5 Big Investment Mistakes

We list below the 5 big investment mistakes made by most investors acros the world.

1. BUYING HIGH, SELLING LOW

Any wise investor knows the basic principle of investment: buy low, sell high. However, investors often ignore this rule, as they get swept up in prevailing market sentiment.

When markets have stormed ahead, sentiment is positive and people are more likely to invest as they don't want to miss out on further gains. Conversely, when markets have performed poorly, sentiment is negative and people are more likely to head for the exit due to fear of clocking up further losses.

People make too many irrational investment decisions, which are based on either greed or fear. The result is that many people invest at the top of the market and withdraw their money at the bottom, having a thoroughly miserable experience of investing along the way.

Waiting for markets to turn the corner could mean you'll miss the boat. Equity markets look ahead of the economy and bad news is factored in early on. In trying to avoid losses in the short-term, investors may well miss out on the significant rebound of the market and end up being behind the curve for any recovery.

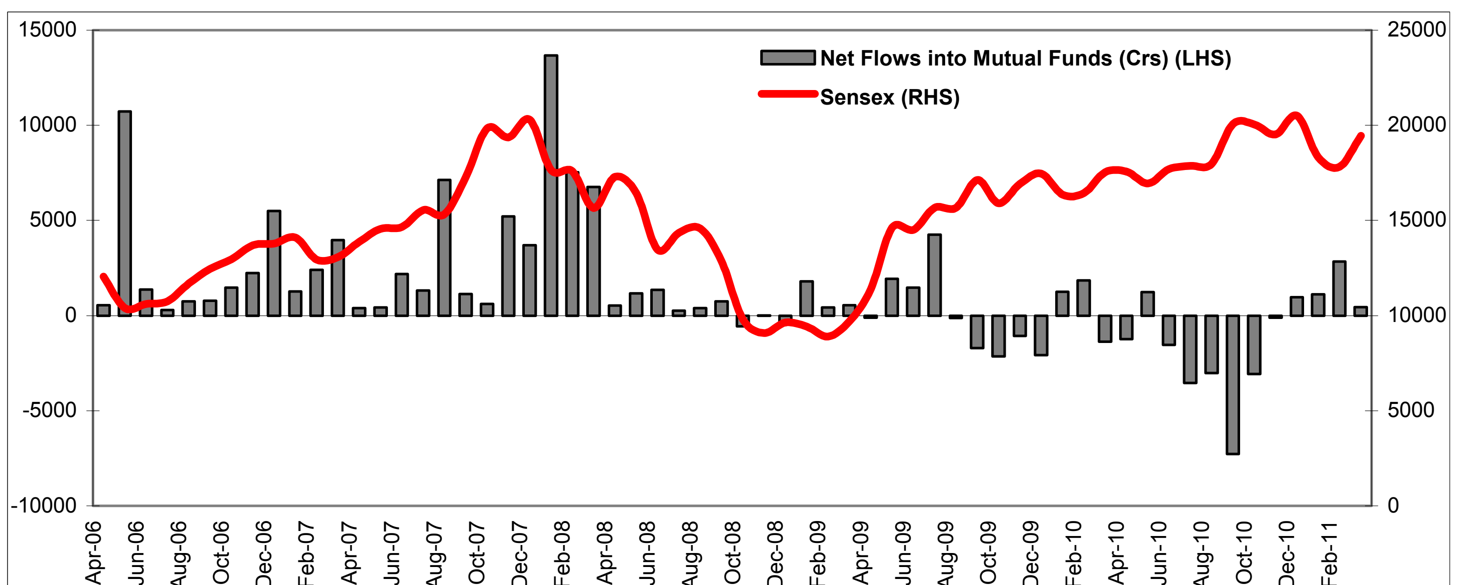
Stocks that have gone up recently, especially those with a lot of press, often attract even more buyers. This obviously drives the price up even higher. People get excited about what they read and see and want a part of the action. They jump into a stock that is already trading at a premium – they buy high.

The other side of the market is when a stock has fallen; most investors may want to sell along with the rest of the market. If you go by price alone, this can be a bad decision (sell low). There are many reasons a stock's price drops and some of them have nothing to do with the soundness of the investment. That's why if you only follow price you may miss an opportunity.

Investors need to realise that emotional investing does not lead to wealth creation over the long run. Relying on emotions is a sure-shot way to 'buy high and sell low'. People tend to give into greed when they see everyone making money in a specific asset class, be it stocks, gold, real estate or anything else.

If all you know about a stock is the price, you may (and likely will) make investing mistakes. Remember, if a stock has had a good run up it may be time to sell, not buy (sell high). Similarly, if a stock has dropped like a rock, it may be a good time to buy rather than sell (buy low). You won't know what to do unless you understand a lot more about the company than its stock price.

The following chart displays the buy high and sell low mentality by analysing the net inflows into equity MF schemes vs the Sensex – see the net inflows in Nov 2007 to Mar 2008, inflows between Dec 2010 and Mar 2011 and outflows between Oct 2008 to Dec 2008.



