7 Investment mistakes you must avoid

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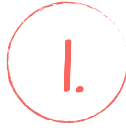
Introduction

In my 20-plus years as a financial adviser, I have seen plenty of investor mistakes – including those I made myself. To be a successful long-term investor, avoiding the "big mistakes" is often more crucial than finding the next "big thing."

Fortunately, almost all the big mistakes are avoidable. The mistakes often are created not because we miscalculate the math but because we misunderstand our emotional response to finances. Humans are very prone to shooting themselves in the foot when managing their investments. It is important to acknowledge that we are often our own worst enemy in finance.

Here are top mistakes I have seen investors make in the past two decades. If you can avoid these, you will be much more likely to invest successfully.



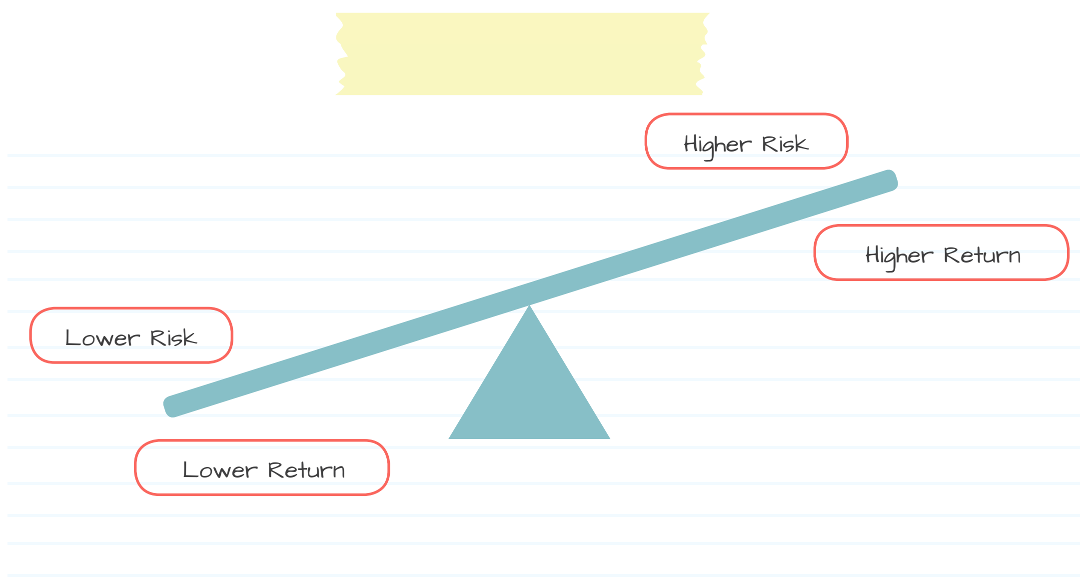
Not acknowledging and calculating risk

All investing entails risk. A working definition of an investor is ***"one who willingly puts his money at risk in an attempt to earn a rate of return better than what is available in a risk-free environment."***

The key words are "willingly," "risk" and "attempt." One must enter the investment arena with forethought, fully understanding that loss is possible and success is not guaranteed. It is simply a standing rule of investing: no risk, no potential of higher return.

Human nature is such that we don't want to accept this "no risk = no return" tenet. It is exactly our risk-averse nature that makes us susceptible to Ponzi schemes. We want to believe that a strategy or investment product affords high return with little or no risk. Time and again, when someone in a suit bearing spreadsheets and unsubstantiated facts offers an investment that sounds too good to be true, checkbooks will open.

If you are unable or unwilling to accept a measure of risk (you may lose money), then you are also not ready to invest. Perhaps you are a saver. All of us should be savers to some extent to achieve our financial goals. Being an investor, however, is a more selective endeavor because it mandates taking risk. Bottom line? Make sure you are ready to accept investment risk before you begin investing.



2.

