

Avoid Making Mistakes with Mutual Funds

By Cal Brown, CFP

What are some mistakes that people make investing in mutual funds?

Perhaps the first mistake people make is not understanding the type of mutual fund they are using, the investment objective, and the risks involved. Some mutual funds are quite safe (Money-market funds, tax-free municipal bond funds), while others are very risky (gold and other “sector” funds). There are many different types of mutual funds, ranging from tax-free municipal bonds, international stock, gold-mining companies, as well as several other types.

But the biggest mistake people make is not buying when prices are low; instead they buy when prices go up. The best times to buy in the past two decades were in October, 1987 (right after “the crash”), during 1989, the last few months of 1990 and in the bear market of 2000-2002. It takes courage to buy when everyone is pessimistic, but that is always the best time because prices are drastically reduced. We will drive all over town to buy clothes on sale, but when stocks go down (“on sale”), most people won’t buy.

People also make the mistake of trying to “time the market.” They try to guess when the market has “bottomed out” so they can buy, or when it has “peaked” so they can sell. It makes more sense to focus on long-term objectives (such as retirement income adjusted for inflation), rather than to speculate on the near-term market impact of current events. In January 1991, a client called me and sold all her shares in a stock mutual fund the day we started bombing Iraq, because she thought the stock market would go down. But her fund went up 10.3% in less than a month! She lost out because she did not “buy and hold.” Historically, the stock market has spent about two-thirds of its lifespan going up, and it’s tough for anyone to beat those odds.

People are mistaken when they ask questions like this: “What is the mutual fund that is paying 15% this year?” Anything that high would have to be a stock mutual fund; the principal is not guaranteed and it won’t pay interest (although it may pay a small dividend). There are several funds which have averaged 15% per year over a 5-year or 10-year time period. But that is an average – the fund did not go up 15% each and every year! It may have gone up 40% one year, down 20% the next, up 5% the next, up 12% the next, followed by another down year.

It may have averaged 15%, but there were ups and downs along the way. The important thing is to pick a mutual fund with a good long-term track record. It is a mistake to select a fund just because it was up 40% or some other extraordinary number last year. More often than not, the best performing fund one year has been a poor performer the next year. It is much better to look at consistent performance over 3- 5- and 10- year time periods.

If you will avoid these mistakes, you can do quite well investing in mutual funds. Equity ownership (i.e., stocks) quite simply is the best way for most individuals to beat inflation

and earn a long-term return on their savings. While there is no ideal, riskless, high return investment, successful investors consistently apply a reality-based discipline. Fear and greed are always your enemies; discipline is always your ally. So, buy good quality funds on a regular basis and hold them for the long haul.