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# 9 Investment Pitfalls

For High Net-Worth Investors to Avoid in 2012

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Few words better characterize today's financial markets than *uncertainty*. We believe investors need to adjust their expectations in order to adapt to the road ahead. It seems to be the nature of today's markets to subject investors to sharp price fluctuations and confusing global events that test emotional fortitude at every turn. Experience has taught us that successful investing requires discipline and the patient execution of a long-term strategy, most especially when it is emotionally difficult; in fact, that is usually the time when opportunities are greatest.

In order to help our clients chart a course in uncertain waters, we've compiled a list of critical mistakes to avoid during the remainder of 2012, and into the future.

### Mistake #1: Expecting a Smooth Ride

You probably remember the heydays of the 90's when many investors felt like they were on an elevator heading for the top floor. Today's markets are not like that, and it's a mistake to think that we will return to those conditions any time soon. In this "new normal" economy, big swings in the markets have many people scared stiff. However, even in a choppy market, with the right mix of investments, there is money that could be made.

In order to help navigate the turbulent markets of today, it is critically important to structure your portfolio to minimize declines in down markets. This definitely does not mean to cash out when you lose confidence and re-invest when you begin to feel better about the markets (See Mistake #2 about the perils of trying to time the market). This means that during periods of market turbulence, you may need to adjust your mix of investments. It is also important to remain flexible in your investment selection, so as to take advantage of mispriced assets in a way that can both help to reduce risk and increase returns.

However, both these techniques require active, professional management. You simply cannot count on achieving these results in a basic retirement account. Regardless of your investor profile or long-term investment goals, making the most of today's markets and holding onto your investment returns will require conviction in your investment strategy. Retreating and starting over each time is almost a sure path to ruin.

## Mistake #2: Trying to Time the Market

When markets are rallying or pulling back, it's often very tempting to try and seek out the top to sell, or the bottom to buy. The problem is that investors usually guess wrong, missing out on the best market plays. Does the cost of trying to time the market make a big difference in your returns? You bet it can.

For example, between 1986 and 2005, the S&P 500 compounded at an annual rate of 11.9%—even while weathering Black Monday, 9/11, and various booms and busts. Over that period, \$10,000 invested in 1986 would have grown to over \$94,000.<sup>i</sup> However, according to a recent Dalbar report, the average investor's return during that period was just 3.9%, meaning that same \$10,000 grew to just over \$21,000.<sup>ii</sup> Why? Trying to time the market. The average investor misses out because their money tends to come in near the top and come out at the bottom. The problem is that the majority of equity gains are made in a very short amount of time. If you're not in the stock when it moves, you may miss out on the whole play.

The bottom line is that it's virtually impossible to accurately find the top or bottom of the market, and no one can do it consistently.

## Mistake #3: Taking Too Much Risk

Not only do many investors pay the timing penalty, they also pay a penalty for having too much risk in their portfolios. During the bull market days of 2000, money poured into equities, mostly into risky tech and internet stocks. The boring “value” stocks trading at low earnings multiples saw many of their investors fleeing towards higher returns. However, during the terrible bear market that followed 9/11, many of those “boring” value stocks weathered the storm well, while the bottom fell out of the tech industry. Investors who took on too much risk, afraid to miss out on the dotcom boom, saw their portfolios take a severe beating.

One of the major differences between amateurs and investment professionals is that the professionals seek to understand and manage portfolio risk. Prudent investors consider the risks contained in an investment position and cut down their position and market exposure if they determine that their portfolio contains too much risk.

The markets of 2012 are still volatile, and holding too much risk can spell disaster for your financial future. A few questions to ask yourself when evaluating your portfolio:

- Are you too heavily invested in one asset class, sector, or geographical region?
- Do you hold too many alternative investments?
- Do you hold many of the same investments or overlap too much?
- Is your portfolio correctly structured for your long-term goals, investment horizon, and appetite for risk?

