The **Enlightened** Investor

Five mistakes to avoid for financial success

By Matthew Lekushoff, CIMA

A Note from Matthew Lekushoff

Many people today are facing difficult choices in achieving their financial goals and are asking serious questions. My goal with this white paper, *The Enlightened Investor*, is to help you avoid the mistakes investors commonly make.

I believe educated investors are the most successful investors. In creating *The Enlightened Investor* I wanted to highlight the potential pitfalls investors often fall into so that you can learn from them and make better decisions. This approach has been specifically designed to achieve two goals: to help you protect the money you already have, and to efficiently capture the market's returns to grow your investments. Additionally, I recognize that reaching your financial goals requires more than just good investment management. That's why the investment approach described at the end of this paper addresses an investor's entire range of financial issues.

I hope that this white paper will provide you with a framework for an intelligent approach to making financial decisions that will help you achieve your most important dreams.

Sincerely,

Matthew Lekushoff, CIMA
Financial Advisor
Raymond James Ltd.

Contents

Five key concepts for financial success

Although investing can seem overwhelming at times, it can be broken down into five key concepts for financial success.

If you examine your own life, you'll find that it's often the simple things that consistently work. Successful investing is no different. However, it's easy to have your attention drawn to the wrong issues. These wrong issues – the noise – can derail your journey.

In this section, we'll walk through the five most common investment mistakes that can stunt your financial success. Then we'll explain how you can incorporate the proper concepts into your investment plans. You owe yourself and your family nothing less than the best chance at achieving your goals!

It's important to note here that while these concepts are designed to maximize returns, it's virtually impossible to eliminate risk, which is inherent in all investments – unless you put all your money in a GIC. Whenever you invest, you have to accept some risk. It's also important to remember that unless you're working with a proactive wealth manager, you'll need to be responsible for regularly reviewing your portfolio and risk tolerance as your situation and the markets change.

Mistake One: Not Understanding Diversification

Most people consider the concept of "Don't put all your eggs in one basket" to be the extent of what they need to do to diversify their portfolios. That is too simple a view of diversification. This has led many to fall into a dangerous trap – one into which you may already have fallen – of believing they're protected when they really aren't..

For example, many investors hold a large part of their investment capital in the shares of the company they work for or the shares of their own business. Even though they understand that they're probably taking too much risk, they don't do anything about it. They often justify holding the position because of the large capital gains tax bill they would have to pay if they sold. Or, they imagine that the shares are just about ready to take off. Often, investors are so close to particular shares that they develop a false sense of comfort (the result of a psychological bias that we'll discuss in Concept Five).

This problem was widespread in the dot.com crash of 2000. Many employees not only saw their jobs disappear but also saw their net worth obliterated because of the large holdings they had in their company stock or that of another company in their industry. These investors thought they "understood" how the industry was doing, but they didn't see the crash coming.

Here's another example: Many investors believe that they have effectively diversified because their portfolio consists of shares of various companies. They don't realize that they're in for an emotional rollercoaster ride if these investments all belong to the same industry group or asset class – which means they all share similar risk factors. Investing all of your money in a number of bank stocks is not the definition diversification.

To be properly diversified, you should have investments from various (and, yes, diverse) asset classes, sectors and industry groups. Once you understand that not being properly diversified can harm you financially, you're ready to move onto the second mistake and consider how to put diversification into practice.

Mistake Two: Not Having the Proper Asset Allocation

It's not unusual for investors to feel that they could achieve better investment returns if they only knew a better way to invest. Unfortunately, many investors are overlooking the forest for the trees and potentially limiting their financial future. Often, investors get caught up in buying the latest "hot" stock or mutual fund without considering the overall makeup (i.e., asset allocation) of their portfolio. It's like creating a hockey team with only forwards and no defense – it would be foolhardy to expect to win without both.

As an investor, you need the right tools, and asset class investing is an important tool for helping you reach your financial goals in good and bad markets!

An asset class is a group of investments whose risk factors and expected returns are similar. Not so long ago, it was difficult for individual investors to find products that represented all the major asset classes. When you could find investments in certain asset classes, the minimum investment was in the millions of dollars, effectively keeping these asset classes beyond the reach of all but large pension funds and high-net-worth investors. Fortunately, the formerly hard-to-find asset classes are now accessible to all investors at a reasonable price, so you can gain the same advantages once enjoyed only by large institutional investors.

