EQInsight

10 common investment errors and how to avoid them

"Deciding to invest is one of the first steps to securing your financial future. However, if you are considering the do-it-yourself approach you need to be prepared to learn new skills to avoid potential pitfalls. These downsides can have a huge impact on investment returns, which experienced professionals are qualified to avoid.

In this guide, we give you some tips on how to avoid the most glaring mistakes. When considerable assets or a significant portion of your retirement savings are at risk – please bear these in mind."

John Spiers
CEO, EQ Investors

1 Being undermined by our human nature

Successful investment requires cool rational thought at all times. Sadly, the human brain is badly equipped for this. We overreact to fear because the amygdala, that part of the brain which controls our responses, has only evolved a little from the period when threats came in the shape of sabre toothed tigers. The consequences of a market decline are considerably less serious but our brains don't really understand that.

We also tend to be overconfident about our level of knowledge and the quality of information we possess. That can lead to greed taking over and affecting our judgement. If things then go badly we suffer remorse, which also influences our decisions.

All humans have these failings but the very best investors have found ways to master their emotions to minimise errors.

"Don't panic when markets enter a period of turbulence: make sure you're happy with the overall characteristics of your portfolio."

2 Trying to second guess markets

The media encourages us to think that we can 'beat the market' by investing and divesting at the right time, but numerous academic studies have shown that even in the hands of professional investors this strategy is unlikely to be successful.

For the private investor, timing decisions are most commonly linked to concerns that markets are going to fall, and beliefs that it might be best to sell now or defer any additional investment. Human brains cope badly with financial stress and start to fear the worst, even though it hardly ever happens.

Most people only start to worry about the direction of markets when there has been a flow of bad news. But by the time we read about it in the press prices will already have dropped, because markets react immediately to known facts. If you do decide to sell, or defer a purchase, it will only be profitable if you are prepared to buy when the news is even worse! Most people are not that brave. Consequently they miss the lowest point of the market and stay 'anchored' on the level at which they sold. Many only get round to buying when prices are much higher.

This behaviour has been measured in the USA for over 20 years in the Dalbar Quantitative Analysis of Investor Behavior. This shows it has cost investors a large part of the returns they would have earned by just staying in the market.

> ***Over the long run it's not market timing that wins, it's time in the market.***

3 Falling for scams

Financial scams are becoming increasingly sophisticated and target the vulnerable, the uninformed and the greedy. The Financial Ombudsman Service (FOS) can provide redress if you are given inappropriate financial advice by a regulated firm. However, the key word here is 'regulated'. If your actions result from the activities of an unregulated firm then you are unlikely to have any recourse at all and may lose all of your investment.

So how can you protect yourself from scams? Some are very convincing. First, check that the firm is regulated by the Financial Conduct Authority (FCA). Make a note of their registration number and then visit the FCA register online at: http://register.fca.org.uk to confirm their details. Comments along the lines of 'our application is being processed' should immediately get your alarm bells ringing, especially if you were contacted via a cold call. Then call the firm on the number shown on the FCA website and verify the contact details you have received – fraudsters can look very similar to a genuine firm.

Next, make sure you really understand what is being proposed to you. Does it seem too good to be true? If so, it probably is. Try explaining it to friends or colleagues and gauge their reaction. Try an internet search to see if there are any useful comments or check the FCA's warning list: http://www.fca.org.uk/news/warnings

> ***Higher potential returns always involve taking more risk. If that doesn't appear to be the case, tread very carefully!***

4 Jumping on bandwagons

It's a famous old adage that investors are driven primarily by fear and greed. When news turns bad, our fear that it will get worse leads to panic selling, often followed by missing the boat when the market bounces back up again. Greed is another example of the herd instinct overwhelming our rational thoughts. Here are two common situations where greed affects our ability to make sound investment decisions.

Markets move in cycles but the timing of these is largely unpredictable. The media only reports when there are extreme movements in markets. Expect to read stories picking out examples of huge gains made by a select few stocks, accompanied by adverts from product providers urging you to jump on board this apparently unstoppable gravy train. This is exactly when alarm bells should be ringing. Instead of taking more risk, now might be time to take less. Or just ignore the hype and do nothing.

Another situation will be an offer to invest in a product that appears to have an extraordinarily strong performance record. In many walks of life past performance does give a pretty good guide to the future, but in the case of investment this really doesn't work at all. The main reason is that there is a tremendous amount of 'noise' in the data. As the time period lengthens, the ratio of noise to facts reduces but only slowly.

One explanation for a strong recent performance record can be that the style of investment is in fashion. When a style is working everyone using this strategy will profit (regardless of skill) and the opposite is true. A common example would be just to invest in 'boring' companies paying large dividends and with good cashflow. This is an entirely sensible approach but there will regularly be periods when it isn't very profitable. Just like hemlines, investment fashions change. So, if this style is being actively promoted it probably means that it's already well into a phase of outperformance and sooner or later that will come to an end.

