

SECOND EDITION



THE **5**
MISTAKES
EVERY INVESTOR MAKES
AND HOW TO
AVOID THEM

Getting Investing Right

PETER MALLOUK

WILEY

THE 5
MISTAKES
EVERY INVESTOR MAKES
AND HOW TO
AVOID THEM

THE **5**
MISTAKES
EVERY INVESTOR MAKES
AND HOW TO
AVOID THEM

Getting Investing **Right**

Second Edition

PETER MALLOUK

WILEY

Copyright © 2021 by John Wiley & Sons, Inc. All rights reserved.

Published by John Wiley & Sons, Inc., Hoboken, New Jersey.

Published simultaneously in Canada.

No part of this publication may be reproduced, stored in a retrieval system, or transmitted in any form or by any means, electronic, mechanical, photocopying, recording, scanning, or otherwise, except as permitted under Section 107 or 108 of the 1976 United States Copyright Act, without either the prior written permission of the Publisher, or authorization through payment of the appropriate per-copy fee to the Copyright Clearance Center, Inc., 222 Rosewood Drive, Danvers, MA 01923, (978) 750-8400, fax (978) 646-8600, or on the Web at www.copyright.com. Requests to the Publisher for permission should be addressed to the Permissions Department, John Wiley & Sons, Inc., 111 River Street, Hoboken, NJ 07030, (201) 748-6011, fax (201) 748-6008, or online at www.wiley.com/go/permissions.

Limit of Liability/Disclaimer of Warranty: While the publisher and author have used their best efforts in preparing this book, they make no representations or warranties with respect to the accuracy or completeness of the contents of this book and specifically disclaim any implied warranties of merchantability or fitness for a particular purpose. No warranty may be created or extended by sales representatives or written sales materials. The advice and strategies contained herein may not be suitable for your situation. You should consult with a professional where appropriate. Neither the publisher nor author shall be liable for any loss of profit or any other commercial damages, including but not limited to special, incidental, consequential, or other damages.

For general information on our other products and services or for technical support, please contact our Customer Care Department within the United States at (800) 762-2974, outside the United States at (317) 572-3993, or fax (317) 572-4002.

Wiley publishes in a variety of print and electronic formats and by print-on-demand. Some material included with standard print versions of this book may not be included in e-books or in print-on-demand. If this book refers to media such as a CD or DVD that is not included in the version you purchased, you may download this material at <http://booksupport.wiley.com>. For more information about Wiley products, visit www.wiley.com.

Library of Congress Cataloging-in-Publication Data is Available:

ISBN 9781119794332 (hardback)

ISBN 9781119794356 (epdf)

ISBN 9781119794349 (epub)

Cover Design: Wiley

Cover Image: © djmilic/iStock/Getty Images

10 9 8 7 6 5 4 3 2 1

This book is designed to provide information that the authors believe to be accurate on the subject matter it covers, but it is sold with the understanding that neither the authors nor the publisher is offering individualized advice tailored to any specific portfolio or to any individual's particular needs or rendering investment advice or other professional services such as legal, tax, or accounting advice. A competent professional's services should be sought if one needs expert assistance in areas that include investment, legal, tax, and accounting advice. This publication references performance data collected over many time periods.

Past results do not guarantee future performance.

Additionally, performance data, in addition to laws and regulations, change over time, which could change the status of the information in this book, and do not reflect the deduction of management fees or other expenses. This book solely provides historical data to discuss and illustrate the underlying principles. Additionally, this book is not intended to serve as the basis for any financial decision; as a recommendation of a specific investment advisor; or as an offer to sell or purchase any security. Only a prospectus may be used to offer to sell or purchase securities, and a prospectus must be read and considered carefully before investing or spending money.

No warranty is made with respect to the accuracy or completeness of the information contained herein, and both the author and the publisher specifically disclaim any responsibility for any liability, loss, or risk, personal or otherwise, which is incurred as a consequence, directly or indirectly, of the use and application of any of the contents of this book. All examples used throughout this book are for illustrative purposes only.

Contents

	Preface	xiii
	Acknowledgments	xv
	About the Author	xvii
	Legal Disclosure	xix
Introduction	The Market Wants to Be Your Friend	xxi
Mistake #1	Market Timing	1
	The Idiots	5
	Why Is It So Hard to Beat the Market?	6
	Efficient Markets	7
	The Evidence (Research and Stuff)	8
	The Media Get It Wrong, Over and Over Again	8
	Economists Get It Wrong, Over and Over Again	9
	Investment Managers Get It Wrong, Over and Over Again	14
	Newsletters Get It Wrong, Over and Over Again	17
	Your Buddy	18
	Strategies That Don't Sound Like Market Timing but Are Market Timing—Oh, and They Don't Work Either	19
	Asset-Class Rotation	19
	Tactical Asset Allocation	20
	Style Rotation	20
	Sector Rotation	20
		vii

