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Worst common mistakes made by DIY investors

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Why DIY investing doesn’t work

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- Numbers - Prove that it doesn’t

- Access - DIY folk lack access
- Industry - Encourages DIY folk to focus on all the wrong things
- Nature of Change - Once every 50 year directional change
- Experience and training - What DIY folk lack
- Behavioral bias - We’re all human
- Retirement years - Facing a different set of powerful issues

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Common behavioral bias - Buy high sell low

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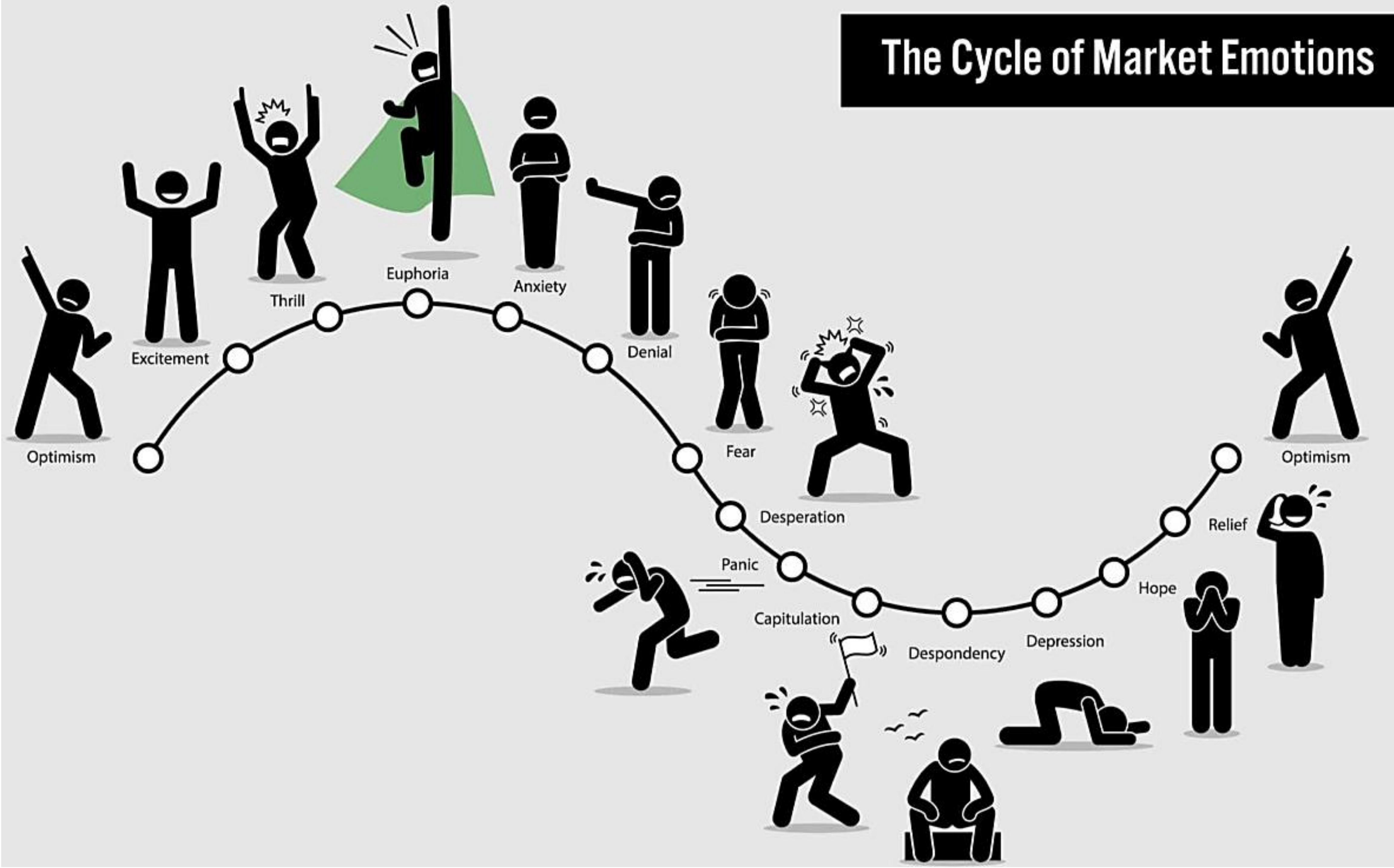

