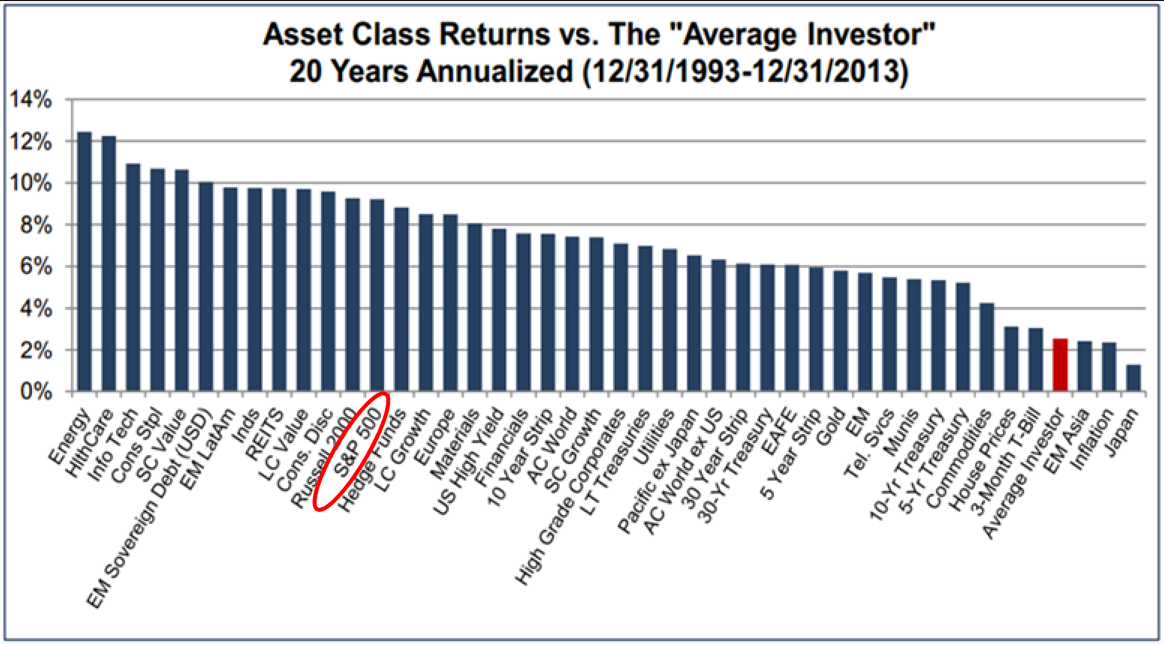
#6 WHERE INVESTORS GO WRONG

Investing in the financial markets is as much an art as a science. While this sounds trite, if investing purely came down to logical science, one could simply read a book or take a class and implement a successful investment strategy over a lifetime. However, this rarely proves to be the case. We are our own worst enemies when it comes to the financial markets. We want to buy markets that are going up and sell markets that are falling. As the saying goes, "the stock market is the only market where things go on sale and all the customers run out of the store." This speaks to the importance of psychology in the investment business. It is all well and good to say you are a long-term value orientated investor, but the reality is often very different. Below we detail some of the mistakes we see, as well as some of the mistakes we have made in our years in business.

Get me in what is doing well and out of what's not...

Without question the most common mistake we see is the never ending desire to time the markets. Everyone wants to be in what is working and out of what isn't. Chasing performance is part of investor psyche, but the damage it can do to a portfolio is immense. Consider the evidence.

The chart below shows a study done in 2013 that looked at accounts at Vanguard to determine how the average investor's individual accounts performed over the trailing 20 years. What they found is stunning. As you can see, over this period energy stocks performed the best (up slightly more than 12% per year) while Japanese equities were the worst. The S&P 500 comes in at around 9% per year. The average investor is the red bar fourth from the right – a little over 2% per year, only slightly ahead of inflation.



Source: Richard Bernstein Advisors LLC., Bloomberg, MSCI, Standard & Poor's, Russell, HFRI, BofA Merrill Lynch, Dalbar, FHFA, FRB, FTSE. Total Returns in USD.

