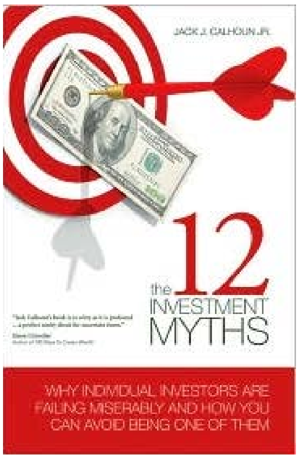
# The 12 Investment Myths




*Why Individual Investors are Failing Miserably and How You can Avoid Being One of Them*

By Jack J Calhoun JR

Jack Calhoun is the managing principal of Capital Directions LLC, one of Atlanta's (USA) oldest and largest fee-only investment advisers. His book is self-serving in the sense that he articulates an investment strategy which his firm provides.

However, there is a real benefit for investors in reading this book: The myths are important for us to understand. Even if we do not totally accept them, we should be aware of his views and have thought deeply about them in relation to our own investment plans.

Calhoun opens his book by showing that the average investor in managed funds in the US earned only 4.5% per year between 1987 and 2007. Yet the S&P 500 index returned 11.8% in that same period.

Calhoun puts this down to a "lack of awareness and appreciation for the role of emotion in investing". Underlying this are the twelve investment myths that the book discusses in detail.

His solution is adherence to the principles which underlie successful investing. In short, Calhoun advocates his firm's strategy which is to investing in widely diversified portfolios and staying the course through the stock market cycles. In other words, a passive investment approach based on a widely spread international portfolio of stocks.

So, what are the fallacies that he sees as causing this general investor failure?

## Myth 1: A savvy investor should be able to beat the market

In other words, there are gurus or fund managers out there who can beat the market. The problem is that the market return beats over 80% of active fund managers. So, Calhoun sees the issue as trying to achieve the wrong result. Instead of seeking fruitlessly to ***beat*** the market, smart investors should be ***using*** the market to beat most fund managers.

## Myth 2: Brokerage firms are built on a client service model

In other words, the broker is on the side of the client. If you believe this then you are living in fairyland. Brokers are salesman. Their model is what Calhoun calls "product-distribution". Brokers are rewarded for distributing stocks to customers. They therefore have a basic conflict of interest. The solution to this, which Calhoun propounds, is to find an independent fee-only adviser, who cannot accept commissions and acts as a fiduciary for clients.

## Myth 3: It's all about performance

This is one of the more powerful myths in the book. Almost everyone believes it. They chase the funds with the recent hot performance record. However, history shows that all outperformance is followed by reversion to the mean. "Investors who chase returns usually miss the run-up and arrive just in time for the downturn." I hear about this all the time in our market. Instead of pursuing Calhoun's strategy of selecting funds with low levels of sales commissions, expense ratios and trading, the typical investor chases the fund which performed best last year. The trap is simple, past performance is usually inversely related to future performance. Since we invest for future returns, why focus on the past. It is better to focus on the funds with the greatest efficiency in terms of cost.

## Myth 4: Activity is good

The argument here is that actually "activity in a portfolio is usually detrimental" and leads to investors missing the market return by a wide margin. This relies on the idea that the best days in the market come unexpectedly and if investors miss them, their return is damaged severely. Calhoun sums up this discussion with the proposition that the only justifiable changes to a portfolio are rebalancing, reallocating and tax-loss harvesting. My comment: This sits oddly with the breakout box on page 7 above. It is difficult to sit for long in a constant portfolio because there are constant changes in stocks due to the process often termed creative destruction.

## Myth 5: Investors do all right for themselves

Here Calhoun relies on cognitive dissonance, the well-known tendency for all of us to recall vividly the successes and to unconsciously block recall of the failures.

My comment: I could not agree more. In my experience almost all private investors do not measure and therefore know their true rate of return. You don't believe me? Just ask them. I suspect that part of this is ignorance about how to do it. It is combined with laziness and even a desire not to bring themselves face to face with their poor performance. Show me investors who rigorously track their performance against the market and against their target return and I will show you a skilled investor. If readers take nothing else away from this newsletter, it should be a resolution to keep good records and to constantly track their return. I track my return daily against the market. Can you say the same thing?