What Smart Investors Have to Say on Market Timing	20
Knowing All This, Why Would Anyone Market Time?	21
Corrections	22
Bear Markets: An Overview	26
Bear Markets Happen for Different Reasons, but the Outcome Is Always the Same	27
Bear Markets Are Not Predictable	28
When Bear Markets “Turn,” They Make People on the Sidelines Look Silly	30
The Market Is Volatile—Get Used to It	30
You Can’t Wait for Consumers to Feel Good	31
Learning to Accept the Bear Markets	33
Miscalculating the Risk of Market Timing	34
But What If I Am Perfect?	34
Lump-Sum Investing versus Dollar-Cost Averaging	36
Learning to Fly	40
Avoiding Mistake #1—Market Timing	41
Mistake #2 Active Trading	43
The History of Active Trading	44
Active Investment Managers Lose to Indexing	45
Newsletters Lose to Indexing	45
Active Mutual Funds Lose to Indexing	45
Survivor Bias (a.k.a. Mutual Fund Performance Is Even Worse Than the Data Suggests)	47
What About the Winners, Huh? What About the Winners?!	48
Hedge Funds Lose to Indexing	51
Endowments—Misperception of Performance	56
Venture Capital (Sounds Sexy but Usually a Dog)	57
The Taxman Cometh (a.k.a. Dear Goodness, It Gets Worse)	59

Portfolio Activity Hurts Performance	59
But Doesn't Active Management Work in a Down Market?	60
Why Indexes Win	61
But Indexing Results in Average Returns	62
S&P 500, Here I Come!	62
Avoiding Mistake #2—Active Trading	64
Mistake #3	
Misunderstanding Performance and Financial Information	65
Misunderstanding #1—Judging Performance in a Vacuum	65
Misunderstanding #2—Believing the Financial Media Exists to Help You Make Smart Decisions (a.k.a. the Media Is Killing You)	67
Misunderstanding #3—Believing That the Market Cares About Today	71
Misunderstanding #4—Believing an All-Time High Means the Market is Due for a Pullback	74
Misunderstanding #5—Believing Correlation Equals Causation	77
October Is The Worst Month to Invest	77
Sell in May and Go Away	78
Misunderstanding #6—Believing Financial News Is Actionable	79
Misunderstanding #7—Believing Republicans Are Better for the Market Than Democrats	80
Misunderstanding #8—Overestimating the Impact of a Manager	82
Misunderstanding #9—Believing Market Drops Are the Time to Get Defensive	83
Avoiding Mistake #3—Misunderstanding Performance and Financial Information	84

Mistake #4	Letting Yourself Get in the Way	85
	Fear, Greed, and Herding	85
	The Overconfidence Effect	89
	Confirmation Bias	93
	Anchoring	95
	Loss Aversion	97
	Mental Accounting	98
	Recency Bias	100
	Negativity Bias	103
	The Gambler	105
	Avoiding Mistake #4—Letting Yourself Get in the Way	106
Mistake #5	Working with the Wrong Advisor	107
	Most Advisors Will Do Far More Harm Than Good	108
	Advisor Selection Issue #1—Custody	108
	Advisor Selection Issue #2—Conflict	113
	Test #1—Independent Advisor or Broker?	114
	Investment Advisor Defined	114
	Broker Defined	114
	So What’s the Difference?	115
	Test #2—Pure Independent versus Independent and Broker	116
	Test #3—Proprietary Funds versus No Proprietary Funds	117
	A Final Thought on Conflicts	118
	Advisor Selection Issue #3—Competence	119
	Competence Check #1—Do the Advisor’s Credentials Meet Your Needs?	120
	Competence Check #2—Is the Advisor Right for You?	120

Competence Check #3—Is the Advisor Following a Process That You Agree With?	120
A Final Thought on Advisors—Principles	121
Avoiding Mistake #5—Choosing the Wrong Advisor	122
Mistake #6 No Mistaking	125
Rule #1: Have a Clearly Defined Plan	125
Rule #2: Avoid Asset Classes That Diminish Results Cash—The Illusion of Safety	127
The Illusion of Gold as a Way to Grow Wealth	129
Rule #3: Use Stocks and Bonds as the Core Building Blocks of Your Intelligently Constructed Portfolio	131
Rule #4: Take a Global Approach	138
Rule #5: Use Primarily Index-Based Positions	140
Rule #6: Don't Blow Out Your Existing Holdings	140
Rule #7: Be Sure You Can Live with Your Allocation	142
Rule #8: Rebalance	143
Rule #9: Revisit the Plan	144
The Ultimate Rule: Don't Mess It Up!	145
Portfolio Example	146
The "I Want to Beat the Market" Portfolio	146
The "I Need 7 Percent to Hit My Long-Term Retirement Goal" Portfolio	146
The "Get Me What I Need for the Rest of My Life with the Least Volatility Possible" Portfolio	147
The "I Have More Money Than I Will Ever Need and I Want It to Grow with Minimal Volatility" Portfolio	148