Portfolio risk can be insidious. You might think that by holding a diverse mix of stocks, bonds, and alternatives that you are adequately managing your risk, but it's very possible that your investments are correlated and may react to a market decline in the same way. One of the best services an investment professional can provide is a clear-eyed evaluation of risk and an asset allocation structure to mitigate it while still helping you reach your goals.

#### Mistake #4: Taking Too Little Risk

A portfolio containing too little risk can leave you feeling safe but sorry as your portfolio misses out on the important market rallies. With so much turbulence in the markets, many investors are flocking to so-called safe haven investments like U.S. Treasuries and cash. This aversion to risk can have serious adverse effects on long-term investments, as too many fixed-rate investments put a cap on your portfolio's upside. Too little growth in your investments can leave you with a shortfall in your retirement years.

While it is true that equities have greater loss potential than short-term fixed-rate investments, they also have a greater potential for gain. For many investors, hunkering down in safe haven investments is a luxury they simply can't afford. With inflation eating away at cash every year, most investors need at least some growth-oriented investments.

#### Mistake #5: Making Emotional Investment Decisions

The vast majority of investors lost money in the mortgage-meltdown crash of 2008. Many cashed out near the bottom, fearing that the markets themselves were collapsing, and still have their money sitting on the sidelines. The scars of the crash, when the markets experienced serious intra-day swings, run deep.

A 2011 study by benefits company Aon Hewitt showed that boomers are especially at risk of making emotional investment decisions. Study results showed that those nearing retirement become very loss averse, and are prone to bailing on the market during declines. The problem is that these are the investors who have the most to lose by making poor investment decisions.

According to the study, the share of 55 to 60-year-old workers with less than 5% of their money in stocks rose from 9% at the end of 2007 to 14% at the end of 2008. Meanwhile, for those 60 plus, the percentage rose from 13% to 18%, and for the 50 to 55 age cohort, it climbed from 7% to 11%. Instead of seeing the big picture, taking advantage of the volatility, and rebalancing, many of these investors cashed out, locking in their losses; worse, most of them did not get back in for the 2009 rally.<sup>iii</sup>

There are two emotions that you need to confront whenever you make financial or investment decisions: fear and greed. Fear can cause us to abandon an investment strategy when the outcome is not what we want. Greed can cause us to chase investment fads and take on too much risk. It's impossible to avoid feeling these emotions when making important financial decisions; however, you can recognize them, and engage your rational mind to overcome them.

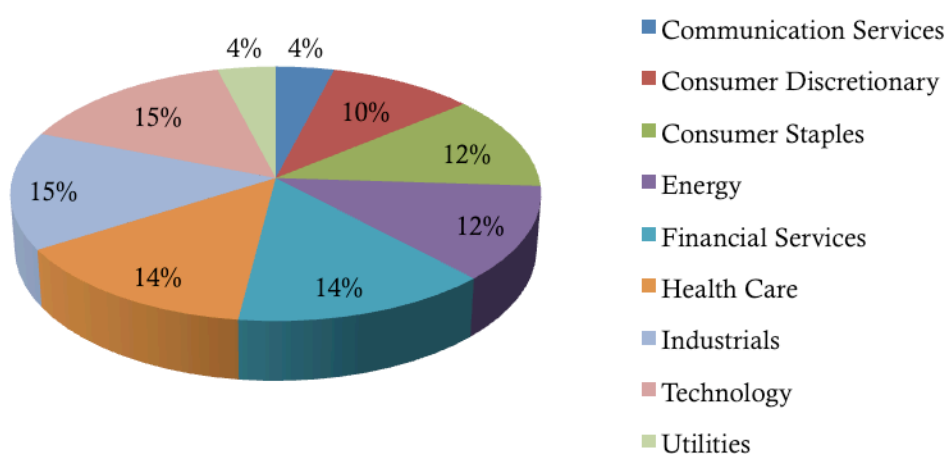
### Mistake #6: Failing to Diversify

Warren Buffett once said that diversification\* is a “protection against ignorance,” meaning that when it comes to investing, there's no way to know everything about an investment and no way to predict the future. Even the Sage of Omaha makes poor investment decisions, and diversification prevents one error from taking down his whole portfolio.

