

## How to avoid the worst mistakes investors make

Paul Merriman  
September 2000

*In this timeless article, originally written for Merriman's educational newsletter, FundAdvice.com, Paul Merriman outlines the biggest mistakes investors make and how you can avoid them.*

In our investment workshops, we always discuss the biggest mistakes investors make. I have identified 18 examples, and I hope they will let you learn from other peoples' mistakes so you won't have to learn them yourself – the hard way.

### Mistake #1: No written plan

It always puzzles me why people who spend days planning a two-week vacation will make five-figure investment decisions seemingly on a whim.

A Fortune Magazine article published in 1999 says people with written plans governing their investments on average wind up with five times as much money during retirement as those without written plans.

Obviously, the act of writing a plan doesn't put money in your pocket. But people who are methodical enough to put their plans in writing are also likely to do many of the other things that lead to successful investing. And of course, even the most brilliant plan is worthless if it just collects dust on a shelf.

With a plan, you can get back on course when you go astray. But without a plan, you can't even know you're off course.

If you don't have an investment plan that's right for you, developing one should be your top priority. Don't have an investment plan? Start [here](#). Or get professional help from someone who does not sell financial products.

People with  
written plans  
wind up with  
five times as  
much money as  
those without.

### Mistake #2: Procrastination

Waiting for the right time can ruin your results over a lifetime. Procrastination takes many forms. You don't start saving for retirement until it's nearly on top of you. You "know" you should review your investments but other things always seem more pressing. You think you'll catch up later when the market is better, when you're making more money, when you have more time.

And there's the irony, because the longer you wait, the less time you have. Every day you delay is a day of opportunity that you can never get back.

### Mistake #3: Taking too much risk

Investment risk is not a theoretical concept. It is the very real possibility, experienced by most investors in the 2000-2002 bear market, that you will lose money.

Far too few  
investors  
understand  
the risks they  
are taking.

Investing requires taking some risk, but many people take too much. They probably know that higher returns go hand in hand with higher risks. But they may believe they are immune from losses or that they'll somehow know when it's time to sell. The problem is that by that time, it's usually too late. Their desire for high returns simply puts the blinders on.

Far too few investors understand the risks they are taking. Most don't understand what could go wrong with an investment when they make it, and they have no plan for what they will do if things go wrong.

People who take too much risk often wind up being speculators instead of investors. But those who are savvy about risk invest instead of speculate. They never forget the importance of limiting and managing their risks. If they speculate or gamble, they do it with money they know they can afford to lose.

### Mistake #4: Taking too little risk

Some people are paranoid about the thought of losing any money at all. They want everything nailed down, secure, guaranteed. The sad truth is that absolute security is only an illusion. It doesn't exist anywhere in nature and it certainly doesn't exist in financial markets.

Very low risk almost always equates with low return. If you put your emergency money in a bank account and earn 1 percent, you may think you're taking no risk. But in fact you are taking the very real risk that inflation will rob your money of its purchasing power. Over long periods this stops being a risk and becomes almost a guarantee.

If you put your life savings in very low-risk investments, you are giving up an enormous opportunity. A few years ago I made \$10,000 gift to each of my three grandchildren for their retirement years.

When my grandson, Aaron, was three months old, I put the money into a variable annuity that will compound until he's 65 years old. I did not choose the annuity's money-market fund option, which at a compound rate of return of 5 percent would turn that \$10,000 into \$238,399 after 65 years.

Instead, I chose to invest the money all in equities, split equally between U.S. and international stocks. If I assume this combination can make an 11.3 percent return, by the time Aaron is 65 the account will be worth over \$10 million.

Had I gone for the no-risk option, I could have short-changed Aaron out of almost \$10 million, or about 99 percent of his retirement. (see "[The best investment I'll ever make: Turning \\$10k into \\$20 million](#)." In that article you will find a link to a copy of the specific trust document we used.)

## Mistake #5: Paying too much money to others

Mutual fund investors essentially throw some of their money away by buying load funds instead of no-load funds. In addition, far too many investors pay far too little attention to recurring expenses. Otherwise, they'd never buy annuities inside IRA accounts.

