometimes that's true, but a lot of the movement in the stock market is essentially random. That's one reason recent performance is a lousy predictor of future performance.

Mistake No. 13: *Overconfidence*

Many investors get into trouble when they start believing that they really know what they are doing. They become overconfident. There's an old saying on Wall Street to the effect that every 1 percent increase in a bull market makes investors think their IQs have gone up a point.

Many overconfident investors put too much of their money into a single stock or a single fund. Then they get emotionally attached, and their attachment takes on a life of its own. Investors' overconfidence tends to persist even when a favored investment starts heading downward. By the time such an investor is finally willing to admit that things have changed, he or she will probably have stayed much too long.

Mistake No. 14: *Focusing on the wrong things*

We'll talk a lot in this book about asset allocation, which is the choice of what kind of assets go into your portfolio. It's generally accepted that asset allocation accounts for more than 90 percent of investors' returns. That leaves less than 10 percent for choosing specific stocks and mutual funds—the very thing on which most investors spend almost all their time and energy.

Even when investors have properly allocated their portfolios, they can look at the wrong things. This happens when they focus on small parts of their portfolios instead of the whole package. They can become obsessed with a small investment that seems to stubbornly refuse to do its part during a bull market. In fact, it's normal and expected for investments to go down as well as up, even during a bull market. That's what makes it possible to "buy low," an essential part of buying low and selling high. But sometimes an enraged investor will overthrow an entire portfolio because of what happens to some small part of it.

This wouldn't be such a problem if investors had a better understanding of diversification. The whole point of diversification is to always have some things in a portfolio that "aren't working." That's because whatever is performing well at a given time won't necessarily continue to do so. And when that happens, you want some other asset class waiting in the wings to have its day in the sun, so to speak.

Mistake No. 15: *Needing proof before making a decision*

This is a variation of Mistakes No. 2, procrastination, and No. 9, requiring perfection. The ultimate stalling tactic for investors who aren't ready to make a move is to require one more piece of information or evidence. You can get evidence for just about any view of the market you want, but you cannot get proof. You can prove what happened in the past, but there's no way to prove anything about the future. It has always struck me as ironic that the main focus of mutual fund advertising is past performance, yet that's the one thing that the funds can't sell and investors can't buy.

If you must have certainty, stick to Treasury bills and certificates of deposit. If you're seeking returns higher than those, you will have to accept some uncertainty. The only certain thing about the future is that it won't look just like the past. Savvy investors who understand that will hedge their bets by diversifying. Remember, investors get paid to take calculated risks. They can't do that if they must know in advance how things are going to turn out.

Mistake No. 16: *Not knowing how to deal with the first 15 mistakes*

The cures for all these mistakes may seem obvious, but they are not necessarily easy. They boil down to education, discipline, and managing your emotions. Throughout this book you will find hundreds of ways that should help you do just that.

Here are a few thoughts right now, while all this investment carnage is fresh in your mind.

- Make sure you have a written investment plan—even if it's only on a single piece of paper—that outlines what you must do to achieve your long-term and short-term goals. Use specific measurable interim goals so you can keep track of your progress.
- Educate yourself. Finish this book and continue learning from the suggested reading list in the Appendix and from the article library on the web site for this book.
- If you don't understand an investment, don't put your money into it. I believe this single step will prevent more grief than almost anything else you can do.

- Sometimes the best course may be to simply slow down. Take a deep breath and apply a liberal dose of patience. It's probably the most underrated virtue I know in this fast-paced world.
- Finally, if you notice that emotions are driving your decisions, substitute a discipline. If you have trouble finding or implementing a proper discipline, consider professional investment advice or money management.

In the end, the best one-word prescription for avoiding most mistakes is diversification.