January 2002 – Common Mistakes Investors Make

Having just experienced two consecutive down years in the market, we believe that it may be beneficial to discuss several of the most common mistakes investors commit. Although we touched upon some of the topics in prior letters, we deem that they merit repetition. The following is our list:

- **Failure to diversify** stock portfolios results in increased risk. Broad diversification across industry sectors and styles (growth versus value) can mitigate the impact of poor results that may be experienced at a given time with a particular sector or style. Obviously the extreme example would be an inordinate weighting in one individual equity. Whether a concentration results from purchase or from appreciation, one should remember the plight of investors in Enron and similar securities that once appeared to be relatively safe.

- **Reluctance to sell loss positions,** possibly due to an aversion to admitting a mistake or due to unmerited optimism, is natural. Setting aside the tax benefits of selling losers, one should evaluate which stocks to keep based on their future prospects not on their historical costs.

- **Failure to define accurately or act consistently with one's risk tolerance** can result in uncomfortable times in a down market. Often investors assess their tolerance for risk, or volatility of returns, during up markets. Only later in down markets do they recognize that the pain caused by a certain level of loss exceeds the exhilaration associated with the same level of gain. Further, some investors, although they understand their risk profile, choose to overlook it in strong markets, only to recall it later in weak markets.

- **Attempting to time the market** is normally a futile effort. As we discussed at length in a prior letter, such a strategy is dependent on precision timing twice, once when deciding to buy and once when deciding to sell. Study after study demonstrates that success at doing such on a consistent basis is extremely rare.

- **Assuming that the last bull market's hot sector or hot stock will lead the current market** often can produce sub-par results. Again, studies have concluded that the market leaders usually rotate from sector to sector and from issue to issue. Thus, an investor can normally achieve better results by accurately evaluating future prospects than by relying on past performance.

- **Rationalizing absurd valuations** is a dangerous exercise**.** A stock's value is often measured as the present value of the future cash flows that it is expected to generate. If the current price implies unrealistic cash flows and growth rates, then overvaluation is likely. In recent years attempts to rationalize unrealistic assumptions or to ignore them completely under the theory that such a valuation approach is no longer relevant led to many disastrous technology investments.

- **Confusing the quality of the company or its products with the quality of the investment** can be costly. The market can bid up the price of a great, profitable company to the point where it no longer will provide an adequate investment return. Also a company may sell a fabulous product, but lack a competitive advantage that allows it to reap an inordinate profit; consequently, the company may not represent a good investment opportunity at the time.

- **Allowing tax consequences to dictate investment decisions** can be analogous to the tail wagging the dog. Often investors make imprudent choices to save or defer a tax that is not material to the long-term economic potential of an alternative choice. Taxes should be a consideration, but not the major one.

- **Excessive portfolio turnover** can be very expensive. The taxes and transaction costs associated with high turnover often represent impossible hurdles to overcome with savvy trading.

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