What I have suggested is just what Calhoun outlines for dealing with this myth: a discipline to follow a sound plan relentlessly and a conscious tracking of our real net return. If readers find this all too difficult, they should either pay someone to do it for them at least monthly, or find an advisor to manage their investments and report regularly on returns.

## Myth 6: The media is a good source of investment advice

Calhoun used to be a journalist as a young graduate. He knows the inside story. His editor once put it to him this way: "Journalists ... are a mile wide and an inch deep". So, it is important to understand that the media is not there to give us investment advice. It is there to sell their publications. They make the headlines and stories as interesting and dramatic as possible to get us to buy and read. Calhoun suggests that we should ignore all of this and focus on only reading the in-depth articles written by people who have really deep knowledge and experience. There are very few of these and their subject matter is not always the most exciting to read.

I have been giving the same advice for years in another way: Avoid stories about market movements and what look like recommendations. If you come across a story about a stock, look at the five-year chart first. If it is not trending up, don't waste effort reading the article. In general, read only for facts and think about the facts on the way to forming your own conclusion. Read in depth only the long and unexciting pieces that most people never read. Seek your excitement and entertainment quite separately from the management of your investments.

## Myth 7: Invest [passively] in good companies

This one will shock most readers. It certainly caused me to do a lot of thinking. Calhoun's proposition is that in the twentieth century this method worked fairly well. However, he thinks that the situation has changed. Markets are now far more volatile and even the best companies can experience sudden and severe price falls due to unforseen short term problems. The last couple of years have seen passive investors experience large paper losses, even though they held only sound companies. When we look more closely at their portfolios, they are too focussed in less than thirty significant holdings. Often, too there is a lack of sector diversification. Almost universally there is a lack of international diversification.  Calhoun's view here is that investing in good companies is about the wrong objective. It is seeking outperformance. His approach is the opposite – seeking to minimise downside risk. This can only come, in his opinion, from wide diversification. So, if we lack the capital to diversify widely, we should use fund managers to achieve it.

Some readers are going to be tempted to email me now and say: "but, Colin, your own plan is highly concentrated in a few stocks." This is true. My defence is that I know that and it is one of the really aggressive parts of my investment plan. It is why other parts of my plan are highly defensive. In addition, I have established a track record that I can beat the market. Maybe I have been just lucky, of that I am intensely aware. It is one of the reasons why I track my performance so closely. It is also why, for many years I followed my own advice. I managed some of my capital myself, but left a significant amount with fund managers as a control. It was only when I continued to beat the professionals that I took all my capital under my own management. Should I cease to beat the market as I get older, I will change my strategy and seek the market return that I am not getting with my own methods.

I know this will surprise many readers. What I have tried to deal with here is one of the most powerful of the unconscious biases in the way we all think. We are all hugely overconfident of our ability. When we poll people about their ability in any area, including investing skill, most people think that they are above average. However, that cannot be. It is simply silly to say that I am above average but the rest of you, who think the same, must be wrong. We should recognise that it is probably us who are wrong.

My prescription for all beginners is this: manage no more than 10% of your capital yourself. Leave the rest with professionals or index funds. As you demonstrate SEVERAL YEARS of above market returns INCLUDING THROUGH A BEAR MARKET, cautiously increase the proportion you manage yourself. Remember it will take at least ten years to reach this point and probably longer. Implied is that you accurately measure your net returns.

If this all seems to be too difficult, adopt Calhoun's solution and use an advisor to construct a widely diversified portfolio, including some part of it internationally.

## Myth 8: Investing is exciting

Here I am perfectly in tune with Calhoun: "... ***successful*** investing is boring." This is because so many investors do not understand "the difference between ***speculating*** and ***investing***." Investing is generally about making a sound plan and carrying it out in all market conditions. There is a complete absence of "action". If investors are managing their capital for the excitement of action in the markets, they are a danger to their own financial health. Seek all the excitement you need somewhere else where it will not harm your wealth. Calhoun suggests that investors should quietly sit on a passive diversified portfolio and let compound interest work for them.