Failure to set a realistic timetable

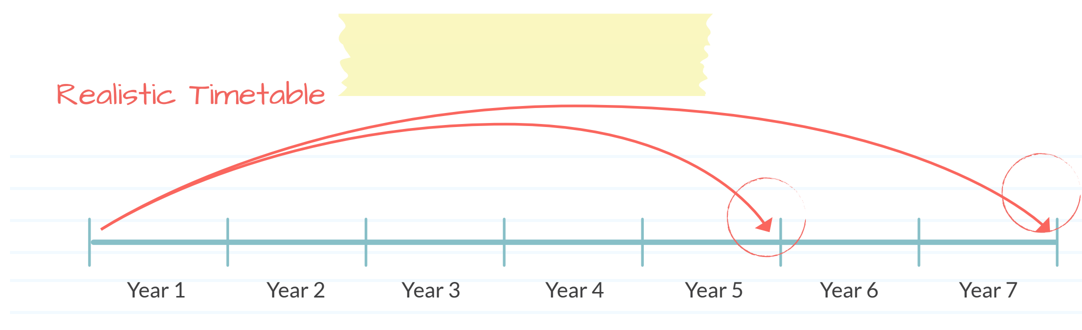
Almost everyone understands that the stock market is notoriously unpredictable on a day-to-day basis. What drives the market today might reverse tomorrow. Divining the daily direction of the market is a futile task that even professional traders often get wrong.

Less understood: The stock market continues to be quite unpredictable on a monthly or yearly basis. The U.S. stock market has a long-term average annual return of about 9 percent. But this attractive return also carries a relatively high standard deviation of about 20 percent. Every year, regardless of your view of the economy or the political environment, you should be prepared for stocks to return between -11 percent and +29 percent. Anywhere in this range would be considered "normal" from a statistical viewpoint.

It is only over the course of a market cycle (typically five to seven years) that the stock market can start to produce a more predictable return. Within a market cycle, it would be common to see 75 percent of the years positive and about 25 percent of the years producing negative stock returns. The distribution of positive vs. negative years within that market cycle is essentially random.

If you were to start investing today, no one could accurately tell if your first year would be profitable. If the first year is not profitable, one is more likely to change strategy or leave the market altogether. Yet, given market history and the normal dispersion of returns, this probably would be a mistake.

Bottom line? Many investors view themselves as patient long-term investors. But when investment results are temporarily unpleasant, they focus on the short term. To be a successful investor, you must always think in terms of market cycles of five to seven years. Short-term thinking damages long-term results.



3.

Trying to know the unknowable

Many investors, professional and "do-it-yourselfers," pay entirely too much attention to the unknown.

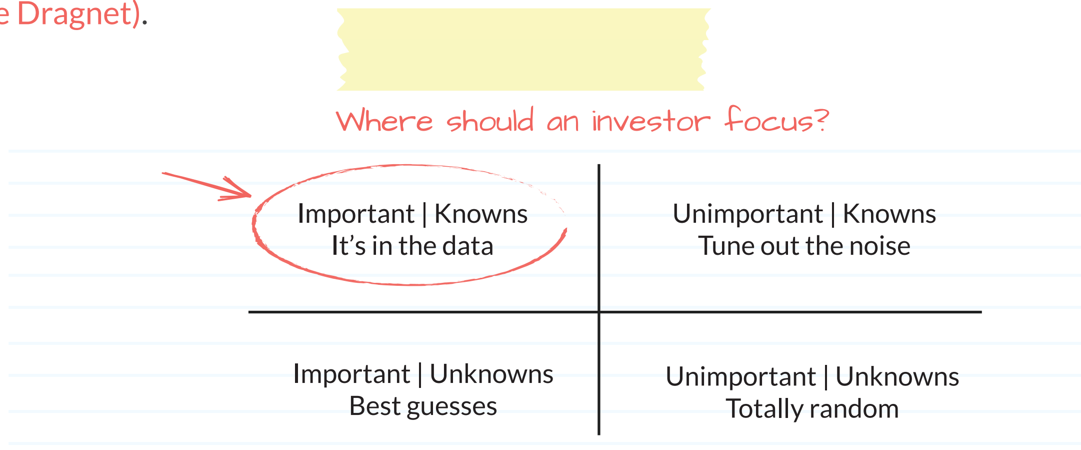
What is unknowable in investing? Tomorrow's market direction. The outcome of the next election. When interest rates will rise or fall. Where the market will finish at the end of the year. How fast the economy will grow this year.

It would be interesting to know the answers to these questions in advance. We can't. They are unknowable. Yet this is where most investment commentary and energy is directed: Trying to forecast events that are determined by human emotion and subjective data interpretation. This unknowable nature of the future is a big hang-up for many investors. It is difficult for them to reject the unknowable and focus on what is known.