2. TRYING TO TIME MARKETS

The financial industry oversimplifies investing and sells market timing as an effortless path to riches – even in tough times. Market timing seems so easy in hindsight. What's more, plenty of professionals -- including brokers, advisers and investment newsletters -- stand ready to offer you guidance on when to trim your exposure to stock funds and when to boost it.

Warren Buffett once said “We continue to make more money when snoring than when active.” Peter Lynch said “Far more money has been lost by investors preparing for corrections, or trying to anticipate corrections, than has been lost in corrections themselves.”

Rather than make guesses regarding the direction of the market, here are some investment rules to follow:

Rule #1: Do not attempt to time the market. Statistically it is a certainty that a minority of the millions of investors can time the market in the short-run – the problem is that very few, if any, can time the market for sustainable periods of time. Don’t try to be the hero, because often you will become the goat.

Rule #2: Patiently make good investments, regardless of the economic conditions. It is best to assume the market will go nowhere and invest accordingly. Paying attention to a hot or cold economy leads to investors chasing their tails. Good investments should outperform in the long-run, regardless of the macroeconomic environment.

Rule #3: Diversify. In the midst of the crisis, diversification didn’t cure simultaneous drops in most asset classes, however ownership of government Treasuries, cash, and certain commodities provided a cushion from the economic blows. Longer-term, the benefits of diversification become more apparent – it makes absolute sense to spread your risk around.

An investment process that includes patience, discipline, diversification, valuation sensitivity, and low-cost/ tax-efficient products and strategies will get you off the financial treadmill and move you closer to reaching your financial goals.

3. FOLLOWING THE HERD

The most obvious example of investors following the herd is the technology boom of the late 1990s. At that time, sensible investment strategies went out of the window and even pensioners relying on their investments for income were selling corporate bond funds and moving into technology, not wanting to miss out on the easy money. In more recent times, investors have piled into gold and other commodities. Remember: if an investment hits a record high, view it as a warning sign, not a reason to buy.

We are social animals who feel safer in numbers, but so do sheep. We take comfort in doing what everyone else is doing, and in the back of our minds we know that even if we’re wrong, at least we’ll be wrong with a bunch of other people. But it was the same line of thinking that led us to do very stupid things in high school just because “everyone else was doing it.”

Though we pride ourselves on rugged individualism, most human beings are deeply conformist. In stock-market parlance, we tend to be trend followers, not trend leaders. Even stock analysts, who ostensibly get paid for independent thinking, generally echo the opinions of other analysts -- and often end up doing no better than guesswork at predicting prices. Imitating the people around us is one of our most basic biological drives

Going against the herd can be extraordinarily difficult. Individual investors typically don't have enough time for independent research. And professionals risk their reputations if they stand up against the crowd. Is it worth it? Usually the answer is yes.

A lot of losses made by investors stem from blindly following a well respected investment expert despite mounting evidence on the contrary. Blindly following the experts is a big mistake, a sickness of an independent mind. One should question the analysis of all investment experts and rely on his own first-hand practical experience and hands-on research. That includes questioning the masters from whom we have learned so much.

Five hundred years ago, the Buddha said: "Be a Light onto yourself!" Your teachers can help you and prepare you. But you have to the one to light up your inner candle yourself.

Block out the noise. News and media outlets thrive on sensationalism. They also need to report new news usually on a daily basis. Think back when the market was doing poorly in the in 2008 and the beginning of 2009. If you were reading the news, it felt like the world was going to end. The tendency was to sell and at that point, the market was already down significantly. Getting too involved in the news short term can make you forget that your investments are for the long term.

4. CONFUSING TOLERANCE WITH CAPACITY

An investor's risk tolerance is a measure of their temperamental willingness to take on risk, while their risk capacity is their ability to recover losses if they incur them.

A 35-year-old has a higher risk capacity than a 55-year-old because if the market falls 20 per cent they would not need to increase their annual return by very much to get back on track. For the older investor, a fall of this magnitude close to retirement may be difficult to claw back. Unrelated to their risk capacity, either investor may or may not have a high risk tolerance.

If you're young – and have plenty of time to recover from adverse market moves – you should focus your portfolio on the assets with the best long-term performance track record: equities. Closer to retirement, when you can't afford to incur heavy losses, hedge your bets by spreading your money between different asset classes.

5. LOSING YOUR BALANCE

Maintaining the balance of lower- and higher-risk assets is important, so that the actual risk you're taking doesn't get out of balance with your tolerance to risk. Rebalancing brings a dual benefit: it reduces volatility and is likely to produce a better return.

A balanced portfolio of funds chosen 10 years ago would have generated more profit if it was rebalanced to the original proportions each year when compared to a portfolio left untouched. Rebalancing controlled the volatility of the portfolio, too.

Some fund platforms offer automatic rebalancing. Investors can do it manually by switching funds or asking their financial adviser to do so.

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