

4 Critical Errors You Must Avoid

By Richard Gibbons

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You might not know it, but you have some real advantages over the so-called pros on Wall Street. Make the most of them. Start by avoiding these four common errors.

For all the attention lavished on the guys who manage hedge funds and mutual funds, nothing beats being a small investor. Peter Lynch said as much in his classic, *One Up on Wall Street: Big institutions have the resources, but we have the potential for extraordinary returns.*

Poor Warren Buffett?

For one thing, we can invest in any company we like. Warren Buffett would love to be able to say that. Instead, his company, Berkshire Hathaway, holds billions in cash because Buffett can't find anything cheap enough to buy. With so much to invest, Buffett must focus on large-cap, super-liquid companies. It must be dreadful having so much money.

Even better, unlike huge institutional money managers, we don't have to perform every quarter. We don't have to jump on every fad, or pretend to be "active" out of a fear of falling behind. We don't worry what our manager or clients think of us. We can focus on buying the best companies at the cheapest prices.

Don't look this gift horse in the mouth. Digging up these rare values is what I -- along with Philip Durell and thousands of "small" value investors -- do every day at Motley Fool Inside Value. Sadly, too many individual investors do not fully exploit these advantages and as a result never reach their true potential to trounce the market.

Trust me, you do not want to be one of those underachievers. Fortunately, by simply avoiding these four common mistakes -- all of which I've made myself at some point -- you can dramatically increase your long-term returns.

Mistake No. 1: Trying to time the market

Each week, hundreds of stocks move up or down 10%. If you could just figure out which stocks will move which way, you'd be rich in no time. Some even seem to bounce between price levels, the way KLA-Tencor (Nasdaq: KLAC) has mostly bounced between \$40 and \$50 for the past five years. If you could just buy at the lows and sell at the highs, you'd have a profit machine!

It's a great idea, except that it doesn't work. Over the short term, price changes are essentially random. People are masters at spotting patterns even in random data. Look at a chart long enough and a winning strategy will appear -- only to evaporate when real money is

at stake. You win sometimes with such a strategy. And you lose sometimes. So it goes with random events.

When investing, you want your results to be less like the flip of a coin and more like the flip of a cat. There's some chance of the poor kitty bonking his head, but the smart money says that he'll land on his feet. So don't time the market. Focus on a proven strategy like value investing, where the expected return is significantly higher than average.

Mistake No. 2: Ignoring costs

Fees, trading costs, and taxes are the bane of the small investor. People "manage" your assets because they want their cut. This can take many forms: fund expenses, trading commissions, account management fees, and the spread between bid and ask prices on stocks. If there's any profit left, the government is quite eager to step in and take its share.

Always be aware of the fees you'll be paying. Recognizing that higher costs mean lower returns, you should plan to minimize fees and taxes. Buy funds with low expenses. With your personal portfolio, avoid needlessly swapping stocks. You'd be amazed how frequently fund managers do precisely that, and how much it costs you in taxes and commissions.

Mistake No. 3: Buying the hype

China is growing wildly and presents incredible opportunities. Satellite radio is the next mass communications medium. The Internet revolution will seem like a blip compared with what's going to happen with nanotechnology, and Veeco Instruments (Nasdaq: VECO) provides the tools that nanotech companies need. With oil so high, the need for electric cars becomes even more important.

All that's true. But that doesn't mean you can buy Ballard Power (Nasdaq: BLDP) because it's one of the leading fuel cell manufacturers and expect to make a fortune. Nortel Networks (NYSE: NT) was a manufacturer of Internet technology at a time when the world's communications shifted from analog to digital. Yet investors who bought at the highs lost most of their money.

Hype usually involves some truth but says little about whether something is going to be a good investment. When confronted with large demographic, political, or technological trends, never just assume that the trend will provide a sufficient tailwind to power your portfolio.

Instead, examine the company-specific factors. A tailwind is nice, but it's critical to understand the competitive advantages of companies in the space. Ask yourself why this company will be able to exploit the trend better than its competitors. Apple (Nasdaq: AAPL) has flourished -- well-intentioned imitators have not.

Mistake No. 4: Betting the market as a casino

The stock market can feel like Vegas. A gambler can go to Harrah's and get lucky tossing dice. An investor can, in complete ignorance, buy a stock, get lucky, and make money. You don't get turned away from either for lack of knowledge or even common sense -- only lack of cash.

Unlike many Fools, I think it's perfectly reasonable for people to gamble on the stock market for entertainment, just as I think it's perfectly reasonable for people to gamble at casinos for entertainment. But I think gamblers in either case should not be surprised, upset, or outraged if they lose money.

But if your goal is to make extraordinary profits, then don't treat the stock market like a casino. Don't buy on hunches or speculations, but because you understand the company and recognize that it's selling at a discount to its fair value. Always have a good grasp of (1) its fair value, (2) the company's strategy, and (3) the challenges that it is likely to face going forward.

Again, I follow this process myself every day -- in my work at Inside Value and when managing my own portfolio. In my experience, this is the only way to buy stocks that offer a superior risk-reward trade-off.

What next?

By simply avoiding these four mistakes, you can dramatically improve your chance of success. Focus on value stocks with a suitable margin of safety, and look at the entire market. Then you can really exploit your advantage as a small and nimble investor. Peter Lynch (and Warren Buffett) would be proud.

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Fool contributor Richard Gibbons, a member of the Inside Value team, has no position in any of the stocks discussed in this article. He tosses cats only infrequently, so no felines were injured during the writing of this article. The Motley Fool has a disclosure policy.