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Avoid These Three Investment Mistakes

By Morningstar.com

Whether it's the Dutch tulip craze of the 17th century, the dot-com mania of the late 1990s, or the most recent rush into real estate, there's no shortage of examples of investors behaving irrationally.

In the world of traditional economists and finance professors, though, that's not supposed to happen. If investors are rational decision-makers, then emotion-driven bubbles shouldn't be possible. Yet human weaknesses can limit our ability to think clearly. Many studies of investor behavior have shown that investors are too willing to extrapolate recent trends far into the future, too confident in their abilities, and too quick (or not quick enough) to react to new information. These tendencies often lead investors to make decisions that run counter to their own best interests.

The idea that investor psychology can result in poor investment decisions is a key insight of an increasingly influential field of study called behavioral finance. Behavioral-finance theorists blend finance and psychology to identify deep-seated human traits that get in the way of investment success. Behavioral finance isn't just an interesting academic diversion, however. Its findings can help you identify – and correct – behaviors that cost you money.

What commonplace mistakes should investors avoid? Here are a few key behavioral-finance lessons worth heeding.

Don't Read Too Much into the Recent Past

When faced with lots of information, most people come up with easy rules of thumb to help them cope. While useful in some situations, these shortcuts can lead to biases that cause investors to make bad decisions. One example is "extrapolation bias," the over reliance on the past to assess the future. Instead of doing all the necessary and possibly tedious homework in researching a potential investment, investors instead "anchor" their expectations for the future in the recent past.

The problem, of course, is that yesterday doesn't always tell you what tomorrow will bring. If you don't believe us, just ask investors who swarmed red-hot technology and Internet-focused stocks in 1999 and 2000 expecting the good times to continue. They didn't, and most folks ended up suffering huge losses.

That's worth keeping in mind if you're drawn to the strong performers of recent years, whether it's real estate, natural-resources, emerging-markets, or even small-value stocks. The recent volatility in those areas is a reminder that the past is no guarantee of future performance.

Realize That You Don't Know As Much As You Think

In a 1981 study asking Swedish drivers to assess their own driving abilities, 90% rated themselves as above average. Statistically speaking, that's just not possible. But most of us are just like the Swedes: We think we're more capable and smarter than we really are. As an investor, you should check your excessive optimism at the door. You might believe you're more likely than the next guy to spot the next Microsoft, but the odds are you're not.

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Changes for 2009

- Employers begin using new withholding tables starting April 1st. Part of the American Recovery and Reinvestment Act of 2009, the "Making Work Pay" credit is phased out for married couples filing a joint return who have modified AGI between $150,000-$190,000. The single (including head of household and married filing separately) phase-out is between $75,000-$95,000.
- Congress recently passed a bill that temporarily suspends the tax penalty for seniors who do not take a required minimum distribution from their retirement accounts.
- The Social Security wage base increases to $106,800 (previously $102,000).
- Maximum 401(k) contributions increase to $16,500 (previously $15,500). Those 50 and older can contribute an additional $5,500 for a total of $22,000.
- The ceiling on SIMPLEs increases to $11,500 with an additional $2,500 for those 50 and older.
- The annual Gift Tax Exclusion increases to $13,000 per recipient, an increase of $1,000 from 2008.

Questions or comments? E-mail us at jperryman@billperryman.com or call (972)770-4800.