Expenses are like leaks in a bucket. The bucket is filled with your money, and you want the water level to grow. Everybody can understand what happens if a bucket has too many leaks in it. It's a pity that investors can't see how this happens with their money.

## Mistake #6: Trusting institutions

I often ask participants in my workshops if they trust their banks. Most of them are pretty emphatic in answering: No! But many of us act as though we do trust banks. We believe the bank will tell us if we should move our money somewhere else within the bank to get a higher return.

You and your bank have a classic conflict of interest. Your best interests are served by accounts that pay the highest interest, which at a bank is usually in a money-market deposit account or a certificate of deposit. But your bank's best interests are served by accounts that pay you little or no interest on your money, like passbook savings and checking accounts.

It's a mistake to rely on a bank to tell you what's in your best interest. It's a mistake to rely on a broker or a brokerage firm to tell you what's in your best interest. The same is often true of insurance companies and government agencies, but that's an entirely different topic.

## Mistake #7: Believing publications

"The 100 Best Mutual Funds"

"These Stocks are Real Steals"

"Got These Funds? Six Standouts You've Never Heard of"

Those are all real headlines from the covers of a popular personal finance magazine. Predictably, they prompt readers to grab the magazine and dive in, even if just out of curiosity.

Study after study shows that the majority of stocks and funds touted in such articles fail to do better than the average of other stocks and funds. But that doesn't stop the magazines, Web sites, radio and television shows and (I hate to admit it) newsletters from cranking out more articles, broadcasts, lists and tips for eager investors.

Serious investors need textbooks more than hot ideas. But people don't want textbooks. They want entertainment, and that's what publications and broadcast outlets provide. Most of us don't spend lots of time reading to educate ourselves. We prefer laughs, escape or relief from the stresses of daily life.

The right way to read financial articles that tout specific mutual funds and stocks is to treat them as useful sources of interesting ideas. But it's a mistake to regard those articles as prescriptions of what you should do with your money.

Serious  
investors need  
textbooks  
more than  
hot ideas.

Writers, editors and publications follow fads. They write about what's in favor and in style. When the winds of popularity change, they are never far behind. That's a very poor basis for making investment decisions.

### **Mistake #8: Failing to take little steps that can sometimes make a big difference**

Some examples:

People fail to fund their IRA contributions at the start of the year.

People fail to make their annual IRA contributions at all.

People leave money in taxable accounts when it could appropriately go into IRAs and 401(k) plans.

People don't maximize their 401(k) plan savings.

People put tax efficient investments in IRAs and tax inefficient investments in taxable accounts.

People have multiple small IRA accounts, paying an annual fee for each one instead of consolidating them into an account large enough to avoid a fee in the first place.

People don't move their money from a checking account to a money-market deposit account at a bank.

People don't move their money from a bank money-market deposit account to a non-bank money-market fund.

Each of these little steps makes a difference. And over a lifetime the little differences add up to big differences – but only for people who take advantage of the opportunities they have.

### **Mistake #9: Buying illiquid financial products**

Liquidity is the ability to get your money back quickly, to turn an investment into cash. A stock is very liquid, because you can sell it whenever the market is open, and you'll have your money in a few days. Mutual funds are even more liquid, letting you have your money the next day.

But liquidity is severely compromised when you invest in limited partnerships, for which there is often no market. When limited partners want to sell their units, they often find that everybody else wants out, too, and there are few buyers at any price. In this garage-sale mentality, the only buyers may be speculators or professionals who buy partnership interests for pennies on the dollar.

### **Mistake #10: Requiring perfection in order to be satisfied**

We've all known people whose attitude is that nothing is good enough for them. People who can't stand to have anything but "the best" are rarely successful at investing.

In fact, there will always be something that's performing better than whatever you have. If you happen to have the one fund that outperforms everything else this month, you are practically guaranteed that some other one will be ahead of yours next month.

Perfectionists often flit from one thing to the next, chasing elusive performance. But in real life, you get a premium for risk only if you stay the course. And if you demand perfect investments, you'll never stay the course.



