Traps that lead to market underperformance

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For ten years I taught online and live workshops around the country to thousands and thousands of people. Classes on building a portfolio, options trading, stocks and much more. My primary goal was to help individuals gain the confidence and the knowledge to manage their own money, to take control of their own investments. You've heard the phrase. . . "You got this!" My goal was to help people "get this!"

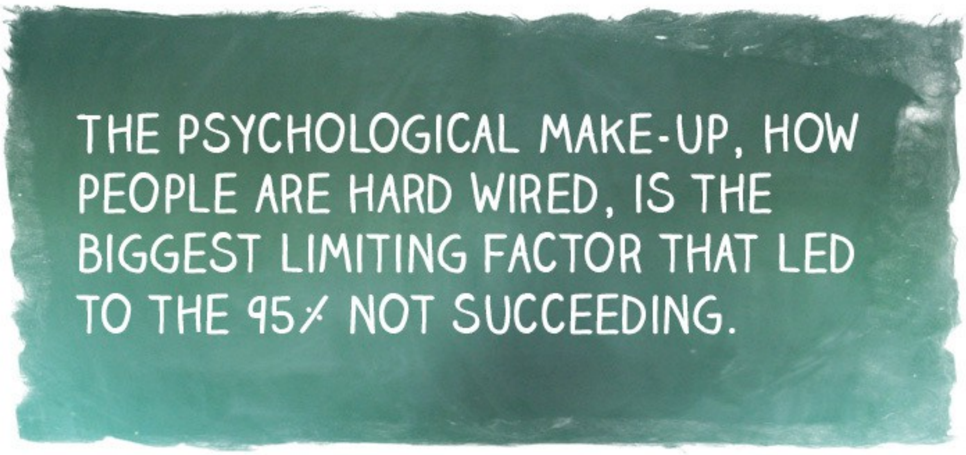
After ten years I realized something, I realized that that I wasn't succeeding in my goal. I worked my tail off for 10 years and I would put a success rate of those I taught at around 5% . . . if I was being generous 10%. (I define success by making money and doing better than buying an index fund whether it be bond or stocks.) Roughly 5% of the people I taught did better than buying an index fund! Very few people could truly say, "I got this!"

While I have many great friends who are very successful in that 5%, friends I still talk to today, I consider my goal to help people "get this" a failure. I failed in my attempt because of something I cannot control or teach. This something lies between everyone's (well most everyone) ears. The psychological make-up, how people are hard wired, is the biggest limiting factor that led to the 95% not succeeding.

Although there are many psychological traps that lead to defeat, here’s a few that I noticed more than others over the past decade. I hope by bringing them up investors can look at the mirror and take a long hard look at how they approach the market.

Following the crowd.

Howard Marks of Oaktree Capital said, “People should like something less when its price rises, but in investing they like it more.” That one line is a great summary of what following the crowd is all about.



The tendency for most people is to buy what’s popular and “hot” in the market. Think about how people live their life. They buy clothes that are in style. They go to popular restaurants, buy popular cars, get popular hair styles, and go to the hottest new movies. Most everything people do is done by following the crowd.

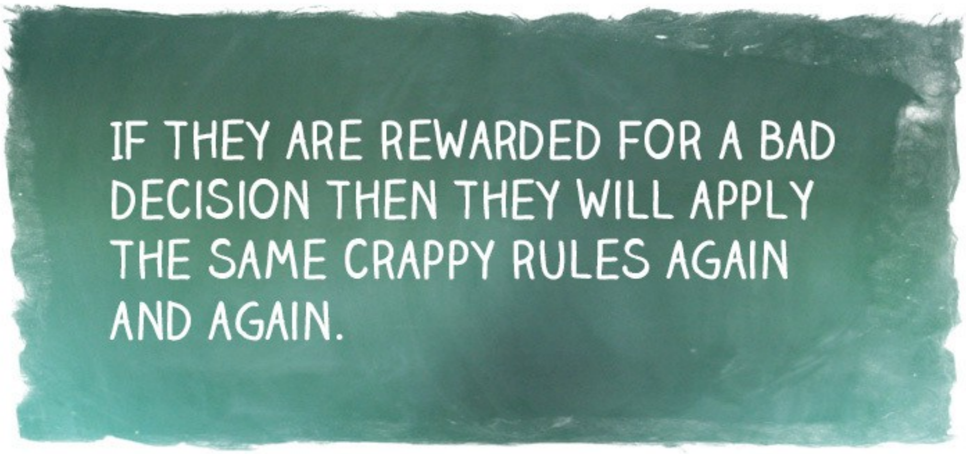
In the investing world someone may see a best friend who has made a ton of money in tech stocks. They too want to make a ton of money (they feel bad that they missed out) and so they do the same thing. They go out and buy tech stocks or whatever stocks are the flavor of the day. This is the core of what “following the crowd” means. Typically when investors do this they are not buying at the bottom, they are buying at the top. Once the “crowd” finds the hot stock or investment and put money into it, there are no more buyers, everyone is in. There’s then only one way the stock can go and it’s not up! Following the crowd will almost always lead to market underperformance.