Why is this? Was the average investor carrying a lot of cash or bonds? No. As you can see, cash and bond returns exceeded the average investor return. What is happening is that investors are chasing performance. They are buying tech stocks in late 1999 and 2000 because they have done so well, only to be crushed when the bubble bursts. They own energy going into 2008 because oil is going to $200 a barrel (it actually goes to $30). Or possibly they loaded up on bonds before they fell hard in 2013.

This is a hard habit to break, though. Every soaring market has a very bullish story to it. Every bear market feels like the end of the world. You almost have to lash yourself to a mast to resist the siren's song. But how do you do this? We have found over the years that a few rules help limit the fallout from this temptation:

- Be in a stock/bond mix that keeps you invested. Pay attention to value. The tech bubble is easy in retrospect, Cisco at 70 times earnings was nuts. But at the time there were numerous stories about why this made sense. High PE's rarely work out for the best.

- Stay diversified. Admit that you might get sucked into a compelling story at exactly the wrong moment, so keep your bets small. Take a look below at the asset class returns over the last fifteen years. As you can see, it is not uncommon for an asset class to go from best of class (top of the chart) to worst (bottom of the chart) in the matter of a year. For example, emerging equities did very well from 2003 until 2007 but have been at or near the bottom in four of the last seven years. It is the same with large-cap growth. It was top of the tables in the late 90's, but was at the bottom in 2000 to 2002. And while REITS have done well lately, history would suggest they will have a stint at the bottom at some point in the future.

Asset Class Returns

2000	2001	2002	2003	2004	2005	2006	2007
REIT 26.4%	REIT 13.9%	HG Bnd 10.3%	EM 56.3%	REIT 31.6%	EM 34.5%	REIT 35.1%	EM 39.8%
HG Bnd 11.6%	HG Bnd 8.4%	REIT 3.8%	Sm Cap 47.3%	EM 26.0%	Int'l Stk 14.0%	EM 32.6%	Int'l Stk 11.6%
Cash 5.8%	HY Bnd 4.5%	Cash 1.6%	Int'l Stk 39.2%	Int'l Stk 20.7%	REIT 12.2%	Int'l Stk 26.9%	AA 7.6%
AA 0.5%	Cash 3.4%	HY Bnd -1.9%	REIT 37.1%	Sm Cap 18.3%	AA 8.9%	Sm Cap 18.4%	HG Bnd 7.0%
Sm Cap -3.0%	Sm Cap 2.5%	AA -3.8%	Lg Cap 28.7%	AA 14.1%	Lg Cap 4.9%	AA 16.7%	Lg Cap 5.5%
HY Bnd -5.1%	AA -0.2%	EM -6.0%	HY Bnd 28.2%	Lg Cap 10.9%	Sm Cap 4.6%	Lg Cap 15.8%	Cash 4.4%
Lg Cap -9.1%	EM -2.4%	Int'l Stk -15.7%	AA 25.9%	HY Bnd 10.9%	Cash 3.2%	HY Bnd 11.8%	HY Bnd 2.2%
Int'l Stk -14.0%	Lg Cap -11.9%	Sm Cap -20.5%	HG Bnd 4.1%	HG Bnd 4.3%	HY Bnd 2.7%	Cash 4.7%	Sm Cap -1.6%
EM -30.6%	Int'l Stk -21.2%	Lg Cap -22.1%	Cash 1.0%	Cash 1.4%	HG Bnd 2.4%	HG Bnd 4.3%	REIT -15.7%

