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Think like a rat and other tips to avoid pitfalls

Kathy M. Kristof

July 11, 2004

LOS ANGELES -- If investors would act a bit more like rats, they'd do much better in the stock market, said Ernie Ankrim, chief investment strategist at Russell Investment Group in Tacoma, Wash.

The evidence? Behavioral scientists conducted a study that provided rewards for predicting whether a green or red light would flash next. The green light flashed 80% of the time, and the red light 20%, in random order. That's about how stock prices perform, incidentally -- winning in roughly four years of five, but in no set pattern.

Both rats and people recognized that the green light flashed more, but they responded differently. Rats chose the green light every time. People tried to predict when the red light would flash. End result: Rats won 80% of the time; people won just 68% of the time.

When it comes to investing, the propensity to perceive patterns where there are none can cause investors to chase hot market segments -- but often after the sectors have started to cool. And it causes them to avoid markets that haven't done well lately, even though that's often the optimum time to invest, Ankrim said.

That's just one of a handful of errors that experts say they see all the time. Investors can save themselves a fortune just by recognizing and avoiding a handful of common mistakes, financial professionals say.

Here's a look at eight of those common gaffes and how to avoid them.

* Investing without a plan. Too often, investors start buying stocks or bonds at random, never looking closely at how those investments suit their goals and lifestyle. That can cause short-term goals to be funded with assets that are too volatile -- a lesson many individuals learned the hard way when stock prices crashed earlier this decade.

Alternatively, some investors try to finance long-term goals such as retirement with investments that are too conservative, and too low-yielding to keep up with inflation.

Investors need a game plan, but there's no formula that's right for everyone, said David Darst, chief investment strategist at Morgan Stanley in New York. He urges investors to look at their income, assets, age, goals, personal preferences and risk tolerance to come up with an investment strategy.

The strategy can be as simple as deciding that six months' worth of living expenses will be in bank accounts and the rest in mutual funds that own big-company stocks. Or, it can be a complicated plan that involves lots of asset classes, international investments and individual stock holdings. But what it needs to be is a plan that the investor understands and can monitor.

The simple way to start is to consider the investor's goals and match asset classes such as stocks, bonds and cash to amounts of money designated to achieve those goals. Cash

investments such as money market funds, Treasury bills and bank accounts are a perfect investment for near-term goals, such as emergency reserves. Stocks are better-suited for long-term goals, such as a faraway retirement. The process of deciding what percentage of invested assets will go into each investment category is called asset allocation, and it's the cornerstone of any good investment plan.

* Getting off balance. An asset allocation strategy is just a first step. The portfolio needs to be adjusted over time, because market gyrations — stocks doing better than bonds, for example — will eventually knock the allocation out of balance. Investors need to force themselves to take some of their winnings from one category and invest that money in parts of their portfolio that aren't keeping pace. It's counterintuitive, but it's the essence of buying low and selling high. Notably, those who regularly rebalanced their portfolios ended up selling some stocks as they were running up wildly in the late 1990s, while buying bonds, which had been depressed. That seemed like a bad idea at the end of 1999, but was brilliant by year-end 2000. Likewise, rebalancers sold bonds in 2002 and bought stocks, Darst said, which was another sage move.

* Losing focus on the long term. Investors should always have a clear idea of why they've purchased a particular stock or mutual fund. They need to think through what factors differentiate this investment from others and what would make that change, said David Brady, president of Brady Investment Counsel in Chicago. Trading when there's no shift in the investment's fundamentals is a mistake. But, too often, investors get swayed by short-term news, such as earnings reports and product announcements. That can cause them to buy high and sell low, he said.

* Failing to account for trading costs. Between paying brokerage fees and income taxes, investors lose a substantial portion of their profits each time they trade. Still, many fail to account for these costs, so they trade frequently and depress their long-term results, Brady said. Leaving investments alone for the long haul is the strategy employed by billionaire investor Warren Buffett. Like Buffett, the strategy has a long track record of success.

* Forgetting fees. Whether investing through mutual funds or actively managed accounts, investors need to pay close attention to the fees that are taken off the top. Usually called "management" or "12(b)1" fees (after the federal regulatory code that governs them) these costs can rob investors of a huge portion of their returns. Investors often think they're innocuous because they amount to just 1% or 2% of their investment assets each year. Investors often think wrong.

"If I can save an investor even just 50 basis points [half a percentage point] in management fees, I can save him a fortune," Brady said. Consider an investor who has \$1 million and earns 10% on average on his investments. Paying 1% versus 0.5% in annual management fees will cost him \$111,000 over 10 years and a startling \$537,000 over 20 years, Brady noted. "That's more than half of his original investment. Fees are a huge issue to a long-term investor."

* Paying too much — or too little — attention. The investment world is made up of two types of investors, Darst said: those who look at their portfolios too frequently, and those who don't look enough. Those who over-manage often trade too frequently; those who under-manage tend to miss opportunities, he said. The smart investor figures out a strategy for checking on investments often enough to make sure they're still suited to his goals, but not so often that he's tempted to rearrange things that are working. What's the right amount? It depends on the investor, Darst said, but at least once annually.

* Swinging at every pitch. Sometimes the investment opportunities are lousy, Darst said. But some investors think that they have to buy something just because they have cash. It's smarter to wait until you find an investment that's a good deal. "It's like baseball," he said. "Let the fat pitch come to you."

Kathy M. Kristof, author of "Investing 101" and "Taming the Tuition Tiger," welcomes your comments and suggestions but regrets that she cannot respond individually. Write to Personal Finance, Business Section, Los Angeles Times, 202 W. First St., Los Angeles, CA 90012, or e-mail kathy.kristof@latimes.com.

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