Avoiding the Common Pitfalls of Investing

Everyone makes mistakes one time or another. As investors, we need to learn from our investment mistakes by recognising them and making the appropriate adjustments to our investing discipline.

Many people invest without learning adequately about the investment process or the different investment products and without considering what they really want to achieve over the long-term. These kinds of investors often react negatively to the short-term volatilities of the markets, heed the advice of self-proclaimed gurus, enter the markets at an inopportune time, and subsequently end up with a mountain of losses.

The following are some of the common mistakes that investors make that can hurt the performance of their portfolio:

1. Not preparing emergency funds before investing

Investing without any allocated emergency funds is like going water rafting without a life jacket. Before venturing out to the markets, investors are advised to set aside at least three to six months of expenses to take care of financial emergencies (such as a job loss) or unexpected cash flow problems. The fundamental purpose of this cash buffer is to provide both fiscal and emotional stability during times of personal economic upheaval.

2. Market timing

Although markets may move in cycles, this does not necessarily mean that we can determine when to enter and exit the market at its lows and peaks respectively. Seasoned and successful investors like Warren Buffett do not use market-timing tools because they, more often than not, do not work. Thus, individual investors will save themselves from substantial losses if they stay away from trying to time the market. In fact, given their limited experience in understanding financial markets, individual investors would do better focusing on investing in unit trusts for the long run.

3. Procrastination

Investors should not procrastinate when investing because an early start can make a world of difference in the potential returns as a longer time horizon will allow compounding interest to work effectively. Meanwhile, the longer you wait to get started with your investments, the more money you will have to put in to get the same returns as someone who started investing earlier.

4. Taking too much or too little risk

As risk and returns go hand-in-hand, the amount of risk you take when investing can determine your potential returns. Nevertheless, there are those who take too much or too little risk. Investors who are high-risk takers often end up as speculators and often make investments without conducting prior research. On the other hand, investors who are too conservative may bear the risk of inflation eating into their purchasing power. Instead of merely relying on your risk tolerance to shape your investments, you should also take into consideration your financial goals and time horizon.

5. Lack of diversification

Diversification is among the most fundamental principle of investing to a flourishing investment portfolio. Even so, many investors neglect to properly address this step by putting all of their eggs (investment) into one basket (asset). A well-diversified portfolio will adhere to all components of asset allocation – considering risk tolerance, investment capital available, investment time horizon and the current portfolio's asset class weightings.

6. Becoming emotional in investment decisions

Most investors allow emotions – especially greed and fear – to drive their investment decisions. For instance, emotional investors will be tempted to sell an investment when its price falls sharply. As a result of following their emotions and gut instincts, many investors end up 'selling at the lows and buying at the highs' of the market. Instead, they should objectively evaluate the reasons for the price decline and see whether they are caused by broader market conditions.

7. Lack of research

Investors should do their homework before investing. Successful investing requires on-going time and effort, which includes investors conducting their own investment research. Investors should also take note that past performance of an investment is not an indication of future performance.

8. Panicking during bear markets

During major bear markets, it is common to see investors letting emotions get the better of them and in the process they sell off their investments in a panic frenzy. Investors who hold a long-term stance would not be affected by these gyrations of the stock markets. Instead, they might view market weakness as an opportunity to accumulate under-valued blue chip stocks at attractive prices.

Everyone make errors in their investments but what separate the winners from the losers are those who apply what they learn from their mistakes. The key to successful investing is not to avoid risk altogether but to recognise the risks you are taking. To avoid unpleasant surprises, do your homework. Nothing beats reading the prospectuses and checking the long-term performance of the investments. As American fund manager Ronald W. Roge once said: "People rush into purchases even when they don't understand what they are buying. People do more research when they buy a refrigerator or a VCR than when they invest thousands in (the markets)."

Even Millionaires Make Mistakes (and Learn from Them)

Benjamin Graham went bankrupt on three separate occasions as an investor. But each time, he documented and studied his failures, and he was eventually able to impart this investment wisdom to countless others, including Warren Buffett, who in turn learned from his own mistakes and failures.

Early in Buffett's career, he mistakenly believed he could save a failing textile mill. After being forced to liquidate its textile operations, Buffett learned to pay up for quality. He turned that failing company into a US$140 billion business.

Another great example is Pixar's John Lasseter. After he graduated from college, Disney hired him to captain its Jungle Cruise ride at Disneyland. Later, the company gave him a shot at being an animator, and he quickly recognised the ability of new computer technologies to revolutionise animation.

However, Disney was so unimpressed with his first feature that Lasseter was fired on the spot. So, he went back to the drawing board. After fine-tuning his processes, he moved on to the company that would become Pixar, where he has won two Academy Awards and churned out a string of blockbuster hits that include *Toy Story*, *A Bug's Life*, and *Cars*. Ironically, he and partner Steve Jobs later sold Pixar to Disney for US$7.4 billion (RM25.1 billion).

Moral of the story: always learn from your mistakes.