What is known? Data. Investors can begin by exploring the data, such as leading economic indicators (one such series can be found at www.conference-board.org), or unemployment insurance claims, (www.bls.gov).

A second known quantity — opinions — is less than reliable. Well-known personalities tell viewers and readers every day that "this" will happen. Investors can find their biases validated by a pundit if they look for it. These opinions are "known" but not important. They will change as quickly as the wind changes. You cannot frame your investment decisions around others' opinions.

Bottom line? Focus on what is known and important. The data. "Just the facts, ma'am." (See Dragnet).



4.

Emotional investing

Investing is hard work. It can be exhausting and stressful. Markets can seem out of control, particularly during a "sale." Over a 20-year period, you are likely to be scared witless more than once. But, over any 20-year period you care to explore, the likelihood of a successful outcome is enormously high.

Why do we get so worked up about market declines if they have always been temporary? Why is it so hard to view the investment landscape with calm and scientific detachment?

Because your hard-earned money is at stake. When the value of your investments is dropping and the daily news is dire, your primordial self is screaming. Get out before it's all gone! Your prehistoric DNA provokes a fight-or-flight impulse. Calm and cool analysis collapses when the dinosaur is about to eat you.

This emotional response is virtually impossible for most people to ignore. It, unfortunately, represents one of the largest impediments to investment success. Too often the emotional response to short-term investment loss overwhelms all rational thought.

Here's an analogy that might help you navigate the next inevitable market storm.

Imagine your primary investment goal is to accumulate 1,000 cans of tomato soup over the next 10 years. How would you approach this?

You probably would put money aside on a regular basis to buy cans of tomato soup. You will need to buy about two cans a week. Some people might buy two cans a week and be blissfully ignorant of the cost, caring only that they would reach their goal in 10 years.

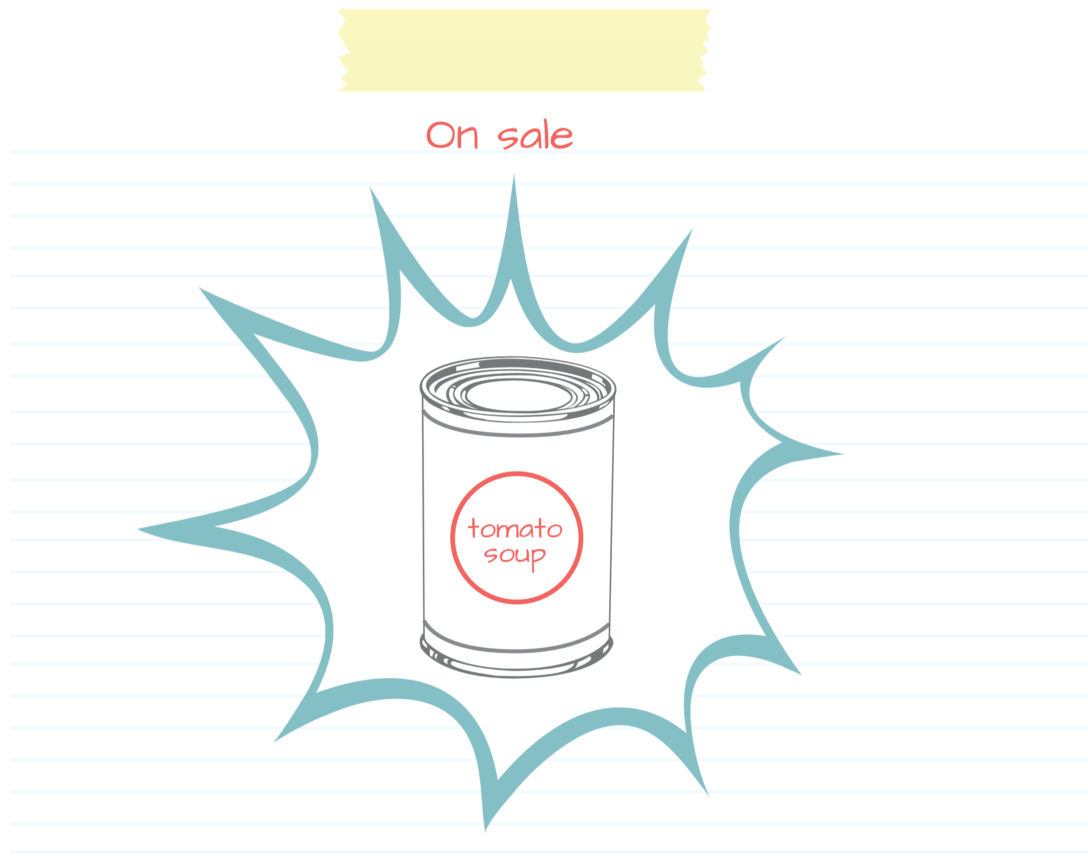
Other people — most people — would start to pay very, very close attention to the price of tomato soup. When it went on sale, they ... would ... buy … more.

