

FUND INVESTORS' BIGGEST MISTAKES AND HOW YOU CAN AVOID THEM

By Albert J. Fredman

Those who invest directly in stocks are particularly prone to making big mistakes. But mutual fund investors are not immune, and fund managers can compound mistakes made by fund owners. One of the biggest mistakes is overconfidence, which is dangerous because the stock market is highly effective at deflating overblown egos.

On the heels of two rough years in the stock market, and confronting money fund yields below 1.5%, it's time to re-examine the rules for building wealth.

Understanding how different investments work is the first step toward profitable investing. The second is making sure you—and your mutual fund manager—always maintain the correct wealth-building mindset. That is particularly important now, when many experts expect single-digit stock returns over the next decade or so.

To become the best possible investor you can, it is imperative to avoid the big mistakes. Behavioral finance researchers investigate how human beings study and act on investment information and their findings can benefit investors.

Those who invest directly in stocks are particularly prone to making devastating mistakes, perhaps even experiencing Enron-style setbacks.

But mutual fund investors are not insulated against these mistakes. In fact, a fund manager can compound any mistakes made by fund owners—after all, professionals are human. Thus, it should come as no surprise that behavioral finance research makes a strong case for buying and holding low-cost, broadly diversified index funds, as I will explain.

THE BIGGEST FUND MISTAKES

The four biggest behavioral mistakes investors make with mutual funds are:

- Being overconfident in your ability to predict future investment performance of markets and fund managers;
- Hanging on to a mediocre mutual fund in the hope of eventually getting “even;”
- Being too myopic about the inevitable short-term losses accompanying stock ownership; and
- Being oblivious to the corrosive impact of compounding costs on long-term returns.

A closer look at these mistakes and the impact they will have on your performance can help you identify your own susceptibility to error.

OVERCONFIDENCE

People typically are overconfident. For instance, research indicates that people overestimate their abilities as drivers. In addition, it's common for a person to think of himself as being above-average. And gender matters: Men tend to exhibit more overconfidence than women.

Overconfidence also applies to investing acumen. Individuals feel confident of their abilities to pick sectors, superstar fund managers, or to properly time the market. Fund managers themselves often are overconfident of their skill to

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**TABLE 1. TURNOVER BREAKDOWN
OF U.S. DOMESTIC EQUITY FUNDS**

Turnover Level	Turnover Boundaries (%)		Median Turnover (%)	Number of Funds
	Lower	Upper		
Extremely low	0	30	17	282
Low	31	75	53	581
Average	76	100	87	286
Above average	101	150	123	326
High	151	3,390	218	368
All U.S. Diversified Stock	0	3,390	80	1,843

Source: Morningstar, Inc.

pick winning stocks and sectors, and to time the market.

A moderate amount of overconfidence is beneficial in many areas of life. People who have confidence tend to be happier and work harder. They also can better cope with life's uncertainties.

Unfortunately, being overconfident about investments is dangerous because the stock market is highly effective at deflating overblown egos. Most people don't realize how difficult it is to beat, let alone match, the S&P 500's long-term average return of about 11% annually.

Overconfidence often leads to overtrading. Investors' fund trading proclivities are evident from the tens of millions of exchange-traded fund shares changing hands daily. A person might be buying and selling actively managed mutual funds in an effort to find the next Peter Lynch. The widely popular discount brokerage trading arenas allow impulsive individuals to jump from one fund family to the next with a quick phone call or a few mouse clicks. The overconfident investor may also make big bets by concentrating on a favorite fund or even margining a position.

Overconfidence tends to ebb and flow with the stock market cycle. Overall, individuals were far more overconfident during the roaring bull market in the late 1990s than they are today.

A bull market is conducive to

overconfidence because people attribute their investment successes to superior skill. Pride can boost confidence when the individual has had a string of successes. In reality, luck probably played a bigger role than skill. The so-called "conviction" stage of the market cycle occurred when stock prices approached their zenith in late 1999 and early 2000. Since then, the level of confidence and the trading activity of individual investors have both fallen sharply.

