An Aubry & Eustice, LLC White Paper

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Seven Investor Traps

An Authoritative Guide on How the Average Investor Becomes an Extraordinary Investor

Introduction

Are you an extraordinary investor? Statistics and probability show that you are most likely not and that you are an average investor. This may come as no shock. It is quite possible that you are likely a frustrated investor who is more frustrated with the advice (or lack thereof, if any) that you have been receiving. In an effort to provide an opportunity for average investors to become extraordinary investors, this White Paper is being published on the ***Seven Investor Traps***. It is an authoritative guide on how the average investor becomes an extraordinary investor. This is the first in a series of White Papers.

In a recent marketing campaign, one of the online brokerage companies encouraged average investors to become extraordinary investors. During a television commercial, it is implied that simply by using their "superior" tools and platform, the average investor will become extraordinary. While this makes for a catchy tag line, there is a huge disconnect. Just because the average American goes to one of the big box home repair stores and buys their "superior" tools, it does not necessarily make that person an extraordinary home builder.

It is possible to be an extraordinary investor, but the key lies in education. More specifically, an investor needs the right education. Without the proper education, an investor can learn all that he thinks he needs to know to be successful, but the reality of what investing is all about can remain hidden and missed altogether.

Most investors who have not received the right education often find themselves in situations that cause a great deal of panic and frustration. Although successes may have been had in the past, they have been few and far between. A lasting, financial peace of mind is beyond anything they could ever imagine. In cases like these, it is not surprising to see those investors give up trying and take themselves out of the game altogether.

Twice in the last nine years, the vast majority of investors have seen losses of 25% to 40%, and quite a few have seen losses of much more than that. Most of us may know at least one person who has lost a great deal more. In fact, you may know people who have lost a lot more than 40% or 50%. We know a retired individual who had the vast majority of his portfolio sitting in ***one*** stock. The value of his account went down 90%! Unfortunately, for him, two things stick out: one, he did not have the right education and two, he is no longer retired.

The fact of the matter is that after the "Dot-com Crash," investors in the United States lost over ***$7.7 Trillion*** in the three years that followed. If that wasn't bad enough, the global stock market lost ***$16.5 Trillion*** during the "Panic of 2008." Yet, what the average investor does not know is that in the time span between the two crashes investors saw one of the greatest five-year stock market performances in history and more than made up for the tremendous losses.

Seven Investor Traps:
An Authoritative Guide on How the Average Investor Becomes an Extraordinary Investor

How does one become an extraordinary investor? It is achieved by avoiding the traps that the average investor falls into. It is very easy for anyone who is not completely grounded within their current investment strategy to fall into *at least* one of these traps. This paper begins the right education for the average investor to become an extraordinary investor.

The average investor:

1. Has an unspecified time horizon
2. Does not understand the importance of risk
3. Tries to do everything on his/her own
4. Falls prey to Financial Pornography
5. Owns the wrong investments
6. Fails to understand the stock market
7. Does not have a plan

Average Investor Trap #1: *Unspecified Time Horizon*

We contend that everyone should consider a time horizon that is forever. Now, before you throw this paper into the trash, let us explain. We know that we are not going to live forever, but how long are we actually going to live? We can guess, based on family history and medical science, that the average life expectancy is somewhere around 78 years of age, give or take a few years. In fact, actuary tables currently put the joint life expectancy for a 62 year old couple at 92. That is, at least one spouse in the couple is expected to live to 92 years of age.

We currently have a client who is 90 years old. (We are very glad that her time horizon was not set to 78 years.) How much longer will she live? No one knows, but she is happy, vibrant and the doctor says that she is "as healthy as a horse." She could, quite possibly, live for another 10 years, but we have to plan that she is going to live forever, because we don't want her to run out of money.

One of our firm's clients always jokes that he is going to die broke. The look of horror that came over his wife's face when he first made that statement is a look that I will never forget. After several minutes of assuring her that he did not lose all of their money, he was able to explain what he meant. If, after his retirement, he could determine *exactly* when he was going to die, he would spend his money accordingly.

What a wise statement! He has worked hard to get to where he is and he wants to enjoy the rest of his life in retirement. He is also wise enough to know that he can not predict the future. He knows he is not going to live forever, but he is planning like he is going to. (See Trap #7)

Even amidst the most recent financial downturn, if an investor truly knew what his or her time horizon was, he would have been able to weather the storm whether he was 20 years from retirement or in retirement. When an investor knows what his time horizon is, he is then able to determine what level of risk he is willing to take on inside his portfolio.

