7 Devastating Mistakes Investors Make

and How You Can Avoid Them

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Ridgewood Investments provides exceptional investment solutions & financial advice to professionals, business owners, and affluent families.

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7 Devastating Mistakes Investors Make (and How You Can Avoid Them)

If achieving success in the world of investing were easy, everyone would be rich. The reality is that many people try and fail with their investments - a reality that is far more common than it needs to be for millions of hard working and upstanding people around the world.

On the other hand, some investors - such as those who had the foresight to invest in long-term successes like Berkshire Hathaway and stick with it- have positioned themselves to reap a lifetime of freedom and success.

One of the key differentiators between these two groups is not so much the ability to make correct decisions as much as it is **the ability to avoid certain devastating errors and mistakes** that are likely to reduce your results by a large margin. The difference can amount to millions of dollars that you won't have to enjoy a more comfortable retirement. For some it will be the difference between having the the freedom to focus on your family and legacy or having to work for the rest of your life.

At Ridgewood Investments, **we believe everyone deserves a chance to enjoy financial freedom and abundance** as the fruits of a lifetime of work in their profession or business. We help busy professionals, business owners, and affluent families secure their freedom and legacies through the power of wise investing.

Over the years, we have noticed certain investors repeatedly making the same devastating mistakes. These mistakes are devastating for at least two reasons. First, they can be extremely costly in terms of both dollars and stress. Secondly, they are all unnecessary and avoidable.

As a firm that takes an education oriented approach, our sincere hope is that you will profit from our discussion of these 7 Devastating mistakes. On the surface, some of these observations may seem less devastating than others, but make no mistake each of these errors can be highly problematic on their own. When combined with each other and given enough time, the results are often devastating to their victims.

We have compiled this article as a resource for investors everywhere and hope that many others have a chance to reflect upon and use these insights to avoid their unfortunate impacts.

Mistake #1:

Emotional Decision Making

Successful Investing is like being in charge of a business - a business that happens to involve managing your savings and financial assets in a way that will produce income and profits while protecting those resources from threats. Just as in any enterprise, success requires the application of a good plan, logic, patience and clear thinking, as well as sound execution.

> ***"success requires the application of a good plan, logic, patience and clear thinking, as well as sound execution."***

Unfortunately, human nature is not wired in a way that enables most individuals to stay calm and focused when pressured by negative news, uncertainty and market fluctuations. To the contrary, human evolution wired our brains with extremely strong emotions like fear and the instinct to flee from danger as a survival mechanism. These "Fight or Flight" responses, which helped us survive in a primitive world, become liabilities in the modern world of capitalism because investors find it very difficult to stay rational and clear thinking when market fluctuations trigger the fear response.

Practically speaking, this mistake means that most investors buy and sell at the wrong times. They often sell things they should keep during downturns out of fear and compound this mistake by failing to buy bargains created by downturns, also out of fear.

The best investors cultivate an attitude of equanimity or calmness that allows them to continue to make logical and rational decisions no matter whether the market is up or down at a given moment. They are careful not to be overly influenced by the market or what the crowd is doing. Unfortunately, given the strong pull of human nature, it's very difficult for most people to not get caught up in the actions of their neighbors.

The best way to avoid this mistake is to have the right personality and enough experience of having gone through multiple cycles or carefully studying the approach of successful investors historically. This antidote to Mistake #1 gives investors the tools to help them deal with new market challenges because they've seen them before and have cultivated the right temperament to be successful again.

Mistake #2:

Thinking Short-Term

Investing successfully is also a competitive activity. In capitalist systems and markets, millions of individuals and firms are competing to get more and better information, and get it sooner, to give them an edge in the competition against everyone else.

To some extent, this process has a Darwinian "Survival of the Fittest" quality - especially in the short term. In choosing to make investments, therefore, it's always important to examine what edge, if any, you have as a participant in the market of investments.

Unfortunately many investors, due to their emotions, become caught up in short-term market fluctuations. Even large institutions, such as funds and endowments on Wall Street, have a tendency to engage in very short-term thinking. One reason that short-term thinking is so prevalent is that short-term performance is easy to track and focus on and most decision makers are incentivized at least partially on short-term factors. This explains why so many analysts, managers and investors expend so much effort trying to forecast the earnings of companies and the market one or two quarters away.