But even if you hold onto the same stock fund for years, your investment results could be disappointing if your manager is too overconfident. Many managers exhibit overconfidence, as evidenced by their rapid-fire trading and consequent high portfolio turnover rates, which often exceeds 100%. In fact, evidence indicates that fund managers who have done exceptionally well during a particular year will trade more actively the following year. Thus, having success leads to more overconfidence and higher portfolio turnover.

Table 1 provides an analysis of the turnover rates of Morningstar's \$2 trillion U.S. diversified equity mutual fund category. Only managed funds are covered—index funds have been excluded. Turnover rates are grouped into five categories ranging from "extremely low" to "high" based on their turnover levels; the ranges of turnover in those various categories are presented in the first two columns.

It is evident that many funds have portfolio turnover rates greater than 100%. (A 100% rate means that a fund holds its average stock for about a year.) In fact, 694 of the 1,843 U.S. diversified domestic equity funds have above-average or high turnover.

A major problem with high turnover is that it translates into high transaction costs. These costs are not reflected in a fund's expense ratio, which may already be high. Rather, the transaction costs accompanying high turnover diminish a fund's total returns. This problem is much more serious at a time when pre-cost investment returns are low. For taxable account holders, high turnover also leads to larger taxable distributions and a higher tax bite, assuming a fund is profitable on average.

CLINGING TO LOSERS

Everyone hates to lose. Many individuals will not part with a losing investment until they get "even," which is usually considered to be their original purchase price. Locking in a loss really injures self esteem. A loss appears larger to most people than a gain of equal absolute value. In fact, research indicates that individuals find the pain of a \$10,000 loss to be about twice the magnitude of the pride associated with a \$10,000 gain. Thus, people try to avoid the psychologically painful feeling of regret.

Being averse to loss certainly makes sense, but individuals do not always analyze it rationally. Ironically, losers often increase their risk in an attempt to eliminate a loss. Like gamblers, would-be investors often increase their bets when their luck sours to avoid finishing in the red. An impulsive individual might hastily double a position in a volatile sector fund that has recently plummeted 50% to "average down" its cost. But a recent low price can easily drift lower.

Professionals also are affected by

**TABLE 2. ANNUAL "CATCH-UP" RETURN NEEDED
AFTER SELLING LOSER TO DOUBLE YOUR MONEY IN 8 YEARS***

No. of Years Loser Is Held	Setback During Initial Period(%)		
	0% Return	10% Loss	25% Loss
1	10.41	12.08	15.04
2	12.25	14.23	17.76
3	14.87	17.32	21.67
4	18.92	22.09	27.79
5	25.99	30.50	38.67

**At 9.05% compounded annually money doubles in eight years.*

loss aversion. Mutual fund managers may take greater risks to overcome a high expense ratio or a losing streak.

The get-even syndrome can be very detrimental to an investor's financial well-being. If an investment slips into the red, individuals hold on steadfastly, hoping for a rebound. Individuals may avoid selling a fund that has gone down in order to avoid the regret of having made a bad investment. By selling, the loss is finalized; by not selling some hope of a rebound remains. But don't be too patient with a loser.

Let's say you want to double your money in eight years. A moderate, 9.05% yearly return will do the job, assuming a reasonably favorable market climate. However, the more years you stick with a dud, the harder it is to "catch-up" to your initial target. Table 2 illustrates the "catch-up" returns needed to accomplish your goal after clinging to a bad investment for various time periods during a favorable market environment.

As expected, the longer you stick with a clunker, the greater your required catch-up return during the remaining time. A 25% slide in the value of your investment over a five-year horizon means you must garner 38.67% yearly over the remaining three years if your goal is to double your money in eight years. Note that even a zero-return investment hurts plenty if held too long. With a 0% return during the first five years, you must earn 25.99% per year during

the remaining three years to double your money in eight years! Like the gambler struggling to recoup losses, investors often take on excessive risk as they scramble to catch up after selling a loser.

With investor psychology, a few "magic" words may work wonders. By using a positive frame of reference, an investor may be much more willing to part with a loser. Instead of thinking "by selling this dog I'd have to realize a huge, humiliating loss," simply think "I'm going to 'transfer my assets' to a more productive use." This frame can be particularly useful if you're trying to convince someone else to abandon a loser.

