WORTH **READING**

New to AAII? Here's a sample of the quality education we provide to individual investors. We hope you find it useful. It touches on one aspect of the broad subjects we cover for anyone who has an interest in handling their own investments. AAII teaches you what you need to know about financial planning, comparing mutual funds, investing for income, screening for and analyzing stocks, asset allocation strategies, handling taxes, saving for and investing in retirement, and more.

We appreciate your interest!

For more information and to sign up for AAII membership, please visit our website at AAII.com. For speedier service, call AAII toll-free at 1-800-428-2244.

©2016 Reprinted with permission from

The American Association of Individual Investors
625 N. Michigan Ave., Chicago, IL 60611
800-428-2244
www.aaii.com

The American Association of Individual Investors is a nonprofit group whose sole purpose is to assist its 150,000+ members with their investment information and education needs. For over 30 years, AAII has been providing guidance and tools to both the beginner and advanced investor. AAII helps members build their investment wealth through guides, model portfolios, a monthly Journal and a comprehensive website.

Reprinted with permission from the American Association of Individual Investors, 625 N. Michigan Ave., Chicago, IL 60611; 800-428-2244; www.aaii.com. ©2016.

Avoiding the Mistakes Made by Ineffective Investors

By Spencer Jakab

Article Highlights

- A lesson each generation of investors seems to learn the hard way is that boring companies make for better investments.
- Reaching for yield means ignoring a key lesson of investing: There's no reward without risk.
- Understand whether or not leverage is used, since investments that use it can experience large losses.

You can learn a surprising amount by loafing around and watching TV.

For example, I got an important lesson about what sorts of stocks to avoid from a rerun of "Leave it to Beaver." I wrote about it and how to avoid other costly investor errors in my upcoming book: "Heads I Win, Tails I Win: Why Smart Investors Fail and How to Tilt the Odds in Your Favor" (Portfolio/Penguin, 2016).

The Lure of Exciting Stocks

The TV episode in question aired during the early 1960s when the "Kennedy bull market" was in full swing. Excitement about the Space Race made any stock related to it, particularly those with the suffix "tronic" or "sonic," a case of buy-first-and-ask-questions-later. There was Vulcatron, Circuitronics, Astron and the gratuitously snazzy-sounding Powerton Ultrasonics. In his classic book "A Random Walk Down Wall Street" (now in its 11th edition, W.W. Norton, 2015), Burton Malkiel tells the story of a company that sold vinyl records door-to-door. Its stock price surged six-fold when it changed its name to Space-Tone.

In the TV episode, which I saw as a child, Wally is learning about stocks and bonds in class. Ward decides that Wally and Beaver should get a real-life investing lesson. They each take $25 of their savings, and Ward matches the amount to make it $100 in total. Ward suggests shares of a local electric utility and then buys it for them. Wally and Beaver dutifully check the newspaper every day to see how it's doing. It barely budges.

Meanwhile, Wally's fast-talking friend Eddie Haskell tells them about a hot electronics company and chides the Cleaver boys for being such squares. Wally and Beaver then start tracking the prices of both, and, sure enough Eddie's recommendation rises consistently. They prevail upon their dad to sell the utility for Eddie's choice. Naturally, losses ensue and lessons are learned.

You can substitute the "tronics" for stocks with a "dot-com" in their name 15 years ago or those today that tout "the cloud" or "3-D printing" or "social media." Some of these will probably do well as investments, but public buzz surrounding a hot new industry will almost certainly make them a poor investment as a group. It's a lesson that each generation of investors seems to learn the hard way: Boring stocks are better.

Superior bang for the buck from dowdy, out-of-favor companies was discussed as early as 1934 in "Security Analysis" (reprinted in 1996 by McGraw-Hill Education), the investing classic by Benjamin Graham and David Dodd. Graham was the teacher, and he has served as the inspiration for the most successful investor of all time, Warren Buffett, so it's safe to say that his theories have worked pretty well in practice.

A 2012 study by the Brandes Institute, "Value vs. Glamour: A Global Phenomenon," updated and reinforced some earlier studies showing much the same thing Graham said but with a lot more mathematical notation. It sliced stocks into deciles by price-to-book-value ratio for five-year periods

ranging from 1968 through 2012. The highest-multiple stocks, a trait associated with glamour, had average annual returns of 6.5%. The other end of the spectrum had annual returns of 14.8%. Compounded over that entire period, a portfolio of the most boring stocks would have been worth 30 times as much as the exciting ones.