Broadly speaking, there are five major asset classes:

- fixed income
- U.S. stocks
- international stocks (including Canadian)
- REITs (real estate investment trusts)
- commodities

We'll look at each of these asset classes in turn, from least to most volatile:

Fixed Income

Historically, fixed income has been by far the most conservative and least volatile of the major asset classes. This is largely because bonds have been designed, for the most part, to have considerably less risk than other classes. Their conservative nature is due to the assured annual return or interest rate that investors can count on, with the exception of a bankruptcy. In the event of a corporate bankruptcy, bondholders are paid out in full before the owners (shareholders) of the company receive a dime.

U.S. Stocks

The U.S. stock market is universally recognized and accepted as not only the largest but also the most liquid stock market in the world. Over the past few decades, however, the definition of what a "U.S." stock is has changed somewhat. Many years ago, U.S. companies derived the overwhelming majority of their revenues from within their own borders. Today, U.S. companies often generate less than half of their revenues and profits from within the country. This has led to U.S. stock markets acting more similar to foreign markets than ever before, thus making it harder to properly diversify a portfolio.

REITs

In spite of the dramatic corrections in global real estate markets, the long-term risk/return performance of REITs has been significantly better over the last four decades than the other asset classes discussed here. Part of the reason for this is that REITs have consistently paid out a strong dividend, which has sheltered investors somewhat from declining overall returns. These dividends have also been viewed attractively by investors looking for income as interest rates have fallen. Another valuable advantage of REITs is the considerable diversification benefits they provide when used in conjunction with the other asset classes.

International Stocks

Broadly speaking, international stocks are publicly traded companies that are not listed on a U.S. exchange. As one would imagine, there's quite a bit of diversity between the varying regions that make up the "international stocks" asset class, including Europe, Asia, South America, the emerging markets and, of course, Canada. As mentioned above, globalization has considerably blurred the line between international and U.S. securities. For this reason, the correlations (benefits of diversification) between these two asset classes have diminished considerably, making the job of managing investments more difficult.

Commodities

Commodities include holdings in the energy, precious metals, base metals and agriculture sectors. They have the dubious distinction of having the highest risk or volatility amongst the various asset classes. They have also had the poorest investment returns over the past four decades. Based on this, one might think that avoiding this asset class would be a wise decision. However, when used appropriately and systematically (i.e., not in trying to time the market), commodities play an important role in improving the risk/return profile of a diversified portfolio.

Mistake Three: Not Having an "Efficient" Portfolio

How do you decide which investments to use and in what combination? Since 1972, major institutions have been using a money management concept known as Modern Portfolio Theory. It was developed at the University of Chicago by Harry Markowitz and Merton Miller and later expanded by

Stanford professor William Sharpe. Markowitz, Miller and Sharpe subsequently won the Nobel Prize for their contribution to investment methodology.

The process of developing a strategic portfolio using Modern Portfolio Theory is mathematical in nature and can appear daunting. But keep in mind that mathematics is nothing more than an expression of logic, so as you examine the process, you can readily see the common sense approach that it takes – which is counterintuitive to conventional, commercialized investment thinking.

In essence, Markowitz proved that for every level of risk, or volatility, there is an optimum combination of investments that will provide the best rate of return. This combination he dubbed the efficient frontier line. To create a portfolio that is on the "efficient frontier", one chooses investments for both their quality and their ability to complement each other to reach the best result given their level of risk.