GRABBING GAINS

On the flip side, abundant research indicates that people are too quick to take their gains. They don't let their profits run far enough because they want to lock them in while they have a chance, fearing that their gains will revert to losses. Pride and regret play a role in their thinking.

For instance, suppose an investor sees a promising stock fund that he wants in his portfolio, but to invest in this fund he must sell another. The typical pride-seeking investor would sell a fund that's in the black rather than one that's in the red. By selling a fund showing a profit—even though it may be small—our investor experiences the feeling of pride. Regret is avoided (or post-

poned) by not selling the loser. With a taxable account, however, it makes better sense to sell the loser and realize a tax loss rather than pay taxes on a gain. In any event, losers often continue to underperform, particularly if they are saddled with high costs.

When a rebound occurs in a fund that was in the red, many investors exit too quickly—with little or no gain in hand. Many individuals have clung tenaciously to their stock funds since the March 2000 market peak. This was rational for those who held well-managed funds because market-risk has been the primary problem—assuming that the investor was not also saddled with a high-cost fund that badly lagged its peers. Now if the economy and stock market make significant rebounds, many will be tempted to cash out when they get even or show a tiny profit. By cashing out, investors are eliminating any chance for making decent returns on their stock funds, which could conceivably reward them for the extended period of pain.

BEING TOO MYOPIC

"Myopic loss aversion" is another term for investor shortsightedness, and it usually afflicts people with long time horizons. Shortsighted investors with long-term horizons tend to be too conservative with their asset allocations. This is common among people saving for retirement.

It's a truism of equity investing that the route to long-term gains is punctuated with periods of short-term losses. Markets are extremely volatile, upsetting compulsive worriers. People who worry excessively may sell a good stock fund at the first sign of trouble.

An individual who suffers from myopic loss aversion may quickly sell out when the market averages plunge by 5% or 10% in a week or so. The person fears losing it all! The fact is that prices often rebound within a matter of days or weeks.

Suppose a 30-something individual is saving for retirement. Each year's investment in equities can be viewed as an isolated gamble. Some people may hold less than their optimal equity allocation because they overemphasize the potential from losses in a single month, quarter, or other brief period. Conversely, if investors focus on the potential outcome over several decades, they are more likely to hold the correct amount of equities. Unlike casino gambling, the expected long-run payoff for equity investing is positive, provided the individual maintains a sensibly diversified portfolio and can remain invested for many years.

Time diversification, or the law of averages, works well for the long-term investor. This assumes that the individual is not saddled with perennial losers—always weed out the clunkers, as explained above.

One rule of thumb for a moderately risk-tolerant individual is to allocate "110 minus your age" to equities. Thus, a 40 year old might have 70% allocated to a mix of equity-oriented mutual funds. Investors with short time horizons might best be served with a very modest (if any) stake in equities.

More individuals may face a form of myopic loss aversion now, given the poor performance of equities since March 2000. These people could have been afflicted by the so-called "snake-bite effect." Taking a big hit on equities may have been so painful that they do not want to have anything to do with stocks or stock funds ever again. Unfortunately, these individuals may have had such a bad experience because they failed to allocate their assets properly and they assumed unacceptable risk.

IGNORING COSTS OVER TIME

People, particularly those who are not financially savvy, often treat small numbers as unimportant. Their bias toward big numbers may cause them to focus on those funds

that generated the highest returns during the past year.

These same people will also ignore what may seem to be minor differences in small numbers, such as expense ratios. The reported net return earned on a fund equals its gross return minus its costs. Expense ratios of mutual funds range from less than 0.20% for low cost index funds to more than 2%. The average expense ratio for U.S. diversified equity funds was 1.42% recently, according to Morningstar.

About 17% of the U.S. diversified equity funds in Morningstar's

database have expense ratios greater than 2%. Small yearly percentage point differences in returns—due to varying levels of costs—compound to huge dollar differences over the years. Time magnifies the wealth-eroding impact of costs.