	The “I Have More Money Than I Will Ever Need, Volatility Doesn’t Bother Me, and I Want It to Grow Along with the Market” Portfolio	148
	A Path to Success: Intelligent Portfolio Construction	150
	You’re the One	151
Conclusion	Let’s Roll!!	153
	References	155
	Index	163

Preface

Over my career as a wealth manager, I have met thousands of individuals searching for a better way of investing. I noticed early on that most of the clients coming on board with my firm were terminating a prior advisor. It became clear to me that these clients weren't getting what they had hoped from their former advisors. While at times the issues were related to communication, relationships, and the like, sometimes the change was because the client wasn't getting the returns they had hoped, or their former advisor had blown up their portfolio. Mistakes had been made along the way.

Many investors don't enjoy investing, don't have the time for it, or don't feel they are particularly good at it. This type of investor searches for an advisor to alleviate the burden—to show them the way. Unfortunately, many if not most advisors make the same mistakes individuals often make. This is the tragedy of the financial services industry. As I have watched fortunes made, lost, and sometimes rebuilt again, I have observed the main problems that led to the deterioration of wealth. The conclusion is quite simple: *In most cases, if an investor has greatly underperformed from an investment perspective, it is not because of the markets, but because of their own, or their advisor's own, mistakes.* All of us, at times, are susceptible to at least one of these mistakes. Many of the greatest investors of all time acknowledge they have made them or are aware of them and actively put up mental roadblocks to prevent themselves from making them. For years, I have spoken about these mistakes, and this book will cover how to avoid these pitfalls and show a clear path toward achieving investment success.

Acknowledgments

This book wouldn't be possible without the ongoing efforts of Molly Rothove, Jessica Culpepper, James DeWitt, Brenna Stewart, and Jim Williams, all of whom contributed to this effort as well as to my newsletters, which are the constant source of in-house comedy prior to the editing process.

Special thanks to all of the incredibly talented people at Creative Planning, including those who helped with the research for the behavioral section of this book: Sarah Ayler, Andrew Horsman, Jeff Juday, Ashley Moulis, Meghan Perry, Conner Sivewright, Stacy Smith, and Chris Wolff.

A huge thank you to the clients of Creative Planning. I have learned so much from my clients over the years. Most importantly though, I learned that these are the type of people who make America what it is: the greatest place on earth to live. These folks make the economy go and grow and many of them have lived or are living the American Dream. My constant search for every possible way to help them has resulted in many of the things we do at my firm, and in the contents of this book.

To my mom who tricked me into believing I could do anything. I believed it until I was too old for it to matter. And to my dad, who taught me enough about investing at an early age that it became my passion. I especially cherish his advice to “ignore almost everything.”

Thanks to my beautiful wife Veronica, who spent a lot of time driving on our family road trips while I worked on this book, and to my three wonderful kids Michael,¹ JP,² and Gabby³ for always keeping me focused on the most important things in life. Finally, thank you to those who helped edit and shape this book. All errors are my own.

¹He must have asked half a dozen times: “Is anyone going to read this book?”

²Thanks for updating me on the NCAA tournament scores while I was writing.

³Thanks for the hugs, delivered almost every hour on the hour!

About the Author

Peter Mallouk is the president of Creative Planning, named the #1 Independent Financial Advisory Firm in America by *Barron's* (2017). *Barron's* magazine named Peter the #1 Independent Financial Advisor in America three straight years (2013, 2014, and 2015). CNBC named Creative Planning the #1 Independent Wealth Management Firm in the United States (2014–2015). Peter is featured on both rankings of *Worth* magazine's Power 100, a list featuring the 100 most powerful men and women in global finance (2017, 2018). In 2017, Peter was a recipient of the Ernst & Young Central Midwest Entrepreneur of the Year Award. Creative Planning provides comprehensive wealth management services to high-net-worth clients, including investment management, financial planning, charitable planning, retirement plan consulting, tax planning, and estate planning services. Creative Planning currently manages over \$70 billion for clients in all fifty states.

Legal Disclosure

Rankings and/or recognition by unaffiliated rating services and/or publications should not be construed by a client or prospective client as a guarantee that he/she will experience a certain level of results if Creative Planning (Company) is engaged, or continues to be engaged, to provide investment advisory services, nor should it be construed as a current or past endorsement of Company by any of its clients. Rankings published by magazines, and others, generally base their selections exclusively on information prepared and/or submitted by the recognized adviser. Rankings are generally limited to participating advisers. The Company never pays a fee to be considered for any ranking or recognition but may purchase plaques or reprints to publicize rankings. More information regarding rankings and/or accolades for Creative Planning can be found at:

<http://www.creativeplanning.com/important-disclosure-information/>