Average Investor Trap #2:
Not understanding the importance of risk

"The single biggest reason that people fail to achieve wealth . . . is that they never really understand risk." Nick Murray

Most investors define risk as the loss of money. Everyone knows that in order to get a reward, one must risk something. And while risk and reward are related, the average investor does not know *how much* risk should be taken on in order to get the desired or *expected* reward. After what took place between October 2007 and March of 2009, many investors are starting to ask themselves, "What does risk really mean to me?" It is very hard to find someone that is completely happy with the performance of their investments during that time span. While the author of this paper has not changed its opinion or understanding of risk, the most-recent crash has caused many average investors ***and*** average advisors to pause and re-think "risk."

Investors are compensated by the risk that they are willing to take on; this makes risk something that is actually *perceived* (when there is more *perceived* risk, investors expect more of a return). The average investor sees risk as "the potential for loss" as this comes into play when the investor measures how much she is willing to lose on an investment. In contrast, the extraordinary investor looks at risk as **uncertainty**. It is the uncertainty of whether or not a particular investment will achieve its expected return. Extraordinary investors are compensated for, and look to capitalize on, this uncertainty.

The average investor hears talk about "controlling risk" and "managing risk" when it comes to investments and becomes very frustrated when their investment accounts decrease in value, and are forced to ride out (or sell out of) the economic storms like we have endured twice in the last decade. However – and this is a very important point – the extraordinary investor knows that "controlling" and "managing" risk does not mean *eliminating* risk. Since risk and return on investments are forever linked, it would be very difficult, if not impossible, to eliminate risk and achieve our financial goals.

The extraordinary investor either knows the history of the capital markets, or trusts an advisor that has the knowledge of such history. Armed with this understanding of the history of the capital markets, coupled with the evidence presented by science, extraordinary investors employ a strategy that builds portfolios to capture the dimensions of meaningful risk factors which allows for the ***control and management*** of risks over time.

The road to investment success lies in identifying the risks that bear compensation, choosing how much of these risks to take on, and then striving to minimize the risks and costs imposed by traditional approaches to investing. Evidence-based investing makes this possible.

Average Investor Trap #3:
Trying to do everything on his/her own

Extraordinary investors are in control of their investments. However, very few extraordinary investors actually manage their own investments.

You may have seen the television commercial that shows a doctor at the hospital talking on the phone. On the other end of the line is an average American sitting at his kitchen table with a knife, a roll of gauze and some tape. After a few seconds of listening to the conversation, the observer can gather that the average American is about to perform surgery on ***himself***!!!

Outrageous! How many average Americans would actually try to perform surgery on themselves? Very few, if any. Why is it, then, that so many average investors try to manage their own investments? One answer is that it seemed so easy during the 1990s. It seemed that any investment, no matter how obscure, made money – and lots of it!

Another reason might be due to the failure of the vast majority of financial professionals to deliver on their promises. Many investors have seen this failure and have decided that they could do a better job on their own. The truth of the matter is, most investors *could* probably do better on their own compared to working with the average advisor.

The third reason – and this makes absolutely no sense – is that some average investors think that it is "fun" to research and buy and sell investments. It is unfortunate, but it is because of the average advisor that the average investor thinks that investing can be done on a part-time basis.

The final reason is that there is a tremendously poor financial education system in the United States. In fact, it is virtually non-existent. The overwhelming majority of people, who by definition, become average investors, graduate without knowing the different behaviors of stocks and bonds or about compound interest (just to name a few). While it is not the average investor's fault that he or she was not properly "taught," it is ultimately the average investors responsibility.

If you were paying attention to the markets during the years 2003 through 2007, you would have noticed that they were five of the best successive years of growth. Ever! While there are several sides to the argument as to why this happened, the extraordinary investor harnessed the power of the massive stock market growth and the **average investor did not. (Neither did the average advisor).**

Dalbar, Inc does a recurring study entitled *Quantitative Analysis of Investor Behavior*. The most recent study completed in 2007 shows that the average investor achieved a 4.3% annual return from 1987 – 2006. The same study also showed that the S&P 500 had an annual return of 11.8% in the same time period. The average investor achieved returns of 7.5% *per year* ***less*** than an unmanaged index. Let's put this into specific dollar terms: if the average investor would have started with $100,000 at the beginning of 1987, after the 4.3% annual return for 20 years, the average investor would have $235,953.09. Not bad. But an 11.8% annual return would grow that same $100,000 into $1,046,956.16.