Table 3 assumes a \$10,000 initial investment and a 10% return on the S&P 500. Future values of the hypothetical S&P investment ignore costs. The costs are shown, however, in the two panels. Panel A displays the dollar loss in wealth for a given annual percentage cost over various time horizons. Panel B expresses the

TABLE 3. HOW COMPOUNDING COSTS ERODE WEALTH

Future Value of \$10,000 Compounding at 10% Annually:

5 Years	10 Years	20 Years	30 Years	40 Years
\$16,105	\$25,937	\$67,275	\$174,494	\$452,593

Panel A. Future Dollar Loss From Compounding Costs

Expense Ratio (%)	Length of Investment Horizon				
	5 Years (\$)	10 Years (\$)	20 Years (\$)	30 Years (\$)	40 Years (\$)
0.10	-73	-235	-1,213	-4,697	-16,169
0.15	-110	-352	-1,811	-6,999	-24,042
0.20	-146	-468	-2,405	-9,271	-31,775
0.25	-182	-583	-2,993	-11,513	-39,373
0.50	-363	-1,155	-5,859	-22,291	-75,399
0.75	-542	-1,715	-8,603	-32,378	-108,355
1.00	-719	-2,264	-11,231	-41,817	-138,498
1.25	-895	-2,801	-13,746	-50,649	-166,062
1.50	-1,069	-3,328	-16,155	-58,912	-191,262
2.00	-1,412	-4,348	-20,665	-73,867	-235,347
2.50	-1,749	-5,327	-24,796	-86,944	-272,150

Panel B. Future Percentage Loss From Compounding Costs

Expense Ratio (%)	Length of Investment Horizon				
	5 Years (%)	10 Years (%)	20 Years (%)	30 Years (%)	40 Years (%)
0.10	-0.45	-0.91	-1.80	-2.69	-3.57
0.15	-0.68	-1.36	-2.69	-4.01	-5.31
0.20	-0.91	-1.80	-3.57	-5.31	-7.02
0.25	-1.13	-2.25	-4.45	-6.60	-8.70
0.50	-2.25	-4.45	-8.71	-12.77	-16.66
0.75	-3.36	-6.61	-12.79	-18.56	-23.94
1.00	-4.46	-8.73	-16.69	-23.96	-30.60
1.25	-5.55	-10.80	-20.43	-29.03	-36.69
1.50	-6.63	-12.83	-24.01	-33.76	-42.26
2.00	-8.77	-16.76	-30.72	-42.33	-52.00
2.50	-10.86	-20.54	-36.86	-49.83	-60.13

dollar loss as a percentage of the future value of the \$10,000 investment. The percentage of the market's return that is actually earned can easily be found by subtracting a percentage loss factor from 100%. For instance, if 20% of the market's return was consumed by cost, the remaining 80% would be retained.

An actively managed large-cap domestic equity fund with a 1.25% expense ratio consumes \$895 (or 5.55%) of the \$16,105 future gross wealth in five years. In contrast, over 40 years, the fund's \$166,062 in costs devours 36.69% of the \$452,593 gross wealth. (Stated differently, only 63.31% of the gross index return remains.) This assumes that the fund's manager exactly matches the market return before costs.

The expense drag is far less with a broad-based domestic equity index fund. With a 0.20% expense ratio, the latter would cost an investor \$31,775 in 40 years, a modest 7.02% of the future index value. Thus, the fund earns 92.98% of the return of the zero-cost index. Even lower expense ratios can be found on the lowest-cost index funds and the broad-based exchange-traded funds.

The expense ratio is not the only cost mutual fund investors face. More funds—even some index funds—are imposing front-end loads these days. Furthermore, as we discussed earlier, high portfolio turnover ratios in turn lead to high transaction costs.

In addition to brokerage commissions—which typically are modest—mutual fund performance is impacted by the following more significant kinds of indirect trading costs:

- *Bid-asked spread:* A stock held by a fund might be quoted at 25 bid and 25.50 asked. The difference between bid and asked prices affects investors when they buy at the asked and sell at the bid. This often occurs.

