HOW TO BUILD A BOMB-PROOF INVESTMENT PORTFOLIO:

THE TEN MYTHS THAT CAUSE INVESTORS TO FAIL

(excerpted as Part 1, from the forthcoming book

The Science of Successful Investing Made Simple)

Investing is a reality-based, evidence-based activity – or it should be. Unfortunately, for all too many investors, reality and evidence are circumvented by false ideas that prevent understanding and sound investment decision-making. Ten myths in particular hamper the investor and need to be recognized for the false ideas that they are. Avoid these ten fables and you will have a good start on the road to sound, scientific investment choices. Here are the myths:

1. Investment is a Do-It-Yourself Project. Most investors not only lack the expertise, they also lack the discipline and the time necessary to properly develop, allocate and manage their investment portfolios. The DALBAR research organization shows that investors continue to under-perform by an astounding *3-7% annually* over any 20-year period of time.

2. You Can Get Rich Through Investing. This rarely happens. If you're already rich and have a lot of money both to invest and to hire the best advice and management, you can get rich*er* through investing, but for most people, whose capital for investment is limited, investment is a way of protecting assets and creating a fund for your goals, not a road to riches. Your gains will be a function of how much you have to invest, and a rate of return capable of turning modest means into great wealth is very unusual.

3. Bond or Stock Picking Can "Beat the Markets." There is risk inherent in all investments, roughly proportional to the returns, and it can't be avoided. It's true that at any time, some stocks or other investment vehicles outperform the market average, but relying on this to gain excess return is an unwise strategy. It's the nature of the beast that some investments will lose money.

4. "Track Record Chasing" Can "Beat the Markets." Just as some investors rely on stock-picking to achieve high returns, others similarly look for the best track record either of investment vehicles or of managers. While there is nothing wrong with judging an investment based on its track record (among other factors), and certainly you should carefully evaluate anyone you consider trusting with your money, the idea that you can achieve excess returns in this way is simply false. Risk is roughly proportional to expected return,, and although a good portfolio that is properly maintained will show a net gain over time, individual investments *will* lose money from time to time.

5. Market-Timing Tactics Can "Beat the Markets." Far too many investors sell out when the market is falling and buy back in when it's on the upswing. If you don't have capable investment advice and management by professionals, you may be doing this. Some investors believe that by choosing when to buy and sell investments based on their rise and fall, they can beat the market average and avoid risk. As with stock picking and track record chasing, avoiding risk is not possible. Risk is part of return. And market timing, by any name or means, is a fool's errand. Unfortunately, even many stock-brokers will still engage in this.

6. Trading, Custodian, and Research Costs Don't Matter. Many of these costs are not readily apparent. It's easy for unnecessary fees, taxes, and other expenses to eat up your returns if you don't keep a lid on them. Managing investment activity so as to contain these expenses is part of the package.

7. Conspiracy Theories. The belief that there is someone, somewhere manipulating prices, or that someone can employ "arbitrage" to outsmart the markets, or that people "in the know" can consistently take advantage of "mis-pricing" to get a leg up over other investors or managers leads to wild-goose chases, unrealistic pessimism, and poor decisions.

8. Oversimplifying the Math. The math of investment is more complex than a simple average, and it's possible to have an average return that looks like a gain but is <u>really a loss</u>. For example, suppose you invest $100 that has a 100% gain the first year and a 60% loss the second year. That averages to a 40% gain over two years, or 20% per year – except it's not, because the loss in the second year is based on double the volume of the first year's gain. That $100 investment becomes $200 at the end of the first year, and in the second year it loses 60% of its value, or $120, and you are left with only $80 – a $20 *loss*.

9. The Wizard of Odds is Out There. Some investors believe that there is someone with a special formula for consistent, low-risk investment, and that enlisting that person's expertise (for a modest fee) will enable them to make a killing on the market. Expertise and knowledge about investing do vary, and sometimes people achieve surprising successes, but there is no magic formula, no way to consistently, reliably beat the market.

10. Your Behavior as an Investor Doesn't Matter. Peter Lynch, the famous investment-fund manager from the 1980s, once said, "Far more money has been lost by investors preparing for corrections or trying to anticipate corrections than has been lost in the corrections themselves." A lot of the value of stocks and other investment vehicles is created (or destroyed) by investor behavior, rather than by anything inherent in the stock itself. When the stock is doing well, money pours in, and when it does poorly, money pours out, in a pattern known as the "Greed-Fear Cycle." Risk tolerance changes from good to bad years, and investor panic or irrational zeal has ruined more than one otherwise sound portfolio.

A wise investor will see the investment market for what it is: a way to achieve a solid return on investment that arises because, overall, return outweighs risk. A wise investor won't see the market as a get-rich-quick scheme, or hold unrealistic expectations of never seeing an investment go sour, or suffer from equally-unrealistic fear of losing everything at once (virtually impossible with a diverse portfolio), or a morose conviction that ordinary investors can't succeed because some evil capitalist mastermind is fixing prices, or a lack of awareness of the way that their own behavior and that of other investors twists and shapes the market.

What should replace these misconceptions, these ten myths about investing?

Investors should treat investment rationally as a scientific enterprise that is statistically predictable even though the performance of any one investment may not be predictable. There are sound rules to investing and most of those are common-sense principles that are not at all hard to follow. These rules won't allow you to become wildly rich from your investments (see myth no. 2, above), but they will allow you to gain a steady and reliable return, to safeguard your assets from inflation and taxes, and to provide an income later in life when your investments mature. Look for Part 2, "The Truth of Investing" in the next issue for more details.