Trend chasing

Believe one can invest in the past

Recency

Recent success decides future decisions

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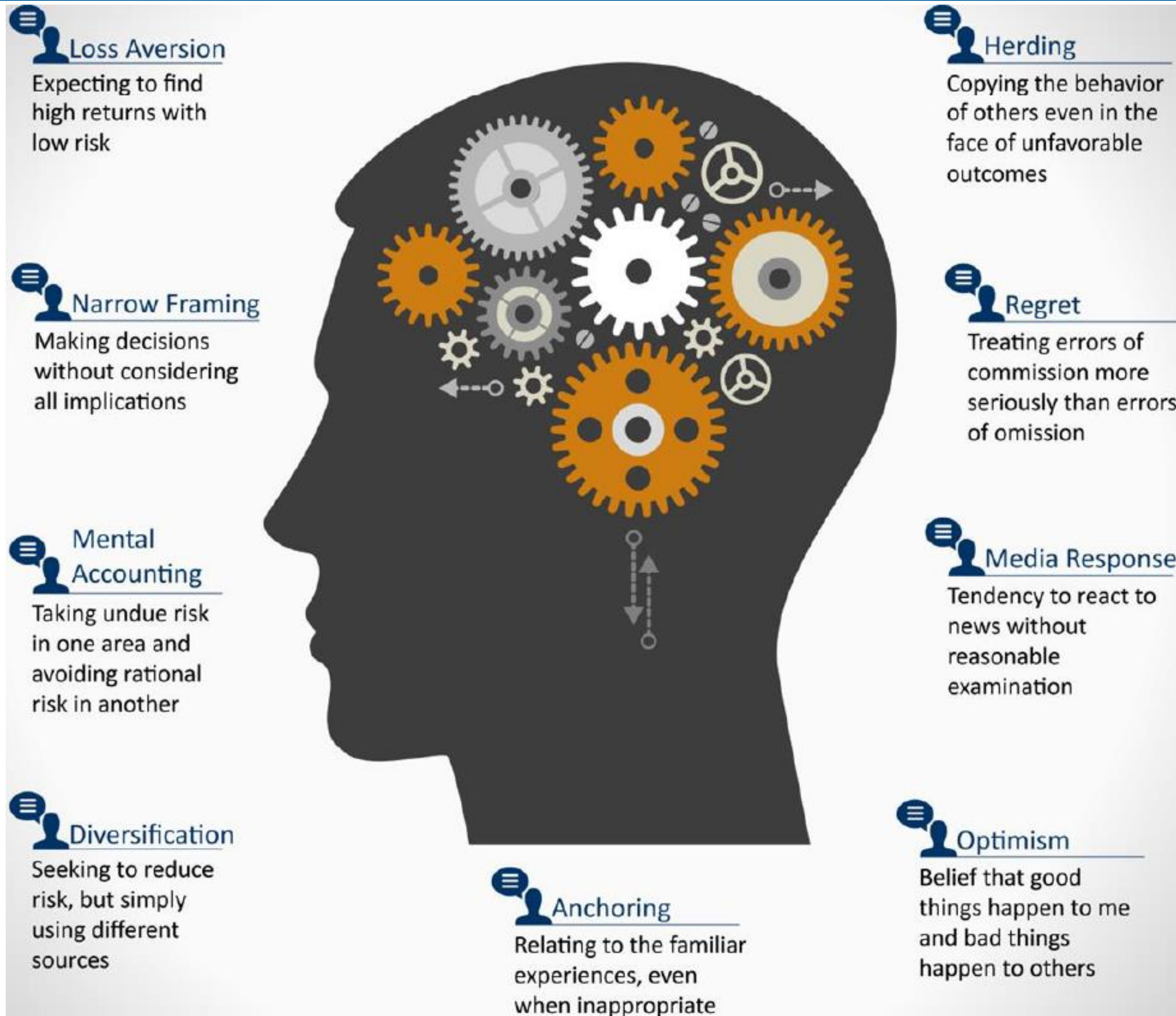
Investing behavioral biases - Nine most common



