Own investment funds and not individual securities

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Summary: Owning individual securities is just a big waste of your time and money. Individual investors tend to be terrible investment portfolio managers. Almost everyone can hire an index fund manager to do a much better job for far less time, money, risk, and consternation. A previous article, "The Solution - ONLY follow financial strategies that are scientific, passive, diversified, savings focused, risk controlled, low cost, and tax efficient," suggested that individuals are much better off with a well-considered financial viewpoint. A stable set of financial beliefs can help you to keep focused and on track throughout your life. This follow-up article discusses the need to own funds rather than individual securities in your portfolio.Own low cost cash, bond, and stock mutual funds and exchange-traded funds, and avoid owning individual stocks and bonds. Low cost index funds automatically provide a higher level of diversification. This tends to increase your net returns significantly, when investment expenses, taxes and the value of your time are considered. The securities industry pushes individual investors to buy and sell individual securities to earn commissions, but the markets tend not to compensate individuals to taking these undiversified risks. Under-diversified investors subject themselves to higher volatility without any reasonable expectation of better returns. (See: Why is diversification valuable to individual investors? and Calculating your investment wage and the opportunity cost of your time)The average individual is an atrocious investment portfolio manager. Overall, the average individual portfolio self-manager probably loses about 2% each year relative to a low-cost, passive index investment strategy. (See: What is the cost to individual investors of sub-optimal portfolio diversification?)Numerous factors cause the sub-par results that the average individual investor achieves through portfolio self-management. The reasons vary from person to person. An incomplete list of the causes includes:
a) His costs are much higher.b) He trades far too frequently and often without any real information to justify a trade.c) His screening and analysis methods are rudimentary at best.d) He only buys companies locally visible or featured in positive media stories.e) He endlessly and fruitlessly chases past performance.f) He fails to diversify and bears substantial uncompensated enterprise risks.g) He maintains overly concentrated and thus more risky positions.h) Often, he holds concentrated investment positions in the same entity that issues his paycheck.i) He holds on to his losers far too long, and he sells his winners much too soon.j) He remembers his wins and may brag about them. He tries to put his losers out of his mind, yet often he still holds them in his portfolio and ignores them. After he finally sells them or they go bankrupt, he removes them from his records to eliminate any painful reminders.k) He pays more in taxes, and he pays taxes at higher short-term rather than long-term capital gains tax rates.l) He does not accurately track his performance against any appropriate market benchmark. Therefore, he does not learn how relatively poorly he has done.m) He tries to time the business cycle and the popularity of industry sectors.Competently managed investment firms would dismiss any professional who exhibited similar behaviors. (While male pronouns were used in the list above, the scientific finance literature indicates that females also exhibit these behaviors, although perhaps not to the extent that males do.)The easy way to avoid all

these problems is just to stop trying to do what professional index fund managers can do far better for you with much lower costs and with greater economies of scale. Buy only low cost money market, bond, and equity mutual funds and exchange-traded funds.   (See: Scientific mutual fund and ETF screening criteria: a summary)In most cases, you should methodically liquidate your individual stock and bond holdings over time, as you rebalance and as you have other reasons to dispose of them in a cost-effective and tax-efficient manner.There are some limited circumstances where one might continue to hold individual stocks and bonds. For example, elderly persons with substantially appreciated stocks may believe that the potential to reset the tax basis of these securities, when transferred upon death, will outweigh the diversification risk. Another example would be an executive who is required by an employment contract or other pressures to hold the securities of his or her firm. Most people do not fall into these categories and should divest themselves of individual stocks and bonds.

How VeriPlan can help: VeriPlan will project portfolio values based upon historical risk premiums. If you hold assets that are undiversified to a moderate or significant degree, you should pay particular attention to variations in return assumptions. VeriPlan’s Portfolio Risk Tool gives you the automated ability to vary return assumptions both systematically and arbitrarily. As with anyone using VeriPlan, you should test return variations that are both above and below your centerline projections. However, you should give particular attention to developing lower projections, because the scientific literature indicates that the typical undiversified individual investor under-performs rather than over-performs the market even before costs and taxes are considered. (See: VeriPlan helps you to project your future risk-adjusted returns in a scientific manner)

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