

Successful Investor Series



10

**Most Common
Investment Mistakes**



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Mutual funds managed by highly intelligent people seldom out perform their benchmark index.

Introduction

"Success in investing doesn't correlate with I.Q. once you're above the level of 25. Once you have ordinary intelligence, what you need is the temperament to control the urges that get other people into trouble in investing." - **Warren Buffett**

The preeminently successful long term investor Warren Buffett clearly states that behavior plays a much greater role in investment success than intelligence. Mutual funds managed by highly intelligent people armed with graduate degrees from the finest universities seldom out perform their benchmark index. Twenty years of data shows that returns made by the average investor lag behind the returns of the average mutual fund significantly. There is a way to go from being an average investor to a successful investor.

Why is behavior more important than intelligence with investing? The answer lies in the way the human brain is wired. We are driven by emotions, including fear and greed, and do not always make decisions in a cold, calculated manner. The field of behavioral finance explains how emotions and biases influence our investment making process. It doesn't take much for even the most intelligent person to get carried away by emotional influences.

Behavioral factors explain why there are bubbles and crashes in the financial markets as history keeps repeating itself. Each time there is a rise or fall, investors refuse to believe it is the same old past showing up. These dangers cannot be listed in order of importance as none are more common or dangerous than others. The most dangerous mistake on the list is the one the investor is currently contemplating. The object of this paper is to prepare and educate investors to the dangers in investing and mistakes that should be avoided. Additionally, we hope this paper helps you in achieving your long term planning investment objectives.



Life expectancy is on the rise in the United States.

Risk comes from not knowing what you are doing.

Investment Mistake 1: Underestimating Your Time Horizons

Life expectancy is on the rise in the United States, thanks to advances in disease treatment, better standards of living and increased health consciousness. On average, people live at least 25 years after retirement. The U.S. Department of Health & Human Services has shown that human life expectancy was 68.6 years in 1952 and by 2004 that figure had risen to 77.8 years. Every year for the last 25 years show the figure is increasing.

What does this mean? Investors should structure their portfolio to get returns to sustain their financial needs with increased life expectancy. Too many investors underestimate the time horizon over which their capital will be needed. As a result, they start decreasing equity exposure and increasing bond exposure as their retirement approaches. As they live longer, their total capital may be inadequate to provide for them. Many run the risk of depleting their funds long before their lives are over.

Successful investors avoid this mistake by having a sound financial strategy that will provide for their financial stability and income needs. They also overestimate their time horizon and implement a conservative strategy thus protecting portfolio assets through their life expectancy.

Investment Mistake 2: Investing In To Many Things

An old adage teaches us, “not to put all our eggs in one basket”, but some investors take this too far. Spreading their portfolio thin by investing in too many stocks or asset classes. Diversification beyond a point doesn’t help the cause of risk reduction and can sometimes increase the risk of the portfolio.

Warren Buffett said, “Risk comes from not knowing what you are doing.” Many investors lose a proper perspective and soon forget why they own certain investments in their portfolio. Investors tend to want to own investments because their friend owns it, which shouldn’t be the only reason for making an investment. Investors must consider factors such as sector, country, currency, valuations, size and liquidity in a properly diversified portfolio. Successful investors avoid this mistake by understanding that portfolio diversification needs to be smart, simple and based on reason.



As inflation increases, your purchasing power gets eroded.

Behavioral experts have proven that investors are far from rational.

Investment Mistake 3: Ignoring the Danger of Inflation

Inflation refers to rises in price. As inflation increases, your purchasing power gets eroded and consumers can purchase a lesser quantity of a product for the same amount over time. If inflation is running at 4% and your portfolio returns 4% net of expenses, you are receiving 0% return in real terms. Hence, inflation is called the “Silent Tax”.

Your portfolio needs to yield a return that is positive in real terms despite inflation. The more cash and bonds you have in your portfolio, the more you suffer in an inflationary environment. A globally diversified portfolio of stocks are historically a good hedge against inflation.