Loss aversion
Irrational risk avoidance

Diversification
Not understanding the source of risk reduction

Media response
Listening to the news

Narrow framing
Restricting your information

Anchoring
Tying yourself to an initial perspective

Regret
Would of, could of, should of

Mental accounting
Treating different sources differently

Optimism
Overconfidence and lack of humility

Herding
Following the crowd

Worst commonly made mistakes

That we seem to make again, and again, and again

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Endless laundry list

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- How organize
- Behavioral bias *vs* lack of training and experience (deep professional gravitas)
- Greatest damage results from errors made due too behavioral bias
  - Often . . . are life changing, can never be recovered from, put one on a different path
- Those due to lack of experience/training are different
  - Tend to just be a slow grind
  - Continually reducing returns each and every year by a modest amount (but a huge sum over the long-run)

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Mistakes due to behavioral bias

For the most part

The two can never be entirely separated . . . since one is a partial cure for the other

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Mistakes due to behavior bias

- Patience
- Get rich quick schemes
- Knockout risk
- Herding
- Home bias
- Investing in the past
- Liquid alts
- Retirement DIY investing
- The “Age of Disinformation”
- Painting everything with the same brush
- Inability to let go of a recent winner

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Patience

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- Lack of required patience
- Failing to give the investment the time it needs to germinate, sprout, grow, mature, and be successfully harvested

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Get rich quick schemes

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- Falling for that next get rich quick scheme

- Every era has them

- Florida land - 1920s
- Clicks over bricks - 2000
- Crypto, SPACs, meme stocks, NTFs
- Cathy Wood

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Knockout risk

- Get a seriously bad 12-month return
- Can’t withstand the emotional pain of that loss
- You bail out

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Herding

- Identifying your preferred herd
- Joining them
- Running with the herd

- Doing what's popular

- You just want to gain approval . . . and be one of the cool kids

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Home bias

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- Overweighting what's
  - Familiar
  - Comfortable
  - In close proximity

- Irrationally thinking the U.S. offers a superior risk/return ratio
  - Doing so, requires the assumption that markets are inefficient and don't work
  - If this were true . . . why would you invest in them?

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Investing in the past

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- Pick investment manager based on who did best
- Select asset mix because it did well since Sep 1981
- Wait to buy until after it’s gone up . . . then wait to sell until after it’s gone down

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Liquid alts

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- Falling for the enticing well-told stories about how you can have it all
- *“All you need to succeed is use our s . . . “*

- The story of liquid alts
  - Full perfect liquidity
  - Zero correlation
  - Return in up markets and return in down markets
  - A new asset category
  - Bringing to your clients what had previously only been available to the Harvard University endowment and the Rockefeller family

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Retirement DIY investing

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- Spousal handoff . . . . when one passes
- Shrinking network . . . . successful investing needs an “expanding network”
- Cognitive decline
- Change is difficult . . . wait too long and can’t pull it off
- Better use for your time

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The “Age of Disinformation”

- Today, we’re inundated, buried with data . . . but mostly just noise

- Failure to ignore
  - Common media
  - Noise
  - Nonsense or irrelevant talk

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Painting everything with the same brush

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- Mutual funds, ETFs, individual stocks, annuities, bank CDs, bond term funds
- One is not better than the other
- They all have their place, they all have their best use
- The key is to understand that best application . . . and consider all of them

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Inability to let go of a recent winner

- Classic mistake resulting from Recency Bias

- Because it was a winner in the past . . . you feel it will be a winner in the future
- Inability to let go of winners

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Mistakes due to lack of adequate training/experience

For the most part

The two can never be entirely separated . . . since one is a partial cure for the other

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Mistakes due to lack of adequate training/experience

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- Ignoring price
- Cost or price
- Taxes
- Risk/time mismatch
- Structure of the investment industry
- Liquidity
- Objective
- Using individual bonds
- Confusing alpha and beta
- Failing to understand how markets work
- Politics

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Ignoring price

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- Price does matter

- Classic examples, buying
  - TIPS bonds today because you want inflation protection
  - 10-year U.S. Treasury bond because you want default protection
  - Tech stocks in 2000
  - Housing in 2007

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Cost or price

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- One of the criteria to consider when selecting which index fund to use is cost
- Why? . . . because an index fund is a commodity

- Question . . .
  - Is your financial advisor a commodity?
  - Is a successful active investment manager a commodity?

