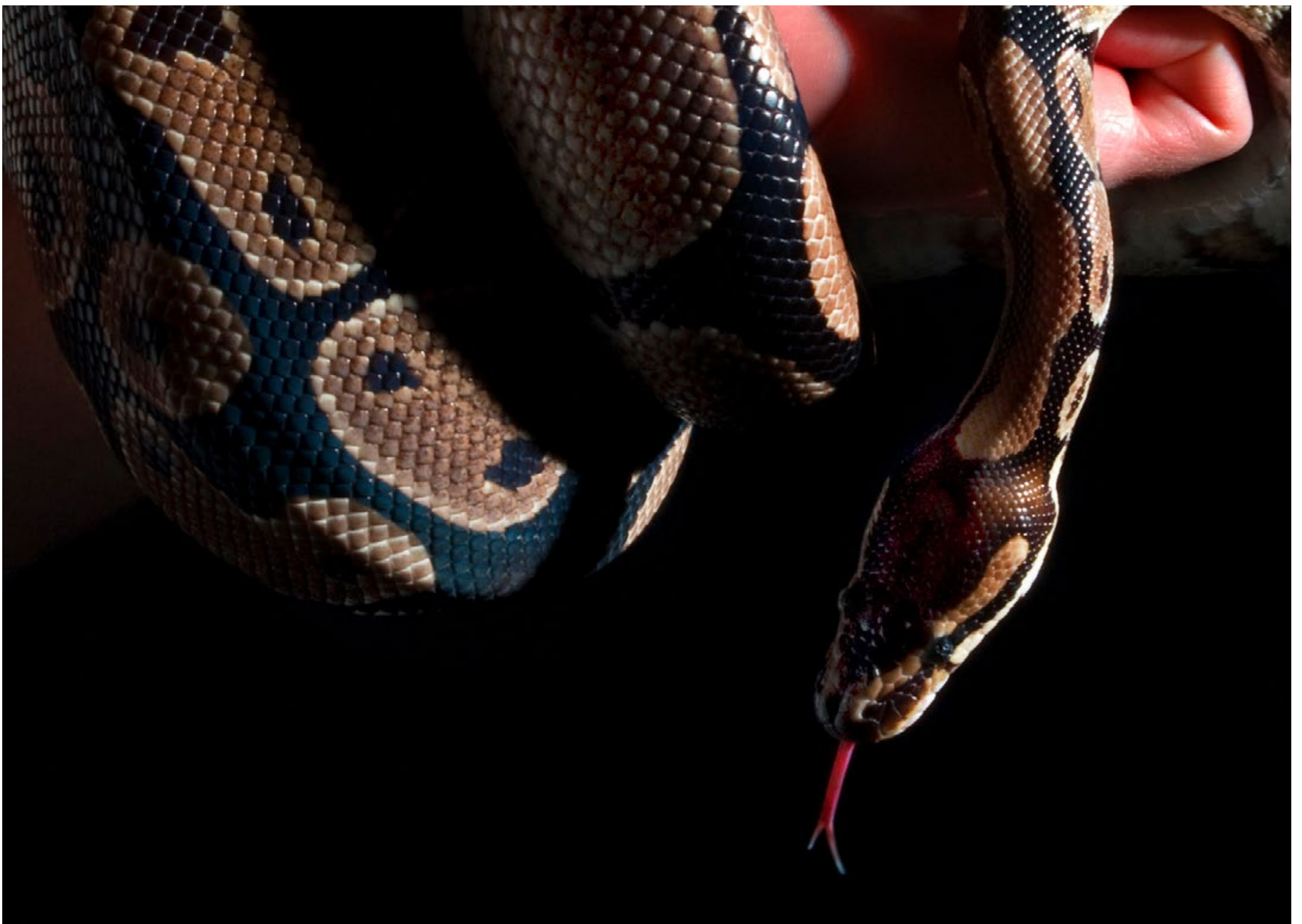
PERSONAL CAPITAL®

7 Deadly Investor Sins



INTRODUCTION

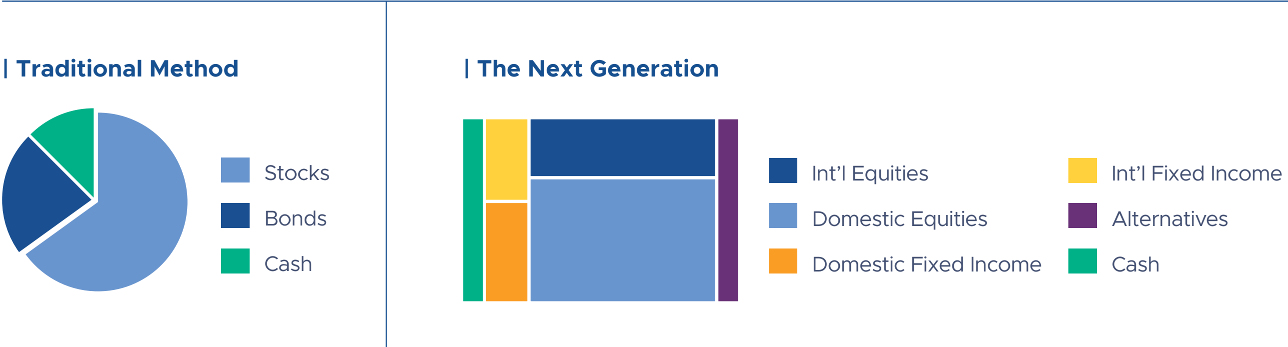
Every investor makes mistakes. Some are relatively harmless, others have the potential to be disastrous.

There's a good chance you are in better financial shape than you realize, but failure to correct one of these sins could significantly impact your ability to reach financial goals.

There is a lot at stake—having to work longer, the inability to pay for college, or having to ratchet down your overall standard of living. Avoid these seven mistakes and you'll be well on your way to a healthier, more rewarding financial life.

Inappropriate Asset Allocation

We cannot repeat this often enough: asset allocation is the most important investment decision you will make.



But most investors don't even know their true asset allocation—it's one of the primary reasons we built our financial dashboard. It is imperative you understand where you are before determining where you need to be. This means having a firm grasp on your aggregate portfolio's exposure to domestic and international stocks, domestic and international bonds, alternatives, and cash. Alternatives are categories such as real estate, commodities and gold. Only then can you formulate a path to your appropriate allocation.

