Investing in the Stock Market – 12 Common Mistakes

By repeatedly committing one or several common investment mistakes, individual investors often prove to be their own worst enemy. Unfortunately, even seemingly simple missteps can, over time, have a dramatic impact on overall returns. Recently, CFA Institute, which administers the prestigious Chartered Financial Analyst® (CFA®) Program worldwide, asked selected members to share their perspectives on some of the most common and costly mistakes they witness individual investors make.

Among the most common mistakes:

No investment strategy.

From the outset, every investor should form an investment strategy that serves as a framework to guide future
decisions. A well-planned strategy takes into account several important factors, including time horizon, tolerance for risk, amount of investable assets, and planned future contributions. "At the outset, individuals should have a clear sense of what they want to accomplish and the amount of volatility they're willing to bear," said Jeanie Wyatt, CFA, CEO of San Antonio-based South Texas Money Management.

Investing in individual stocks instead of in a diversified portfolio of securities.

Investing in an individual stock increases risk versus investing in an already-diversified mutual fund or index fund. Investors should maintain a broadly diversified portfolio incorporating different asset classes and investment styles. Failing to diversify leaves individuals vulnerable to fluctuations in a particular security or sector. Also, don't confuse
mutual fund diversification with portfolio diversification,said Brian Breidenbach, CFA, CPA, Managing Principal of
Breidenbach Capital Consulting, LLC in Louisville, KY. You may own multiple funds but find, on closer examination, that they are invested in similar industries and even the same individual securities.

However, remember that it is also possible to over-diversify and own too many investment products − particularly if an investor has a modest portfolio − generating higher overall fees relative to the portfolio size, said Wyatt. The best course of action is to seek a delicate balance between the two. Often, this can best be done with the advice of a professional or trusted advisor.

Investing in stocks instead of in companies.

Investing is not gambling and shouldn't be treated as a hit-or-miss proposition. Investing is assuming a reasonable amount of risk to help finance enterprises you believe have positive long-term growth potential. Analyze the fundamentals of the company and industry, not day-to-day shifts in stock price. "Buying a particular stock purely on the basis of market momentum or because you like a company's product or service is a sure fire way to lose money," commented Bob Bilkie, CFA, president of Southfield, MI-based Sigma Investment Counselors. In addition, examine a company's corporate governance profile to make sure it has basic corporate governance protections. It may help you avoid a future problem.

Buying High.

The fundamental principle of investing is buy low and sell high. So why do so many investors get that backwards? The main reason is "performance chasing," notes Beth Hamilton-Keen, CFA, of Mawer Investment Management Ltd in Calgary, Alberta. "Too many people invest in the asset class or asset type that did well last year or for the last couple of years, assuming that because it seems to have done well in the past it should do well in the future. That is absolutely a false assumption." Cathy Tuckwell, CFA, of Scotia Cassels Investment Counsel in Toronto, Ontario agrees: "The classic buy-high/sell-low investor profile is someone who has a long-term investment strategy, but doesn't have the tenacity to stick with it," she said. "They throw their strategy out the window in response to short-term blips in the market and invest tactically instead of strategically."

Others at risk for "buying high" are those who follow investment fads, buying the "popular" stocks of the day. Typically, these investments become fashionable for brief periods, leading many to invest at the height of a cycle or trend − just in time to ride it downward. Always look critically at the prospects for future performance of a given investment, not just past performance, Tuckwell emphasized.

Selling Low.

The flip side of the buy-high-sell-low mistake can be just as costly. “Too many investors are reluctant to sell a stock until they recoup their losses,” said Rajiv Vyas, CFA, of MTB Investment Advisors in Baltimore, MD. “Their ego refuses to acknowledge a mistake of buying an investment at a high price.” Smart investors realize that may never

happen and cut their losses. Keep in mind not every investment will increase in value and that even professional investors have difficulty beating the S&P 500 index in a given year. Always have a stop-loss order on a stock. It’s far better to take the loss and redeploy the assets toward a more promising investment.