When was the last time you changed the oil in your car by yourself? Most of us may remember changing the oil in our own cars, or at least we may remember watching our fathers change the oil. Why don't most of us change the oil in our cars any more? There are two probable reasons. The first is time. It is a much more efficient use of our time to have the corner "Quick Change" or the dealership (the experts in your car) do the job. The second reason is that it is too blasted complicated. When was the last time you opened the hood of your car? Do you even know where the oil filter is?

Managing investments is a full-time job. Why is it that the average investor thinks along with work, the kids, vacation, golf, charities, religious activities, and life in general that he or she can manage their own investments? Average investors try to do everything themselves. Extraordinary investors do their homework, get educated and hire someone to do the "heavy lifting" for them.

Average Investor Trap #4:
Falling Prey to Financial Pornography

In August of 1995, Jane Bryant Quinn wrote in *Newsweek* that "Americans are indulging themselves in investment porn." She went on to write, "publications that merely dispense information will see their readers melt away." She could not be more correct. "Financial magazines" and "newsletters" are more popular than ever, partly because of Trap #3.

If you happened to read the leading financial smut back in December, or the first week of this year, you saw that every magazine was touting themselves as knowing where the "best investments of 2009" were going to be. How was this possible? Did they have a crystal ball? If someone really could predict the future and know ***exactly*** where riches were going to be made, do you really think they would sell it for a mere $2.99 a copy?

It is well-documented that the 1980s, 1990s, and parts of the 2000s saw some amazing returns. However, because the average investor had been reading articles and reports pushed by the purveyors of financial pornography, the increase in his investments were not as much as they should have been (See Trap #3). And, if you were following this "financial porn," you probably saw that your accounts paid the price.

The cost of following financial pornography is great.

The average investor also falls prey to what we call "advice for the masses." One individual stands in front of the camera or microphone and says, "You should own this in your portfolio." How does this person know? Do they know what your personal goals and objectives are? Are they aware of your individual risk tolerance? No and no. How can they give ***you*** this "advice?" More importantly, why should you follow this person's "advice?"

The financial world has perpetuated four myths that compound the problem of financial pornography.

Myth # 1 – Stock selection*:
- The belief that investment professionals can consistently and predictably add value by exercising "superior skill" in individual stock selection

Myth # 2 – Track record investing*:
- The belief that finding funds that did well in the past is a reliable method of indicating which funds will do well in the future

Myth # 3 – Market timing*:
- The belief that investment professionals are able to accurately utilize market timing techniques to effectively predict up and down markets

Myth # 4 – The costs of investing*:
- What you don't see can't hurt you

(*Each of these Myths will be discussed in detail in our next White Paper.)

Extraordinary investors do not fall prey to financial pornography.

Average Investor Trap #5:
Owning the Wrong Investments

The average investor constantly tries to buy what's "hot"…hot stocks, hot mutual funds, hot real estate. (Is there anything that has been "hot" since October of 2007?) While changing investing strategies is not inherently wrong, it is bad for the average investor when he or she changes "strategies" more often than the wind changes directions.

> "Had you used the (1999) top-10 performer's table as your shopping list, the best you could have done from January 1, 2000 through March 2003, was lose a little more than half your money". (Russell Kinell, Director of Fund Analysis, Morningstar)

The average investor owns the wrong investments because they fall prey to Trap #4.

Recently, this author received an email extolling the virtues and the "secrets" of stock picking and market timing. After reading through the content, the author laughed and then promptly deleted the email. The concepts of stock picking and timing markets are actually some of the greatest lies perpetuated by the financial world.

Because the most recent financial meltdown was so extensive and well-advertised, it would be assumed that investment "experts" would have found it easy to pick stocks and out-perform the US market (-37.6% in 2008). Unfortunately for the average investor, this was not the case. Consider the following:

- A prominent money manager and self-described "contrarian" investor wrote in a January 2008 Forbes column: "You have to choose carefully here, since many financial stocks will not come back for a long time, if ever. . . . The safest plays are among the big banks."

  Outcome: Prices for the seven financial stocks mentioned in the column, including Citigroup (-77.2%), Freddie Mac (-97%) and Wachovia (-85.4%), all declined an average of 74.0% in 2008.
  (Dreman, David. "Seize the Day." Forbes, January 8, 2008. Wall Journal, New York Stock Exchange 2008 Summary, January 2, 2009.)