Many investors suffer from two common allocation sins: being too conservative and/or poorly diversified. These are sometimes one and the same. Being too conservative often comes in the form of too much cash and bonds and not enough stocks (more on cash in the next section). It can occur at retirement where there is a misguided belief that portfolios should largely consist of bonds and 'safe' investments, or during key working and saving years. The consequence of being too conservative too soon could be running out of money.

The appropriate asset allocation should be tailored to your personal financial situation, accounting for your risk tolerance, time horizon, expected withdrawals, and legacy wishes, among other factors. It should be a diversified mix of lowly or uncorrelated asset classes. In every scenario, investors should seek the highest return for the right level of risk.

We suggest starting with Personal Capital's free online Retirement Planner.

It will help determine your appropriate asset allocation by combining real-time financial account aggregation, deep investor profile data, and the expertise of financial professionals. It is designed to balance an individual's need, ability, and willingness to take risk. It will then run a Monte Carlo projection engine to determine the odds of meeting spending goals, also known as "not running out of money".

But even with a proper asset allocation in place, a portfolio can still be poorly diversified. Unnecessary risk can occur in one or many of the following areas:

- Style & size (e.g. small cap growth)
- Economic sector (e.g. technology stocks)
- Singular holding (e.g. Facebook stock, GE corp bond, etc.)