### Mistake #11: Accepting investment advice and referrals from amateurs

If you had a serious illness, I hope you'd consult a nurse or a doctor, not somebody on the street who had an opinion about what you should do. And I hope you would treat your life savings and your financial future with the same care as you would treat your health.

Yet too many people make big financial decisions based on things they hear. "I heard this hot tip." "I know somebody in this company." "I've got an inside source about this new product." "My broker is making me a ton of money."

The lure of the hot tip is all but irresistible to some investors eager to find a shortcut to wealth. Unfortunately, many investors have to learn the hard way that there are no reliable shortcuts.

A client once told me he had heard from friends about a woman who "made a lot of money" for his friends. My client, normally very conservative, cashed in \$250,000 of his portfolio and turned it over to this woman, who said she would invest it in "a conservative strategy." Within two months, she had lost half of the \$250,000. Only then did my client learn she was not even licensed to do what she was doing. The woman's compensation was to be 20 percent of whatever profits he made, giving her an incentive to generate big gains quickly. But he didn't understand that until it was much too late.

### Mistake #12: Letting emotions – especially greed and fear – drive investment decisions

I think the two most powerful forces driving Wall Street trends are greed and fear. Think about these two emotions the next time you listen to a radio or TV commentator explain what's happening in the stock market. You'll hear fear and greed over and over.

There's fear of rising interest rates, fear of inflation, fear of falling profits. You name it, somebody's afraid of it. Fear is why so many investors bail out of carefully planned investments when things look bleak – and since everybody seems to be selling at the same moment, prices are down. That, in turn, reduces profits or increases losses.

Greed blinds investors, making them forget what they know. In late 1999 and early 2000, greed prompted many inexperienced investors – and some experienced ones too – to stuff their portfolios with high-flying technology stocks, which had just had a terrific year. In the spring of 2000, technology stocks, especially the most aggressive ones, plunged without warning, leaving many of these greedy investors wondering what had hit them.



Wall Street trends are driven by greed and fear.

Investors obviously want to make money. But this legitimate desire turns into greed when it runs amok. Likewise, investors obviously should want to avoid losing their money. Yet when a healthy respect for bear markets leads to panic selling, caution becomes counterproductive.

### Mistake #13: Putting too much faith in recent performance

We tend to think that whatever just happened will continue happening. Sometimes that's true, but a great deal of the movement in the stock market is random. And recent performance is a lousy predictor of long-term performance.

Ironically, recent performance is at the heart of the mechanical active risk management systems we use and advocate. Our systems don't predict the markets; instead, they identify and follow existing trends, on the presumption that those trends are likely to persist long enough to take advantage of them.

Somebody asked me how we can use recent performance while we advise investors that it doesn't mean much. It's a good question.

When we use recent performance in a mechanical trading system, we are using recent history as a tool. We have no emotional attachment to any part of that performance or our use of it, and we're ready at any time to switch gears when our systems tell us to do so.

Contrast that with an investor who identifies the hottest-performing mutual fund over the past year and who therefore buys that fund because he or she believes that hot performance means something (for instance that the fund has a brilliant manager or the "right" strategy) significant.



Overconfident  
investors get  
into trouble.

Many investors get into trouble when they become overconfident that they know what they are doing. This belief tends to make investors put too much of their money into a single stock or one mutual fund. Such confidence takes a while to build up, and investors tend to make their commitments too late to fully participate in whatever it is that has impressed them so much.

By this time, the investor's emotional attachment has typically taken on a life of its own. Then when a favored investment starts falling behind, the investor's confidence persists. By the time the investor is finally willing to admit that things have changed, he or she will have stayed much too long.

As you can surely see, that is very different from the mechanical, unemotional way that we use recent performance in our active risk management strategies.

#### Mistake #14: Failing to resolve disagreements between spouses

It's not uncommon for members of a couple to have quite different comfort levels and priorities for investing money. He may think she's taking excessive risks; she may think he's hopelessly conservative. Or of course it could be the other way around. When couples discuss finances, including investments, there are often power struggles going on under the surface. And when somebody is determined to "win" or to "keep the peace," sound investment decisions often suffer.