The first step consists of diversifying between asset classes. This means maintaining a good mix of stocks, bonds, cash, and perhaps some other types of alternative investments like real estate, or other investments that are a good fit for your goals and investor profile. The problem is that many investors have a tendency to chase performance by aggressively investing in a single class of investment: stocks when the equity markets are rallying, and bonds or cash during a market decline. This lack of diversification can play havoc with a portfolio during times of market turbulence.<sup>iv</sup>

The second part of a properly diversified portfolio is diversifying within an asset class. One of the most critical mistakes many working investors make is to have too much (more than 10-15% of their portfolio) in their company's stock, which can spell disaster if it takes a turn for the worst – imagine, losing your job and your retirement savings in one fell swoop. For example, it's important to have a good mix of small-cap, large-cap, international, and sector-diverse equities in a portfolio. While a certain stock or sector might be affected by a market decline, a gain in another might offset it.

## U.S. Sector Weighting Options



Source: Morningstar

### Mistake #7: Focusing more on Returns than Managing Risk

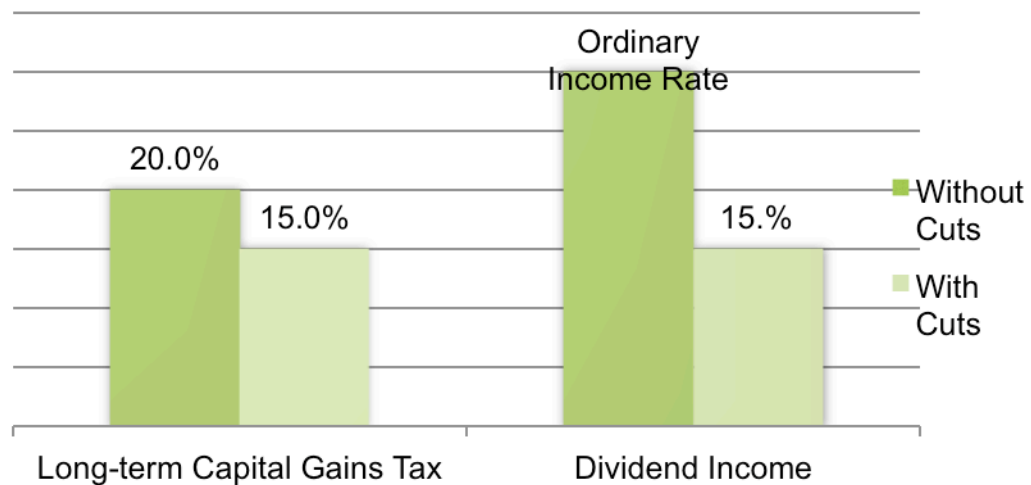
Chasing performance is one of the biggest errors made by investors. That feeling of “I don’t want to miss out” has probably led to more investment mistakes than any other factor. If you take the time to study past performance, you will discover that it is not a reliable way to predict future winners. The growth stocks that were popular in the 90s had been churning out double-digit returns for several years, when they suddenly went south, taking many investors’ portfolios with them.

The lesson here is that if a particular asset class has outperformed for three or four years, you can know one thing with certainty: you should have invested three or four years ago.

Often, by the time the average investor has decided to invest, the “smart money” has already gotten out while the not-so-savvy money continues to pour in. Don’t make this mistake. Stick to your strategy, rebalance, and focus on getting into investments with great fundamentals.

