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Financial Planning

STOCKS VS. BONDS: WHY SOME PEOPLE LOSE AT A WINNERS' GAME

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As we noted in the March issue, in the long run stocks provide the best returns of any major asset class. However, we all hear stories of people who've done poorly with stocks. What's up with that?

Like many things in life, tools that can be helpful can also be harmful if not used properly. Think about driving a car. Or using electricity. Or even taking a bath! For most things in life, you need to have some basic safety rules.

For the stock market, we've found three main hazards that prevent people from succeeding with their investments. These hazards are:

- Lack of diversification
- Investing in speculative stocks
- Market timing.

Diversification (in finance, often called "the only free lunch") is key to being a smart investor and succeeding in the stock market over the long term. Diversification means investing in different companies, industries, sectors and countries. Investing in only one sector, or using only one method of selection, increases your risk. By diversifying you wisely spread your money across several different areas.

You also create a cushion. For example, if one industry experiences a hardship and drops, your money in other areas will likely not have the same consequences. That money may actually benefit! Take energy as an example. If energy prices fall, energy companies will suffer. But companies that use a lot of energy should benefit. So, investing in both types will help reduce the risk from uncertain energy prices.

The second factor to consider is the type of stocks. Looking at stocks being hyped in the news, and then rushing to put money into them, is *speculative* investing – and risky. Sure, hearing about new start-up companies is intriguing. However, with no track record of their ability to grow or sustain profitability, such stocks may not be the best place for you to invest your hard-earned funds.

Fact is, the failure rate of start-ups is high. It usually makes more sense to invest in well-established companies that made it through the start-up phase and now have organizations, processes and tested, proven strategies. In the long run, proven success will always be a safer choice than hopeful speculation.

Trying to "time the market" is the third reason investors tend not to do well with stocks. Often people get emotionally involved in their investments. Trying to predict ups and downs, they keep moving their money in and out of the market. Such *market timing* is tempting, but studies show that predicting market fluctuations is nearly impossible. Trying to do so actually increases your risk of doing poorly over time.

By letting their emotions take control, then buying high and selling low, these investors underperform the very market they are trying to follow. *Time in the market*, not timing the market, is the key. Only by staying invested for long periods can you increase your chances of success. Famed investor Charlie Munger put it well: "The first rule of compounding: Never interrupt it unnecessarily."

Invest for the long term

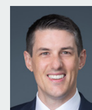
To be truly successful, view the money you put into the stock market as a long-term investment. One way to do this effectively is by trying your best to remove your emotions from the equation. And part of that means not checking your investment account daily!

To help you succeed with your investments in stocks, you need to flip the above hazards around and turn them into safety tips for investing:

1. Diversify your portfolio
2. Invest in well-established companies, and
3. Avoid trying to time the markets.

Following the market in the short term can be nerve-wracking. For that reason, only invest in stocks with money you won't be needing soon. Knowing that your stock market money isn't needed in the short term will help you ignore the market's short-term swings.

And, somewhat counterintuitively, if you have savings or surplus cash put aside for your short-term needs, you should view any stock market drops as good events. When these drops occur, they enable you to add to your long-term investments at discounted prices. Of course this only works if you add when markets drop, rather than doing the opposite.



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