Looking ahead just 10 years with an inflation rate of only 3%, the hidden cost of inflation means a monthly food bill of \$300 today will cost \$403 a decade from now—that’s a staggering 34% increase!

Successful investors avoid this mistake and protect against inflation by investing in sufficient and careful amounts of stocks and bonds.

Investment Mistake 4: Getting Caught Up in Euphoria

Most investment theories assume that investors are rational. However, behavioral experts have proven that investors are far from rational. There are times when the overall sentiment is so positive that, despite no independent support, the only direction the market goes is UP! The excitement of participation in a strong market often entices investors to follow the crowd, believing that the majority can’t be wrong and leading to losses when the market normalizes. Such bubbles have happened many times in the past and certainly will happen in the future.

Some past examples of investment bubbles are:

***1999 Technology Bubble *2005 Real Estate Bubble *2008 Oil Bubble**

When someone tells you “this time it’s different,” you need to avoid the temptation to act against your interests. Irrational exuberance will most certainly lead to losses because what goes up (without any basis), eventually comes down.

Successful investors avoid this mistake by staying focused with their well-structured financial strategy and using healthy skepticism.



Investors often forget that stock market declines are temporary and advances will soon follow with time.

Margin calls can impose a significant cost and the investor can find themselves in a tough spot if the market goes up or down.

Investment Mistake 5: Panicking In Turbulent Times

Acting inappropriately in a declining market can be a big financial mistake and a huge temptation to investors. Once a bubble bursts, investors tend to act as though the market will never recover. Investors must acknowledge that the market will experience declines, but will be balanced out by long-term gains.

Going back a century, data shows that investors who bail out of equities and bonds during times of uncertainty are almost always making the wrong decision. Investor's who panic and sell often times miss the advances. Investors often forget that stock market declines are temporary and advances will soon follow with time. Remember the following events that led to market declines:

***1970's Stagflation *1987 Stock Market Decline *1990's Savings & Loan Crisis**
***1995 Asian Crisis *September 11, 2001 *2007 - 2008 Credit Crises**

Successful investors avoid this mistake by not losing sight that their current condition is only temporary. They don't focus on short-term volatility rather on long-term probabilities of achieving their objectives. They look to history as a guide to bring them through the current crisis. We must have faith in the future. The dark clouds don't last forever!!!

Investment Mistake 6: Enticed by Leverage

Leveraging refers to investing in stocks and other instruments by borrowing money. When stock markets are on the rise, it is seductive to think about borrowing money at a low rate and investing with the hope of making higher returns. However, with higher returns come higher risks and if sufficient returns do not materialize, the investor may not be able to meet their debt commitment. Also, margin trading (trading on borrowed money) significantly amplifies the effect of leverage and once the market starts going against the investor, margin calls can impose a significant cost and the investor can find themselves in a tough spot if the market goes up or down.

Successful investors avoid this mistake by not investing beyond their means. Leverage has the potential to make you pay dearly and the possibility of accelerated losses.



Speculating is often a matter of luck and beyond anyone's control.

A large percentage of the population doesn't have a map or plan for their financial future.

Investment Mistake 7: Speculating

An investor chases value while a speculator chases price. A speculator is interested only in catching the trend. The focus is on benefiting from price fluctuations with no understanding of the inherent value of the asset. Benjamin Graham, the father of value investing and Warren Buffett's college professor, distinguishes between investment and speculation as follows.

"An investment operation is one which, upon thorough analysis, promises safety of principal and a satisfactory return. Operations not meeting these requirements are speculative."

Take careful note of Graham's insight; speculation does not promise safety of principal and satisfactory return. Hence winning by speculating is often a matter of luck and beyond anyone's control. Stock market bubbles are inherently speculative and hence not sustainable. A speculator thrives as long as a greater fool exists. Beware that the fool isn't you.

Successful investors avoid this mistake by developing long term investment goals, and avoiding the temptation of adopting short term goals, which encourage stock speculation instead of prudent investing.