Case in point, I talked to a client the other day who refused to let me buy a certain stock for them. They had a relationship with the company that we wanted to buy and they didn’t like it. In fact they outright hate the company! And it wasn’t just them, almost anyone you talk to hated the company. Instead they wanted to invest in the most popular stock in the world right now. So what do you think we did? You got it! We bought the hated company for most of our clients and it’s working out beautifully as I type (the popular stock is doing nothing). That is the opposite (contrarian) of following the crowd and its hard . . . but it’s how you should invest. (Please understand as a fiduciary firm we have to do what our clients want, we tell them the story then they either give us the thumbs up or the thumbs down. Most of our clients, because of our track record, give us the thumbs up. One client didn't in this circumstance, the individual that absolutely hates the company!)

Overconfidence.

The worst thing that can happen to new investors, (and I would tell people this when I first starting teaching them), is that the first investment you make is a big winner. In fact, I would hope the first trade they would make is a loser! People would look at me like I was crazy when I would tell them that. However, it's pretty simple why . . . losing a little keeps them humble and willing to listen and learn. It helps them learn to respect the market.

You need to understand that the first investment someone makes, they normally don't follow the rules. They buy a stock that someone else is buying (see following the crowd above) or they buy something because they love the company. This is not sound investing, in fact it's horrible investing.