Sorting stocks by valuation is a pretty blunt instrument, though. Identifying a "too good to be true" investment should be a little like pornography—you'll know it when you see it. In practice, though, we're easily beguiled. I'm not aware of a litmus test to overcome that, though legendary investor Peter Lynch came as close as anyone. In the first book that I ever read about investing, "One Up on Wall Street" (Simon & Schuster, 2000), he warned readers to avoid exciting stocks, including anything with an "x" in it.

Naturally, I violated this rule with my very first bonus check back when I was a stock analyst. Eager to put my money to work in a hurry, I naively took a tip from a fund manager, a client of our firm, about a hot new company called YBM Magnex and its whiz-bang technology, "permanent magnets." I still have only a hazy grasp of what a permanent magnet actually is, but it sounded cool.

The stock price rose for a while and, much to my shame, I got a friend and fellow junior analyst excited enough to invest in it too. Then one day the FBI raided the company, which, it turns out, was a fraud run by an alleged Ukrainian mobster. Oops.

Years later, with my pride healed and a job writing about investments instead of making them, I decided to test out Lynch's oddly specific warning. The results were surprising. I found 109 stocks in the Wilshire 5000, the broadest U.S. stock index, that began or ended with an "x," including a few that did both. Right away I could see that he was on to something. Only 49 of them had been profitable in the previous year. Even after ignoring the money-losing ones, the remaining stocks were far more expensive than the broad market on measures such as price-to-book-value ratio and were also a lot more volatile. In other words, they were both costlier and riskier as a group. What's more, I found a disproportionate number of scandals affecting companies with that dreaded letter.

Why would there be a connection? As any Scrabble player can tell you, few words have an "x," so that letter, probably along with "z" and "q," lend themselves to snazzy-sounding made-up names. By my calculation, an "x" appears in company names 17 times more frequently than in actual English words.

Being tempted by exciting stocks is just one of what I dub The Seven Habits of Highly Ineffective Investors. I could have written about 70 or even 700, but these are the specific pitfalls you're most likely to encounter.

Be Wary of Hot IPOs

Another doozy is to chase hot initial public offerings (IPOs). I'm sure you've heard of the fantastic gains to be made in IPOs. It's true, but probably not for you. During the dot-com boom, companies such as VA Linux, Foundry Networks, the theGlobe.com and webMethods all surged by at least 500% on their debuts. The average stock offering in 2000 rose by 71% on day one according to University of Florida finance professor Jay Ritter—eight years of typical stock market gains in just eight hours.

Here's the catch, though. Unless you happen to be well-connected—a hedge fund manager, let's say, or a fabulously wealthy private banking client—you won't get a shot at that. Access to an IPO is like a celebrity showing up at a Michelin-starred restaurant and being quickly seated by the maître d', not standing in line at Denny's where it's first-come, first-served and your money as good as the next person's. Companies primed for explosive gains usually have to be bought once they actually start trading post-explosion.

Buying on that first day and selling a few hours or perhaps a few minutes later is no better than a crapshoot. Buying and hanging on to the stock in the hopes of owning the next Apple is, on the other hand, more like shooting yourself in the foot—particularly when it comes to a small, unproven company.

Professor Ritter's calculations show that IPOs tend to lag the broad market in each of their first three years on the market. The smaller the company, the worse your odds. Companies with less than $1 billion in sales in 2014 dollars lagged the market by just over 20% per year on average. They're fool's gold.

There's No Reward Without Risk

Another destructive investor habit, particularly in these days of ultra-low interest rates, is reaching for yield. I've heard many sad stories firsthand of people on a fixed income who, because they hadn't saved enough or because they lost a lot of money in the market, pushed the envelope with securities that seemed to promise them something for nothing. Recent examples have been master limited partnerships (MLPs) and royalty trusts that left their investors high and dry in the energy bust. There are plenty more, though, such as unlisted real estate investment trusts (REITs) that appear conservative but carry hidden costs and pay their investors by devouring their seed corn.

