Stock Market Perspective: Seven Deadly Sins of Investing

Since biblical times, seven seems to be the magic number when discussing sins of one sort or another, so we might as well use it when discussing mistakes and counterproductive behavior that result in disappointing investment performance. The list below is a good one. Identifying the problems is important, but saying how to cure them is even more so. The solutions are what separate successful investors from those with unsatisfying returns.

▶**1) Emotion:** This one is the basis of several of the others and comes in many guises. Fear and greed are often cited as major drivers of investors' behavior. Another example is "falling in love" with a particular stock or mutual fund. Investment decisions motivated primarily by emotions are not likely to produce favorable results. Fear and greed are usually the strongest near market extremes and result in buying near the top and selling near the bottom, which has been shown to be common investor behavior by several studies of the actions of typical mutual fund investors.

Most of the sins result from making decisions based more on emotion than on reason. A successful investor will avoid these mistakes.

Cure: Turn emotion into reason. This is easier said than done. The solution I use for managed accounts is carefully researched "mechanical" trading models based on mathematical formulas. The basic idea is crunching numbers and having the computer determine what actions are to be taken and when. It is certainly far from perfect, but it does take emotion out of the process.

▶**2) Disorganization:** Having so many accounts and investment "strategies" that one spends too little time reviewing and analyzing holdings is the major indication of this malady. It can easily result in having investment weightings that are far from the appropriate overall target allocations. Being too heavily weighted in what has done the best recently usually increases risk levels by making one vulnerable to almost inevitable pullback.

Cure: Focus on the major investment objectives rather than "failing to see the forest" by looking too closely at individual trees. I can help by reviewing your entire investment portfolio with you and discussing your objectives, strategy for achieving them, and appropriate overall target allocations.

▶**3) Myopia:** This often results in ignoring long-term trends and paying the most attention to recent news making events such as the sudden rise in energy prices. To some extent, in this context myopia is associated with fear and greed. The emotional behavior and the failure to look at the larger context to put things in perspective feed off of each other.

Cure: Don't lose track of the big picture and overall objectives. For example, one can ask if he or she is so sure that energy prices are going to continue to rise at a rapid pace—contrary to the usual course of markets that are subject to the laws of supply and demand—that it is worth the risk of overweighting in those sectors or changing one's investment strategy and target allocations. In other words, keep things in perspective and don't try to chase the latest headline grabbing news events.

▶**4) Impatience:** This one seems to be a way of modern life. How often do you find yourself rushing from one activity to the next? Do you hate waiting in line? It seems normal to want to "do something" and "take control." That often is not what works well when investing. To some extent, impatience is yet another consequence of emotional investing.

Cure: In this case, it is the obvious advice to be patient. Step back and try to look at the big picture of your overall investment portfolio and objectives—see myopia above—and ask if the purchase or sale you are thinking about fits with your overall plan and approach. If so and the decision is not being driven by emotion, usually either fear or greed, then go ahead. Otherwise, patience is likely the best course of (non-)action.

▶**5) Greed:** We talked about it before in conjunction with emotion and myopia, but it is worth its own sin because it is likely the greatest cause of major investment errors. Greed can precipitate two investment mistakes: selling a rising holding too soon to make sure of a profit and buying into a hot, rapidly rising, issue without a valid foundation doing so. What seems to follow is the hot investment cools off and reverses course, one holds on for awhile, possibly having fallen in love with the issue, and finally fear takes over when the stock or mutual fund continues to fall. The result is a substantial loss.

Cure: Aside from the too obvious don't be greedy, one needs to keep focused on the long-term investment objectives rather than trying for quick gains. Having realistic expectations and doing the normal amount of research before taking action—not being impatient—is also an important part of keeping greed out of investment decisions.

▶**6) Arrogance:** To some extent, it is a fellow traveler with greed. When one's investments are doing well, usually when markets are rising, the risk is feeling invulnerable and omniscient. That often leads to high risk actions inconsistent with overall investment objectives. Sooner or later, usually sooner it seems, the markets will go in the opposite direction and the trades made due to arrogance will fail dramatically.

Cure: Some humility when evaluating one's investment abilities is always in order. The most successful investment professionals admit their methods are far from perfect and there is an enormous amount they do not know. I distrust anyone who proclaims something they are recommending "can't miss." Unfortunately, those on TV or sending out enticing mailings rarely show much humility. As Louis Rukeyser used to point out after his guests had made their annual forecasts that did not agree with each other, "I guarantee you that some of them are going to be wrong." I thought he should add, but was too nice to, that every one of them could be wrong.

▶**7) Cowardice:** This is at the opposite end of the attitudinal spectrum from arrogance. Normally, it results from fear, often from having been burned by falling markets and poor past investments. This can easily result in being afraid of taking even the smallest loss, and some losses are an inevitable part of investing in equities and most other instruments. The problem is that for most investors avoiding the possibility of loss will not permit them to get the returns needed to achieve their investment objectives.

Cure: Set up an investment approach that keeps risk to reasonable levels and has a high probability of meeting longer term investment objectives. Then execute according to the plan. I can help in both regards. If one accepts that certain types of investments are needed but is afraid that he or she won't be able to take the needed steps, then having someone else do it is critical.