Step 5: Avoid The Biggest Mistake Investors Make

Description

We're about to share with you the secret to avoiding a $10 billion investing mistake. It's not more money, a higher IQ, or superb market timing. It's mind control.

The way we're wired — our natural inclinations to seek more information, look for patterns, compare options, and even flee to safety — is great at keeping us out of harm's way. As proof of this, when is the last time anyone saw a sabre tooth tiger? But these same emotional tendencies are also our biggest liability when we're in investing mode. In other words, your brain is to blame for all those boneheaded money mistakes. To prove that we too have brains, most of us Fools have made all the same boneheaded money mistakes too!

Just ask uber-investor Warren Buffett. The chairman of Berkshire Hathaway openly admits that a short in his analytical circuitry — his "thumb-sucking" reluctance (Buffett's words) in the 1980s to pick up more shares of **Wal-Mart** (NYSE: WMT) because of a one-eighth of a point uptick in the stock price — cost him $10 billion in potential profits over time. Essentially, Buffet's brain cost him $10B. Ouch. And this is from a guy who has famously said, "Success in investing doesn't correlate with IQ … what you need is the temperament to control the urges that get other people into trouble in investing."

2 traits you must have to be great

And now, the information you've been waiting for: the secret ingredients to investing success, regardless of education, investing styles, or golf handicaps: Timeline and temperament.

Timeline

As we mentioned in Step 4, investing in stocks requires a minimum five-year time horizon. Think of it like sending some of your money on vacation while your other money takes care of the more immediate chores, like paying for car repairs, a house, or a kid's university tuition.

But, at the risk of sounding like a country and western song, it can be hard to be a long-term investor in a short-term world — which brings us to the second secret ingredient for investing greatness.

Temperament

Successful investors have the ability to remain calm and level headed when everyone around them is freaking out. That mindset makes the difference between investors who consistently outperform the market and investors who get lucky for a while. Wal-Mart foible aside, Warren Buffett says this is the key to his success. When a group of business-school students asked Buffett why so few have been able to replicate his investing success, his reply was simple: "The reason gets down to temperament."

Money, IQ points, and lucky socks are no help when your investment is down 50%. But if you can keep your emotions in check and ignore the noise, you'll be able to hang on (even back up the truck and load up) rather than selling out at potentially the worst time. If you look back at history and study how investing fortunes were made, you'll find it wasn't by jumping in and out of stocks based on fear and greed, but by buying great businesses and investing in them over the long haul.

Hop off the emotional roller coaster

To cultivate a good temperament — one that focuses on the long term, not the short term, and ignores the crowd in favour of a well-thought-out strategy — channel your inner George Clooney (or whomever you feel is the cool dude/dame du jour). Build resistance to the emotional triggers that lead to bad investment decisions. Here are a few exercises we Fools regularly do to keep our cool:

- **Memorize this affirmation:** "I am an investor; I am not a speculator." All together now: "I am an investor; I am not a speculator." As investors, we:
- **Buy stock in solid businesses**. We expect to be rewarded over time through share price appreciation, dividends, or share repurchases.
- **Don't time the market.** And we certainly don't speculate when we buy stocks. Speculation is what Wall Street traders do.
- **Focus on the value of the businesses we invest in.** We try not to fixate on the day-to-day movements in stock prices.
- **Buy to hold.** We buy stocks with the intention of holding them for long haul. (That said, we are willing to sell for reasons we outline in Step 10.)

We recognize that believing your affirmation is sometimes easier than living it. To avoid behaving like a speculator …

- **Tune out the noise:** Put down the newspaper, turn off CNBC and/or BNN, and stop clicking that. And that. And, yes, that too. None of it is doing you any good.

Fixating on the market's minute-to-minute news won't help you make your next brilliant financial move. At best, all the hours, days, and weeks spent soaking in sensational stories will yield a few timely *bon mots* to toss off at the next office happy hour. Mostly, though, it's all noise, and it's costing you a serious amount of sound sleep — and maybe even some actual money.

- **Spread out your risk:** In order to get some quality Zs, you need a solid asset-allocation plan — meaning a portfolio with a bunch of investments that don't always move in the same direction. You need to diversify. (We'll get into the details of diversification in Step 9.)

Putting an assortment of eggs in various baskets isn't the only way to spread your risk. You can also avoid the risk of investing in a company at exactly the wrong time. Say you're interested in buying shares of Scruffy's Chicken Shack (ticker: BUKBUK), but you just don't know when to pull the trigger. The answer? Take a bunch of shots!

Practically speaking, you do this through dollar-cost averaging — accumulating shares in a stock over time by investing a certain dollar amount regularly, through up and down periods. For instance, every month for three months you purchase $500 of Scruffy stock, regardless of the stock price. The beauty of this system is that when the stock slumps, you're buying more, and when it's pricier, you're buying less.

"Buying in thirds" is another way to average in to an investment: Simply divide the total dollar amount you want to devote to a particular investment by three, and pick three different points in time to add to your position.

- **Stay strong, think long!** For Fools, investing success is not measured in minutes, months, or even a year or two: We pick our investments for their long-term potential. So resist the urge to act all the time. Make decisions with a cool head after letting new information sink in. Sometimes the best action to take is no action at all.
- **Distract yourself with something useful:** If you're going to obsess about your investments, use your time productively and review your investment philosophy and process. For example, pick any investment that's interrupting your sleep. Write down why you bought the business in the first place. Ask yourself: Has any of that fundamentally changed? This exercise underscores that short-term ups and downs in the stock market have little relevance to winning long-term investments and wealth generation.

If you don't already have one, start a watch list so you can keep up with the companies that pique your interest. (We'll show you how to spot great businesses in Step 6.) Add your list to an online portfolio tracker so that all the company news will be in one place.

When preparation meets opportunity, that's when great investments are made.

Action: Get in touch with your inner investor.

Do you know your time horizon and tolerance for risk and loss? Do you want to research stocks? In other words, what colour is your investing parachute?

Take this eight-question quiz to tap into your inner investor. It will help identify your natural inclinations, and guide you to investing strategies that are best suited for your temperament.

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