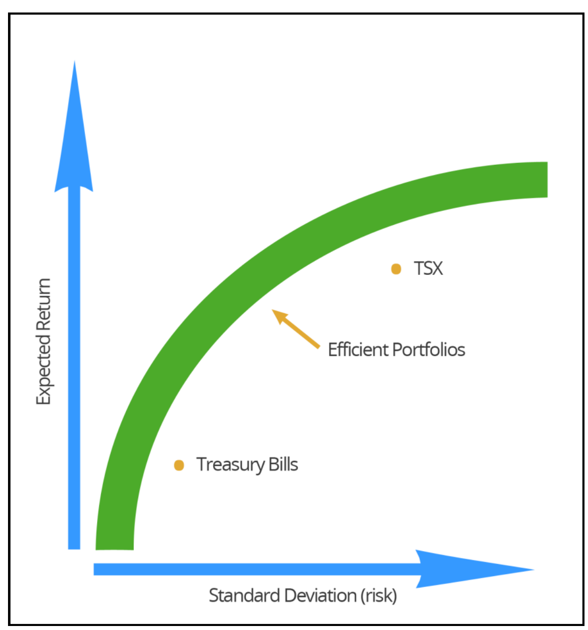
For example, when players are chosen for Team Canada in hockey, you may assume that only the best players in Canada are picked. This is not the case, nor should it be. Hypothetically if 6 of the 23 best players in Canada were goalies, it would make little sense to add that many to the team. You would also want specialists that could kill penalties or win face-offs. In other words, you start with a philosophy of how you want the team to play, and then you develop a list of the positions and number of players for each position that are needed to reach that objective.

With investing, you start with an idea of the return you would like to achieve while considering the risk you are willing to handle. This dictates the percentage of each asset class you should choose. Following that, the best investments in each category are chosen and double checked to ensure they balance each other out.

Most portfolios fall significantly below the efficient frontier as they rarely start with the required result (risk & return) in mind. Instead they often pick what they think are the best investments without considering how they will balance each other out in various market conditions. This was clearly seen in the dot.com boom when many portfolios were dramatically overweighted in technology companies. As you likely remember, they all went down at the same time in a similar fashion, providing virtually no "diversification" when it was needed most!

The graphic below illustrates the efficient frontier relative to the "market." As can be seen the efficient frontier optimizes returns whatever risk level you choose.

Exhibit 1. The Range of Efficient Portfolios



Mistake Four: Not Rebalancing

Creating a portfolio that serves your risk needs is clearly important. As discussed, that means investing in a diversified group of asset classes that creates the optimal returns for the amount of risk you're comfortable with. However, just creating an "efficient" portfolio and leaving it be isn't enough to generate the returns and manage risk. You need to adjust the portfolio appropriately from time to time. This is necessary because of something called "Portfolio Drift". This portfolio drift is something that very few investors give much thought to.

Portfolio drift occurs when asset classes have varying intermittent rates of return. The result is that they will start to make up a larger or smaller percentage of the portfolio than planned. For example, let's say that in your portfolio, REIT's made up 15% of your holdings. Now let's say that they were generating 10% returns and 2 other classes were doing 5%. Well, it's not going to be long before REIT's make up 17-20% of the portfolio, right? They're growing faster in that period. Although this can be beneficial in the short term, it can become dangerous over the long term when that asset class inevitably "corrects." When that happens, the portfolio will experience considerably higher volatility (i.e., losses) than one would expect. This would be the equivalent of a hockey coach putting on all forwards, and leaving no defense.

Many saw this happen during the 2008/2009 market correction, as investors suffered considerably higher losses than they needed to. Stocks had outperformed other asset classes by a significant margin in previous years, which led to bloated equity positions in many portfolios due to a lack of diversification. As a result, many investors' net worth and retirements were jeopardized because they either forgot or didn't know they were supposed to rebalance their equity positions down to their original holding targets.

Exhibit 2. The Benefit of Rebalancing

	SECURITIES NOT REBALANCED		SECURITIES REBALANCED YEARLY	
Year	Rate of Return	Ending Value	Rate of Return	Ending Value
Start Value		**$500,000**		**$500,000**
1	A= 25% B=-15%	$525,000	A= 25% B=-15%	$525,000
2	A=-15% B=25%	$540,000	A=-15% B=25%	$551,250
3	A= 25% B=-15%	$567,000	A= 25% B=-15%	$578,812
4	A=-15% B=25%	$583,200	A=-15% B=25%	$607,753
5	A= 25% B=-15%	$612,360	A= 25% B=-15%	$638,140
6	A=-15% B=25%	**$629,856**	A=-15% B=25%	**$670,047**
Increased Profitability from Rebalancing				**$40, 191**

Mistake Five: Not Understanding Investor Psychology

In other words: Investor, know thyself!

Investor psychology is one of the most problematic, yet least understood and thought-about aspects of the investment process. As human beings, we're poorly prepared to be wise investors given our natural response to fear and greed.

