CBS MarketWatch

The top 12 mistakes investors make

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Last Update: 4:12 PM ET Jun 18, 2004

SAN FRANCISCO (CBS.MW) -- Investors who've been buying and selling stocks for a few years like to think they know what they're doing. But we all make mistakes.

And some knock us flat more often than others: A false sense of being diversified and focusing too much on tax-avoidance are just two of the most common and costly investor errors, according to chartered financial analysts surveyed by the CFA Institute, which administers coursework and exams leading to the designation

Given the turbulent stock market of late, more investors are wondering which way's up, and that confusion can lead to even more problems.

"If someone is confused or concerned, they don't understand why they're not achieving investment success ... they don't recognize what the problem is," said Bob Bilkie, a chartered financial analyst and president of Sigma Investment Counselors in Southfield, Mich.

"You often don't even know that you're doing something until someone points it out," he said.

Here are the 12 mistakes represent our most common blind spots.

No. 1: Plan-less

Are you buying great companies, maintaining a diversified portfolio, being tax efficient? It's not enough.

Without a road map -- a.k.a. investment strategy -- you could be enjoying a meandering trip through the pasture lands, but never realize you're miserably lost.

"If you don't know where you're going, you're never going to get there," Bilkie said. First, figure out your objectives: Retirement, kids' college tuition, you name it.

Then determine your strategy. Say your objective is to retire in 10 years, and you need your portfolio to produce $20,000 in cash flow for living expenses.

"Most professionals use a rule of 5 percent spending. If you need $20,000 in cash flow, you need $400,000 in assets to produce that cash flow. You need to save and invest to get to $400,000 within the next 10 years," Bilkie said.

"The way you get there is your strategy. You might say 'I'm going to put my money in a coffee can in the backyard.' Then you have to get four $100,000 bills in that can in those 10 years, and that's your strategy."

No. 2: False sense of diversification

Most investors know the problem of focusing too heavily in any one industry, but few realize that the heady feeling of diversification gleaned from mutual funds is often false.

"If you own fund A, fund B and fund C, and effectively they're the same funds because their top 10

holdings are more or less the same, then you're not diversified," said Brian Breidenbach, a chartered financial analyst and managing principal of Breidenbach Capital Consulting, in Louisville, Ky.

"You can think 'I've got this great diversification when really you don't have diversification at all," he said.

Many 401(k) plans compound the problem by offering "several large-cap mutual funds, and they might have only one small-cap option," Breidenbach said. "It doesn't help the participants much to have three identical asset-class-type funds."

But owning a broad array of funds may come with its own problems, Bilkie said.

"If they want to buy several different funds -- a small-cap value fund and a small-cap growth fund, and a midcap and a large cap -- eventually they're going to be replicating the structure of the Wilshire 5000," Bilkie said, referring to the index measuring equity performance of nearly all U.S. companies.

"Rather than buying all those funds, just buy the Wilshire 5000. You'll save 80 points in management fees. Vanguard Total Market fund (VTSMX) is basically the Wilshire 5000 -- you're going to have the same diversification at a fraction of the cost."

Over-diversification is another potential mistake. "There is an optimal point of diversification with regard to the number of stocks you own," Bilkie said.

Above that number, "the transaction costs and the costs of following those (stocks) outweigh the diversification benefits."

What's the ideal number of stocks? That varies by expert. For his part, Bilkie said about 200 stocks represents optimal diversification.

"Within that 200 you'll want to cover the smaller stocks, the middle-size companies (and) the large-cap stocks, as well as the growth and value-oriented companies."

No. 3: Investing in stocks, not companies

For some investors, that feeling of "I love this product" inspires cash outlays in a company's stock, while others abide by technical charts.

"I've seen people that just look at charts. They don't know and they don't care what the companies do," Bilkie said.

"That's fraught with peril (because) you don't then have an opportunity to think independently and critically about whether the pattern you've observed on the chart can reasonably be sustained."

For instance, an egg-packaging company has surged recently because of the low-carb craze, Bilkie said. "It would be folly to expect that rate of increase in the consumption of eggs to continue into the future, but if you were just investing based on the chart, you might buy that stock."

To assess a company, do the work. Professional investors look at price/earnings ratios, sales growth, earnings growth and profit margins. They study balance sheets and assess industry competition.

