The Biggest Common Investment Errors

It's hard to believe but it's now been 10 years since the first rumblings began prior to the Great Financial Crisis. My guess is we'll be re-living many of the events that led to the worst crisis since the Great Depression in the months and years ahead.

Financial stocks and some home builders saw some trouble in the summer of 2007 but one of the first warning signs that something was wrong in the markets occurred during the quant crash in August of 2007.

AQR's Cliff Asness created many of these quantitative investment strategies and had to personally deal with this upheaval. This week he wrote a piece describing what it was like to invest through a period where nothing is working in your fund. While it's never fun to sit through brutal losses you also have to put these things into perspective from an overall portfolio standpoint and look beyond individual strategies, which is what Asness did (emphasis mine):

An unheralded fact of the quant crisis of '07 was that from peak to trough of the factor drawdown, the S&P 500 was flat to up a bit. That is, even while losing big, quant factors were market-neutral during the quake. The overall market's lack of interest or reaction to the quant crisis in 2007 is important. ***It would be an interesting contest, and perhaps a future blog topic, to come up with the single biggest common investment error out there. But one candidate would surely be over-worrying about parts of your portfolio and not focusing on the whole.*** *Granted sticking with a levered market-neutral quantitative factor investment process would be quite difficult through the '07 quake if that was 100% of your portfolio. But difficult at a 20% allocation? At 10%? At 5%?* ***Sizing exposures such that you can stick with your investments through their worst times is a big part of long-term success. Conversely, sizing your investments such that you're near guaranteed to abandon them during really tough times is a recipe for near certain failure.*** *I would wager that had they kept an overall portfolio perspective, few quant investors (outside of the all-quant firms themselves) were suffering enough to have had to take action at even the depths of 2007. But many might have panicked by viewing just their quant/factor sleeve in isolation - perhaps a lesson for next time (if there is a next time!).*

Looking past the individual slices and thinking about the entire pie in terms of an overall portfolio construct is such a simple part of the investment process, but as Asness noted, it's highly overlooked. I'm going to sound like Captain Obvious here but portfolio management is about managing a portfolio, not just the individual parts.

You have to understand beyond how certain asset classes, strategies and securities function on their own and determine how they complement one another to understand your true risk profile, diversification and exposure to certain risks. This is hard to do when you see your friends making money on an individual stock or fund as the fear of missing out (FOMO) can be difficult to avoid.

I also liked Cliff's idea about coming up with the single biggest common investment error. I don't think there is just one because it likely depends on the individual or organization in question. But here is my list of the most common investment errors:

Not paying attention to asset allocation. Security selection is sexier but asset allocation is far more important for 99% of investors.

Fighting the last war. Chasing past performance and investing as you wish you would have invested after seeing what just happened is a time honored tradition in the markets. It's also a losing strategy since most investors end up following momentum but at a value investor's time horizon, a losing combination.

Setting unrealistic expectations. The difference between reasonable return expectations and the returns investors assume they deserve is the cause of a lot of heartache and crippling errors in the markets.

Having no plan in place. Even a suboptimal plan is better than no plan at all. Creating a document (or investment policy statement in industry-speak) that lists how you plan to invest, save, your goals, constraints, etc. is something I'm guessing 90-95% of investors don't do or never use.

Confusing your time horizon with other investor's time horizons. Depending on the market environment traders tend to become investors and investors tend to become traders and everyone wants to be a macro investor at some point. Ignoring how others invest is the path to investment enlightenment.

Overconfidence. Intelligent investors all seem to possess just the right amount of self-doubt in their process and abilities. Falling in love with yourself is a sure way to blow yourself up in the markets.

A misunderstanding of risk. There are plenty of different ways to define risk both personally and in the markets but investors are constantly worried about risks that either don't impact them or that they have no control over in the first place.

Using the wrong benchmark. The only true benchmark that should matter to any investor is whether you're able to achieve your financial goals. Getting in a goals-based mindset is hard when everyone else around you is worried about beating the S&P 500 or finding the next fad investment but your financial goals are what you're investing for in the first place.

Source:
The August of Our Discontent: Once More Unto the Breach (AQR)

Further Reading:

Doubling Down on Risk

Now here's what I've been reading lately:

- What if we had another Great Depression? (Irrelevant Investor)
- Why everyone should write (Collaborative Fund)
- How to build a firm through candor and consistency (Big Picture)
- Why you feel richer or poorer than you really are (NY Mag)
- Getting a major in multipotentiality (A Teachable Moment)
- The meanest reversion (Mullooley)
- Jason Zweig will be appearing at our EBI Conference in November (TRB)
- 10 questions to ask about protecting against a financial disaster (Humble Dollar)