COMPASS WATCH

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INVESTMENT MISTAKE #4: INVESTING IN THINGS YOU DON'T UNDERSTAND

Every now and then, when the times seem to warrant it, we write about "investment mistakes" and how to avoid them. Our comments are not only suggestions for our readers, but reminders to ourselves since it is all too easy even for experienced, professional investors to be wrong on occasion. Previous "investment mistake" articles in Compass Watch have included: #1: Chasing Returns (Spring 2005); #2: Ignoring Risk (Spring 2006); and #3: Lack of Discipline (From Too Many Choices) (Winter 2006). At the present time, it is obvious that much damage to the economy and financial markets has come from investing in things which were poorly understood. At the top of the list are the many mortgage-related securities which have shaken our financial systems to the core, from individual companies like Bear Stearns, Citigroup and Merrill Lynch to massive U.S. government agencies like Fannie Mae and Freddie Mac. By failing to understand adequately the true credit quality and other vital investment characteristics of these highly-complex securities, a serious financial crisis has been created which may take many months, perhaps years, to unwind.

It is also becoming painfully clear that in many cases retirement plan participants are being provided investment choices they don't understand and this is leaving them well short of their investment goals at retirement (see "When 401(k) Investing Goes Bad", Wall Street Journal, Monday, August 4, 2008, The Journal Report, page R 1 ff). Already by 1995 and updated since, Dalbar, a Boston-based financial services research firm, was publishing studies showing that mutual fund investors (many of them retirement plan participants), were only earning a fraction of the return of the mutual funds they were investing in.[1] The reason for this is that many investors tend to get in at the top and out at the bottom – a good way to lose, not make money. Some of this problem is simply "chasing returns," which never works. But the more basic problem is a failure to understand the investment choices themselves - - how they operate and why.

Warren Buffett, one of the greatest investors of all time and one of the world's richest persons due to his investing prowess, has much to say about understanding one's investments. Quotations attributed to him are sprinkled throughout the financial press and, although frequently cited, are much less frequently followed. Like these: "Risk comes from not knowing what you are doing," or "investment must be rational; if you don't understand it, don't do it." And, one of our favorites: "You should invest in a business even a fool can run, because someday a fool will."

Even if one believes they truly understand an investment, however, surprises do occur. Managements change, companies face litigation, tax rates may go up, new regulations can hobble a company and competitive threats suddenly appear. Nevertheless, successful investing necessitates tilting the odds in the investor's favor. This is done, in part, by careful price and valuation analysis. But even more important is truly understanding what an investment is and does. Right now there are many financial institutions (and the taxpayers bailing them out) who are wishing they had understood their investments a whole lot better than it turns out they actually did. Investing in pools of overpriced-home mortgages, supported by holders who were unable to pay them back, never was a great investment idea. They should have understood that.

At Compass, we work very hard to research and understand the investments we make long before committing funds to them. Then, after making these investments, we continue to monitor and study them carefully. Good investments can still decline in value and it is possible to lose money, even in investments you understand. Nevertheless, an essential characteristic among successful investors is that they know what they are doing and why. And that is our promise at Compass.

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[1] For more information about Dalbar's work, see Compass Watch, Vol. 17, No. 1 (Spring, 2005), "Investment Mistake #1: Chasing Returns."

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