2008	2009	2010	2011	2012	2013	2014
HG Bnd 5.2%	EM 79.0%	REIT 28.0%	REIT 8.3%	REIT 19.7%	Sm Cap 38.8%	REIT 28.0%
Cash 1.4%	HY Bnd 57.5%	Sm Cap 26.9%	HG Bnd 7.8%	EM 18.6%	Lg Cap 32.4%	Lg Cap 13.7%
AA -22.4%	Int'l Stk 32.5%	EM 19.2%	HY Bnd 4.4%	Int'l Stk 17.9%	Int'l Stk 23.3%	AA 6.9%
HY Bnd -26.4%	REIT 28.0%	HY Bnd 15.2%	Lg Cap 2.1%	Sm Cap 16.4%	AA 11.5%	HG Bnd 6.0%
Sm Cap -33.8%	Sm Cap 27.2%	Lg Cap 15.1%	AA 0.3%	Lg Cap 16.0%	HY Bnd 7.4%	Sm Cap 4.9%
Lg Cap -37.0%	Lg Cap 26.5%	AA 13.5%	Cash 0.1%	HY Bnd 15.6%	REIT 2.9%	HY Bnd 2.5%
REIT -37.7%	AA 24.6%	Int'l Stk 8.2%	Sm Cap -4.2%	AA 12.2%	Cash 0.1%	Cash 0.0%
Int'l Stk -43.1%	HG Bnd 5.9%	HG Bnd 6.5%	Int'l Stk -11.7%	HG Bnd 4.2%	HG Bnd -2.0%	EM -1.8%
EM -53.2%	Cash 0.2%	Cash 0.2%	EM -18.2%	Cash 0.1%	EM -2.3%	Int'l Stk -4.5%

Abbr.	Asset Class – Index	Annual	Best	Worst
Lg Cap	Large Caps Stocks – S&P 500 Index	4.24%	32.4%	-37.0%
Sm Cap	Small Cap Stocks – Russell 2000 Index	7.38%	47.3%	-33.8%
Int'l Stk	International Developed Stocks – MSCI EAFE Index	2.97%	39.2%	-43.1%
EM	Emerging Market Stocks – MSCI Emerging Markets Index	7.38%	79.0%	-53.2%
REIT	REITs – FTSE NAREIT All Equity Index	12.68%	37.1%	-37.7%
HG Bnd	High Grade Bonds – Barclay's U.S. Aggregate Bond Index	5.70%	11.6%	-2.0%
HY Bnd	High Yield Bonds – BofAML US High Yield Master II Index	7.54%	57.5%	-26.4%
Cash	Cash – 3 Month Treasury Bill Rate	1.24%	5.8%	0.0%
AA	Asset Allocation Portfolio*	7.08%	25.9%	-22.4%

Past performance does not guarantee future returns. The historical performance shows changes in market trends across several asset classes over the past fifteen years. Returns represent total annual returns (reinvestment of all distributions) and does not include fees and expenses. The investments you choose should reflect your financial goals and risk tolerance. For assistance, talk to a financial professional. All data are as of 12/31/14.
*Asset Allocation Portfolio is made up of 15% large cap stocks, 15% international stocks, 10% small cap stocks, 10% emerging market stocks, 10% REITs, 40% high-grade bonds, and annual rebalancing.

** Source: NovelInvestor.com*

- Pay attention to correlated holdings. In 2015 you may have avoided the trouble in the emerging world, but if you owned commodities you suffered anyhow. It is critically important to always be thinking how your holdings are interrelated and which positions actually provide you diversification in troubled markets.

- Be willing not to be the life of the party. Look at the asset class returns in the table on page 2. A lot of people want to own what is best so they can brag to their friends. But the more prudent course is to own a mix of everything (the black line). You are never the worst and you are never the best. You can't brag at the party, but you won't be crying in your beer!!

Some event *(fill in the blank)* is going to happen – Therefore I'm selling

A related idea is so called headline risk. It could the debt ceiling debate we saw a few years ago, or possible hostilities with Iran. Whatever it may be, people will wake up one day, read the paper, and decide that whatever big bad event is out there is reason to go to cash. All too often this is a recipe for trouble. Take the first Iraq war in 1990. Let's say you were sure the coalition was going to invade and that oil prices would skyrocket, so you sold out of stocks. To begin with you look like a genius. The S&P sells off 18% just before the war starts, but after it is clear the coalition will win a resounding victory, the markets soar and gain over 30% over the next 12-months. Numerous people were left sitting in cash during the bounce.

