Avoid These Six Nest Egg Mistakes!

By David G. Dietze, JD, CFA, CFP™
Founder, President and Chief Investment Strategist
Point View Wealth Management, Inc.
March 30, 2014

The market is a bit like the weather. We spend a lot of time talking about it, but the truth be told there's not much we can do about it.

However, much as you can prepare for a wide range of climatic conditions, investors can prepare for various economic scenarios. It's just a question of being humble about the clarity of your crystal ball and recognizing and compensating for certain behavioral instincts that can be injurious to our economic welfare.

Here are six ways you can put the odds in your favor for whatever the market throws your way.

1. Don't Over Diversify

Diversification. It's the only free lunch in investing. It's guaranteed to reduce your risk, without necessarily reducing your returns. It's the only responsible strategy in a world where you don't have tomorrow's Wall Street Journal today.

There are diminishing returns from diversification. Two positions cut your risk in half, three positions by another sixth, four positions by another twelfth, etc.

The extreme over diversification comes when you're working with mutual funds. Most mutual funds have over 100 positions. With one fund, you've virtually eliminated the risk of a single stock blow up.

The problem arises when you start adding funds to your portfolio the way you might add individual stocks. You're not getting more diversification benefits; at best you can expect to mimic the market, because your portfolio is approaching holding everything in the market. There is no focus; one fund may be selling what another is buying. There are too many uncoordinated left hands and right hands.

Holding everything in the market is an index fund strategy. If you've turned your portfolio into one large index fund, you're wasting your time paying high fees to star managers, the actions of which may well be cancelling one another out.

Avoid over diversification, particularly with mutual funds, or throw in the towel and select a low cost index fund.

2. Eschew Under Diversification

No one admits to being under diversified. Still, it happens time and time again. The most likely causes are attachment for your employer's stock or stock received from a loved one.

There's no doubt that the typical investor knows the business where she works best. That breeds confidence. However, it doesn't justify an overweight position in that security.

We've seen over and over how even the C-suite was in the dark about its own business. Think AIG, Lehman, WorldCom, Enron, and Tyco. If senior management is clueless what hope do you have?

Remember, your job's already at the risk of your employer's health. Don't add to the risk by holding stock in the employer, to say nothing of having it comprise too much of your nest egg.

The story is similar with stock received as a gift or inheritance from a family member. Although you don't have your job at risk with the same company, too often the outsized exposure is rationalized because the family member admonished you to hold onto the stock. Or, you think it's always been a family holding so it should stay that way. That type of justification doesn't warrant failing to reduce your exposure and staying diversified.

3. Buying High Selling Low

Everybody wants to buy into a winning story, a manager that's doing well, a favorable trend. Indeed, in most areas of business you keep adding resources to what's working and subtracting from what's not.

Investing is different, because what appears to be working will often be priced that way. In the markets, everything is generally priced according to the prevailing story. You won't make money by paying top dollar or more for a story that's already known to other investors.

It's an unfortunate fact that few investors capture the returns of the average mutual fund. After the fund has turned high, investors stampede in, only to beat a hasty retreat when performance starts easing.

Consider that most investments are cyclical; reversion to the mean is the rule. Stick with quality investments, but buy them when shunned by the public, or simply out of favor. Ease up your buying or exit when the masses embrace them. Try to buy low, sell high.

4. Failing to Consider the Tax Implications of Every Investment Decision

For taxable investors, it's axiomatic that it's not what you make that counts, but what you make after taxes. You can't change the tax laws, but you can change your behavior to minimize the cost.

The easiest way is to reduce your trading. Before swapping positions consider carefully the tax liability you'll trigger by taking profits on your investment. In many cases the possible advantages of the trade will be outweighed by the certain tax bill.

There's a host of other ways to reduce your taxes. Prefer individual stocks to mutual funds; that way you're in charge of the trading, not the fund, and you don't risk paying taxes on profits from periods before you invested.

Hold your investments in the accounts that make the most tax sense. Keep your ordinary income producing investments, like CDs, most bonds, and REITS in tax sheltered accounts. Keep your stocks, which receive favorable treatment on dividends and long term capital gains, in your taxable accounts. Indeed, any unrealized appreciation on a stock is forgiven entirely if still held on the date of passing.

Further, hold fast growing investments like stocks in your Roths and 529s, because most profits generated there are completely tax free.

If buying bonds in a taxable account, consider tax exempt ones. They may yield less but net you more because they're tax free. Analyze if you come out ahead by dividing the tax exempt rate by one less your marginal tax rate to get a tax equivalent yield.

5. Over Doing Your Emergency Fund

The party line is to have 3 to 6 months of living expenses in cash at all times. Given that cash has never yielded less, that advice can be quite costly.

Emergency funds make less sense the bigger your nest egg. After all, you can always sell securities to cover a crisis. Sure, they may be down and you feel selling may not be to your advantage. Offsetting that is that a depressed market reduces your tax bill and the much feared emergency is unlikely to occur. You may be able to do some buying elsewhere, like in an IRA, which can take advantage of the depressed selling conditions in your taxable account.

Consider, also, if you've got other resources in an emergency, such as borrowing against your investment account, your home, or from others. Disability insurance, a working spouse, and severance payments may also make the expense of maintaining a large emergency fund too much.

Even if you decide to maintain an emergency fund, you may not need to keep it all in cash. Consider investments that typically zag when stocks zig; high quality bonds may be a more constructive use of your emergency money than mere cash.

6. Holding Your Stocks in Your Safe Deposit Box

In the day it was fashionable to hold your securities in a safe deposit box. Many bonds were "bearer" ones, meaning they belonged to whoever had physical possession, so like cash you wanted them locked up.

Today, however, nearly all securities are registered, meaning that you have recourse to the issuer or its agent in the event of loss or theft.

More importantly is the potential for loss of dividend payments mailed to you or your security becoming obsolete due to organic changes affecting the issuer. We had a client whose son lost the value of his American Motors stock certificate after it merged into Chrysler, which then merged into Daimler. While they should have, neither Chrysler nor Daimler would honor the American Motors certificate, and the value did not justify a full blown law suit to remedy.

Some like the safe deposit route as a technique to enforce a buy and hold strategy. You can't sell what it's not easy to get your hands on.

However, out weighing that is the hassle and risk of multiple 1099s and mailed dividend checks, while taking the risk that your safe deposit security becomes out dated.

In sum, put the odds in your favor by avoiding these nest egg errors.