- *Price-impact cost:* Buying a stock tends to bid up its price while selling tends to push it down. The larger the transaction, the higher the price-impact cost. Because mutual funds often trade stocks in large blocks, their price-impact costs can be high.
- *Opportunity cost:* Mutual funds are often not able to complete a trade rapidly. It may take days or weeks to acquire or dispose of a block of stock in a particular company. In the meantime, the price can move against the fund manager, adversely impacting the results.

While difficult to quantify, trading costs of a large-cap domestic equity fund might consume 75 to 90 basis points of gross value yearly. Conversely, trading costs are minuscule with a broad-based domestic equity index fund.

The examples discussed above to illustrate Table 3 referred only to expense ratios. The impact of trading costs can be added in. An actively managed domestic equity fund could easily have expenses plus transaction costs that equal 2% yearly, causing it to consume a staggering 52% of future gross wealth in 40 years! Stated differently, that fund returns less than half of the market's return in 40 years. This is most devastating to younger investors with multi-decade time horizons.

BEHAVIORAL LESSONS

Studying the common mistakes of mutual fund investors reveals several important behavioral lessons.

Behavioral Lesson #1: Don't try to beat the market.

Optimism can have an adverse effect on investment decisions when people set unrealistic expectations. Overconfident investors feel that their winners were due to skill and, thus, that they can continue to win. However, luck often plays the bigger

part, and anyone's good fortune can turn on a dime.

Overconfidence can lead to substantial losses when investors overestimate their ability to identify market-beating investments. Individuals and fund managers who try too hard to beat the stock market often find that the market will beat them. That's because trying to beat the market can lead to overtrading and inadequate diversification.

The secret in making big money over long periods of time lies not in making the big gain; rather, it is to avoid the big setbacks.

Behavioral Lesson #2: Accept the fact that stock markets will fluctuate.

A shortsighted investor might view the stock market as akin to a gambling casino, overemphasizing the potential for (and harm caused by) near-term losses. These are the kinds of investors who might put all (or most) of their long-term assets in a money market fund to avoid losing principal.

Unfortunately, these people don't realize that inflation's long-term impact on wealth can be far more devastating than simply having to ride with the short-term ups and downs.

If you focus on the potential outcome over several decades, you are more likely to hold the correct amount of equities.

Behavioral Lesson #3: Build a well-balanced portfolio.

Keeping your asset-class balance is essential for being an emotionally successful investor. Elementary portfolio diversification is still the best way to guard against the risk of irreparable financial harm and its accompanying emotional consequences.

Build a well-designed portfolio based on factors such as your age, time horizon, earnings, net worth, and risk tolerance.

Those who jump in and out of investments frequently don't have a well-thought-out portfolio. Being overweight in a volatile fund or

stock can cause an undue amount of emotional stress, which in turn can trigger indiscriminate selling.

A well-balanced portfolio is definitely easier on one's emotional state.

Behavioral Lesson #4: Use low-cost, tax-efficient index funds.

Over time, small differences among expense ratios can add up to big costs. Compounding high expense ratios with rapid-fire portfolio turnover is the recipe for poor performance, particularly in a taxable account.

Succinctly stated:

High Costs + Taxes = Mediocrity

The way to escape the corrosive

impact of high costs is to use broad-based index funds for your portfolio core—or your entire equity allocation. Favor index funds that target the S&P 500, Wilshire 5000, or Russell 3000.

Exchange-traded funds provide a low-cost option for disciplined investors following a buy-and-hold program.

Costs will weigh even heavier going forward as equity returns are likely to be far lower during the next 10 to 15 years than experienced during the unprecedented bull market years.

Behavioral Lesson #5: Know when to sell (and when to stay put).

It's often said that the sell decision

is more difficult than the buy decision.

A disciplined program for selling is needed to avoid the financially debilitating mistakes of clinging to losers, selling winners too soon, overtrading, and panic-driven selling during a market tumble. A pattern of unfocused selling year-after-year typically leads to disastrous investment results.

The first step to intelligent selling is to build a well-balanced portfolio. However, everyone experiences disappointments.

Don't let the prospect of regret prevent you from selling a loser that could impede the performance of your portfolio. Humility can pay in this case. ♦

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