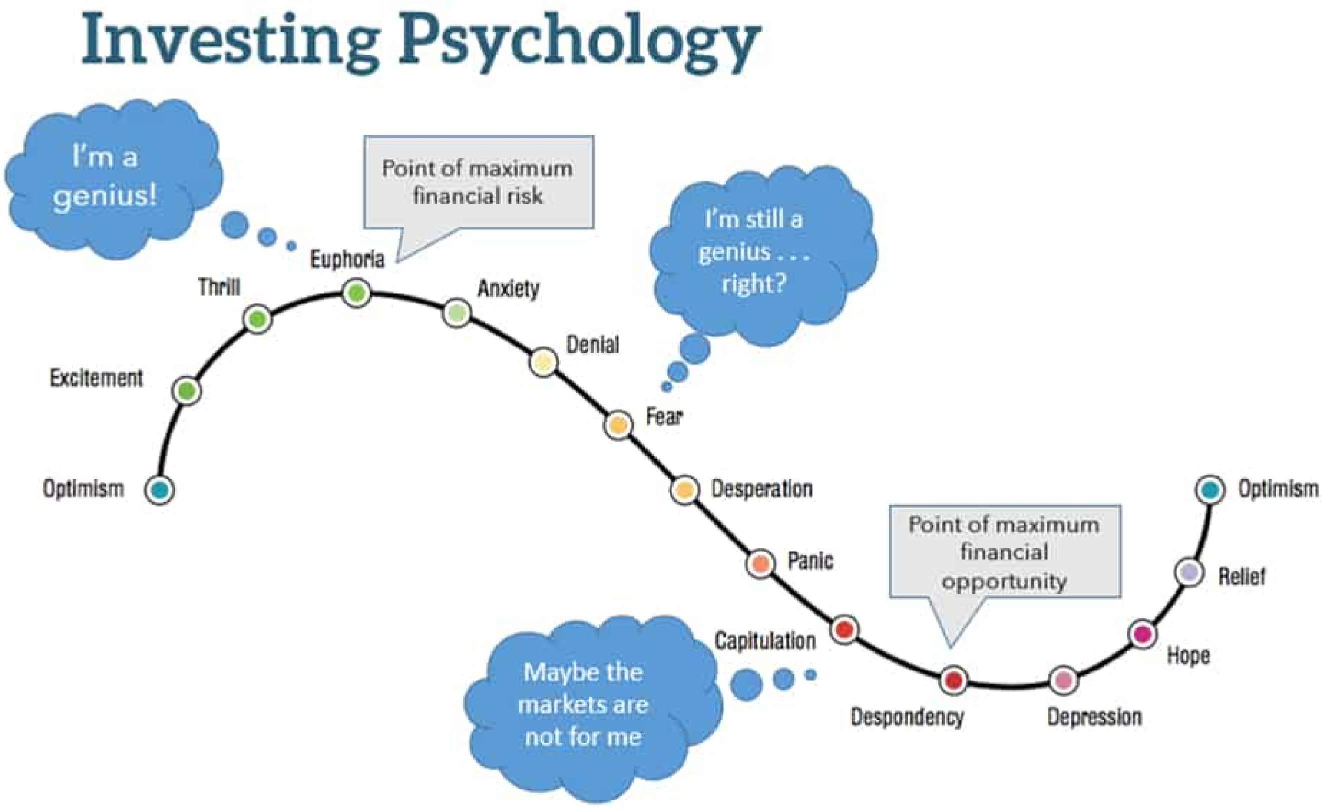


If they are rewarded for a bad decision then they will apply the same crappy rules again and again. I can't tell you how many accounts I saw chopped in half or how many sad stories of people that were caught in this trap.

The other side to this trap is the motivational side. Someone would attend a workshop that I or someone else taught where we discussed different strategies. As we teach these workshops the individual thinks "I got this!" When they get home that overconfidence leads to overtrading or opening positions that are just too big and carry too much risk. Before they know it they have a portfolio drawdown of 10, 20, 30%. This overconfidence could come by attending a workshop, reading a book, watching a T.V. show or seeing an online presentation.

Buying and selling at the wrong time.

The image below is the best example of this trap. The typical investor buys after the bull market has already occurred, during the "excitement" and "thrill" stage. Then they sell when they can no longer take the heat, at the "despondency" and "depression" stage.



During the last bear market in 2008, I witnessed this cycle occur perfectly. In 2007 people were buying stocks hand over fist as the market hit the “thrill” and “euphoric” state (especially the real estate market). They then sold at the “panic” and “despondency” state because they couldn’t take the pain. Why did people do this? It’s natural. It’s how most people are hard wired. It’s not because they aren’t smart or don’t know better, they just can’t ignore the emotions that they are feeling at the time.