What would our shopper do if tomato blight caused a temporary shortage of tomato soup and the price rose temporarily? He or she would … save money until prices dropped.

Buying tomato soup is not emotionally charged. It's just "business."

This is such a simple concept and yet so hard to apply to investing. When the price of our investments falls, we want to sell them. And when the price is high, we want to buy more.

Bottom line? Remember this simple analogy next time the market suddenly drops, taking the value of your investments with it. This does not mean the end of the world is near. It means ... **investments are on sale and you probably should buy more**.



5.

Jumping into investments before determining asset allocation

It is thought in the professional and academic investment world that fully 94 percent of your potential investment return is determined by your asset allocation vs. the selection of individual investments.

What is asset allocation?

Asset allocation is a complex term to describe a simple concept. It means your specific mix of asset categories, or how much of your portfolio is dedicated to stocks, bonds, cash and alternatives. In our practice, we focus on four main asset categories.

Stocks (aka Equities). When you own stock, either outright or through a mutual fund, you are an owner of the company that issued the stock. You are entitled to the benefits, and risk, associated with ownership. Many companies pay a dividend to stockholders. If business improves, their stock price often rises — sometimes dramatically. But if the company does poorly and goes out of business, stock investors could lose all of their investment

Bonds (aka Fixed Income). Bonds represent a lending arrangement between an investor and a business or other entity. When you own a bond, you are essentially lending money, often at a fixed interest rate for a defined period. A certificate of deposit (CD) is a similar arrangement. Many corporations issue bonds to finance the business. Federal, state and local governments also issue bonds. Bonds are often viewed as less risky than stocks because, as a lender, you have a higher probability of recovering your principal in case a business fails. Unlike stocks, bonds often are issued with a maturity date, which is when the principal is to be returned to the investor.

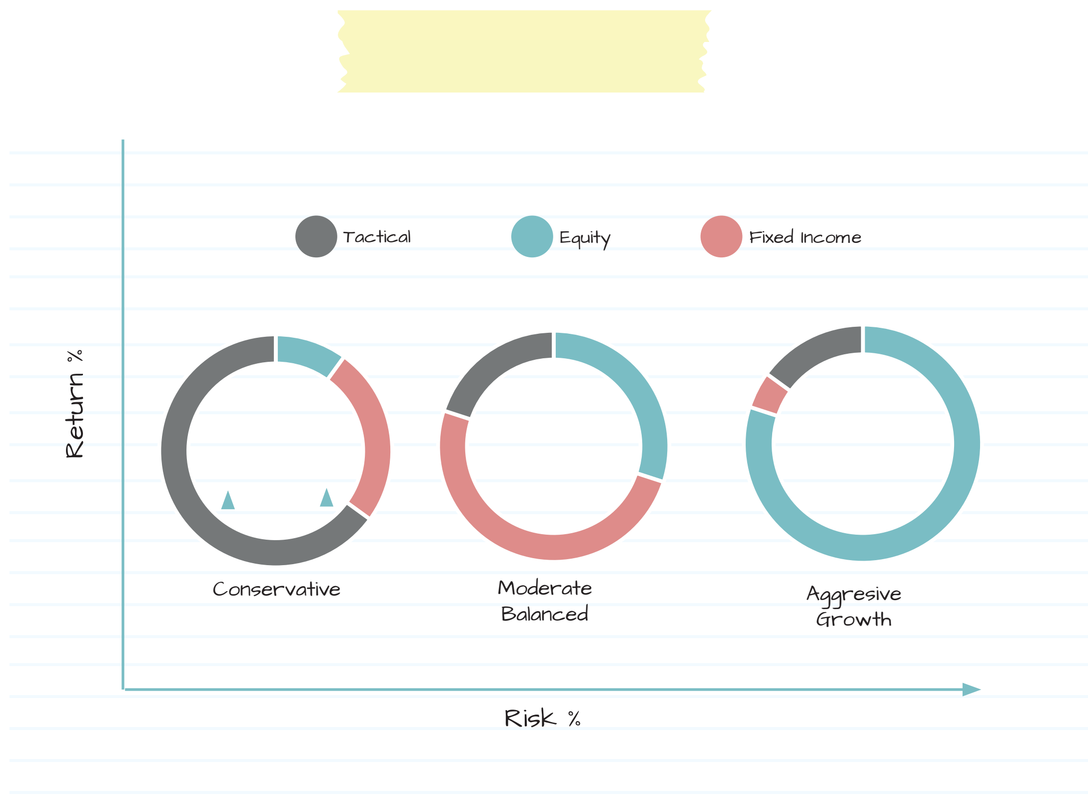
Alternatives. This is a broad category, but generally includes assets that are **non-correlated** not influenced by stocks or bonds. Events that cause their price to change are different from those that affect other assets. They “dance to a different tune.” Hedge funds, commodities and real estate investment trusts (REITS) are examples of investment “alternatives.”