It was the same thing with the debt ceiling fiasco in 2011. While the market sold off going into the deadline, it quickly bounced back leaving many investors behind. The level of bond yields has been the recent worry de jour. The mantra has been "the Fed is printing money hand over fist. Inflation has to soar at some point killing bond investors." As it turns out exactly the opposite has happened. There are two key points to be made on this topic:

1) There are two decisions to make when reacting to scary headlines – when to sell and when to buy. Neither is easy and your odds of being right on both decisions is very low.

2) We have found that even if you get the scenario right, knowing how the markets will react is tough. Recently, oil falling to $40 a barrel should be good for the U.S. because it is basically a big tax cut for the economy. If the economy picks up the market should do well. However, the opposite is proving to be the case. Oil is going down because China is slowing. This is stirring worries about a global recession and stocks are faltering as a result. The markets are fickle in how they react to everything from falling commodity prices to political events.

Investing based on headlines is problematic at best. Often times when a story makes the front page it is already factored into prices.

I don't understand the strategy, but it has hot track record

This is the KISS concept. Keep it simple stupid. Over the years we have looked at numerous investment products that promised high returns with low risk based upon very complex strategies. It might be a dense algorithm or 'unique' hedge fund like strategy or tricky tax structure, but regardless, it is typically a recipe for problems.

To pick on hedge funds for a moment, take managed futures (we could use any hedge fund asset class, but we happen to have the data easily at hand for managed futures). Managed futures are typically momentum based strategies that trade a number of equity, fixed income, currency, and commodity markets. They did phenomenally well in 2008: up +18.3% versus a loss of -36.6% for the S&P. Of course few people owned them then because returns had been so-so up until that point. But never mind that. Beginning in 2009 there was a raft of new products all promising managed future returns.

Conferences were full of gleaming wholesalers pitching the products. Full page ads were taken out. CNBC adverts extolled their virtues. So how have they done? In a word – terrible. The table below shows the returns for the Credit Suisse Managed Futures index against the S&P 500, a bond index, and a basic 60/40 portfolio.

	CS Managed Futures Index	S&P 500	Barclays Aggregate	60/40
2008	18.3%	-36.6%	5.2%	-19.8%
2009	-11.3%	25.9%	5.9%	17.9%
2010	12.2%	14.8%	6.5%	11.5%
2011	-4.2%	2.1%	7.8%	4.4%
2012	-2.9%	15.8%	4.2%	11.2%
2013	-2.6%	32.2%	-2.0%	18.5%
2014	18.4%	13.5%	6.0%	10.5%
2015	-4.1%	1.2%	-0.1%	0.7%
2009-2015	0.4%	15.8%	4.3%	11.4%
Volatility	10.5%	11.4%	3.7%	6.5%

Since 2009 managed futures have returned just +0.4% versus +15.8% for the S&P, +4.3% for bonds, and +11.4% for the 60/40 portfolio. And volatility hasn't been much less than the S&P. This doesn't mean managed futures won't work again. But when the industry is rolling out products to capitalize on a strong performance run, it is best to look away, or at least keep your holding small. This is doubly true if the underlying strategy is tough or impossible to understand.

It has been a similar story with MLPs the last couple years. Domestic oil production is clearly revolutionizing the energy industry and MLPs are a way to play this trend. Products have proliferated to take advantage of this paradigm shift. And what do you know - they have been crushed in 2015. MLPs are correlated with oil prices after all (their proponents claimed they were not) and many MLPs are hitting new all time lows.

There is nothing inherently wrong with either managed futures or MLPs. They can make a lot of sense at the right point of the cycle and at the right price. But when the Wall Street sales machine kicks into gear – look out!!

Summary

Sad to say, but this really just scratches the surface of the mistakes we've seen. We could almost write a book on the topic. And this is what makes investing so challenging, but so interesting at the same time. Everyone can learn the theory in a relatively short time, but it takes years to understand the psychology of the markets, of investor behavior, and yourself.