7 Common Investing Mistakes

by Steve Raymond and Leonard Simpson

When clients come to us to review their investment portfolios, we see a few common mistakes that may have unintended consequences. Here are the most common mistakes we see.

Waiting too long to start investing

Albert Einstein is quoted as saying, "The most powerful force in the universe is compound interest." Most people don't realize just how powerful compound interest is. For example, assume a 25-year-old saves $200 per month for 10 years (a total of $24,000) and nothing more through age 65. If he earns an average of 8% compound interest, he will accumulate over $400,000. If the same person waits until age 35 to start contributing $200 per month, and continues to save the same amount every month until age 65 (a total of $72,000), he will only accumulate about $298,000—even though he contributed three times as much money as the person who started at age 25. That is the power of compound interest!

Neglecting your investments (not reviewing them)

Over time, even a well-designed portfolio can become inappropriate if it is not reviewed periodically. For example, if the stock market performs unusually poorly (think 2008-09), your portfolio can become more conservative than you had intended. Similarly, if your income increases substantially over the years, your portfolio might not be as tax-efficient as it could be. We suggest that you take a quick look at your portfolio at least quarterly, and review it thoroughly at least annually.

Diversification

By diversifying a portfolio, you can reduce the risk—or volatility—of your portfolio. Holding investments in many different industries, companies, countries and asset classes helps protect you from fluctuations in any one part of the global economy. If your portfolio is concentrated in a few securities, you may experience more volatility than you expect, and that may cause you to make emotional decisions. For example, investing a fraction of one percent of a portfolio in Enron or Worldcom (as they failed) would have done much less damage than if 10% or more of your portfolio was invested in one of those stocks.

Asset allocation

Different asset classes, (think "stocks" or "bonds") can have different performance characteristics in any given time period. Riskier asset classes, like small cap stocks may have a higher rate of return over the long term, but may also experience much more volatility. On the other hand, short term government bonds are typically more stable, but have a lower rate of return. Other asset classes include real estate, commodities and collectibles.

Because some asset classes may go up when others are going down, it is possible to smooth out the returns of a portfolio by using multiple asset classes. An effective asset allocation strategy may spread a portfolio over a number of asset classes in an attempt to minimize the volatility of a portfolio while maintaining a target rate of return over a period of time.

Not having (or following) a plan

Every year, Dalbar releases a report called the "Quantitative Analysis of Investor Behavior", which consistently shows that investors underperform the underlying markets they invest in. The primary reason for investor underperformance is that they trade in and out of their investments at the wrong time. Whether the switching is due to emotional reasons, dissatisfaction with investment performance, or some other reason, one thing is very clear: many investors do not have a disciplined approach to investing, and do not follow a long term plan.

Your long term plan should take into consideration your time horizon (when will you need to spend the money), risk tolerance, resources available and income needs. Take time to think about your plan before building your investment portfolio, and then stick with it.

Fees

It is wise to seek out advisors and investment products with reasonable fees. However, don't make low fees your primary concern. Over time, high fees can drastically cut your overall return. But sometimes the fees are worth paying. For example, if you need guaranteed monthly income no matter what the stock market does, the high fees and expenses of an annuity may be worth paying. The message here is simple but not necessarily easy to follow: look for low cost ways to implement your investment plan, but make sure you pay for (and get) the advice and features you need.

Taxes

Taxes on capital gains, interest income and dividends can reduce your total return substantially. Utilizing 401(k) plans, IRAs and Roth IRAs can help defer or eliminate some or all of those taxes. Using Index Mutual Funds and Exchange Traded Funds (ETFs) can also help reduce some of the taxes you will pay – or at least help you manage the timing of gains and losses. So take the time to learn which investment vehicles can help you manage your individual tax situation.

Conclusion

Start learning about investments, and saving money as soon as you can. And teach your children about money and investing as early as you can. It can make a huge difference.

There are many good books about the basics of investing. Make sure you put one or two of them on your reading list. But try to stay away from the gimmick "How to Make a Million in a Month" type of books. You should aim to provide yourself with the time tested methods of building your nest egg.

If you need help, there are plenty of honest and competent advisors ready and willing to help you. Don't be afraid to pick up the phone and call one.

Securities and investment advisory services offered through Ameritas Investment Corp. ("AIC"). Member FINRA/SIPC.
AIC and 20/20 Financial Advisers of Sacramento, L.L.C. are not affiliated.