Mistakes first-time investors make

2015-09-21

Investing in the stock market is a good way to plan for your future and the earlier you start, the more you will get out of it. Saying that, there are some common mistakes made by first-time investors that can reduce profits. The article would address a few of these mistakes.

Not having a plan

Successful stock market investors have a solid plan and they stick to it. New investors on the other hand tend to go blindly, like a boat without a compass and therefore get lost and stranded at sea.

A personal investment plan helps you to map your goals and objectives, your entry and exit points, the amount of capital you will invest in a certain trade, any potential risks, the maximum amount you are willing to lose and your plans to diversify your portfolio. With these details you will be able to invest with purpose, according to your own principles.

New investors who make a plan may also struggle to stick to it and change their course whenever the market dips or whenever an investment doesn't go exactly as they expected. Sticking to your plan will help you to navigate your portfolio even when times are tough. Not having one can cause you to flail out and make emotional decisions that are detrimental to your aims.

Know your appetite for risk

Another mistake first-time investors make is not thinking properly about 'risk' versus 'reward'. They tend to invest in riskier investments than they really have an appetite for. Then when the value of the riskier investment declines, they will panic and sell out of the investment.

If they had taken a more considered view of risk and reward, they would adopt investments that are more in line with their desire for risk and thus they would be less likely to sell out of their investments at the wrong time.

Investors must accept that markets are unpredictable Not accepting the simple fact that it is impossible to accurately predict what the market is going to do is a mistake made by many.

Could the market drop the day after you make an investment? Yes, but it could rise, as well. While professionals can tell you the factors that may cause the market to rise or fall, they can't tell you if the market will rise or fall. Everyone is working with a cracked crystal ball. The sooner you accept this reality, the better off your portfolio will be.

Certain investors might find periodic investing as a hedge against mitigating the aforementioned. This will reduce the timing risk of jumping in with two feet on a single day, while avoiding making a decision based on what you think the market will do.

Don't invest your emergency money!

The most common mistake is investing money in the market that should actually be kept in an emergency fund. Slightly differently, the mistake is investing money that you know you need to spend in the near to medium term.

Rule number one of investing is to make sure you can leave those funds in the market for at least five years (and 10 years is better). Here's an example: Suppose you've saved up money for a home on down payment. It's earning pretty much nothing in your savings account. You look at the market returns of year 'x' and think, "Well, if year 'y' is another good year I'd get to my down payment goal faster by being in the market." However, your logic is flawed because if y is a down year and your goal is to buy a home the year after, you've just set yourself back considerably.

While markets over the long run are driven by the underlying earnings growth and performance of the entities they represent, in the short run they are fuelled by excitement and fear—both of which can be quite unpredictable. This is why it's vital to be able to stay in the market long enough that the underlying long-run economics of the entities in which you are investing can trump the short-term human sentiments.

A related mistake is thinking that you can beat the market. Once you've identified the money you can afford to truly invest for the long run, diversify your portfolio.

Playing the guessing game

Playing the guessing game with your stock market investments is exactly the same as gambling. It is your ability to work with stock market data and other relevant channels of information that distinguishes the two.

A real investment is not made on speculation or on the basis of a rumour that you heard but on a valuable opportunity that you have researched and which looks like it will pay enough long-term profits to justify the risk.

New stock market investors tend not to do their homework very well, or at all. You should never take a stab in the dark with the stock market. Instead, try to gather and monitor enough data that you can start to make informed decisions about where you will invest your money.

Do your homework, stick to the plan and your investments just might pay off.

Not understanding risk

Every investment comes with a certain amount of risk. That is the nature of the stock market and of all investments. Newcomers often don't properly evaluate the risk of their investments or their own tolerance to that risk. This can cause them to make flamboyant moves with serious life savings that quickly land them in the dump.

On the other side of the coin, risk aversion can create a psychology of scared money, in which the first time investor is frightened to take an opportunity that looks lucrative because they don't want to risk the losses.

There are safe bets out there; investment options that come with very little risk. One example is to purchase blue-chip stocks from a very well established company. There is always some risk involved but you can be fairly confident that these stocks will rise, or that the company will pay dividends.