A properly diversified stock portfolio, for instance, should have exposure to all economic sectors. The reason is simple: stocks in the same sector tend to behave more similarly to each other than to stocks in other sectors. So if technology blows up, your exposure to energy, health care, or utilities is there to act as a counterweight. Think about it. If you were entirely invested in technology in 1999, or financials in 2006, you would have lost over 80% of your portfolio value in the subsequent downturns.

You should also aim for exposure across different styles, sizes, regions, and to the extent possible, sub-industries. Spread out your risk. Doing this reduces portfolio volatility and can actually improve expected return. Greater return with less risk is the Holy Grail of investing. Ideally, each stock should only represent a small percentage of the aggregate portfolio. When positions get much greater than 5-7%, a portfolio begins to take on meaningful concentration risk.

Too Much Cash

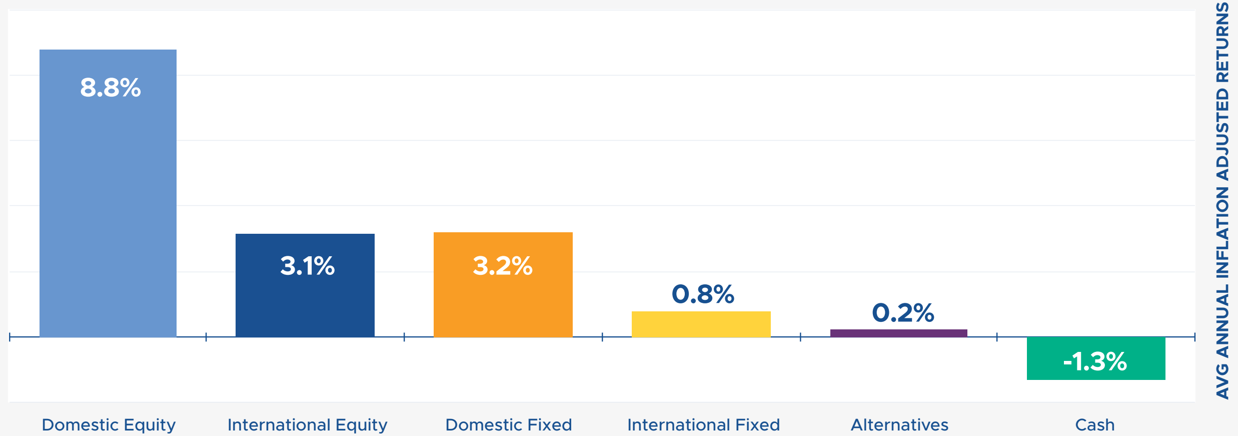
Another deadly investor sin: holding too much cash. And this isn't a problem concentrated amongst retirees— it is rife across all ages and demographics.

Much of it is driven by fear following the 2008 financial crisis. The severity of this downturn created a lingering psychological impact, whereby investors still don't feel "good" about the stock market or economy. As a result, they leave significant portions of their portfolios sitting in cash, often in excess of 20%. And with yields at next to nothing, this is akin to stuffing cash in a mattress.

Why is this a sin? It significantly hinders your long-term return potential. Historically, cash has generated the lowest annual returns out of the six major asset classes. The last 10 years serve as prime example of its inherent risk. After accounting for inflation, it was the only asset class to produce a negative real return. This means those with cash heavy portfolios technically paid a fee to avoid other asset classes.

The impact can be even more severe over longer time horizons. Most investors sit on the sidelines waiting for the "all clear" signal to jump back into stocks. Unfortunately, such a signal doesn't exist. And by the time they finally feel "good" about the market, they've already missed most of the upside. The S&P 500, for instance, has more than doubled since the March 2009 bottom. Many and more have missed a substantial amount of this bull market run.

Of course, there are times when holding larger cash balances make sense. The key is making sure it fits into your overall asset allocation.



