Why we do the things we do

Pete Alepra, senior vice president, RBC Wealth Management, Cedar Rapids

Phone: (319) 368-7023 | Email: peter.alepra@rbc.com

Whether it's a conscious decision to avoid realizing a paper loss or not paying enough attention to your mix of assets, most of us at one time of another have committed a costly investor mistake.

Sometimes understanding why we do the things we do can help us avoid the recurring investing pitfalls. The following provides a brief look at why we make some of the most common and expensive investor mistakes.

By far, one of the most common and costly mistakes involves holding on to a losing stock or investment. In all aspects of life there is a natural tendency for us to have the big comeback story, one where we're down and out but come back to make it big … or at least not lose so badly.

That sentiment is similar to how many investors look at a losing stock. It hurts psychologically to realize that paper loss — so much that many investors hang on and hope.

Many times hope comes with a painful opportunity cost attached — not only in the form of a realized paper loss, but also in the opportunity cost of not investing those funds in an alternative with the likelihood of a better return.

While a lot of investors don't want to realize a paper loss, some do the exact opposite — they avoid a realized gain to avoid its tax consequences. That disdain for paying taxes can lead to holding onto investments too long, turning a tax penalty into an investment loss that more than offsets any tax consequences.

Also, as a paper gain mounts, not taking some funds off the table can lead to a portfolio that is heavily weighted in one stock or investment.

The easiest part of investing is buying — selling is the more challenging part of the equation. Unfortunately, greed and fear often dictate our investment decisions.

To help clarify a selling decision for a client, I will often ask two questions:

- Would you rather sell today and see the value continue to go up, or hold the investment and experience a decline in value going forward? Which do you handle better?
- If you did not own the investment today and it was suggested you buy the same dollar amount of the same investment, what would your thoughts be?

Other times, investors simply maintain a false sense of diversification. For example, investors who hold several mutual funds may consider themselves fully diversified.

However, if those mutual funds have the same investment objective, an investor could be living with a false sense of diversification. Holding three mutual funds that focus on small cap growth companies does not mean your portfolio is balanced.

Investors need to make sure they understand the objectives of the funds they are holding. Diversifying by asset class will often alleviate redundancies in the underlying investments.

Everybody wants to own the next Apple stock, and many investors catch a news bite or see a company's stock highlighted in the media and figure it's the next hot stock. The more they hear about it from other sources, the more comfortable they are to buy into the company.

However, many times by then it's too late. A stock that's a media darling most likely already has had a lot of expectations built into its price.

Another big mistake investors make is buying a company after a sudden price drop. To many investors, a cheap price equals a good value — they don't look past the market price of a stock to determine its relative value.

Typically, a recent material plunge is the result of a significant change in the company's circumstances.

On the other hand, just because a company provides good products and is run well doesn't necessarily mean that buying its stock at any price is a prudent decision. Investors often buy at any price when the "name recognition" of a company is more prominent.

But if a company is well understood to be a solid, profitable company, chances are its share price already may reflect future expectations of the market.

In life, some people spend time always looking for the next best thing or the greener pasture. For investors, the tendency to look for and trade into the next best investment can lead to excessive trading.

That churn effect on investing can represent another costly investment mistake and can significantly affect any gains on the investments.

While the pitfalls mentioned here do not cover all the common and costly mistakes investors make, they do highlight some of the reasons behind those mistakes. As the saying goes, "Those who do not learn from their mistakes are doomed to repeat them."

Sometimes knowing why you made them in the first place is the greatest aid to avoiding them in the future.