The Largest and Most Hidden Cost of Investing

I've written in my commentaries, before, about the hidden costs of investing -- some which are not readily available to the average investor either from stock brokerage firms, financial planners or mutual fund purveyors. Among those we've previously discussed are items such as bid/ask spread costs, soft dollar costs, commissions (obviously), tax costs, market impact costs, delayed trade costs, management costs and others that might be considered minutiae. However, while these are generally known to many and should be by professionals, perhaps the largest single cost experienced by investors is: "investor behavior cost!"

As I've discussed before and something that many who have attended our classes have learned therein, there have been several well known studies conducted by Dalbar Research on investor behavior. One of the more interesting ones illustrated that over a period of time when the S&P index (a proxy for the largest capitalization stocks trading in the U.S.) was returning in the neighborhood of 16% p/yr on average, the average investor was earning less than 5% over the same period.

"Ah," you might say: "I have the help of my trusty stock broker / financial planner / or online services so I can do better." Unfortunately, another thing that the Dalbar research showed was that even with the help of a "professional" such as mentioned, the additional returns that their supposed skill added was less than 1%. Thus, even with expert help, the average investor was only able to earn barely above 5% over a period of time when the stock market was zooming. In this case, a "hidden cost" of almost 10% p/yr!

The conclusion of the study was that it was the investor's behavior -- getting in and out of investments or the market(s) at exactly the wrong times, chasing performance or panicking that was the cause of such desultory performance. Now, the investor can be excused for such behavior because typically, investors are human and, as such, are impacted by their own emotions and these emotions are additionally fanned by the media trumpeting the latest craze or predicting doom and gloom and end of the financial world scenarios. This is what drives reader and viewership and what sells, so this is what is going to be fed to the investing public.

Worse though are the various stock brokers, financial advisors, financial planners and financial salespeople who prey upon these investors' emotions, who should, theoretically know better (note, I'm not painting them all with a

hugely broad brush, but a very high and significant number of them -- as illustrated by numerous industry publications reporting on their behavior). Mostly, what drives these so-called professionals' responses to investor panic (both on the upside as well as the down) is not necessarily any specific evil intent, but rather an enabling response to the investors' panic driven desires. Rather than provide the support and discipline that an investor requires during either manic or depressing times, the advisors give in to the investor's emotions with their own emotions and enable dysfunctional behavior rather than face the prospect of losing a client. At a minimum, this is why investor coaching and a written Investment Policy Statement are so important to a successful investment experience.

In sum, when one takes into account the behavior of investors and worse, their equally emotionally driven advisors, and you look at the differential in returns between what the market delivers and what investors are able to reap -- even with help, this is a truly staggering cost. So when investors, investment services and advisors concentrate on a few basis points differential in costs between one investment and another -- this is literally a case of missing the forest for the trees. What's a difference of a few basis points in cost compared to substantial percentage differences between what an emotionally driven investor receives and what the market(s) actually deliver.

Ultimately, what counts is not investment performance, but rather: INVESTOR PERFORMANCE! Mind your investor emotions or, better yet, work with an "investor coach" rather than an "investor enabler!"

A couple of interesting articles appeared recently that touch on this subject matter and is worth your consideration. First, Dan Solin whom readers have seen in my commentaries before. He had a brief article in the Huffington Post. Here are a few of his thoughts:

"...Here's real wisdom from Einstein. He defined insanity as doing the same thing over and over again and expecting different results. Welcome to the world of investing where brokers and financial pundits start each year hoping you are as uninformed as you were last year. They depend on your lack of familiarity with the overwhelming data indicating they are emperors with no clothes, whose real expertise is separating you from your money by pretending to have the ability to predict the unpredictable and to bring order to random events.

Around this time last year, the respected journal *Pension & Investments* published an article titled: *For 2011, it'll be all about equities.* A survey of 2,007 responding institutional investors picked "winning" asset classes for 2011. Stocks garnered the most

votes with 40%. Commodities were next and bonds came in last.

James W. Paulsen, chief investment strategist at Wells Capital, predicted the S&P 500 index would reach 1425 and achieve "possibly" a 15% total return.

The reality was quite different. The S&P 500 closed the year at 1,257 -- almost exactly where it was a year ago. The winning asset class was fixed income. A broad index of Treasury bonds was up 9.6%.

Let's give this some perspective: The biggest, best, brightest, most sophisticated and highly compensated institutional fund managers can't predict whether stocks will outperform bonds in a given year.

How do you like the chances of your broker picking stocks, timing the markets or picking outperforming mutual funds?

My New Years wish for all of you is this: Fundamentally change the way you invest. Cancel your retail brokerage accounts. Eliminate all individual stocks, bonds and actively managed mutual funds from your portfolio. Don't listen to anyone who tells you they can add "alpha" by "beating the market" or predicting whether it will rise or fall. Ignore the financial media with their breathless predictions about the impact of yesterday's news on tomorrow's prices. Don't succumb to the sense of urgency, which causes fear and panic. Stop the transfer of wealth from your pockets into those who "advise" you.

Follow Einstein's advice and don't repeat your mistakes. Do that and I like your chances of having a happy and prosperous New Year."

The second was from *Forbes* which had a story related to Nobel Laureate, Daniel Kahneman's latest book. A few brief excerpts from their observations:

"The Entire Investment Profession Is Built On An Illusion Of Skill... One revolutionary thrust of Kahneman 's new bestseller, "Thinking, Fast and Slow"– is that all the predictions by analysts, economists, corporate CEOs and cable TV talking heads about the stock market in 2012 are pure unadulterated guesswork and beliefs that are in effect an illusion of the future they project. So much for George Soros and Warren Buffett and Bill Gross and Larry Fink and Byron Wien, and all the other highly paid and acclaimed soothsayers of the markets. Think how few of them got the markets right...

For Kahneman has decided that " a major industry appears to be built largely on an illusion of skill. Billions of shares are traded every day, with many people buying each stock and others selling it to them… The puzzle is why buyers and sellers alike think that the current price is wrong… For most of them, that belief is an illusion..."

Luck, chance, randomness play a much more powerful role than we ever thought possible. You should be getting very anxious right at this point. You mean my investment icon, Warren Buffett, is just lucky? Maybe the stocks he buys go up because he buys

them – not because they are of superior profitability and management skills...

A study of Fortune's Most Admired Companies found over a 20 year period that "the firms with the worst ratings went on to earn much higher stock returns than the most admired firms." What a punch in the solar plexus that was...." (FT: See the Fama / French "Three Factor Model" and the "Value" premium!).

--

Frederick C. Taylor CLU, CFP®, AIF®
"Your Wealth Coach"
Professional Associates

Phone: (770) 578-0257 / 0684
Fax: (678) 560-8891
Cell: (678) 361-3413

***Atlanta Magazine* 2010 & 2011 "Five Star Wealth Advisor"**

FOLLOW ME ON FACEBOOK (FredCTaylor) & TWITTER (Fred_Taylor)