Investing in Mutual Funds? 3 Big Mistakes to Avoid

Description

Online low-cost trading platforms are making it easy for new investors to get into the investing scene. Mutual funds are a lower-risk and more passive way to invest than individual stocks.

So, new investors often start building their wealth by investing in mutual funds. They could go with actively managed funds, which aim to outperform a specific index, or index funds, which replicate the returns of an index. Actively managed funds come with a greater management fee. Therefore, lower-cost index funds could be a better option, as the savings do add up over the years.

Here are three big mistakes to avoid when investing in mutual funds.

Not understanding the risks in mutual fund investing

Mutual funds go up and down, just like stocks. Although investors reduce company-specific risk from investing in equity funds that move according to the movements of a basket of stocks, investors are still subject to systematic risk.

If you cannot manage the volatility, you could end up selling at a loss when the fund price goes down. Stocks in the same industry tend to move in tandem. So, when there's a downturn in bank stocks, a mutual fund consisting of stocks in the financial sector will also experience a downturn.

Buying a mutual fund because of great past returns

Years ago, I remember having a conversation with a friend who was a financial advisor. He said there were some mutual funds that were doing very well for his clients. I guessed correctly that it was biotech funds. I was able to answer because I observe the market regularly.

However, I wasn't an expert in the sector. So, even though it was doing really well in the prior few years at the time, I did not invest in it. Moreover, from my previous experience, most of the time, areas that do well don't tend to do well all the time. There will be corrections along the way. And usually, it's safer to invest after a meaningful correction.

A year after the conversation, the biotech sector still roared on, and I thought I was wrong, but eventually, it did underperform. However, as a growing sector, it has had its wins. Money often rotates between sectors, which simply take turns beating and underperforming the market.

Taking **iShares Biotechnology ETF**, which trades under NASDAQ:IBB, as an example, its five- and 10-year total returns were 6% (underperforming the U.S. market's 15% return) and 17% (versus the market's 11% return), respectively.

The takeaway for this section is that just because a mutual fund has done well, it doesn't mean it'll continue doing well. If a fund has been roaring, and you still like the prospects of the sector, start a partial position and consider adding on meaningful selloffs of 10-30% from a peak.

Expect to make quick gains from mutual funds

Mutual funds are meant for long-term investing and wealth creation. Aim to invest in areas that have a long growth runway.

You can also invest in mutual funds like the **S&P 500** that cover the broad market. The idea is to build a position over time, especially buying more units during market downturns.

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