Fortunately there is a silver lining to all this short-termism in the markets - which is that if you are willing to be one of the few investors with a long-term time horizon, you will be able to make better decisions (and ultimately prosper) because Wall Street is generally not as focused on the long term.

> ***"if you are willing to be one of the few investors with a long-term time horizon you will be able to make better decisions."***

Ironically, when it comes to long-term prospects, not only is the competition less but, in many cases, the task of forecasting is easier. Unlike the weather and counterintuitively, it can be easier to identify a handful of great investments that are almost certain to appreciate substantially over the next 10 years (think quality), though it would often be far more difficult to predict the market price of those same investments over the next 10 days or 10 months.

Part of thinking long term is to be constantly searching for value, i.e. trying to identify those investments that are too cheap relative to their future potential. Usually value investments are unpopular and may continue to be unpopular for several more years. Unless an investor has the ability and discipline to think long term, they will not be able to invest in the best opportunities with the maximum amount of value.

Mistake #2:

Thinking Short-Term cont'd

When you are able to think long term and measure your results in longer periods of time, the odds of success are much greater, because your framework helps you focus on the most important factors rather than on the noise that drives short-term fluctuations. Practically speaking, most investors are thinking in terms of quarters or a year or two at most. Contrast that timeframe with that of most great investors, who think in terms of 5 to 10 years.

Simply by making this one change to their approach - lengthening their investment time horizon - the majority of investors would greatly improve the quality of their investment decisions as well as their results - and avoid falling into the trap of Mistake #2.

Mistake #3:

Investing Without Understanding

One of the keys to success in investing is to invest only in things that you understand thoroughly. Understanding something well is part of the edge needed to survive and thrive in the competitive environment of capital markets.

Unfortunately however, many investors make the mistake of investing in things that they don't fully understand. Sometimes it is because they are operating with a poor framework and don't appreciate the importance of doing their homework before making investments.

"many investors make the mistake of investing in things that they don't fully understand."

There are many reasons people invest without understanding. Many investors are just too busy with work and other life priorities and lack the hours needed to really do their homework. For others, it's very easy to follow tips or news articles or invest in companies that seem like they're succeeding in the market without really understanding all the details.

Even if you have the time, good investing also requires some basic skills, including an understanding of accounting plus the ability to read financial statements.

Unfortunately these things are rarely taught in schools, leaving many investors ill-prepared to analyze investments and recognize the important details behind every opportunity.

Accounting and finance is the basic language of business and investments and a fundamental ingredient of every great investor's toolkit. An understanding of accounting is important, because the history of a company and its prospects for the future can be best understood in part through the numbers that tell the story. The footnotes of any company's financial statement can reveal key insights or pitfalls associated with the opportunity.

Understanding must also go beyond the numbers, because basic accounting and financial statement analysis are necessary, but not sufficient. At least as important are an understanding of the qualitative factors that make each business and its future prospects either bright or challenging. These factors include an assessment of the quality of management and the business franchise and the competitive dynamics applicable to that company.

Without these basic assessments, it will be difficult for an investor to truly say that they have a good understanding of the investments that they are pursuing. Making Mistake #3 can be devastating to many investors' results because it turns the process of investing into gambling.

Mistake #4:

Chasing Performance

Since one of the main goals of most investors is to grow their money, it is not surprising that they are motivated to pay attention to how their investments are performing relative to others available in the market. In particular, investments that are rising and are being talked about as "winners" tend to attract a growing following. Conversely, investments that are falling and unpopular tend to draw derision and lose supporters. The corollary is that investors can often fall into the trap of chasing performance rather than following value.

> ***"Investors who chase performance routinely end up paying such high prices that many of their investments have almost no chance of generating returns that would justify the price paid"***

One type of mistake - following performance in the upward direction - gets people into trouble because they end up investing into bubbles that form as irrational popularity drives the value of certain popular investments far higher than they deserve. It was chasing performance into bubbles that got so many investors into trouble with both the Dotcom crash in the early 2000s as well as the housing crash in the late 2000s.

Investors who chase performance routinely end up paying such high prices that many of their investments have almost no chance of generating returns that would justify the price paid.