- Price in only relevant in the absence of value
- Don't let prospects/client think you're like an index fund

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Taxes

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- Letting the tax-tail wage the dog
- Which is more important to you?
  - Make a profit
  - Minimize your taxes
- In the long-run tax minimization makes a huge difference
- In the short-run it’s a irrelevant distraction

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Risk/time mismatch

- Failure to match how much time you've got (or have given the investment)

- With . . .
  - The type of investment you're using
  - The level of risk you've taken

- Old Chinese proverb
  - *If you have one year, plant rice. If you have ten years, plant trees. If you have one hundred years, educate children*

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Structure of the investment industry

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- Failure to adequately understand how the investment industry works

- It’s there to make money from you . . . not for you

- Industry’s two greatest strengths
  - Identifying a mispricing, exploiting it for great gain, and thereby eliminating the mispricing
  - Making up and delivering enticing stories

- Misleading you into DIY investing

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Liquidity

- Most investors are irrational when it comes to liquidity

- They demand more than they need
  - Sacrificing considerable return

- But the opposite is also not uncommon . . . not maintaining sufficient liquidity
  - Then demanding liquidity at the worst possible instant, and being severely hurt

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Objective

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- Lack of clearly defined objective
- Inconstant, continually mutating objective
- Multi-dimensional objective with numerous internal contradictions and inconsistencies
- Disconnected from life-needs . . . e.g.: “best the S&P 500”
- Confusing wants and needs
  - Needs . . . generally define the specific objectives of a best-lived, life-long financial journey
  - Wants . . . generally play to your emotional devils

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Using individual bonds

- Just criminal

- Accepting a large level of additional risk with no offsetting benefit
- Additional risks
  - Liquidity
  - Idiosyncratic
  - Default
  - Pricing
- It's impossible to adequately diversify
- Trade costs are horrific and generally well hidden
- The most interesting and useful areas of fixed-income aren't even available . . . forcing you into the least rewarding corners

- Individual bond portfolios are an anachronism from a dark past

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Confusing alpha and beta

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- Incredibly common
- “Don’t confuse brilliance and a bull market”
- Example
  - Bond manager
  - Put up 9.5% annualized since Sep 1981
  - With remarkable consistency
  - Falsely erroneously conclude that they’re brilliant
  - When in fact this manager actually lost you an average -25bps per annum
  - The returns were all attributable to the bull market on bonds
  - And when the bond market reverses . . . This “investment” will be unusually tragic

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Failing to understand how markets work

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- Not understanding that investment markets are
- In the long-run
  - Weighing machines
- In the short-run
  - Voting machines
  - Think of the famous “Keynesian Beauty Contest”

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Politics

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- Letting one's political views to guide or influence their investment decisions

- We've got 100 years of rock-solid data on this
- Investment managers who've based their investment decisions on political views fail
- The behavior of U.S. stock and bond markets is unrelated to political control of the legislature and/or administration
- Except in rare and unusual circumstances

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Advisor value added

Just how much does the advisor save the client by preventing mistakes and behavioral bias?

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Three sets of studies

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- External . . . Dalbar or Cerulli Associates
- Internal . . . when an organization has the client data
- Survey . . . Vanguard, Envestnet, Dimensional, Morningstar

- My understanding is that the number is solidly between 200bps and 300bps
- And that's actually pretty easy to understand
- Given just how much damage is done by some of these mistakes

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Client hires a financial advisor

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- How do they make their selection

- Who is quoting the lowest fee
- Who is showing me the hottest past performance numbers
- Who will beat the markets by the greatest amount
- Who wines and dines me the best

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Maybe . . . clients would be best served by . . .

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- Basing their selection of a financial advisor on . . .

- Which advisor will do the best job of
  - Eliminating behavioral biases (both mine and theirs)
  - Preventing the types of mistakes just mentioned

- The data says . . . clients would be best served by such an approach

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The end of an era (Sep 1981 - Oct 2021) So, what's next?

Friday

February 11th

11:00 a.m. EASTERN

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Important Disclosures

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