Investments in which you stand to gain more, generally (but not always) come with a higher amount of risk. New investors fail to think about what they stand to lose as well as what they stand to gain. Your risk tolerance will likely determine, at least to some extent, your style of investment.

Short-term thinking

Many new investors rush to make their first stock market investments. The stock market isn't some sort of get-rich-quick playground.

New investors often enter with high hopes for a steep and rapid profit and they want to make it big with short-term investments. This makes for bad investment decisions at the best and for many leads to nothing but a quick exit from the marketplace.

More established investors have a totally different idea about what makes a short-term and a long-term investment. In their view, a long-term investment might be 20 or more years, and even when they consider an investment to be short-term they will probably be looking to stick with it for three-to-four years.

If you thought you were going to turn a quick profit in a few months, then it is time to reframe your approach to time. Be in it for the long run, or don't be in it at all. Investment is best seen as a process of long-term wealth accumulation.

Selling out in a panic

If you do have a long-term plan in place and you understand that stock market movement is best understood over the course of years and not weeks and months, then you probably won't be in much of a panic if stocks start to decline. Stocks rise and fall all the time.

First-time investors, if they have a short-term attitude towards investments, or obsessively monitor their stocks for daily movement, can often get more than a mild case of hysteria if they spot a downward trend. This can cause them to sell out their position blindly, without properly considering whether or not they are likely to rise back up.

Very short-term trends are not great indicators overall and experienced investors may see opportunity for recovery. Whatever happens, you shouldn't panic. Now is the time to make wise, sober-minded decisions.

Don’t ignore your investment losers

First-time investors are attracted to the latest investment winners and ignore the losers. The problem with this philosophy is that investment winners and losers tend to rotate due to many influences, including the business cycle and interest rates. If first-timers fully understood that rotation exists in the investment world, their gaze would analyse recent losers and winners quite differently.

Don’t always chase yesterday’s winners

A common mistake of both novice and more experienced investors is chasing hot performers by extrapolating past performance into the future. If those results disappoint, investors tend to bail out and move their money into another hot performer, repeating the cycle. Combining a properly diversified portfolio with an eye for value when investing money, are good ways to avoid the inevitable disappointment of chasing performance.

Jumping in head first

The basics of investing are quite simple in theory – buy low and sell high. In practice, however, you have to know what is low and what is high in a market where everything hinges on different readings of a variety of ratios and metrics. What is high to the seller is considered low (enough) to the buyer in any transaction, so you can see how different conclusions can be drawn from the same market information. Because of the relative nature of the market, it is important to study up a bit before jumping in.

At the very least, know the basic metrics such as book value, dividend yield, price-earnings ratio (P/E) and so on and understand how they are calculated and where their major weaknesses lie. While you are learning, you can see how your conclusions work out by using virtual money in a stock simulator. Most likely, you’ll find that the market is much more complex than a few ratios can express but learning those and testing them on a demo account can help lead you to the next level of study.

Playing penny stocks

Unfortunately, what penny stocks offer in position, size and potential profitability has to be measured against the volatility they face. Penny stocks can shoot up but they can also crash in moments and are exceptionally vulnerable to manipulation and illiquidity. Getting solid information on penny stocks can also be difficult, making them a poor choice for an investor who is still learning.

Going all in with one investment

Investing 100 percent of your capital in a specific market, whether it is the stock market, commodity futures, forex or even bonds, is not a good move. Although you may eventually decide to throw diversification to the wind and put all your available capital into these markets once you are familiar with them, it is better to risk a little bit of capital at a time. This way, the lessons learned along the way are less costly but still valuable.

The bottom line

When you are starting to invest, it is best to start small and take the risks with money you are prepared to lose. As you gain confidence and become more adept at evaluating stocks and reading the market sentiment, you can start making bigger investments. None of these investments are bad in and of themselves but they do tend to be very unforgiving towards rookie mistakes. The trick is learning to invest in more stable markets before you jump into the wilder areas.

Source: Daily Mirror