> "If you want ... to get rich quickly, then you will never get rich; but if you want to get rich without respect to time, then you will get rich quickly. ... You have to have a real love of work. Without that, nothing can be accomplished." Nikolay Gogol *Dead Souls*

## Myth 9: All risk is the same

Here Calhoun explains the difference between "good risk" and "bad risk". Good risk he defines as market risk. He sees it thus because stocks yield a higher return long term than bonds and it is this return which we should seek. He sees everything else as bad risk – which comes from insufficient diversification and active management of portfolios. His solution is obvious: spread "your portfolio across a wide variety of asset classes and investment styles", such that we take the level of market risk that we can tolerate, or need to take in pursuit of our required living standard in retirement.

## Myth 10: The end is near – so why invest?

This one centres on fear and availability bias. Disasters are so much more real than good events. We recall disasters vividly and way out of proportion. Good outcomes over the long haul simply do not register much in our consciousness. Much of this sensitivity to bad news is due to the widespread availability of news. We are brought face to face with disasters in real time and then the images are replayed over and over until they seem to be burned into our brain. The opposite happens with good news. It simply does not sell. This is why when September 11 happened, I suggested we turn off the TV in order to focus on a balanced view and avoid having fear branded into our minds. It is in a newsletter I wrote at the time and it is still on my website.

Calhoun's answer here is simple enough. Focus on the long term progress of mankind. See how we always overcome setbacks in the long term. Therefore, investing in a diversified long term portfolio across numerous economies should give us a reliable market return. We have to see this over a lifetime of investing, not a few years or even a single decade.

## Myth 11: I'm not a market timer

What Calhoun is talking about here is the way most investors switch their portfolios around in response to short term events. His view is that for the vast majority of investors (my aside: remember that we all think we are above average) this detracts from their investment performance so that their return is significantly lower than the long term return for the market as a whole. His suggested answer is to fall back on Modern Portfolio Theory. In other words, "a prudently diversified portfolio suitable to your risk and return needs."

This is an interesting discussion because it will be rather confronting to all the active investors in my readership. Like some of the earlier myths, this one caused me to ponder carefully how I could reconcile being a self-confessed market timer.

My efforts at market timing have taken many of the 40 years I have been in the market to develop and hone. As I said earlier, I may be fooling myself by being lucky, but not realising it. Then again, that is not a complete answer. As a market timer, I have a very disciplined approach to carrying out a sound investment plan which I have tested with real money over time and succeeded. Because I have succeeded does not automatically mean my readers will succeed with my plan, because they are not me and do not have my knowledge and experience. I do not say this in order to boast, because hubris is one of the biggest dangers in investing. I say it for two reasons: Firstly, because I have proved I can make my plan work. Secondly, as a way of reminding readers that they should not put themselves in my shoes without a similar multi-year documented record of beating the market. Some of my readers may well have this, but it is far rarer than most people are prepared to admit.

My feeling is that there are numerous ways to make money in the market and Calhoun's way is not the only one. However, he has the facts and record to prove that his method works. Most of those who profess to be good at alternative approaches lack the record and fool themselves to their long term disadvantage.

## Myth 12: An investment advisor's job is to find you "opportunities"

Here, Calhoun takes aim at the advisors who constantly present clients with the latest and greatest investment opportunities. He sees them as simply salesmen in disguise, as was discussed in an earlier myth. Instead, Calhoun suggests finding a fee-only advisor, who formulates a sound plan for us to meet our objectives with a risk level that we can tolerate. Then the advisor's role is to protect that plan from our human proclivity to change horses in mid-stream because of vivid short term problems.

Finally, the question arises: why should we read this book? I am glad I read it. I had some initial difficulty in making myself read a book by someone who seemed to be espousing an approach that was the antithesis of my plan. However, I gradually came to realise the benefits:

1. It made me think outside my comfort zone.
2. One of the ways the law looks for truth is to have opposing counsel present their cases. It was powerful medicine to force myself to read what may seem to be opposing views.
3. The result was that I was forced to think afresh about many of my beliefs about investing. I began to understand my own methods in more depth.
4. I found that I was close to Calhoun on many ideas, but on the areas where we differ, I was not as far from him as I initially thought.
5. I now feel more secure in my methods because I have let them be tested by considering new or different ideas.

Some people ask me why I write and teach investing. Their guess is that it is to make money. They are dead wrong. My income is primarily from my investing. I write and teach because I love doing it. This is mostly because I have learned that the only way to truly understand something is to teach it. That is one reason why I constantly implore readers to write down their investment plan and then explain it to someone else. The benefits of doing this are truly amazing. Thank you all for being my audience.