*Data sources: Ibbotson Associates, MSCI, Standard & Poor's, World Gold Council, BP.com, US Energy Information Administration, Robert Shiller Online, MIT Center For Real Estate, Yahoo Finance. Calculations are based on the long-term historical performance of asset class proxies: S&P 500, MSCI EAFE until 2000 and MSCI ACWI ex-US post 2000, 10 Year U.S. Treasuries, 10 Year Foreign Government Bonds, and 30 Day T-Bills. Alternative asset class represented by a hypothetical index of 50% real estate and a 50% gold/oil combination.

Paying Excessive Fees

Most people don't actually know how much they pay for investment management or fund fees, and unfortunately it is often much more than they realize. Not all fees are easily understood, and many are embedded deep within investment products making them difficult to see. Over time they can be a significant drag on investment returns. Always know what you pay in fees. Aggregating your accounts on our financial dashboard can help.

PROFESSIONALS

Investors who choose to hire a professional often pay annual fees based on assets under management. Amounts vary wildly, but typically range from below 1% of assets on the low end to 3% on the high end. Some advisors directly pick stocks, while others pick mutual funds (often called wrap accounts or fund of funds). Paying anything near the high end of that range is almost never warranted, particularly for those picking mutual funds which come with their own set of fees. And if you use a broker, you could be paying sizeable commissions on each and every investment you make. Annuities and some other life insurance products are notorious for such commissions, which is why brokers are so quick to recommend them. So when hiring a professional, make sure you clearly understand what they charge, as well as any commissions you might be responsible for.

FUND FEES

According to the Investment Company Institute and Lipper, the simple average expense ratio of equity funds was 1.31% in 2015. And expense ratios are just the beginning. Mutual funds carry several additional costs—some visible and some hidden. These can include sales loads, which are paid to the selling broker, as well as similar fees paid to the fund company. There are also embedded costs associated with trading, research, and potential market impact (hidden fees). Add these up and the real cost of owning mutual funds is often 2% to 3%, or more. These are huge hurdles to overcome considering most funds don't outperform their respective benchmarks. And this doesn't even include the impact of taxes. The best way to avoid excessive mutual fund fees is to avoid mutual funds altogether (at least active mutual funds). ETFs are often cheaper, more tax efficient alternatives.

Poor Tax Management

Most don't like thinking about taxes. Many investors distance themselves from the topic, as it can seem too 'complicated', 'time consuming', or 'boring'. However, improper tax management can cost you more than 25 percent of your long-term return, severely limiting your spending power in retirement. The two most common tax missteps are not taking advantage of retirement plans and using tax inefficient investment vehicles, like mutual funds.

RETIREMENT PLANS

Almost all companies offer some form of tax advantaged retirement plan. It could be a 401k, a 403b, or a Roth 401k, among others. Individual Retirement Accounts (IRAs) are also available. While there are different rules surrounding contributions and withdrawals for each plan, a key similarity in all of them is tax-deferred growth. This is a major gift to investors, compliments of the US government. Why? The power of compounding. Investments grow unabated from taxes with dividends and income reinvested along the way. This significantly improves long-term return potential and the probability of reaching your most important financial goal: retirement. Moreover, most employers offer some form of matching contribution based on the amount you save into the plan. This is free money and only further improves your chances of success. So if you have the means to save, make sure to take advantage of any available retirement plans. You'd be surprised how many investors don't.

TAX EFFICIENT VEHICLES

There are thousands of investment vehicles to choose from, and each can have radically different tax implications. Knowing which are most efficient (and which are inefficient) is a vital first step in reducing your tax bill—it also helps filter your choices to a smaller, more reasonable list.

| Hypothetical Growth Of 100k Portfolio

Mutual Funds are notoriously bad from a tax perspective, and more than half of all American households own a mutual fund. High turnover often creates large annual tax bills. According to Morningstar.com, the ten largest mutual funds by assets had an average turnover ratio of almost 75%. Most of these are actively managed funds where managers attempt to outperform a benchmark by selling winners to lock in gains. The impact is clear. A 2010 study by Lipper (Taxes in the Mutual Funds Industry – 2010; Assessing the Impact of Taxes on Shareholder Return) showed owners of mutual funds in taxable accounts gave up an average of 0.98 percent to 2.08 percent in annual return to taxes over the last 10 years. This is significant. As seen in the figure below, a difference of 1% over 10 years results in over $17,000 less on a $100,000 portfolio.