In contrast to the conservative income investors who get burned reaching for yield, fast-money types already know a key lesson of investing: There's no reward without risk. They just think they can come out a winner when so many others lose. If you've watched a financial TV show recently, you'll have seen that online brokers and sellers of trading software encourage this notion. They show a man (it's always a man) watching green and red lines on a screen in his tastefully decorated home. He makes a few mouse clicks, smiles, and you know he just made more money than you did all week without breaking a sweat.

But in real life such frenzied activity greatly increases your odds of being a lousy investor. In a study by economists Brad Barber and Terrance Odean, who examined the records of 66,465 households with accounts at a discount broker-

age, there was a direct inverse correlation between trading frequency and returns even before considering commissions. They sorted investors into five groups according to how often they traded. While average investor turnover at the time was 75% a year—a figure that is already too high to be healthy, in my opinion—the most active group traded at three times that pace and was about a hundred times more active than those in the lowest quintile. The only group to make a positive market-adjusted return was the one with the lowest turnover. The difference in return between the most and least frenetic traders was a massive 5.7 percentage points annually.

Combining Morals With Money May Cost You

Another habit of ineffective investors is one born out of the noblest motives—combining your morals and your money. For example, part of your pension may be invested in a fund that shuns companies that make guns, booze or tobacco or those with large greenhouse gas footprints. More religiously focused funds also may ban pharmaceutical companies that sell contraceptives or hospital chains involved in abortions. If you own individual stocks then you may avoid investing in such companies yourself, consciously or not. There have even been mutual funds that cater to specific religious beliefs, including Sharia-compliant ones for Muslims and a number of now-defunct ones for various Christian denominations (some had differing standards on hard liquor, gambling or firearms but shared a devotion to high fees).

The sad truth, though, is that not only isn't it especially profitable to be good—it's downright good to be bad. Academic studies on the subject haven't reached a firm conclusion as to why. Perhaps because they're shunned businesses or maybe because many happen to be in recession-proof fields, the very companies that don't show up in the portfolios of do-gooders have often been great investments.

U.S. tobacco companies, for instance, had an annualized return of 14.6% a year from the beginning of the 20th century through 2014, according to researchers at London Business School. The overall U.S. market returned just 9.6% during that time. That's a huge difference. Those investing exclusively in tobacco made 165 times as much as those just owning the broad market. Smoking!

Those gains haven't gone unnoticed, but funds that have tried to capture the extra return from vice have been oddly unpopular. An exchange-traded fund with the ticker symbol PUF (get it?) that invested along those lines peaked at barely $10 million in assets and had to fold, though its underlying index—known as the SINdex—lives on. From the end of 1998 through the beginning of 2015, it had an annualized gain of 16%. A dollar invested would have

Seven Bad Investing Habits

In his book, "Heads I Win, Tails I Win" (Portfolio/Penguin, 2016), Spencer Jakab lists what he describes as the Seven Habits of Highly Ineffective Investors. Those habits are:

1. **Get in on That New Hot Deal**: Though initial public offerings (IPOs) have averaged an 18.6% gain during the first day of trading, those profits are only available to investors who were able to actually participate in the IPO. Buying shares on a stock's first day of a trading is very risky. The odds of buying into "the next (fill in the blank)" are even worse.
2. **Combine Your Money and Your Morals:** Sinful stocks (e.g., tobacco and alcohol) have bested the S&P 500 index both over the long term and between 2000 and 2015. Investors who are morally opposed to such companies can consider donating some of their investment profits to charities such as the American Lung Association.
3. **Buy What's Fashionable:** The market constantly votes on which companies are "most likely" and "least likely" to succeed and adjusts valuations accordingly. Shares of the most-admired companies trade at premium valuations and, as a result, tend to lag shares of the least-admired companies.
4. **Reach for Yield:** Plenty of income investments with high yields have risks that aren't apparent to unsophisticated investors. Focusing on the yield instead of how exactly the dividend or distributions are being paid can lead to very large losses and other risks.
5. **Use Exotic Products to Enhance Your Returns:** Funds that use leverage or invest in commodities have realized actual returns that are far different from the underlying assets and indexes they are designed to track (either in the same direction or inversely) resulting in large, long-term losses. Even principal protected notes are highly risky, despite their name.
6. **Trade Frequently:** Frequent trading is a loser's game any way you slice it. Studies of traders found those who traded most frequently incurred the worst returns; those who traded the least had the best performance. Furthermore, stocks that were sold by individual investors fared better than the stocks those same investors bought in exchange.
7. **Use a System:** A system that turns risky strategies into consistent gains simply does not exist. Those who tout "profitable" trading systems often charge a high price for them. Add in the additional cost from frequent trading and the resulting combination is hazardous to your financial health.

grown nearly three times as much as the broad stock market.

