Reveals The Twelve Most Common Investment Mistakes That Separate You From Financial Security

Key Ideas

1. Discover how you can make more by risking less.
2. Reveals the dangerous deception hiding behind historical investment returns.
3. Shows you how “experts” can cause more harm than good.

Investment mistakes cost you money – that's why they must be avoided.

There are only two paths to gaining the experience necessary to know how to minimize investment mistakes:

1. **Smart Path**: by learning from other people's investment mistakes
2. **Expensive Path**: by making your own investment mistakes and learning from the school of hard knocks

"You must learn from the mistakes of others. You can't possibly live long enough to make them all yourself."– Sam Levenson

Frankly, I'm no masochist. I prefer the more efficient method of learning from other people's investment mistakes wherever possible.

Learning vicariously helps you avoid losses, which leaves more profits in your pocket and accelerates your journey to financial freedom.

For that reason, let's look at the top twelve investment mistakes gleaned from years of coaching experience so you don't have to pay the price of direct experience.

Investment Mistake Tip #1: Diversify, But Don't Diworsefy

Diversification is a valuable risk management tool, but only when used properly. Diversification only adds value when the new asset added has a different risk profile.

For example, when diversifying a U.S. stock portfolio, you may want to consider non-related markets like gold, gold stocks, real estate, bonds, commodities, and other asset classes that exhibit low or inverse correlation.

"Wise men profit more from fools than fools from wise men; for the wise men shun the mistakes of the fools, but fools don't imitate the successes of the wise."

– Cato the Elder

Diworsefying is adding more assets with a similar risk profile until your investment performance replicates the averages. For example, adding U.S. equity mutual funds to a diversified portfolio of U.S. stocks is di-worse-ification.

Your goal when diversifying should be to add independent and sometimes opposing sources of return. This can lower portfolio risk and possibly increase overall return when coupled with other investment techniques explained below.

Investment Mistake Tip #2: Don't Pick Stocks – Asset Allocation Is More Important

Multiple research studies agree that at least 90% of the variance in a diversified portfolio's returns are attributable to asset allocation.

What's surprising, however, is that most people mistakenly focus 90% of their efforts on the remaining 10% of return by trying to pick individual securities. It makes no sense.

"The ability to focus attention on important things is a defining characteristic of intelligence." – Robert J. Shiller

Don't make the mistake of spending all your time on the decisions that will make little difference in your overall performance.

Don't try to pick the next hot stock or top performing fund when the experts who live and breathe this stuff are consistent failures at the task.

Instead, spend your limited time and resources determining your correct allocation to asset classes and strategies, and you'll be putting Pareto's Law (the 80-20 rule where 80% of your results come from 20% of your efforts) to work for you.

Investment Mistake Tip #3: Don't Confuse Historical Returns With Future Expectations

Just because your investment advisor told you the average historical returns from the U.S. stock market are approximately 10% annually (or 7% or 8% depending on time period and whether adjusted for dividends and inflation) doesn't mean you should expect similar.

The future will likely be very different from historical averages, and your average holding period may not be long enough to replicate average returns.

For example, most long-term historical stock return studies use average holding periods of 30 years or more. Even if your investment career is 30 or 40 years, your average holding period will likely be less than half that length.

The bulk of your savings are usually accumulated late in your career and spent throughout retirement. Almost nobody begins investing at age 30 with a large lump-sum and retires at age 60 on that investment to create a 30 year holding period. Life doesn't work that way.

The result is you should expect far greater variability in expected returns than long-term averages would indicate.

Additionally, average returns are a statistical fiction that seldom exist in reality. According to Nassim Taleb, author of "Fooled by Randomness," the average return on the Dow Jones Industrial Average from 1900 to 2002 was 7.2%.

Only 5 of the 103 years had returns between 5% and 10%. Obviously, the "average" is far from typical.

"A reasonable probability is the only certainty." – E.W. Howe

Finally, long term averages may have little relevance to your current investment situation because the current investment environment may be anything but average.

For example, few investors are taught that their holding period returns for stocks are inversely correlated to valuations at the beginning of the holding period.

In other words, if stock valuations are higher than average when you begin investing, you should expect 7-15 year returns lower than average.

If stock valuations are lower than average when you start investing, then you can reasonably expect 7-15 year returns higher than average.

In short, the investment advice you receive about long term probabilities and average returns may have little or no relevance to the actual results you get.

Don't make the mistake of basing your investment plan on historical average returns – even if your investment time horizon is long-term.

If investing was that simple and obvious, then more people would be successful at it – but they aren't.

Investment Mistake Tip #4: Don't Invest Without a Plan

Don't make the mistake of spending more time planning your vacation than planning your financial future.

Numerous studies show that people who are methodical enough to create a written investment plan can expect to outperform their peers, not by just a few percentage points, but by multiples.

You must create a disciplined plan based on mathematical expectancy because anything less is gambling and not investing.