- A veteran market analyst favored stocks that had been "excessively punished" in the subprime-related meltdown: Nordstrom, Tiffany, J.Crew, and his favorite, American International Group (AIG).

  Outcome:

American International Group (AIG)	-97.3%
J. Crew Group (JCW)	-74.7%
Nordstrom (JWN)	-63.8%
Tiffany & Co. (TIF)	-48.7%

  (Tergesen, Anne. "What the Pros Are Saying." *Business Week,* December 31, 2007. *Wall Street Journal,* New York Stock Exchange 2008 Trading Summary, January 2, 2009.)

Extraordinary investors look for consistent, long-term returns. The only way to do this, while controlling and managing risk (Trap #2), is to employ a globally diversified portfolio that is built upon the understanding of the history and the science of the capital markets, **not** guesswork and speculation.

Average Investor Trap #6:
Failing to Understand the Stock Market

"Fear has a greater grip on human action than does the ***impressive weight of historical evidence****." (Dr. Jeremy Siegal/Peter Bernstein, emphasis added)*

The stock market (or more precisely, the stock *markets*) is/are much more difficult to understand than the average investor makes it seem. The average investor thinks that all he or she needs to do is read and listen to the analysts in magazines and on television, or do a little research on their own in order to do better than the "markets". Unfortunately, this is just a fantasy. (See Trap #3)

Let's take a look at the S&P 500, the standard benchmark in investing in the United States. This is an index, or a market, that measures a relatively broad cross section of the stock market in the United States.

From 1926-2008, the average annual return of the S&P 500 has been 9.62%

In that time span there have been:

- 82, one year periods – of which 70.7% (58/82) have been positive
- 78, five year periods – of which 87.2% (65/78) have been positive
- 73, ten year periods – of which 95.8% (70/73) have been positive
- 68, fifteen year periods – of which 100% (68/68) have been positive

The extraordinary investor knows that the markets are completely random. That is, we don't know what the stock markets are going to do tomorrow, next week, next month or even next year. But we do know that we have a pretty good chance of making money over the course of five years or ten years, and that we have an excellent chance of making money over the course of fifteen years.

The extraordinary investor knows that the percentages get even better when portfolios are built using scientific evidence. Scientific evidence is not based in opinion, feelings or hope. The scientific evidence provided by the capital markets is based on basic economic principles. One of those basic economic principles is the ***fact*** that capital flows to where the expected return is the greatest. It is also just as much a fact that one can not predict with any degree of consistency or accuracy where capital will flow next.

The history of the capital markets has been turbulent. When the turbulence becomes strong, as it has since October of 2007, the average investor becomes fearful. It is ironic, however, that the turbulence (uncertainty) is exactly how we are rewarded as investors. Shy away from the turbulence, shy away from the reward.

Average Investor Trap #7:
Not having a plan

When confronted with the question, "Why do you invest?" the average investor might say, "Because I am supposed to, right? You put money into an investment and watch it grow. I just have to figure out which investment and when to get in and out." Unfortunately, with this

approach, the average investor sees the 4.3% annual growth over 20 years as positive. The extraordinary investor has an investment plan – a strategy – and knows what to ***expect***, and plans to accomplish it.

To paraphrase financial author Nick Murray, no airplane can take off without a flight plan; no ship can sail without a plotted course; and no investor can contemplate a successful financial journey without a plan. **No one plans to fail financially; it is just that most people fail to plan.**

It is estimated that less than 3% of all Americans actually sit and write down their goals. Similarly, average investors do not sit down and write out goals for their financial plan. Extraordinary investors, however, have a specified time horizon; have determined their tolerance for risk; use professional help; ignore the purveyors of financial pornography; own the right investments; and understand the randomness of the markets. They know, and do, all of this because they have a plan.

If you are not completely satisfied with your investments or your plan, visit www.aubryeustice.com or call (877) 857-7500.

About the Author

Mark J. Aubry is the Managing Director of Aubry & Eustice, LLC, which has developed a specialty in helping clients simplify very confusing and overwhelming topics. Through customized and coordinated solutions, the firm helps clients move *Beyond Financial Planning*.

Mark speaks regularly to business organizations, athletic programs and on college campuses. He has appeared on television more than fifteen times discussing financial, investment and business planning topics and has a background in teaching Economics and Investments, most recently at Illinois Wesleyan University. A member of various industry organizations, Mark has provided consulting services to other planning firms and broker-dealers on moving from a commission-based platform to that of a fee-based platform.