One spouse will give in or compromise, possibly with resentment. I'm reminded of a line in a song from the musical "My Fair Lady" in which Henry Higgins is complaining about the disruption a man feels when he lets a woman into his life: "Make a plan and you will find she has something else in mind, and so rather than do either you do something else that neither likes at all."

#### Mistake #15: Focusing on the wrong things

It's generally agreed that asset allocation – the choice of which assets you invest in – accounts for at least 95 percent of investment returns. That leaves less than 5 percent for choosing the best stocks and the best mutual funds. But most investors focus at least 95 percent of their attention on choosing funds and stocks. Their energy would usually be better spent on asset allocation.

Some investors also focus on small parts of their portfolios instead of the entire package. They can become obsessed with some small investment that seems to stubbornly refuse to do its part. Occasionally, an enraged investor will overthrow an entire strategy because of what happens to some small component of it.

### Mistake #16: Not understanding how investing works

Many people don't understand diversification; they just know that it's supposed to be good for you. They would be better investors if they learned how to put together non-correlated assets.

The entire point of diversification is to always have some things in a portfolio that "aren't working." That's because whatever is performing well at any given time won't necessarily continue to do so. And you want some other asset class waiting in the wings to find its day in the sun, so to speak.

### Mistake #17: Needing proof before making a decision

The ultimate stalling tactic for those who aren't ready to make an investment is to require one more piece of information or evidence.

You can get evidence, but not proof. You can prove what happened in the past. But there's no way to prove anything about the future except to wait until it happens.

I think it's ironic that the main focus of mutual fund advertising is past performance – yet that's the one thing that the funds can't sell and investors can't buy.

There are two track records for any investment. The first one just came to an end, and it includes all of history. It can tell you the range of returns and risks that are reasonable to expect.

You've got  
to learn to  
live with the  
ambiguity of  
an uncertain  
future.

But it can't tell you anything about the future. The second track record starts the moment you invest. It's the only track record that matters to you, and it may or may not have any resemblance to the track record of history.

If you really need certainty, stick to Treasury bills and certificates of deposit. But if you're seeking returns higher than you can get from those, you will have to accept some uncertainty.

The only thing you can be sure of about the future is that it won't look just like the past. That's why savvy investors diversify beyond what seems certain at any given moment. To be a successful, happy investor, you've got to somehow learn to live with the ambiguity of an uncertain future.

### How to overcome these common mistakes

These mistakes are very common. If you recognize any of them in your own investing pattern, it doesn't mean there's anything wrong with you – just that you have room for improvement.

The cures for many of these mistakes are obvious, though they're not always easy to implement. They boil down to education, discipline and managing your emotions. Try the following suggestions:

Make sure you have a written investment plan that outlines what you must do to achieve your long-term goals. Use specific, measurable goals so you can “keep score” on your progress.

Educate yourself. Study the extensive article library at our Web site. Read a book or two from our site’s recommended list. For a refresher on the basics, read either “Investing for Dummies” or “Mutual Funds for Dummies”. Both are good.

If you don’t understand an investment, don’t put your money into it. I believe this single step will prevent more grief than almost anything else you can do.

Sometimes the best course is simply to slow down. Take a deep breath and apply a liberal dose of patience. Patience is probably the most under-rated virtue I know.


When you notice emotions are driving your decisions, substitute a discipline. If you have trouble doing that, consider professional investment advice or professional management.

Now let’s have a little straight talk, just for the record. It might look as if I have a bit of a conflict of interest here because I manage money professionally for clients. That business provides the lion’s share of my income. And here I am in a newsletter advising do-it-yourself investors to consider professional management.

My highest priority in this newsletter is to give readers the best information and advice I can possibly give them. I tell it like it is, and if I ever have to stop doing that, this newsletter will be history.

From the start, FundAdvice.com has never hesitated to tell investors everything they need to know to do it themselves. If you can successfully put into practice what you learn here, and thus have no need for professional management services, nobody will be happier about that than I am.