There are many different investment strategies that honor Expectancy Investing principles, but all of them require disciplined implementation over many years to assure that you come out a winner in the end.

That means you should never “invest” (read: gamble) on rumors, hot tips, stories, conjecture, future predictions, or an expectation the market will go up.

You must have a plan based on provable positive expectancy, and none of these approaches qualifies as a plan despite their widespread use and popular appeal.

Your financial security deserves better.

“Life is what happens to you while you’re busy making other plans.” – John Lennon

Investment Mistake Tip #5: Don’t Forget to Invest in Your Financial Education

You must learn before you can earn. Every investment you make in yourself will pay you dividends for a lifetime.

I often tell coaching clients that investing isn’t brain surgery. It’s far more complicated than that.

Investing done right is both an art and a science. For that reason, you must be wary of half-truths and oversimplification that don’t respect the inherent complication of the process.

Investing is an art because we’re emotional human beings masquerading as rational decisions makers.

Our decisions are affected by our values, moods, crowd psychology, previous experience, greed, and fear. Yet, we persist in the illusion that we invest logically.

"Education is a progressive discovery of our own ignorance." – Will Durant

Investing is also a science because it requires a proper strategy based on provable scientific principles like diversification, asset allocation, valuation, correlation, probability, and much more.

You must balance both the art and the science to become a consistently profitable investor. You must work on yourself to improve your decision-making process while also developing your knowledge of investment strategy.

That's why FinancialMentor.com's stated purpose is to build your financial intelligence so that you can build your wealth.

There's nothing more financially dangerous than an investor making a million dollars' worth of decisions with a thousand dollars' worth of financial intelligence

When it comes to investing, a little knowledge can be a dangerous thing, and a lot of knowledge can be a profitable thing.

So invest in your financial education. It will pay you dividends for a lifetime.

Investment Mistake Tip #6: Don't Forget to Match Investment Style with Personal Goals

Don't make the mistake of climbing the ladder to investment success only to discover it's leaning against the wrong wall.

There's no single right answer to investment strategy that will result in financial success for everyone, but there's one right answer that will be true for you.

Your job is to find the path that will honor your skills, resources, goals, values, and risk tolerances so that you experience personal success and fulfillment from achieving financial success.

Just because some seminar guru made his millions doing the "blah, blah, blah" strategy doesn't mean it's the right strategy for you.

Also, just because your financial advisor makes money by selling you paper assets (stocks, bonds, mutual funds, insurance, etc.) doesn't mean your personalized path to wealth won't include alternatives to paper assets such as real estate or building your own business. One size doesn't fit all.

Your journey to financial freedom is about discovering what size will uniquely fit you. (You can discover how to design your personalized plan for financial freedom here…)

Investment Mistake Tip #7: Don't Place Excessive Trust in "Experts"

Everybody has a conflict of interest with your wealth except you.

Investment institutions manage your money so they can charge fees, and financial advisors sell you products so they can earn commissions.

Similarly, the investment media seeks to maximize subscription and advertising revenue thus biasing editorial policy toward sizzle that sells rather than substance that serves.

The bottom line is your investment advice is coming from sources whose business objectives are focused on *their* wealth. Not yours.

Don't make the mistake of trusting the experts. You should always operate from the assumption that the investment advice you receive is biased.

> *"An economist is an expert who will know tomorrow why the things he predicted yesterday didn't happen today."* – Laurence J. Peter

To understand how bias creeps into your investment advice, simply look at how the source's pockets are lined. Know that where they stand limits what they see.

We all have biases. That includes you and me.

With that said, I also believe there are many well intentioned, honest, good people doing their absolute best to work with the limited knowledge and conflicting data that make up the investment world.

Most “experts” are confused by investing just like you, or if they’re confident, it’s because they’re blind to the humbling reality that the essence of investing is putting capital at risk into an unknowable future. Outcomes are always probabilistic at best because the future will always be unpredictable. Nobody ever truly knows what will happen, including the experts.

The result is you should never mistake professional opinions for fact just because they carry an air of expertise or come from a large institution.

Most experts are trained in a specific school of thought and don’t see outside of it.

There’s no single investment truth and anyone claiming to have it is proving that they don’t.

When you learn that there are many shapes and dimensions to the complexity of investment truth and stop believing the supposed experts, your healthy skepticism will bring you closer to consistent profits.

Investment Mistake Tip #8: Beware of Low Liquidity

A liquid investment is something that can readily be converted into cash, and an illiquid investment is something with barriers that keep it from being converted to cash.

Examples of liquid investments include United States Government Bonds and large, listed corporate stocks. Illiquid investments include some partnership interests, thinly traded stocks, and most real estate.

Looking back over my investment career, nearly all of my major losses and financial setbacks can be attributed to loss of liquidity.

The reason is simple: your ultimate risk management tool is to exit the investment to control losses, but inadequate liquidity can lock you into an investment causing losses to grow to unacceptable levels.