Investment Mistake 8: Not Creating A Purpose & Written Plan

Why do you invest? What rate of return are you expecting? When can you retire? What lifestyle do you desire in retirement? What's the risk that you will run out of money? What will college cost for children and grand children? How much stock and bonds should you own? All of these questions are important. People want and need to know these answers. Unfortunately, a large percentage of the population doesn't have a map or plan for their financial future. It's a human instinct to procrastinate.

Successful investors avoid this mistake by understanding the importance of having a sound financial strategy. They take the time to answer their important financial questions and work with their advisor on structuring a written plan that will provide for their financial stability and long term income needs.



Successful investing takes time and patience.

Diversification is the process of spreading your assets among different types of investments.

Investment Mistake 9: Lacking Patience

Our current society teaches and encourages instant gratification. There are ATM machines, drive thru's for: food, laundry, banks and even marriages in Las Vegas, automatic payroll deposits, automatic vehicle deductions, and television remotes. These things are helpful and make our lives easier. However, they also make it challenging for us to show patience in other areas of our lives. They can take from our mind the virtue of patience.

Investing is similar to gardening. The process of planting a seed and having it grow requires time and patience. It is unproductive to pull out the growing plant to examine it's root system to determine if the plant is growing.

Successful investing takes time and patience. The market doesn't always work as per investment models and frameworks, and often times exhibit bouts of irrationality.

Successful investors avoid this mistake by waiting and avoiding hasty decisions and recognizing that they need to look at the market with a long term perspective.

Investment Mistake 10: Ignoring Diversification

The market is unpredictable. Diversification is the process of spreading your assets among different types of investments to help lower your risk of loss, since gains in one investment may offset losses in another investment. This powerful idea is especially important when market volatility is high. During such periods, investors tend to make ill-considered buy and sell decisions that can jeopardize their portfolio asset allocation and undermine their strategy. While diversification may offer protection in a volatile market, it does not ensure a profit, nor does it provide any guarantee against a loss.

The areas of investment diversification would include the following: Fixed Income, US Equities (Big Companies & Small Companies), International Companies, Emerging Country Companies and Real Estate. Another area of diversification would include types of investment accounts: Taxable, Tax-Deferred and Tax-Free.

Successful investors avoid this mistake by spreading their assets among different types of high quality investments and not ignoring foreign equity markets. The world everyday is beginning to be less flat and more accessible.



In Summary

The ten most common investment mistakes are summarized as follows.

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|---------------------------------------|--|
| 1. Under-estimating Your Time Horizon | 6. Enticed By Leveraging |
| 2. Investing In To Many Things | 7. Speculating |
| 3. Ignoring The Danger of Inflation | 8. Not Creating a Purpose & Written Plan |
| 4. Getting Caught Up In Euphoria | 9. Lacking Patience |
| 5. Panicking in Turbulent Times | 10. Ignoring Diversification |

Conquering behavioral investment weaknesses are not easy but is important. This paper is meant for investors who are willing to learn. Some mistakenly believe that they can outsmart the market by sheer intelligence. Let such people continue to encounter investment dangers.

We end this paper with a final quote from Warren Buffett.

"You're neither right nor wrong because other people agree with you. You're right because your facts are right and your reasoning is right - that's the only thing that makes you right. And if your facts and reasoning are right, you don't have to worry about anybody else."

Successful Investing!



How **Arista** can help you

Arista Wealth Management specializes in retirement and income planning for individuals, families, retirees and business owners with complex financial situations who are interested in building clear financial strategies. We collaborate with clients to create individual financial plans using the best technology, products, resources and team available. The outcome is a clear financial strategy based on your hopes and dreams. We strive to make YOU successful.

Independent and Unbiased... Arista Wealth Management is an autonomous firm with no ties to sales managers or quotas. The financial professionals at Arista Wealth Management offer securities and advisory services through Fidelity Investments, which is a member of the NASD, SIPC and FINRA. This is an important benefit that every client should be aware of because we are not compensated by selling clients' proprietary investments; therefore we are able to give clients objective and unbiased advice so that they may make an informed decision. All portfolios are customized to the specific needs, time horizons, and risk management of each clients' goals and situation.

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