Churning your investments.

Too-frequent trading cuts into investment returns more than anything else. A study by two professors at the University of California at Davis examined the stock portfolios of 64,615 individual investors at a large discount brokerage firm between 1991 and 1996. The study found that, without transaction costs, these investors received a 17.7% annualized return, which was 0.6% per year better than the stock market itself. But, after transaction costs were included, investors' returns dropped to 15.3% per year, or 1.8% per year below the market. Again, the solution is a long-term buy-and–hold strategy, rather than an active trading approach.

Acting on “tips” and “soundbites.”

“Listening to the media for their sole source of investment thinking rather than pursuing a professional relationship with an advisor is a far too common investor mistake,” said Todd Lowe, CFA, at Parthenon LLC in Louisville, KY. While breaking news and “insider tips” may seem like a promising way to give your portfolio a quick boost, always remember you are investing against professionals who have access to teams of research analysts. Seasoned investors gather information from several independent sources and conduct their own proprietary research and analysis before making an investment decision. “Believing that information that is new to the investor is not known to anybody else is a real mistake. A useful rule is that if you’ve heard it, so have many others, so the information is likely already factored into the market price,” counseled Bilkie.

Paying too much in fees and commissions.

Incredibly, investors are often hard-pressed to cite specifics on the fee structure employed by their investment service provider, including management fees and transactions costs. Investors should, as a
precondition to opening an account, make sure they are fully informed as to the associated expenses that accompany every potential investment decision, emphasized Wyatt. In addition, investment returns should be adjusted for all expenses paid to ascertain overall performance.

Decision-making by tax avoidance.

While individuals should be aware of the tax implications of their actions, the first objective should always be to make the fundamentally sound investment decision. Some investors, rather than pay a large capital gains tax, will allow the value of shares in a well-performing stock to grow so large it accounts for an inordinate percentage of their overall portfolio. Similarly, when it's time to harvest a gain, investors shouldn't be overly concerned with holding onto the security past the one-year purchase date simply to take advantage of the lower capital gains rate. A wiser move is to simply find a good tax advisor. This is not applicable to Sri Lanka since there is no capital gains tax on shares provided it is not considered a
trading income.

Unrealistic expectations.

As we witnessed during the recent bubble, investors can periodically exhibit a lack of patience that leads to excessive risk-taking. It is important to take a longterm view of investing and not allow external factors cloud actions and cause you to make a sudden and significant change in strategy. Comparing the performance of your portfolio with relevant benchmark indexes can help an individual develop realistic expectations, said Robert R. Johnson, CFA, managing director of the CFA and CGIPS Programs at CFA Institute. According to Ibbotson Associates, the compound annual return on common stocks from 1926-2001 was 10.7% before taxes and inflation and 4.7% after taxes and inflation. Returns on long-term bonds over the same time period were 5.3% before taxes and inflation and 0.6% after taxes and inflation. “Expecting returns of 20-25% annually will set an investor up for disappointment,” Johnson noted.

Neglect.

Individuals often fail to begin an investment program simply because they lack basic knowledge of where or how to start. Likewise, periods of inactivity are frequently the result of discouragement over previous investment losses or negative growth in the equities markets. To be certain, investors should continue investing in every market − albeit through different investment vehicles − as well as establish a mechanism to make regular contributions to their portfolios. Investors should also regularly review their holdings to ensure they are adhering to their overall strategy.

Not knowing your real tolerance for risk.

Keep in mind that there is no such thing as risk-free investing, said Johnson. Determining your appetite for risk involves measuring the potential impact of a real dollar loss of assets on both your portfolio and psyche. In general, individuals planning for long-term goals should be willing to assume more risk in exchange for the possibility of greater rewards. However, don't wait until a sudden or near-term drop in the value of your assets to conduct an evaluation of your level of tolerance for risk. "The encouraging aspect for investors is that, with a little diligence, all of these mistakes are easily avoidable," added

Wyatt. (Source CFA Sri Lanka)