Avoid The Biggest Financial Mistake I Ever Made

Description

Investing regularly in a large-cap index such as the S&P 500 or FTSE 100 is a good way of generating a high return over a long time period. However, investors could potentially obtain significantly higher levels of capital growth through taking a greater amount of risk. That's especially the case when an individual has a long-term time horizon, since this means that they are able to withstand greater risk than an investor who relies upon their portfolio for an income in retirement, for example.

The problem, though, is that many investors (myself included) focus on reducing risk, rather than concentrating on return. Clearly, reducing risk has a place in every portfolio to some extent, but the reality is that in order to generate higher returns, greater risk nearly always needs to be taken.

Risk/reward

For any investor with a 10-year (or more) time horizon, it may be a good idea to take more risk than that offered by the FTSE 100 or S&P 500. Certainly, buying units in a large-cap tracker fund can generate high-single digit total returns each year over an extended time period. But with inflation eating away at those returns by the time retirement eventually comes along, the real return to an investor who focuses on FTSE 100 or S&P 500 stocks could be less impressive than they had anticipated.

As such, buying mid-cap stocks or even smaller companies could be a shrewd move. In many cases, it is possible to buy smaller stocks which have strong balance sheets, impressive cash flow and sound earnings growth outlooks. They are likely to be more volatile than their larger peers, which can make them seem less appealing in the short run. In the long run, though, more risk can equal higher returns and a larger retirement savings nest egg.

Timing

Taking more risk is not limited to the type of company that an investor holds within their portfolio. It can also be applied to market timing. Some of the best times in history to buy stocks have been when the outlook for the stock market has been at its worst.

For example, the FTSE 100 and S&P 500 have risen significantly since the depths of the financial crisis in 2009, while they also made gains in the aftermath of the dot.com crisis in the early 2000s. On both of those occasions, though, the safer option was to wait until the economic outlook improved. However, investors who bought when the prospects for the world economy seemed exceptionally poor are the ones who have often been rewarded with multi-baggers in the years following those crises.

Of course, it is still worthwhile to focus on buying the best-quality companies during recessions and bear markets. In fact, investors should be even more careful than usual when buying stocks that are experiencing challenging economic conditions. But the reality is that by taking risks during the most challenging periods for the stock market, investors may be giving themselves the best chance of earning high rewards in the long run.

As such, while reducing risk is a good idea at times in life, taking risks given a long-term time horizon could help you to boost the size of your retirement savings.

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