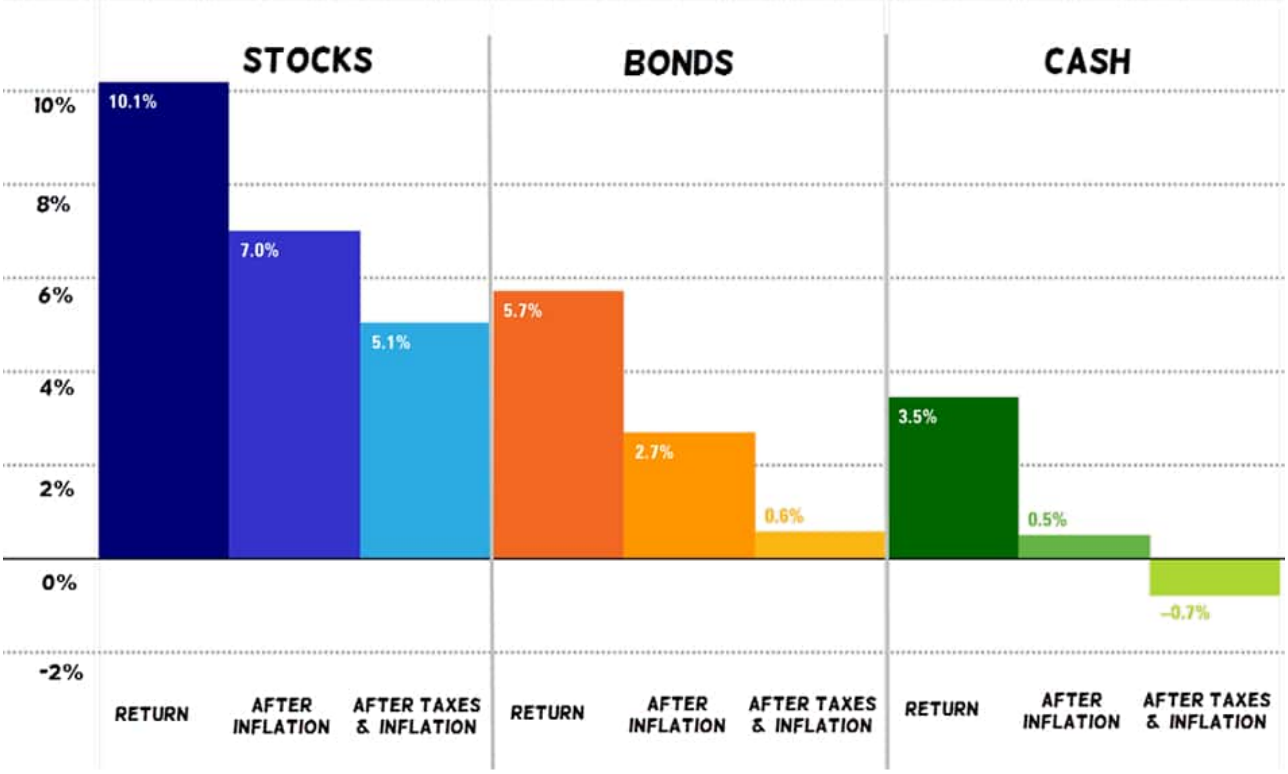
The big problem with this is that the cycle continues for investors. The pain that the losses caused in 2008 resulted in people not getting back into the markets in 2009, 2010, 2011, 2012. The little voice inside their head says, “I’ve missed the bull market and I’m not going to experience the pain that occurred in 2008.” It’s not until they feel the absolute need, because the crowd is making money, to get back in the market which is the exact wrong time. Rinse and repeat the cycle.

Misunderstanding risk.

The last trap I will mention is one that may be controversial in nature. However its one that I have to talk about. There are three points I will make, two of which apply to how an individual’s portfolio is built and managed over time. It’s also completely opposite of what someone would read in an academic book or would actually get from most financial “experts.”

1. People take too much risk. This is an obvious trap and one that was referenced earlier. I cannot tell you how many sad stories I’ve heard of individuals that have loaded the portfolio up on a stock or option strategy because “all the stars are aligned” only to see the investment blow up and the broker pick up the phone for a margin call. They either

forget about the stop loss or the proper position size or something else that leads to portfolio ruin. Overconfidence leads to people getting in over their head and way too much risk.
2. People scale down portfolio risk way too early in life. Consider the formula that is widely used in the investing world. Take your age and subtract it by 100 and it will give you the allocation that you should have for stocks and bonds. For example, if I'm 60 years old then I should have 60% of my portfolio in bonds and 40% in stocks. Huh? The chart below tells you just how crazy this is. If I'm 60 years old (with 30 years of life remaining), I'm going to have 60% of my money in an investment that historically has provided an after inflation and taxes return of .6%? Really?