Relative to mutual funds, Exchange traded funds (ETFs) are a step in the right direction. In fact, greater tax efficiency was the primary reason they were created. But the best way to mitigate taxes is to create a portfolio of individual securities, or a combination of individual securities and ETFs. This allows for tax management on multiple levels. With a wider set of options to meet cash flow needs, it's easier to defer gains into future years. And if you have to sell low basis positions, you can harvest losses from poor performers to mitigate or neutralize the impact.

If you have taxable and tax-deferred accounts, you can also tax locate. This involves placing higher yielding securities in tax-deferred accounts to shield their income. Additionally, income from most REITs and bonds does not qualify for the same favorable tax rate as stock dividends. It is advantageous to strategically place these securities in tax-deferred accounts. Combined, these tactics help maximize total portfolio value and reduce your annual tax bill.

Failure to Account for Inflation

Failure to account for inflation can be a costly mistake. Inflation eats into investment returns and can erode portfolio values over time.

As such, excluding it from projections will cause investors to underestimate the level of growth required to generate income. This will likely lead to an asset allocation that is too conservative.

Let's examine two scenarios. Both assume a starting portfolio value of $100,000 and starting annual withdrawal of $4,000. Inflation is set at 3%. In both scenarios, the $4,000 annual wit drawal needs to increase by inflation in order to accommodate the rising cost of living. The first investor properly accounts for this and builds a portfolio with a nominal projected return (before inflation) of 7%. The second investor fails to account for inflation and builds a portfolio with a nominal projected return of 4%, which he believes is sufficient to cover the $4,000 annual withdrawal (4% on a $100,000 portfolio). As seen in the figure below, the second investor's portfolio is depleted by year 30. Throw in a few poor performing years and the portfolio could deplete much sooner.

Living off Interest

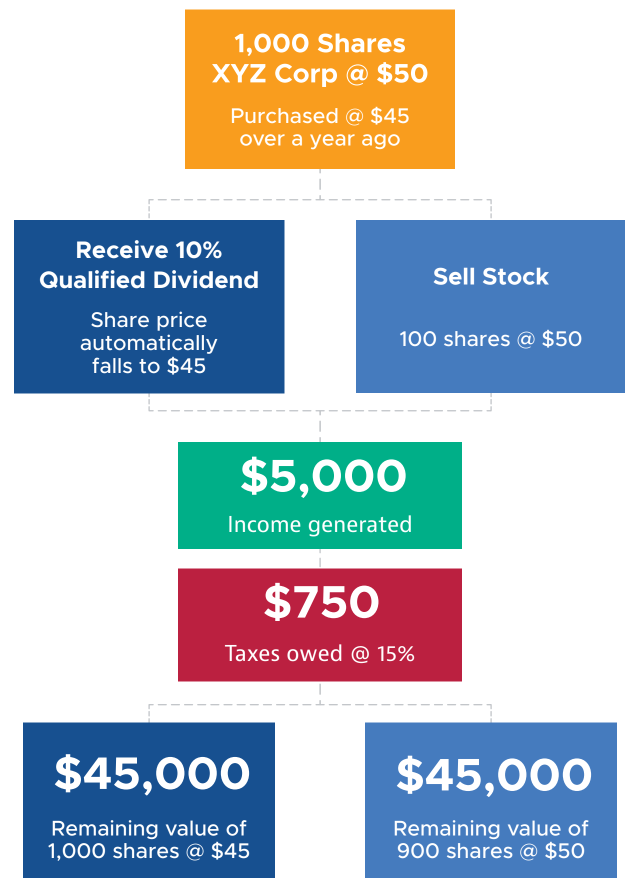
One of the most common misperceptions in investing concerns dividends and interest income. Put simply, many retired investors prefer higher yielding securities so they can "live off the interest". But this is primarily a psychological bias rooted in arbitrary mental accounting practices. In reality, capital gains provide the exact same economic benefit as dividends and interest income.