The other type of performance led decision making that can also create problems is when markets (or certain investments) are falling in price (usually temporarily). Even the best investments can easily fall in any given year by 20 or 30%. In fact, Berkshire Hathaway, which has been one of the best all-time investments in the history of the market - increasing in value thousands of times for long-term investors - has had many periods where it has fallen temporarily by uncomfortable amounts. The same can be said for almost all great investment opportunities and the most successful investors stay with them and ignore poor short-term performance (knowing the difference is part of your understanding). So this second version of the mistake leads investors to sell good investments too early because they are spooked by some short-term negative performance and they lose patience - when they really should be holding on.

Mistake #4:

Chasing Performance cont'd

Chasing performance is a pitfall that is not limited to stock market investments; it can apply in a different form to income or yield oriented investors as well. In higher yielding bonds and preferred securities, as well as real estate investment trusts and master limited partnerships, the term "Chasing Yield" refers to the tendency of many investors to gravitate towards higher yield investments only to experience capital losses when these "sucker" yields are later cut or disappear entirely because they were unsustainable.

The antidote to this mistake is to focus on a sound process that ignores short-term performance and is based on other more enduring factors, such as the quality of the business franchise and the management. By having a sound framework to fall back on, investors can stop worrying about the short-term performance - either good or bad - and continue to think long term, confident that the soundness of their approach will ultimately yield solid performance and shield them from Mistake #4.

Mistake #5:

Trading Too Much

In committing this mistake, many investors lose sight of the purpose of their investments, which is primarily to compound the value of their holdings and grow them significantly over the long term - and ideally do so as tax efficiently as possible.

Many investors who are excessively focused on short-term results end up buying and selling too much. Various versions of this mistake are particularly common among those who believe that trend following approaches and technical analysis - using all kinds of charts and price graphs and stop-loss strategies - are a good idea.

> ***"The most successful investors, like Warren Buffett, trade very infrequently and hold investments for many years, if not decades."***

Their hope with all this trading activity is to get in and out of the market at the right times. Experience shows that this hope is misplaced and the most likely result of all this trading activity will be selling winners and missing out on market gains over time. Of course, many Wall Street firms make their money based on the transaction activity of their clients. They have an incentive to promote trading frequency in order to boost their revenues.

It is telling that there are far more long-term investors who are wealthy and successful than there are short term traders who make and hold on to any substantial wealth in the long run. In fact, it's very difficult to identify very many, if any, truly great investors who have made money with short-term trading as their primary approach.

One of the reasons that this is true is that those who buy and sell too often have to fight the drag to their results that comes from paying taxes and incurring trading expenses - costs that inevitably eat away at their results.

The most successful investors, like Warren Buffett, trade very infrequently and hold investments for many years, if not decades. Implied in this strategy is that they've done their homework and selected their investments very wisely, with an emphasis on quality and long-term prospects in the first place. Provided this is the case, trading infrequently and buying quality investments and letting them grow your wealth through steady compounding is one of the most reliable ways to get great results with your investments and avoid Mistake #5.

Mistake #6:

Picking the Wrong Advisor

Unfortunately there are many pitfalls when it comes to choosing someone to advise you on your investments and finances, which leads many investors who know they don't have the time or interest to take on this job by themselves to choose bad advisors.

> ***"The difference between a great advisor and a poor advisor can be the difference between a comfortable life or one that is far less successful."***

Selecting the right advisor is a critical decision that many investors make poorly. Searching for an exceptional advisor who can provide great investment and financial guidance is a process that investors should undertake intelligently and carefully. The difference between a great advisor and a poor advisor can be the difference between a comfortable life or one that is far less successful.

This is a high payoff decision that can provide enormous leverage to your investment of money and time over the course of your entire life. Many investors don't understand the critical importance an advisor has to their team and in their life and therefore are not careful or selective enough in this choice.

Some of the criteria to identify a great investment advisor are to scrutinize:

Their Education

- Do they have degrees from the most selective schools?

Their Experience

- Were they high level professionals at highly successful firms with a demonstrated ability to deal with complex ideas?

Their Personality

- Are they empathetic and caring?
- Are they able to explain and educate you to make sound decisions in a way that you can understand?

Their Trustworthiness

- Do they avoid conflicts of interest, such as commissions?
- Are they transparent?