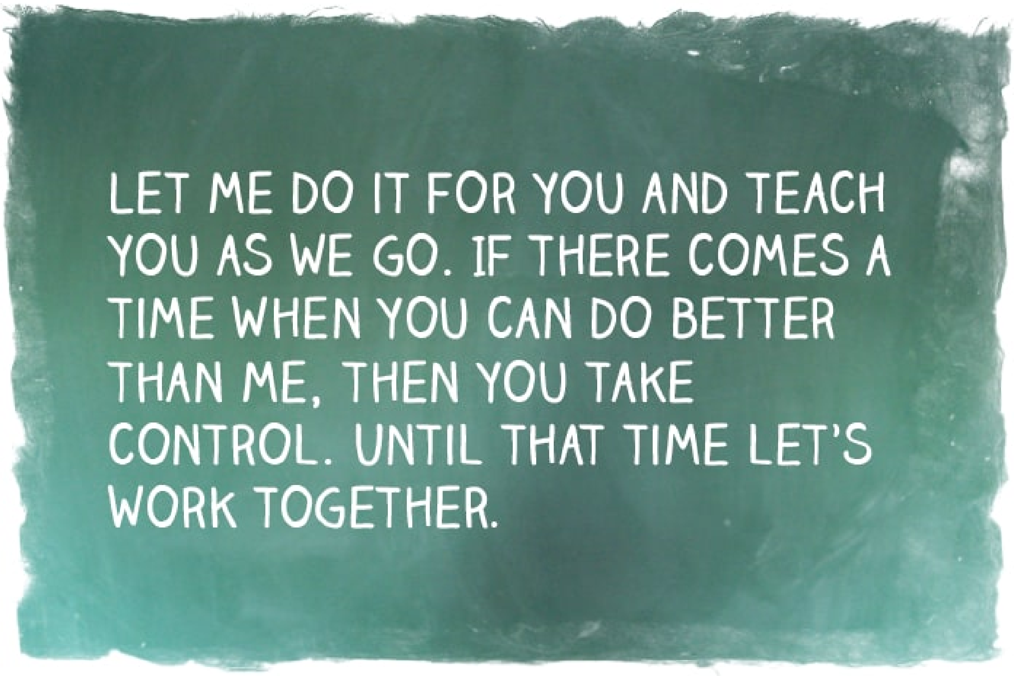


Source: Morningstar

The approach should be personalized for the individual and should be based on building your wealth not dialing down the risk to a point where you run out of money when you need it the most. For more information on this topic see the following article "Buy and Hold vs. Timing the Market: Which one is better?". It contains an approach that is much better than dialing down the risk and returns earlier than you should relying on a silly formula to build a portfolio.

People rely too much on mathematical equations and not on the investments they are buying. There are dozens of theories and ratios that have been developed in the world of finance all with the goal to tell you how much risk is contained in your portfolio. They are well intentioned but they miss the mark, especially for skilled value investors. Most of them are built around the volatility of an underlying. The more volatility (up and down movement of the stock) the more risk, the less volatility the less risk. This utilization of volatility as a risk measure is wrong . . . if riskier investments reliably produced higher returns, they wouldn't be riskier!Howard Marks explained it best:

> Theory says high return is associated with high risk because the former exists to compensate for the latter. But pragmatic value investors feel just the opposite: They believe high return and low risk can be achieved simultaneously by buying things for less than they are worth. In the same way, overpaying implies both low return and high risk.He continues . . .Skillful investors can get a sense for the risk present in a given situation. They make a judgement primarily based on (a) the stability and dependability of value and (b) the relationship between price and value.People have a hard time understanding these concepts so they typically choose the investments with low volatility (supposedly low risk) without knowing the true value of the stock. The stock could be wildly expensive which leads to underperformance of the market and individual goals. If an investor truly knows what they are buying and the price they are paying then the reliance on theoretical risk ratios are not needed for the risk of the underlying is known to the investor.



As I sit here remembering the ten years I failed at my goal of teaching people how to invest and succeed themselves, I'm truly humbled. It's hard to know that no matter what I did I couldn't truly help people. That one reason is why I'm no longer just teaching people. It's why I left a good employer to help build an investment firm with my partner.

In my current role, which is a lot more fulfilling, I not only teach people about the market, I truly help people by doing it for them. I can tell people, "Let me do it for you and teach you as we go. If there comes a time when you can do better than me, then you take control. Until that time let's work together." I now live the best of both worlds as I'm finally able to help people accomplish their financial goals. When I lay my head on pillow at night I can sleep a lot better knowing that "we got this!"

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