Cash. The easiest asset category to understand, cash includes savings accounts, money markets and short term (less than 12 months) government bond funds. This asset category is highly liquid, virtually risk-free and has a lower potential return than the other categories.

An investor's asset allocation, then, is the percentage dedicated to stocks vs. bonds vs. alternatives vs cash. This allocation, more than the individual investments selected, will dictate the expected long-term return of a portfolio.

Many investors make the mistake of plunging directly into picking investments before deciding on an allocation mix. Professional investors always begin with a discussion of risk and time that leads to asset allocation. Only then are individual investments considered.

Once an asset allocation is determined, it is important to rebalance the portfolio on a regular basis to ensure that the original intended mix does not skew over time. Bottom line? An annual rebalancing is adequate for most investors.



Having too much or too little cash

It's often difficult for investors to determine how much cash they should keep in reserve of their investment accounts. In general, during optimistic periods when market conditions have been favorable for some time, investors keep very little cash reserves, preferring to have their funds invested. Conversely, when the market environment is challenging and investors have recently suffered losses, cash reserves are generally higher.

This is another example of market timing. Investors often get this backwards. They are raising cash when prices are low, and putting that cash to work — when prices are higher.

After the Great Recession of 2007 to 2009, I routinely saw extraordinarily high cash reserves among investors. Much of this cash was raised during the sell-off in the stock market when investors feared that prices would continue to fall and they would be left with little or nothing if they didn't "go to cash" — even if that meant selling investments at a significant loss.

In 2017, when the market has spent eight years recovering and is again at all-time highs, I see cash levels dropping. The cash that was raised, at tremendous lost opportunity in 2008-2009, is being put back in the market — at significantly higher prices.

Sound familiar? Next time, remember ... tomato soup!

A mathematical approach is better than an emotional approach to determine an adequate and logical level of cash. Many methods determine that level, and most are common sense. My guide for clients who are retired: an amount equal to two to three years of the annual income drawn from investment accounts.

I base this guide on my research of historical "bear markets" and their impact on balanced portfolios. A "bear market" is one where the overall stock market is down by more than 20 percent. Four bear markets significantly affected a balanced portfolio of 50 percent stocks (S&P 500) and 50 percent bonds (U.S. Treasuries). The bear markets of 1973 to 1974, 1987, 2000 to 2002 and 2007 to 2009 had an average negative return in balanced accounts of -18.45 percent. It took on average 30 months for the portfolio to recover to its previous high water mark.

Drawing from a portfolio during one of these bear markets can vastly change its potential longevity: It increases the possibility of running out of principal.

My research indicates that during severe bear markets, it is better to stop drawing from an investment account and instead draw from a cash reserve account. Because the average bear market historically took 30 months to recover, it's prudent to keep two to three years' cash reserve until the portfolio recuperates.

