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Three Mistakes Investors Keep Making Again and Again

Successful Investing Requires Avoiding Common Mental and Emotional Pitfalls

By Morgan Housel

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Forget derivatives, inverse exchange-traded funds or 50-day moving averages. Investing shouldn't be difficult.

Spend less than you earn. Put the difference in a low-cost broad-based index fund. Leave it alone and let it grow over time.

Yet markets are unpredictable, and people are emotional. Mixing the two breeds misbehavior and regret, as the temptation to buy stocks when they're high and sell when they're low overwhelms common sense.

Depending on how it's calculated, buying high and selling low has cost the average investor anywhere between one percentage point and four percentage points a year in lost return over the long run.

The cost of this misbehavior can be devastating: Over a 20-year period, $10,000 grows to more than $38,000 at a 7% annual return, but just $22,000 at a 4% return.

Successful investing is mostly a battle with your own brain. With stocks more than doubling in value over the past five years, now is the time to prepare yourself for the emotional roller coaster that will come during the inevitable correction.

Here are three common pitfalls investors fall for.

Incorrectly predicting your future emotions.

Too many investors are confident they will be greedy when others are fearful. None assume they will be the fearful ones, even though somebody has to be, by definition.

Christopher Gardner, president of FMF&E Wealth Management in East Syracuse, N.Y., recalls a pair of clients who were comfortable with the idea of big price swings during the boom last decade and said they were prepared to handle them when they came.

Both threw in the towel as soon as the 2008 crash hit.

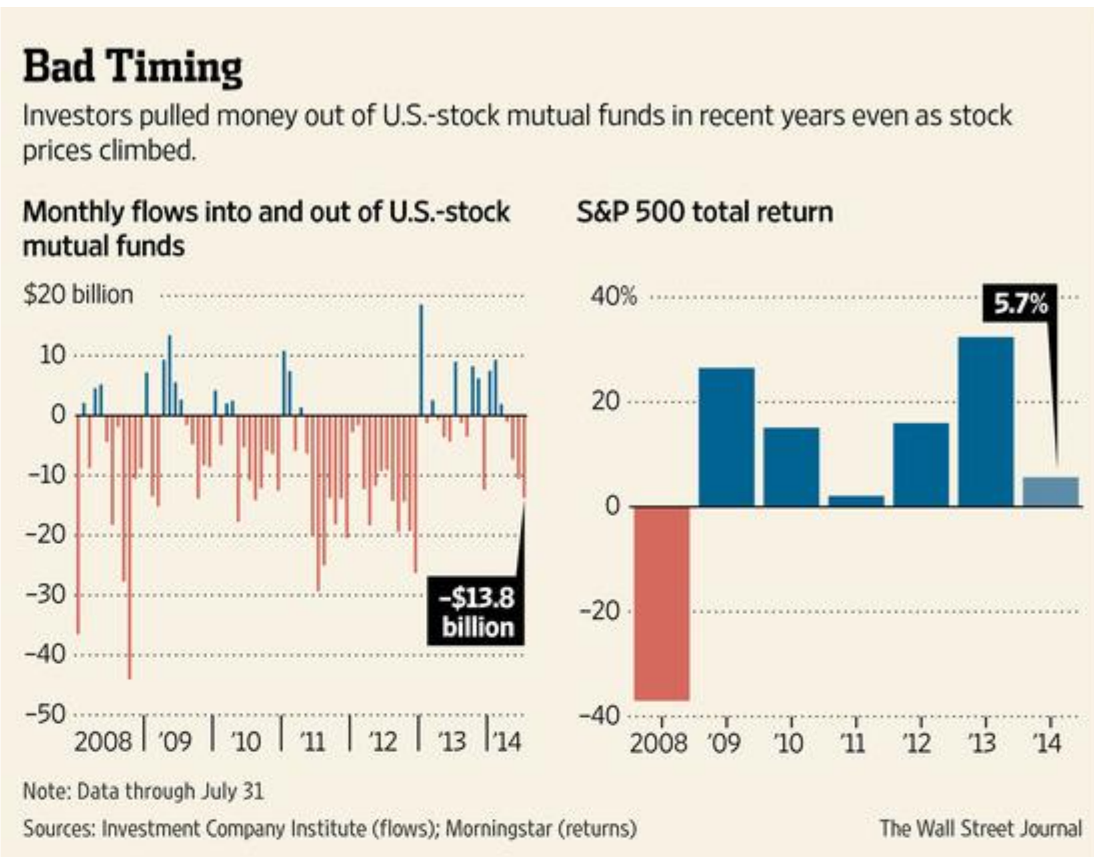
"They closed their accounts and transferred the money to a bank account," Mr. Gardner says. "There was absolutely nothing I could do to talk them out of it."

The problem: "The vast majority of people overestimate their willingness to take risk. Fear is a strong emotion and often plays a much greater role in decision making than logic."

Past behavior may be the best way to judge risk tolerance. If you panicked and sold stocks in 2008, you probably have a low risk tolerance, regardless of what you think today. If you went headfirst into technology stocks in 1999, you are probably susceptible to future bubbles, regardless of how contrarian you think you are now.

Coming to terms with this reality is vital to avoiding future regret.

Mr. Gardner's clients who dumped their stocks in 2008 now use a more conservative investment strategy than before. "They are now much more in tune with their willingness to take risk," he says.



Failing to realize how common volatility is.

Napoleon was said to define a military genius as a man who can do the average thing when all those around him are going crazy.

The same holds true for investors. You needn't have been a genius to have done well in stocks over the past decade. You just had to not have panicked in 2008, when everyone around you was going crazy.

One key to keeping a cool head during market drops is realizing how common they are. If you don't understand how normal big market moves really are, you are more likely to think a pullback is something unusual that requires attention and action. It often doesn't.

From 1900 to 2013, a broad index of U.S. stocks returned an annualized 6.5%, after accounting for inflation and dividends, according to data from Yale University economist Robert Shiller. Yet chaos in any given year is normal: The spread between an average year's highest and lowest close was 23 percentage points.

Investors regularly want explanations for why the market is dropping. The honest answer—that this is just what stocks do sometimes, like why some days are colder than others—feels inadequate to some, which can cause untold amounts of overanalysis, anxiety and misbehavior.

Trying to forecast what stocks will do next.

The inability to forecast hasn't prevented the desire to keep forecasting. No matter how bad forecasts are, investors come back for more.

"We really can't forecast all that well, and yet we pretend that we can. But we really can't," former Federal Reserve chairman Alan Greenspan said last year.

In 2005, investment bank Dresdner Kleinwort published a study of aggregate professional forecasts such as stock prices, interest rates and gross domestic product growth.

As a group, the forecasts were terrible. But the researchers found a fascinating trend: an almost perfect lag between forecasts and actual results.

Analysts would wait until stock prices rose and then forecast that stock prices were about to rise. After interest rates fell, analysts would forecast that interest rates were due to fall.

"Analysts are terribly good at telling us what has just happened but of little use in telling us what is going to happen in the future," the researchers wrote. Yet the appetite for such predictions is still insatiable.

A world without forecasts doesn't have to be scary. It just requires making room for error. The great investor Benjamin Graham once wrote that the purpose of having a margin of safety—an emergency fund, job flexibility, avoiding expensive stocks—was "rendering unnecessary an accurate estimate of the future."

I don't know if we'll have a recession this coming year. Nor does anyone else. But if you have a margin of safety, you don't need to know. Humility can be more valuable than prescience in investing, because it's sustainable and far easier.

You have no control over what the market will do next. You have complete control over how you react to whatever it does.