Tens of thousands of years ago, many of our great ancestors were rewarded for being overly cautious. Running away at the sound of a peculiar noise may have been embarrassing if it was just the wind, but doing so when it was actually a predator allowed our ancestors to survive long enough to have children. Those without this fear instinct may not have been so lucky.

However, overreacting to our well-conditioned fear instinct often causes investors to miss out on opportunities after a major market decline, such as the one seen in 2008/2009.

Below is a brief synopsis of some of the most prevalent psychological mistakes (but not all of them) we're prone to when investing.

Overconfidence

Investors naturally have varying degrees of confidence in their investment prowess This confidence level isn't always a reflection of their actual ability. Confidence can serve us well in many aspects of life, even in the absence of talent; however, investing is one area where confidence in the absence of ability can be particularly punitive.

Overconfidence may be most prevalent when the odds are near even. In other words, when facing a decision with a 50/50 chance of success, we often have a much higher expectation of success than we should. When investing, this often occurs when investors believe they can "time" the ups and downs of the market – and then make significant financial bets on that perceived ability.

It may not be surprising that men tend to experience this overconfidence effect considerably more often than women. The result is that male investors often have returns that are considerably more volatile (i.e., larger profits and losses) than their female counterparts. Overconfidence is also fed by the next psychological pitfall: over-considering the past.

Over-considering the past

Most of us know the George Santayana saying, "Those who don't learn from history are doomed to repeat it." The saying has considerable merit, but it's important to note that the lessons of short-term history can be radically different from the longer-term perspective.

For example, before Hurricane Katrina hit in 2005, there had been many years of low hurricane activity in the region. As a result, insurance companies earned strong profits from low insurance claims. This led to lower premiums, given the perceived low risk of future hurricanes. Investors also noticed the easy money these "conservative" insurance companies were making. Unfortunately, many people made the mistake of assuming the recent past (rather than longer-term trends) would predict the future. When Hurricane Katrina hit, many insurance companies were bankrupted because they had inadequate reserves to pay for a hurricane that was actually quite predictable from a longer-term perspective.

Short-term trends affect both overconfident and pessimistic investors in a similar way. Both believe that the current trend will continue, and then fail to plan or act in a logical manner when the markets revert back to their means.

Pride and regret

Have you ever heard someone say "I'll sell my shares when I break even"? This is often called "get-evenitis" by those who study investor psychology. Frequently, when investors are losing money on a particular security, it becomes a personal matter for them. It's believed that this occurs because it's easier for investors to blame the company they own than to admit they made a mistake. Selling the security at a loss would be admitting the investor's own mistake. On the other hand, if the investor waits until they break even, then all is good again.

Unfortunately, attempting to get your money back the way you lost it isn't much different in the stock market than it is in gambling… it usually ends badly!

Representativeness and familiarity

For the most part, people are comfortable with what is familiar to them. This isn't just a social phenomenon. It's also an investing phenomenon. For example, before their respective stock market crashes, Japanese investors had 98% of their investments in Japanese holdings and Greek investors had 93% in Greek holdings. This over-allocation of securities from within their borders, or "home country bias," has very little investment reasoning to it and more of a psychological one. It isn't just a Greek or Japanese phenomenon, either. Other countries, including New Zealand, the U.S. and even Canada, also struggle with this tendency to own securities from within their borders. It makes sense psychologically – these companies are where we shop, or provide the services we use, or are companies we hear about in the news.

Home country bias even extends to employees, often with disastrous results. It was common during the dot.com boom for employees to either have stock options or share purchase plans to acquire stock in the company for which they worked. As the boom continued, these shares enviably increased in value and employees often increased their holdings, since it looked like their profits would continue to grow. They erroneously figured that working for the company they were investing in gave them an inside track on how the company was doing. Unfortunately, many people saw their net worth destroyed when the entire sector imploded. Compounding that tragedy, many also lost their jobs or saw their incomes fall dramatically.

Investors must be careful not to allow their net worth to be overly determined by the country they live in or the company they work for just because of familiarity.

Social proof

Highlighted in Robert Cialdini's classic book Influence, social proof outlines how our surroundings influence us to make decisions that aren't always the wisest. As much as we all want to believe we are unique and make our decisions based on our own instincts and values, this is less true than we may think. Walking the streets of Toronto I can't tell you how many times I've seen dozens of pedestrians waiting to cross at a red light when there isn't a car in sight. Finally one brave soul starts walking and the rest, assuming he must be right, inevitably follow.