However, being a goody-two-shoes is only a minor drag on your returns and makes you feel better. The following are two investor errors that can blow a hole in your nest egg with alarming speed and no warm afterglow.

Playing With Volatility Is Like Playing With Fire

All of the other mistakes I highlight in my book, from overpaying for active funds to frequent trading, may be painful but they don't send your dollars to money heaven. They go into the pockets of a savvy investor or the profit of a financial services company. This one is different, though. There are now a plethora of distressingly popular funds available to individual investors that are practically designed to incinerate your cash. They target volatile underlying assets and then pile leverage on top, tempting buyers with the potential for gaudy overnight profits.

One fund, the Direxion Daily Small Cap Bear 3x ETF (TZA), returns three times the inverse of an index of small stocks. It rose 35% one day and has gained at least 10% on 37 separate trading days at the time of this writing. But its small losses added up. Someone holding the fund from its debut in November 2008 would have lost 99.9% of their money. The fund has had to undergo reverse splits in order to avoid falling below minimum stock market share price requirements by trading at mere pennies. The most volatile of these products—market choppiness equals losses—are expected to lose over 90% of their value in a normal year.

Naturally, people own these funds for periods as short as days, hours or even minutes. Where else can you make a few percent in a few hours? All you have to do is sell it at a higher price to some fool. As tempting as that sounds, the odds of you being the patsy are pretty high. Think about it: In aggregate, all the people who hold this security for even a short while collectively own it for its whole life. You have to be pretty fortunate to be among the winners rather than the losers.

Understand What You Are Buying

Other exotic products have the appearance of solidity and safety. Commodity investing is a good example. The world's running out of oil, copper, platinum and lots of other stuff. And owning something tangible sounds a lot more reassuring than a piece of paper such as a stock, bond or exchange-traded note. Unfortunately, people don't understand what they're buying.

Take the United States Oil Fund (USO), which was formed in 2006 to represent an interest in crude. The average price of oil that year was $58.30 a barrel, and as I write these words, it's right around $50. Well, at least it didn't lose too much value—right? Wrong. Since 2006, an investor in the fund is down by 83%. How could the return be so far out of whack with crude oil? Fees are a part of it, but the main reason is a phenomenon called contango. Investors don't own an actual barrel of oil—42 gallons of crude—because that would be very expensive and cumbersome to store. Instead they own a futures contract or a fraction of it.

Unfortunately, when the price of crude oil available for delivery or cash settlement in a month is higher than today, the futures price and the physical price have to converge and be identical on settlement day. If they didn't, it would mean free profits for oil traders. That small erosion in the value of the future compared to actual oil repeats each and every month that contango persists. Even if oil prices rise, it's like walking down an up escalator—you have to move quickly just to stay even.

Be Wary of Investment Services

An even worse idea than dabbling in these exotic products, though, is signing up for one of those services that tell you when to buy and sell stocks—or even derivatives—promising quick gains. There are dozens of them.

The basic thing you need to remember about them is that the knowledge they are selling you would be vastly more valuable (assuming it worked) if its purveyors kept it to themselves or, even better, charged fat fees and did it through a hedge fund.

Avoiding Failure

Recognize yourself in any of the above situations? Don't feel bad. As the subtitle of my book says, smart people are particularly prone to failure as investors. It seems that the more decisions we make, the more wrong we are. The path to better returns is to take as many choices out of your hands as possible and to reduce your costs in the process—an investing twofer. A regularly rebalanced set of index funds is likely to trump any advice from a purported expert or your own brilliant plan. In fact, I'm convinced investing genius is exceedingly rare. ➤

***Spencer Jakab** is a financial journalist who writes and edits the "Heard on the Street" column in The Wall Street Journal. He is author of the book "Heads I Win, Tails I Win: Why Smart Investors Fail and How to Tilt the Odds in Your Favor" (Portfolio/Penguin, 2016). Find out more at www.aaii.com/authors/spencer-jakab.*