But the plain truth is that successful investing – like successful dieting – is harder than it looks. I know this (on both counts) from plenty of experience. Again and again we’ve pointed this out. But sometimes education is not enough. Sometimes the smartest thing to do is hire a professional, either to advise you or to take on the day-to-day discipline of carrying out your strategy. If I didn’t point this out, I’d be doing you a disservice.



Successful  
investing is  
harder than  
it looks.

So I’d like to leave you with a few thoughts about how to choose an advisor or a manager. Don’t do it casually, because they (perhaps I should say “we”) are not all alike.

**Choose a manager with experience.** The vigor, idealism and enthusiasm of youth is wonderful. But there’s something very valuable about the experience that comes from having lived through good times and bad, having lived through market crazes and fads and having learned from mistakes. I believe nearly four decades in this business have made me a much better manager than I was when I started out.

**Choose a manager you can trust and with whom you are comfortable.** This is totally subjective, but you are a human being with emotions that can derail you. Even if you find an advisor who is recommended by the world’s greatest authorities, unless this person wins your trust and confidence, he or she isn’t the right advisor for you. Rarely do I tell investors to follow their gut feelings, but this is



an exception. If you leave your advisor's office feeling pressured to do something you don't want to do, you probably have the wrong advisor for you.

**Choose a manager who will put your interests first.** Your best bet is somebody who has no conflict of interest with you, somebody who doesn't sell any products or have a financial stake in the specific choices you make. But if for some reason you can't avoid a real or potential conflict, choose somebody who, in advance, openly discusses the situation to your satisfaction.

**Choose somebody who understands and is committed to whatever is important to you.** Part of this is finding somebody who can help you discover and articulate the choices you will inevitably make. If the most important thing to you is avoiding the loss of your capital, don't settle for somebody whose attitude toward that objective is only grudgingly lukewarm. And on the other hand, if what you want is flat-out growth with no holds barred, don't go to somebody whose passion is designing bond portfolios.

At the start of this article I told you I had 18 examples of mistakes, but I've listed only 17 so far. I have saved No. 18 as a "bonus" to readers who made it all the way through this long article.

### **Mistake #18: Spending so much time focused on investments that "real life" gets crowded out**

I'd like to repeat some thoughts from an article I wrote a few years ago for Alaska Airlines Magazine on the subject of what smart people do to prepare for retirement.

I've seen over the years that good retirement planning involves a lot more than just managing your money properly. Smart people take care of their health, both mental and physical. Smart people cultivate new relationships and nurture established ones. The happiest retired people I know are those who seem to have many favorite people in their lives, including people who are younger than they are.

Smart people have plenty to live for. They have no trouble making a list of 100 things they would love to do if they had the time. And smart people don't wait for retirement to make their dreams come true. They know life is uncertain, and all the tomorrows we assume are ours can be snatched away in an instant. Whatever their age, smart people find ways to make their dreams become reality, starting now.

Past performance may not be indicative of future results. The content in this article is intended for educational and informational purposes only and not as investment advice or an offer or recommendation to buy or sell an investment product. Any investment decision made carries risk including the risk of financial loss and is ultimately the responsibility of the individual who should consult beforehand with a financial advisor.

Merriman is an investment advisory firm registered with the Securities and Exchange Commission. Based in Seattle, we manage more than \$1.5 billion in investments for clients all across the country.

Since Merriman was founded in 1983, we have maintained a commitment to empowering people, whether they become our clients or not.

We give advice on everything from investment basics to college funding and retirement distributions, taking the time to educate our clients along the way so they can feel comfortable with their money management strategy.

Our services are specifically structured to help reduce the level of emotional decision making that can derail the best of plans. Your advisor will work with you to create a detailed investment plan and then will work on your behalf, making sure it gets implemented and keeping your portfolio appropriately structured over time.

We give you the time and freedom to focus on the more enjoyable aspects of life.

For additional information about our programs, services and investment philosophy, or to request a one-on-one consultation with one of our financial advisors, please visit us on the web.

[www.merriman.com](http://www.merriman.com)

**Merriman**  
Invest Wisely. Live Fully.