Don't forget to look at the company's corporate-governance profile. "Make sure there's a sense of responsibility to shareholders on the part of the board," Bilkie said.

No. 4: Buying high

Investors know they shouldn't, but they do it nonetheless. "Every investor is predisposed to buy high and sell low," Bilkie said. "We tend to convince ourselves that the recent past represents the future."

Breidenbach agreed. People are "unfortunately probably psychologically wired to fail in this area. They gravitate to safe things," he said. But then "you've missed all the opportunity in that price appreciation."

Focus on a company's prospects for future performance, and leave the past to the historians.

No. 5: Selling low

Some investors bail at the first sign of bad news, when the company may well recover from its downward blip, while other low-sellers ride a company down its final death spiral, refusing to give up hope it will bounce back.

This is where your company research comes into play. "If you know the company, (you can) take the emotion out of everything," Breidenbach said.

But don't feel bad if you've made this mistake. Even the professionals have a hard time. "Knowing when to sell is the hardest aspect of investment management," Bilkie said.

That said, make sure you have an exit strategy for every stock you own. Some impose a "20-percent-drop-means-I-get-out" rule, but Bilkie said he assesses each stock individually. "You have to know what's in the band of normal outcomes on a daily trading basis."

No. 6: The churn factor

Many investors confuse trading activity with better performance, but that can be a costly mistake.

"The more you turn your investments over ... the more (transaction) cost is going to weigh on your performance return," Breidenbach said.

Instead, think of investments like a garden: Keep a close watch, but don't constantly dig. "If you go out every day and uncover the acorn to see how it's doing, you'll never get an oak tree," Bilkie said.

No. 7: Acting on tips and sound bites

Whether the source is your cab driver, your best friend or the newscast, remember the hot tip requires further investigation.

"Just because someone thinks it's a great company doesn't mean anything. They're not looking at the price inefficiencies or seeing what's in the drug pipeline," Breidenbach said.

No. 8: Paying too much in fees, commissions

Even institutional investors often fall prey to this mistake, Breidenbach said.

"Most people are not able to do a good comparison because the data is not presented in an apples-to-apples way," he said. "What may appear to be cheap on an operating-expense ratio isn't so cheap because maybe the actual commission is marked up in the security."

Remember, too, that "too much" will vary by investor, Bilkie said. "I may require much more handholding

and much more assistance ... so I should expect to pay more."

Some say 1.2 percent for financial advice is appropriate, Bilkie said, but "if you were doing all of the work, that's paying way too much. If, on the other hand, someone was giving you full advice and managing the portfolio for you, 1.2 percent is a fair rate."

No. 9: Tax-avoidance at any cost

Being tax efficient is one thing, but too many investors lose sight of the bigger picture: Their return. Here's an example to scare the most tax-savvy among us:

One of Breidenbach's clients held over $3 million in shares received after his company was bought. The client was afraid of steep capital-gains and alternative minimum tax costs, and refused to sell even after Breidenbach noted potential problems with the company going forward.

In a matter of months, the stock fell by half. "The $3 million holding became a $1.2 million," he said.

"Don't let tax be the only thing that drives you," he said. Put taxes in perspective: "It's a darn shame that you actually had to pay taxes because you were successful."

No. 10: Unrealistic expectations

A few years ago, investors were too optimistic and these days, pessimism reigns. Instead of see-sawing, investors should temper their enthusiasm as well as their black-cloud outlook, Bilkie said.

"Recognize that the market is cyclical and when it's going down it's not going down forever and when it's going up it's not going up forever."

To avoid unrealistic expectations, investors should learn how investments and securities markets work. Like any sport, if you don't know the rules, you're going to lose, Breidenbach said.

No. 11: Neglect

You may feel good that you're putting money into your IRA every month, but that's not enough.

Investors say "if I just buy it and put it away, I'll be all right," Breidenbach said. "You hear that a lot ... it's scary. You're just not going to get anywhere."

Instead, investors should conduct regular portfolio check-ups, at least every three or six months.

No. 12: Not knowing how much risk you can really bear

Investors usually think losing money will be easier than it really is. "If you have a $1 million portfolio and it goes down by 10 percent, most people say 'I can handle 10 percent,'" Breidenbach said, "but they don't realize they have $1 million dollars that went down to $900,000. People get upset when they lose money."

One dubious upside to the recent bear market? More investors have a clearer idea of their risk tolerance.

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