Intelligent
Capitalworks
Financial Guides For The Journey

The 9 Habits of Successful Investors

Minding investment behavior gaps

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"The investor's chief problem – and even his own worst enemy – is likely to be himself."[1]

Benjamin Graham

According to Warren Buffett, the key to successful investing is to "control the urges that get other people into trouble in investing."[2] These urges are natural and subconscious; the challenge is to recognize and mitigate their influence. Developing these habits will help you ***control the urges*** and make more thoughtful, deliberate investment decisions – ultimately becoming a more successful investor.

1. Be An Investor

Often, participants in the stock market call themselves investors, but act like speculators. Speculators "invest" based on a security's short-term performance and frequently change their strategy. Genuine investors invest to achieve their long term goals (per an investment policy), and resist the urge to be influenced by speculators' manic-depressive behavior.

The most successful investors take advantage of market volatility by selling securities at high values and purchasing them at low values – when speculators are most pessimistic. Investors must remain disciplined and not allow the constant fluctuations in security prices to influence their investment choices. Not easy to do, but possible.

2. Learn from History

Stock market movements - especially over the short-term - are mostly random and highly unpredictable. Unfortunately, this fact does not preclude "experts" from pretending they know what will happen. The urge is to believe the future is predictable; yet successful investors recognize there is no crystal ball. History is rich with examples of investors' poor performance because they were influenced by short-term market dynamics to abandon their strategy for a more attractive "opportunity".

The research firm, Dalbar Inc., found that investors (both stock and bond) underperformed their respective benchmark over several distinct periods of time…and by significant amounts.[3] Morningstar® found that investors underperformed the very funds they were invested in – by trading in and out of the funds rather than holding for the long term.[4] Dalbar and Morningstar attribute this underperformance to buying after strong performance and selling after poor performance.

When it comes to knowledge pertaining to investments, Warren Buffett said it best: "What counts for people in investing is not how much they know, but rather how realistically they define what they don't know."[5] This may sound counterintuitive, but recognizing the limits of your knowledge and forecasting ability can help you avoid costly mistakes.

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3. Look Forward

Investors should learn from past history, but that does not mean past performance of a security or a fund foreshadows its future performance. Since the future is unpredictable, experts and novices alike look to the past as a predictor of what is to come. Successful investors resist the temptation to invest based upon past performance.

While the urge to extrapolate past returns into the future is strong, it can have costly consequences. For instance:

- The Legg Mason Value Trust beat the S&P 500 for 15 straight years. The solid performance and length of outperformance influenced many to invest in the fund, believing that this fund was truly special. Then the fund lost 55% in one year. After the big loss, the portfolio manager was asked what went wrong. His answer, "the strategy worked, until it didn't."[6]

- John Paulson's Advantage Plus hedge fund earned over 260% from 2007-2009. In response to the awesome performance, money flocked into his funds . . . just in time for investors to lose 52% in one year.

4. Have Realistic Expectations

Price fluctuation is a natural occurrence when investing. Successful investors expect periods of negative performance. While the stock market has generated positive returns over time, it has been achieved with several periods of losses – some of which have been quite severe. You should expect periods when stock market losses are 15% or more.

Positive outcomes are desirable – no one likes losses. When the stock market is down, speculators become fearful and the media exacerbates those fears. Unfortunately, many investors become influenced by this fear and join the speculators in the depression state. While not ideal, the urge is normal. If you anticipate that losses will occur and understand price fluctuations are normal, you can mitigate the urge to do the wrong thing at the wrong time.

Even in positive stock market years, there can be periods of significant losses.

- 1998 - The S&P 500 lost 19% in just 6 weeks. Then rallied, ending the year up 26%.
- 2003 - S&P 500 started the year down 8%. Ended the year up 28%.
- 2010 - S&P 500 up 13% for the year, but experienced a loss of 16% in less than one quarter.

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5. Use Prudent Measurements

The frequency of portfolio evaluation can influence poor investment decisions. It isn't wise to measure the distance between New York and Los Angeles using inches; similarly you shouldn't use short-term metrics to evaluate a long term investment strategy. Successful investors will either (i) not be influenced by short-term market performance, or (ii) not pay attention to short term performance – so not to be influenced to abandon their investment strategy.

The urge to micromanage investments is strong. The more often you evaluate your portfolio, the more likely you will be influenced to make adjustments . . . often to the detriment of your long term performance.

6. Be Open Minded

Being open minded is difficult because no one likes to be told their view is wrong. However, when it comes to investing the most successful investors understand how they could be mistaken – and what that would cost them. While you should be optimistic, you need to understand the potential risks of your investment choices.

The urge to discount or ignore contrary opinions, and seek out information that confirms your thoughts, is natural and powerful. However, without an open mind to understand how you could be wrong, you may underestimate the risk in your decisions. No investor is infallible; mistakes are part of the game. As John Bogle (founder of Vanguard Group) said, "Successful investing involves doing just a few things right, and *avoiding serious mistakes*."

7. Discern The Truth

Your brain detests uncertainty. When faced with uncertainty, the brain looks elsewhere to form opinions and provide some feeling of certainty. Your mind may translate something you hear frequently into something it believes is true or probable. The problem is that just because you hear something a lot doesn't mean it is true – it just means it is well publicized.

Additional information may not always help you. It may be relevant to the topic at hand, but not to you. For example, what does GDP for next quarter have to do with your long term goals? Why do you care what experts speculate will happen next week/month in the market? It matters to the financial media because they need to sell advertising, but it shouldn't matter to you. The truth is that there is a lot of noise out there. Successful investors recognize the noise and avoid the urge to allow the frequency or volume of "important" news to hijack their investment plan.

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8. Know Your Threshold

How much are you comfortable losing in the short to medium term? This is an important question that requires some thought. Due to the nature of the stock market, there will be several periods of losses, and some may be large. Investors that lose more than they expect may be influenced to sell at the wrong time.

Successful investors are conscious of the losses they are able to withstand, and select portfolio strategies to minimize the probability of exceeding that threshold. Did you sell in 2009? If so, despite your best intentions going forward it is likely you will do so again if losses exceed your threshold. The urge to limit future losses when experiencing losses is great – the best antidote is to not exceed your threshold of pain to begin with.

9. Be Opportunistic

The foolproof way to be a successful investor is to buy low and sell high. Easy to say, incredibly difficult to do. It is much easier to buy when the market is increasing rather than decreasing. After all, who would want to buy a security only to see it go down in value? 'Why throw money down the drain' is the mantra. That may be correct if your time horizon is one year, but not if your time horizon is several years.

The most successful investors heed the advice of Warren Buffett – buy when others are fearful and sell when others are greedy. Since this is contrary to the natural urge, successful investors will often create an investment strategy in which they pre-commit to purchase securities at lower prices (i.e. if the market goes down 15%, move 5% from bonds to stocks), and not care about its price the next day/week/month. A written investment strategy may help you be opportunistic by committing – in advance – to strategies that may enhance your long-term performance.

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1 Graham, Benjamin (2006) The Intelligent Investor, Revised Edition. Harper Business Essentials. New York. g. 8
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3 Dalbar, Inc. (2012) Quantitative Analysis of Investor Behavior, Adviser Edition
4 Haig, Rachel (2009) "Did you do as well as your fund?" Morningstar
5 Buffet, Warren (1993) Chairman's Letter dated March 1, 1993 . www.berkshirehathaway.com/letters.1992.html
6 Wall Street Journal, December 10, 2008

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