### Mistake #8: Ignoring the Impact of Taxes

The Bush-era tax cuts and their extensions are scheduled to expire at the end of 2012. While we cannot predict what actions Congress will take, 2012 will very likely be a critical year for tax planning. For example, as seen in the chart below, capital gains and dividend income taxes will grow significantly in 2013, meaning that investors experiencing investment gains may have a heavy tax burden in the coming years.



Source: Turbo Tax

In order to avoid being hit with high taxes, look for ways to take advantage of this year’s maximum long-term capital gain rate of 15%. For instance, consider selling appreciated assets before year-end and postpone selling those with losses until 2013.

Though this strategy is not right for everyone, for some of our clients, we are shifting a portion of their investments to assets that generate federally tax-exempt income, such as municipal bonds. Note: While taxes are not something you should ignore this year, your investment strategy should be based on your investment goals, appetite for risk, and time horizon.

## Mistake #9: Not seeking Professional Advice

In a study conducted at Yale and Princeton, psychologists gave undergraduate students questionnaires asking how they compare with their classmates in a variety of skills and tasks. For example, one question asked: “Are you a more skillful athlete than your average classmate?” The overwhelming majority of students responded that they are above-average athletes, drivers, dancers, students, and so on.<sup>v</sup> Obviously, not all of them can be above average. The same issue of over-confidence exists among investors. It was easy in 1999 and 2000 for investors to delude themselves about their investing skills when a few lucky stock picks quadrupled overnight. However, consider how many of these genius investors were able to save their portfolios during the bear market that followed?

Quite simply, the old days of achieving steady returns through cookie-cutter approaches are over. Successfully navigating the turbulent investing world of today requires professional training, active management, and loyalty to a long-term, active investing strategy.

## Conclusion

Investors who recognize and avoid these nine common pitfalls give themselves a great advantage in meeting their investment goals. Particularly in times of economic uncertainty and market turbulence, we believe that it is important to seek the advice of a financial professional when investing. A long-term investment strategy requires a personalized plan that takes into account your current and future needs, investment time horizon, and appetite for risk. This helps to ensure that no matter what the markets are doing in the short-term, you know that your investments are working towards your long-term goals. It is critical that you develop the discipline to stick with your plan. That discipline is most important when markets are pulling back and investors’ fears can get the better of them.

While it is impossible to predict what the markets are going to do in 2012, generally, each downside contains an upside somewhere else. We specialize in seeking out these upsides and diversifying\* our clients’ investments into different asset classes. Our goal in doing this is to help them smooth out the highs and lows, avoid the worst-case scenarios, and take advantage of the opportunities that exist.

One of the most important benefits of working with a professional financial advisor is the greater comfort of knowing that you have professionals monitoring the economy and financial markets. We want to assure you that we diligently research current trends and use all the analytical tools at our disposal to help you make solid investment decisions. Above



all, we want to help our clients relax and enjoy the lifestyle that they have worked to build, knowing there is an experienced, vigilant hand at the tiller.

If you ever have questions or concerns about your portfolio, we are at your service.

**Call today for a free consultation 561-961-5418, or visit [www.kpwealth.com](http://www.kpwealth.com).**

**Footnotes, disclosures, and sources:**

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Past performance does not guarantee future results.

You cannot invest directly in an index.

Consult your financial professional before making any investment decision.

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We have not independently verified the information available through the following links. The links are provided to you as a matter of interest. We make no claim as to their accuracy or reliability.

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<sup>i</sup> Source: Yahoo Finance

<sup>ii</sup> <http://www.qaib.com/public/default.aspx>

<sup>iii</sup> <http://www.forbes.com/sites/janetnovack/2011/09/26/study-boomers-making-more-401k-investing-mistakes-than-younger-folks/>

<sup>iv</sup> <http://news.morningstar.com/articlenet/article.aspx?id=310230>

<sup>v</sup> The Role of Constructs in Psychological and Educational Measurement

Book by Henry I. Braun, Douglas N. Jackson, David E. Wiley; Lawrence Erlbaum Associates, 2002.