How does this misperception hurt investors? It's simple: it leads to less diversified portfolios.

In an attempt to generate more income, many investors build portfolios concentrated in high yield stocks. This can lead to unintentional economic sector bets. Telecommunications and utilities, for instance, tend to have a greater number of dividend paying companies. These sectors also happen to act very defensively—at least historically speaking. So while you'd likely be better positioned for down markets, you could miss significant upside returns during bull markets.

The pursuit of higher yields in the fixed income world poses an entirely different risk than stocks. Bond investors are typically compensated for risk through higher yields. This could be for default risk, interest rate risk, and/or inflation risk, to name a few. But regardless of the reason, higher yielding bonds typically carry higher risk. So investors looking to increase their level of interest income could unintentionally increase their portfolio's risk profile. Moreover, investors need to be wary of taxes. Qualified stock dividends and capital gains are currently taxed at the same rate. Not true for bonds. Interest is taxed as ordinary income, so increasing your portfolio's yield could also increase your tax bill.

Remember, there is no guarantee higher yielding investments will outperform their lower yielding counterparts over the long-term. Maintaining a diversified mix of both will shield your portfolio from unnecessary risk.



Poor Debt Management

No financial picture is complete without first examining household debt—the most common forms being mortgages and credit cards. Managed properly, both can provide valuable benefits in the form of tax deductions and/or improved liquidity. But managed inappropriately, the impact to your financial health can be substantial. Two potentially costly mistakes are selecting the wrong mortgage and keeping high interest debt.

MORTGAGE: Selecting the right mortgage mostly refers to the fixed/variable decision. In other words, does it make more sense to take out a fixed or adjustable rate mortgage, also called an ARM. Both have benefits. A fixed rate, for instance, is just that—it's fixed. This means regardless of what happens to prevailing interest rates, your mortgage payment will remain steady. Clearly this can be advantageous during periods of rising rates. In an ARM, however, your payments would change over time to reflect broader interest rate movements. While this would be hugely beneficial in a downward trending interest rate environment, it could be disastrous should rates rise.

A good rule of thumb is to base your decision on expected time horizon. If you expect to live in the home for less than 10 years, an adjustable rate mortgage could make sense. If rates increased, you wouldn't be subject to higher payments for very long. Conversely, a fixed rate mortgage could be appropriate if you planned to keep home for a significant period of time. Of course, there are always other factors to consider. For instance, mortgage rates currently sit at historical lows. This leaves more risk embedded in adjustable rate mortgages— there is more room for interest rates to move up than down.

Homeowners should also consider refinancing. It doesn't work for everyone, but it's easy to look into and certainly worth a shot. Additionally, you should be wary of your aggregate exposure to cash. While having a mortgage and some cash is okay, large amounts are only warranted if the yield is higher than your mortgage rate—an unlikely scenario in today's low yield environment.

HIGH INTEREST DEBT: One of the most common mistakes is carrying large credit card balances for extended periods of time. This is almost never appropriate. Paying off high interest debt should always be a top priority. One of the few exceptions is if doing so would prevent you from contributing to a 401k plan with an employer match—which is essentially free money. Otherwise, most credit card rates are simply too high to justify any other strategy.

Financial bliss is within reach

If you've committed one or more of these sins, don't be discouraged. You're not alone. Every investor stumbles from time to time.

Just remember, it's never too late to improve your financial health. Avoid these seven deadly investor sins from this day forward, and a spot in financial Elysium could be yours for the taking!

For more information give us a call at 855.855.8005.

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