To illustrate, I use this example in my practice with clients who are retired or soon to be retired.

Example

Profile: Retired, age 67

Income needs:	$25,000	From Social Security
	$25,000	From Investment Accounts
	$50,000	Total Annual Income

Available Investment Assets: $700,000

Suggested Portfolio Solut

$625,000	Balanced Portfolio (adjusted to suit investor risk profile)
$75,000	Cash Reserves (3 years of investment account withdrawals)

7.

Not asking questions

When I was a young financial adviser, 20 years ago, I often found it awkward to ask direct questions of potential clients to learn what I needed to offer competent advice. I was raised in an environment where it was impolite to talk about money. I kept expecting clients to tell me, “Well, that’s none of your business, young man!” in response to my questions.

Just as a good physician can’t treat patients without a complete understanding of symptoms and medical history, a good financial adviser must ask direct questions and complete a comprehensive financial profile of clients before offering investment advice or financial guidance. This can be uncomfortable for clients, but it soon becomes second nature to seasoned financial advisers.

Similarly, it’s often difficult for clients to ask direct questions of their financial advisers. It might seem rude or inappropriate to question a professional but, in the end, your money is at stake. The decision to hire a financial adviser to handle your investments and to offer planning and guidance is important.

You should feel perfectly comfortable asking, and your financial adviser should be equally comfortable answering, the following questions:

Questions to ask ...

- What makes you different from other financial advisers?
- Are you a fiduciary? If not, why? How are you paid? Can you explain the difference between "fee-based" and commission based compensation?
- How would you describe your investment philosophy?
- Who makes investment decisions? How do you decide what investments to buy, and when to sell? Who will be the custodian of my assets and how can I access and review them?
- How many clients do you have? Do you have a specialty?
- Do you have any client complaints or legal actions against you? How can I verify?
- What is your service commitment for clients? How often will we meet?

A good long-term relationship with a financial adviser is a two-way street. Only by asking many questions will each of you know if your relationship will be a "good fit."

Once you begin working with a financial adviser, at a minimum, you should expect the following in the relationship:

These are the minimum expectations. May your financial adviser far exceed them.

Bottom line? Never be afraid to ask questions. If you are not comfortable asking an adviser questions, that might raise a red flag.

Expectations ...

- A personal, confidential conversation about risk, time frame and income needs.
- A written plan.
- Customized asset allocation to suit your needs.
- Investment selection and explanation.
- Complete transparency on fees and costs.
- Continued monitoring of investments and achievement of financial goals.
- Consistent communication on performance and views on market and economic conditions.
- Regular meetings.
- Fast response to service issues that may arise.

In summary

I hope learning these investment mistakes can help you avoid them. I, and many others, learned them the hard way. Avoiding these mistakes will greatly improve your investing success.

Bottom line:

- Find your risk-level comfort zone
- Set realistic time frames
- Focus on the data ... tune out the noise
- Avoid emotional decisions
- Stay the course
- Focus on the longer term
- Ask questions, knowledge is power

Remember, with investment mistakes, “We have met the enemy and he is us.”

About the Author

Jonathan Lokken is the Managing Principal at Lokken Investment Group, LLC. He has been professionally managing client investments since 1997. Prior to starting Lokken Investment Group, LLC in 2008, Jon was Vice President and Branch Manager for Merrill Lynch in Rehoboth Beach, Delaware, from 1998 to 2008.

In 2004, Jon attended the University of Pennsylvania's Wharton School program for the Investment Management Consultants Association and subsequently and subsequently earned the Certified Investment Management Analyst (CIMA®) designation. This credential requires continuing education on a biannual basis to remain in good standing. Additional information can be found at www.imca.org.

Jon is a 1983 graduate of Carleton College in Northfield, Minnesota. He and his wife, Karlyn, have lived in Sussex County, Delaware, for over 20 years with their three daughters, Hannah, Jessica and Claire. Jon is active in the community, having served on the boards of Sussex County Habitat for Humanity and Peoples Place. He is a proud supporter of the Lewes Library, the Lewes Chamber of Commerce and the greater Lewes community.

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Get in touch!

Lokken Investment Group, LLC
1413 Savannah Road, Suite 4
Lewes, DE 19958
Tel 302.645.6650
Fax 302.645.6622