> ***In the investment world 'the boring option' is often the safest, and herds are rarely right.***

5 Being too cautious

Investing money is very different to holding cash in a bank account. When we place our first investments, we need to teach ourselves to understand the concept that we could lose money. If we let our apprehension take precedence we can end up with a relatively cautious portfolio, even though the timescale of our investment could be decades (e.g. for a pension). This is likely to result in significantly lower returns.

First it's important to understand that market fluctuations are an essential ingredient of investing. If you are investing for a long period (over 10 years) via regular savings then you should actually welcome market setbacks. They result in your new contributions being invested at a more favourable price.

When it comes to the underlying content of your portfolio, the evidence historically has been that the highest returns are generated by 'real' assets, namely equities and properties, rather than fixed interest bonds (though the latter did perform extremely well for 30 years after 1982). Therefore, if the timescale is long it usually makes sense to have a high exposure to real assets.

When your attitude is risk is assessed look carefully at the results. If it suggests that a cautious portfolio is recommended even when your timescale is measured in decades it will be worth double-checking some of the answers to your questions. However, if you are a beginner and likely to panic when markets drop then it may be better to tolerate lower long-term returns.

> ***“If you are investing for the long term try to come to terms with volatility – it's an inevitable consequence of maximising returns.”***

6 Being influenced by the media

Most private investors will seek information from what appear to be reputable and well-informed sources. In the UK, the calibre of personal finance journalism is generally high and there are many sources of intelligent comment. Although this content is financially underpinned by advertising revenue (derived mainly from financial product providers) the journalists have a fierce sense of independence that will usually minimise any bias.

A greater risk arises in the wider press and social media. Investment news only makes it to the front pages, or TV news, either when markets are crashing or hitting record highs. These are exactly the times when most investors need to sit firmly on their hands and not join the herd. The media are in the business of entertainment, not providing investment advice. They will try to find the most charismatic exponents of extreme views, not necessarily those with the best qualifications. In any case, there's no evidence that anyone can consistently predict market movements over the short term, so any predictions should be taken with a pinch of salt.

A common result of these episodes will be an urge to sell your investments before they drop any further. Unless you expect to need that money for other purposes soon, this will usually lead to missing out when the market bounces.

> ***“If you want to sell on the way down, be prepared to buy back in when the outlook is even worse than when you sold.”***

7 Not diversifying enough

Creating a successful investment portfolio has some similarities to cooking. First you need to identify the best possible ingredients. Then you need to combine them skilfully to create the best all-round flavour.

Investing in assets such as equities will generally provide the best returns over the longer term, but your returns only matter when you want to access your capital. These investments will fluctuate in value and those that do so most will (generally) have the greatest potential for return.

Not all investments fluctuate in the same way or indeed in the same direction. Some investments might be rising in value whilst others are falling. We call this 'negative correlation'. By combining assets that correlate differently, we seek to build diversified portfolios that will maximise returns for a given level of risk.

One of the problems with diversification is that correlations between different assets vary over time. Usually fixed interest bonds represent a source of protection during equity market falls but that's not always the case.

> ***“The overwhelming view of professionals is that broad diversification is a sensible approach.”***

8 Failing to rebalance

Investment portfolios have some characteristics in common with gardens: they need regular maintenance to keep them in order. Just as some plants grow faster than others, the same will happen with your investments, which increases your exposure to the more successful constituents. This might appear to be a good thing but it means that your portfolio is losing its original balance and probably becoming more risky.

Simple rebalancing effectively means taking the top off your winners and topping up the laggards. In effect you will tend to be selling down holdings that have become overvalued and buying more of those that appear cheap.

Rebalancing should be carried out at least annually. As long as you are not paying transaction fees then a more frequent approach can help, especially if there have been some big market movements. It's also important to consider any taxation implications - it might not be worthwhile to incur Capital Gains Tax.

> ***"Rebalancing is an essential part of efficient portfolio management."***

9 Going all in (or out)

Since 1984 the FTSE 100 index has fallen by more than 10% in 3 months (or sooner) on more than 35 occasions. If you had invested your life savings just before this happened, you'd be unhappy and probably less inclined to invest again. You might think that a skilled adviser will be able to predict falls of such a magnitude but the reality is that markets operate in a way that makes that impossible.

The only reliable approach for mitigating your risk of being unlucky with timing is to spread your bets. A common approach might be to split the investment into four chunks which can be invested at regular intervals over 12-18 months. If the timing of a phase is in the middle of a period of market turbulence you might be tempted to wait but this must be resisted.

> ***"Phasing takes much of the stress out of large new investments or withdrawals. Stay rational and stick to your plan."***

10 Not facing up to losses

If you make an investment and it drops in value your reaction is likely to be to resist selling until it at least returns to the purchase cost. Humans are poor at coping with errors and so our approach tends to be to 'anchor' ourselves at the price we paid. We persuade ourselves that we will eventually be proved right.

There is nothing shameful about making a mistake, professional investors do it all the time. It's how you deal with it that counts. The pros try to look at all their holdings dispassionately with no regard at all to whether they are standing at a profit or loss (unless there is tax payable on disposal).

> ***"Ask yourself: would I buy this investment today? If the answer is no, then you probably shouldn't continue to hold."***

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