One element of trustworthiness is whether your advisor eats their own cooking - investing the bulk of their own money in the same investments that they are recommending. Surprisingly, many advisors don't. Even more surprisingly, few prospective clients even ask the question.

Mistake #6:

Picking the Wrong Advisor cont'd

Incentives also make a big difference, as some advisors work on a fee-only basis while many other advisors, such as those who sell life insurance or those who work in a brokerage firm setting, often generate at least some, if not a majority of their income, from trading activity and commissions related to what products they can convince their clients to buy from them.

Unfortunately many investors don't understand that all advisors are not created equal and that - between conflicts of interest and lack of a consistent philosophy or high level education and experience - a large percentage of advisors lack the fundamental skills or qualities that would make their advice worth taking.

A related pitfall is that most investors struggle to identify a great advisor and don't even realize that there are large differences among the variety of available advisors.

As a result, many investors choose an advisor based on superficial metrics like the size or the brand name of the advisor's firm or their advisor's personality and social skills, rather than truly scrutinizing the quality and soundness of their approach. If they had a better understanding, they might look for smaller firms with high integrity professionals who have the right philosophy, education, temperament and experience to deliver a better overall result and thereby avoid Mistake #6.

Mistake #7:

Diversification Mistakes

A key aspect of successful investing is position sizing. This is the issue of not only deciding what to invest in, but also trying to figure out how much of your available liquid assets should be allocated to the investments you choose. Many investors make diversification errors, either because they concentrate too much or they diversify too much. Unfortunately, both types of diversification mistakes can substantially detract from the long-term benefits your investments will ultimately produce for you. However, it is worth noting that, of the two types of mistakes, over-concentration in the wrong investments can be by far the deadlier of these diversification errors.

In addition to managing the level of diversification in your portfolio, it's also important to manage the liquidity of your investments. Certain investments, such as those in the stock market, are more liquid, in that they can be turned into cash quickly, while other investments, such as those in private funds and in most types of real estate, are illiquid and therefore need to be sized in a way that allows you to have ample cash access from other parts of the portfolio.

Another version of this mistake is not putting enough money into one's best ideas - also known as di-WORSE-ification. All the greatest investors are great not just in terms of identifying promising investment opportunities but also in portfolio construction and position sizing. They are experts at figuring out how much of their total funds should be invested in each opportunity and how each of these opportunities relates to the others in ways that increase their long-term returns and minimize their long-term risk exposures.

Warren Buffett is famous for saying he could improve your ultimate financial results by giving you "a ticket with only twenty slots in it so that you had twenty punches - representing all the investments that you got to make in a lifetime. And once you'd punched through the card, you couldn't make any more investments at all. Under those rules, you'd really think carefully about what you did, and you'd be forced to load up on what you'd really thought about. So you'd do so much better."

A just-right level of diversification and proper position sizing is an art that gets developed over years of experience and sometimes as a result of costly mistakes. Just being aware of and giving emphasis to proper position sizing is a great start towards avoiding Mistake #7.

Conclusion

Now that you have a better idea of the seven deadly mistakes that many investors make, you have a roadmap to improve your own results.

Unfortunately, it is far too common for many investors to make not just one, but often a majority of these errors at one time or another. Awareness and education is the first step to avoiding these mistakes in your own life. As a result of taking the time to obtain and read this guide, you are well ahead of most other investors in being aware of these pitfalls and having a chance to avoid their consequences. Most people allow inertia and procrastination to get in the way of their best interests. We hope you will be one of the minority who takes action and profits from these insights by taking the time to start applying them in your own decisions.

Of course, some people who lack the time or interest to apply these principles diligently on their own would benefit far more from working with an advisor such as Ridgewood Investments. At Ridgewood, we provide our clients a turnkey outsourced solution that does not require them to expend their own effort to focus on these factors themselves. We take care of everything on their behalf.

The best way to determine whether our approach could help you transform your own results is to chat with us about your unique situation. Our investment reviews are comprehensive and informative. Whether or not you decide to work with us, we guarantee that you take away some actionable ideas and strategies that you probably didn't know about.

Don't let these common mistakes devastate your retirement.
You are not alone, there is a better option.
Call us at 973-544-6970 to schedule a meeting today.

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