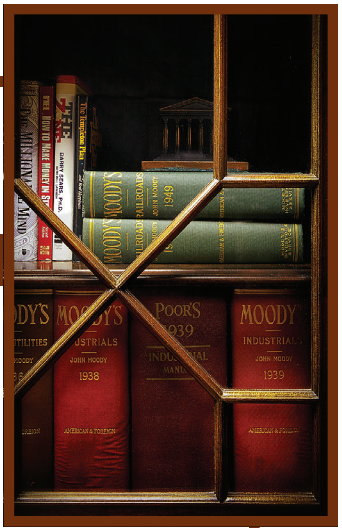
The Investment Letter

Volume 88, No. 2 February 2017



8 Common "Do It Yourself" Investor Mistakes

Investing is vital for financial prosperity. Successful investments can grow assets over the long-term and help produce income for short-term needs. Some investors elect not to work with investment professionals, known as do-it-yourself investors by many. When an individual has ample time, high knowledge of the markets, and sufficient interest, do-it-yourself investing may be a viable option.

However, investing is more than a hobby given its importance for each person's financial future. All too often, we have observed do-it-yourself investors commit errors that jeopardize their returns. Here are the 8 common mistakes we have observed from these investors during our tenure.

1. Failing to Properly Identify Risk Tolerance and Financial Goals

Investment portfolios should be carefully constructed with your risk tolerance and financial goals in mind. Many do-it-yourself investors, however, fail to identify a clear strategy with their investment holdings and, instead, buy what seems "hot" in the moment. By doing so, these investors may take on more risk than what is comfortable and often avoid the most direct path to financial goals.

Properly identifying risk tolerance and financial goals forms the bedrock of successful investing. It is also a continual process, as goals and risk tolerances evolve over time. For most do-it-yourself investors, this step is wrongly overlooked because it takes time and knowledge of well-diversified portfolios to create a custom approach. Investment professionals, such as Investment Counsel, can assist with creating portfolios with specific financial goals in mind. Most investors can also benefit from the objective advice of investment professionals to help honestly assess how much risk he or she is willing to assume with their investments.

2. Lack of Diversification

A diversified portfolio helps reduce the risk of investment loss. What exactly is diversification? The concept is straightforward: diversification seeks to make investments in different industries or asset types (for example, stocks or bonds) to reduce overall exposure. Some do-it-yourself investors, however, will invest in only a few companies or select one industry that they know well. Others may invest entirely in bonds, causing them to incur higher risks of loss and missed opportunities in the stock market.

3. Too Much Diversification

While diversification can help reduce risk of investment loss, too much diversification may jeopardize returns for investors. Many do-it-yourself investors will invest in mutual funds that are over-diversified. Some mutual funds invest in over 100 different securities, which add up to far too many holdings to maximize gains. If a stock boasts strong gains, there is a high probability those gains will be offset by other losses in the mutual fund. Additionally, the investor does not optimize gains from strong performing securities because the total amount invested in each company is extremely small.

4. Procrastinating

Prospective do-it-yourself investors can be reluctant to enter the market out of fear it is not the perfect time to invest. It is of course prudent investing to be aware of the macro and micro-economic climate. However, perceived imperfect economic conditions can cause this "timing" to drag on for many years. A well-balanced portfolio of U.S. stocks can expect to produce average annual returns of around 6%. Outright reluctance to enter the market threatens these gains over time.

5. Trading Too Much

On the other hand, do-it-yourself investors may be quick to buy and sell securities once they enter the market. There are three disadvantages to this approach. First, it is not effective over the long-term. No professional investor has been consistently able to apply techniques to predict stock movement and capitalize on frequent trading. Second, this approach creates additional fees and tax liabilities, which reduce the net return on the investment. Third, it essentially requires the investor to be "correct" three times: when (1) purchasing the stock at the "correct" time; (2) selling the stock at the "correct" time; and (3) re-purchasing additional securities at the "correct" time. It is more effective to buy and hold high-quality securities that will produce long-term gains over time.

6. Frequent Withdrawals

Investors sometimes use investment accounts as checking accounts, withdrawing funds frequently. There are two main disadvantages to frequent withdrawals. First, the investor may incur more tax liability if there are any realized gains associated with the withdrawal. Second, and most importantly, the investor does not reap the benefits of compounding interest on these funds.

Albert Einstein once called compound interest the "Eighth Wonder of the World." Its importance cannot be overstated when it comes to investments. A simple example can illustrate: say you have $100,000. Assuming a 6% annual return with compound interest, your initial investment would grow to $320,713.55 in 20 years! By making frequent withdrawals, investors are missing out on harnessing the power of compound interest.

7. Ignoring Tax Consequences

Some do-it-yourself investors will also trade throughout the year, only to find some unwanted surprises when it comes to tax season. There are several techniques to reduce tax liabilities, many of which go unnoticed by these investors. When calculating net returns on investments, it is essential to subtract additional tax liabilities caused by the investments. Do-it-yourself investors often neglect to factor in the importance of tax liabilities created by their investments.

8. Overpaying for Investment Fees

Collaborating with an investment professional can often assist investors because the professional adds a layer of objectivity and expertise to the process. When doing so, it is essential for the investor to understand their investment fees. Many investors, especially those working with professionals who trade on a frequent basis, are paying extremely high fees that are cutting into their net returns. Additionally, there may be professionals who charge commissions associated with different product offerings. When viewing overall investment performance, investors must be sure to view their net performance minus fees.

Investment Counsel is a fee-based, Registered Investment Advisor. What does this mean? We do not charge any commissions and we only offer impartial advice to our clients. We also make sure to research industry fees and offer low fees to our clients.

Conclusion

We like to point out these common mistakes because our firm has seen them committed all too often before seeking our services. We have worked with many former do-it-yourself investors who have benefitted from our objectivity, expertise, and investment approach. We have also worked extensively with younger family members of clients, such as children and grandchildren, who may be new to investing. Through this work, we seek to create successful investing strategies that can survive generations. ■

Investment Counsel News

Inside the Office

We continue to offer complimentary financial plans to our clients and client acquaintances. Please contact us if you would like more information on this service!

Outside the Office

On behalf of Career Dress, Chris' wife, Barbara (center), gratefully accepted a donation from Women's Life Chapter 864.

Career Dress Services is committed to promoting the economic independence of low/moderate income women in Southeast Michigan by providing professional attire for women actively seeking employment.

For more information www.careerdress.org.