Never make the mistake of accepting low liquidity unless the potential reward is so great as to merit the additional risk.

Only give up liquidity when you have other risk management disciplines to control risk of loss for this investment.

Investment Mistake Tip #9: Beware of Excessive Conservatism or Risk Taking

The essence of the investment game is balancing risk with reward, and the better you get at risk management, the more reward you can pursue.

The high-flying tech stock or new issue investor is making the same mistake as the guy who solely invests in C.D.'s, U.S. Treasury bills, or bonds.

They're polar opposites of the same extreme thinking because neither has balanced risk with reward to maximize his long-term wealth.

Remember, a ship may be safest sitting in harbor, but that's not what ships were built for. Similarly, it's reckless to take a ship out of harbor when the "perfect storm" strikes.

You should invest aggressively when the reward merits the risk, and conserve capital by hiding in the safe harbor of cash equivalents when risk is excessive.

Always have an exit point for every investment so you can preserve capital when the perfect storm strikes.

Investment Mistake Tip #10: Don't Confuse Brains with a Bull Market

A rising tide lifts all boats. When the tide goes out is when you see who is standing naked in the water.

Don't mistake brains with a bull market just because you happen to be in the right place at the right time and made some good money through sheer luck.

"A smooth sea never made a skilled mariner." – English Proverb

The ability to conserve capital and even prosper when underlying market conditions are adverse is where you separate the novice from the skilled investor.

That means having a risk management discipline to manage losses to an acceptable level.

Investment results should only be viewed over the course of an entire market cycle because short-term results in one-way markets can lead to false conclusions.

Investment Mistake Tip #11: Don't Confuse Total Return with Value Added

When measuring investment results, don't make the mistake of looking solely at how much money you made.

The reason is because total return is a composite of market return, style return, and management skill. Looking at total return without separating the source of the return will cause false conclusions.

The real measure of investment skill is value added return, and that's determined by comparing total returns against an appropriate benchmark index over a full economic cycle. By doing this, you isolate style and market returns from management skill.

For example, a growth stock manager with annual compound returns of 25% could be a dud or a rock-star depending on whether the benchmark growth stock index gained 32% (value lost -7%) or lost 3% (value added +28%) over the same time period.

Conversely, your investment style might be inherently bull-biased to where you do well in risking markets but lose horribly in declining markets.

Performance over the full market cycle relative to an appropriate benchmark is how you determine investment skill and value added.

Investment Mistake Tip #12: Don't Focus Excessively on Expenses or Taxes

> *"The avoidance of taxes is the only intellectual pursuit that carries any reward."*
>
> – John Maynard Keynes

Don't make the mistake of never selling an investment because you don't want to pay taxes or fees. Conversely, you also shouldn't ignore the tax consequences.

Taxes and fees are just one factor (transaction expenses) to consider when analyzing how a transaction will impact overall portfolio performance.

Other factors to consider, which may take priority over tax and expense concerns, include risk control, asset allocation, expected reward, and many others.

The objective of investing is to maximize profits for any level of risk, with taxes and fees being only one component to that equation.

Whether or not you should pay taxes and fees by making a transaction will depend on how the transaction is expected to impact investment performance net of fees and taxes.

For example, many people thought I was nuts to sell my entire investment real estate portfolio in 2006 and pay a horrendous tax bill on the gains. By 2009, those same people realized the taxes paid were nothing compared to the losses and headaches avoided.

Oversimplifying the decision by looking at just one factor (transaction expenses) can lead to expensive mistakes. Balance is the key.

Bonus Tip #13 (Extra Bonus): Have Fun Investing

Have fun investing because wealth isn't a destination to be reached, but a journey to be enjoyed. It's a lifelong process that doesn't end until you're six feet under ground, so you might as well figure out how to enjoy the experience along the way.

Many people view investing as a chore. They labor over the numbers, get confused, and worry. Their investment results typically reflect this lack of enthusiasm.

I view the investment game as a big treasure hunt. It's like playing Monopoly for adults with real, live money where you get to make your own rules.

It's an adventure that's mentally stimulating and creates endless opportunities for personal growth while enhancing the quality of my life.

"We struggle with the complexities and avoid the simplicities."

– Norman Vincent Peale

The truth is that neither attitude is right or wrong, but one takes you toward financial success and the other moves you away. Which would you rather have: fun or frustration?

The choice is yours…

In Summary

In summary, it's a lot easier to enjoy the investment process when you learn how to avoid committing some of the most common and expensive investment mistakes.

Making money is more enjoyable than losing it.

Steering clear of just one of these deadly dozen investment mistakes can literally make the difference between wealth and poverty.

Direct experience has taught me each one of these investment mistakes the hard way, and I share them with you here in the hope you can take a less expensive route to the same knowledge.

If you have an investment mistake (or two) that I overlooked, please add it to the list in the comments section.

I look forward to hearing your thoughts….