This herd mentality is prevalent in investing as well. Part of the reason the housing market in the U.S. became such a bubble was that the media, friends, co-workers, even taxi drivers all had stories about how much money had been made buying property. It became universally believed that property could never go down in value. This made it almost impossible for many people to stay away from real estate given the huge profits others had been making on it for years.

There will most certainly be other "hot" trends – from real estate to commodities to technology or something else we haven't heard of yet and this hot trend will catch the fascination of the masses. The key to sound investing is to take a step back and look at each situation with a level head.

When considering how to protect yourself from your psychological mistakes, there are two keys things to remember. First, make sure you understand the various aspects of investor psychology, especially any blind spots you are personally susceptible to. Second, make sure you have a well-defined system or plan for investing that you follow closely. Having a system or plan – as opposed to investing by "feel" – can insulate you from the many psychological blunders that have hurt the net worth of countless investors.

If nothing else, I hope this paper has opened your eyes to the 5 most frequent mistakes that investors can fall prey to. I will consider this a success if it does nothing more than give you pause long enough to stop yourself from making costly investment decisions that could potentially hurt or even cripple you and your family's financial future.

An enlightened approach to your financial life

Money means different things to different people. What is your dream?

What's your dream? You may want to achieve or maintain financial freedom so that you never have to work again – even if you plan on working for the rest of your life. You may want to make it possible for your children or grandchildren to have a high-quality education. You may dream of a holiday home on the beach or abroad. Or, you may have achieved tremendous success throughout your career and want to leave behind an enduring legacy that will enable your favourite charity to continue its work.

Whatever your dreams, you need a plan to help you make wise decisions about your money. A plan that will enable you to achieve everything that's important to you. Chances are that you have a wide range of financial goals, as well as diverse financial challenges. We know from experience that a broad range of issues requires a broad, comprehensive outlook. It's for this reason that most affluent clients want their financial advisors to help them with more than just their investments. These clients want real wealth management – a complete approach to addressing their entire financial lives.

True wealth management is much more than just investment management. The challenge for anyone who wants help addressing all of their financial needs is finding a trusted partner that provides true, comprehensive wealth management.

We define wealth management as a formula:

WM = IA + AP + GS

Investment Advising (IA) is the astute management of investments over time to help achieve financial goals. It requires financial advisors to have a deep understanding of their clients' most important challenges. It also requires financial advisors to design an investment plan that takes into account investors' time horizons and tolerance for risk, and describes an approach that will maximize the probability of them achieving their goals. Finally, it requires financial advisors to monitor their clients' portfolios as well as their financial lives over time, so that they can make adjustments to the investment plan as needed.

Advanced Planning (AP) goes beyond investments to look at all other aspects that are important to clients' financial lives. We break this down into four parts. 1) We assess where you currently are financially. 2) We make sure we understand what goals you have for you and your family that involve money, planning and time. 3) We develop the most efficient (in terms of taxes and logistics) plan to achieve your goals. 4) We help you implement and stay on top of the tasks required to achieve your plan's goals. Then we start the process all over again as your situation or goals evolve.

Great Service (GS) is the final element. Great service can mean different things to different people, but there are usually a number of elements everyone agrees on. These include consistent and regular contact, proactive investment and taxation advice, access to a strong network of financial professionals, financial education and, perhaps most importantly, someone trustworthy who can always be counted on to act in your best interests.

About Matthew

A Certified Investment Management Analyst, Matthew is one of less than 200 Canadian advisors with that advanced accreditation. A University of Western Ontario graduate, Matthew has been in practice as a financial advisor for 16 years and with Raymond James Ltd.'s flagship Toronto office, The 53rd, for over six years.

A deep thinker on economic realities and extremely well read, Matthew is also a dedicated proponent of continuous professional development. He completed the requisite Canadian Securities Course, as well as additional courses with the Investment Funds Institute of Canada.

Despite a prolonged period of market volatility and economic uncertainty, under his proactive guidance and watchful eye, Matthew has taken great satisfaction in organizing his clients' financial lives to help their financial worth grow.

Matthew is privileged to call many of his clients friends, given the close, trusting relationships forged over a career devoted to managing their financial affairs with both insight and discretion.

RAYMOND JAMES®