



Sutton & Associates, LLC

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The 7 Mistakes Investors Make

(And How to Avoid Them)

2008 was one of the most traumatic years in history for stocks. It is perhaps the saddest of ironies though, that in a time when so many are preparing for retirement that America would experience its worst financial crisis since the Great Depression. Even with hundreds of billions of dollars in rescue and stimulus packages, the outlook for 2009 and beyond is iffy at best. Stock portfolios are still at great risk. Retirement itself is at risk, and while many people could withstand the damage in 2008, they simply cannot afford a repeat performance in 2009. In this report, we take a look at seven common mistakes that investors often make and lay out our thesis for helping you to avoid these common pitfalls. While there is no single foolproof investment strategy that will guarantee success, there are some easy steps investors can take that will help to maximize their chances of meeting their goals.

Mistake #1 – Buy and Hold

The ‘buy and hold’ strategy can be the largest mistake that investors and advisors make in managing a portfolio. While on the surface, buy and hold seems to make sense, it is similar to wearing the same type of clothing no matter what the weather forecasters are predicting! Just like the weather, our economy and the businesses that operate within it are always changing. To be a successful investor, it is necessary to stay up to speed with these developments and make changes as circumstances dictate. Granted, there is a fine line and sometimes stockbrokers and investment advisors will take things too far and constantly buy and sell investments.

A good rule of thumb is that a general macroeconomic trend or a change in the business cycle will last at least a year. These trends do not change overnight. However, they do in fact change, and businesses that are set up to do well in a growing economy will run into problems when that economy slows. On the other side of the ledger, firms that generally do well during recessionary periods might see their results suffer when growth resumes anew. 2008 was a prime example of this. The trends were changing in early 2008, and those who were on top of those trends could act accordingly before the major damage was done to the markets later in the year. As the graph on Page 2 shows in very simple terms, a straight buy and hold strategy has not worked out over the past decade. While the argument can easily be made that not much has been lost, when you consider the increase in the cost of living over the same period, the investor is behind because the dollars don’t buy as much as they used to.

Instead, it is much more advantageous to work with a firm that understands the major economic and business trends and positions assets accordingly. For example, we took many of our client accounts to cash and short-term debt instruments during the early part of the summer of 2008. And where we weren’t

able to do that, we put hedging strategies in place to protect assets to whatever extent possible. As a result, our average portfolio was +/- 5% from where it was when it started with us in 2008. If, as many in the financial media suggest, we see even a modest rally in 2009, those portfolios will be positioned to quickly recover anything lost in 2008.



Such cannot be said for a portfolio that loses 50% in a year. At an average rate of return of 7% (assuming we immediately return to average performance), it would take **over 10 years to recoup that loss!** For those either retired or on the brink of retirement, 10 years is not an option.

Mistake #2 – Stocks when young, bonds for retirement

Another myth commonly espoused to by many in the financial community is that one should hold stocks when younger, and bonds when they retire. The logic here is that stocks will provide the growth while bonds will provide the income for retirement. While there is certainly some truth to the rationale, particularly when looking at risk tolerance, there are some greater risks that are being left out. The biggest is market risk. The person who now wants to retire and lock in retirement income is potentially forced to sell stocks at a substantial loss in order to buy bonds for their income. This reality did not only play out in 2008, but in the 2000–2002 bear market as well as the crash of 1987.

The intended outcome of any investment strategy should be flexibility and control – you want to be able to be proactive as the environment changes and you want to be in control to whatever extent possible. For clients that are beginning to near the age of retirement, we seek to position them in income–

producing assets such as Royalty Trusts, Master Limited Partnerships, and Unit Investment Trusts. These vehicles often pay in excess of 2–3 times what government bonds yield. Currently, many of these vehicles yield 10–15% and even more in some cases. The rationale we use is pretty simple. When our clients are still working, we are able to take those great dividends and reinvest them. When our clients decide they want to retire and start requiring income, instead of being forced to sell, we simply have the client use their dividends to help provide retirement income. The goal is flexibility and not being forced to sell when the market is down.

Another area in which the traditional scenario is lacking is bond yields. This has never been more evident than right now. While many costs continue to rise dramatically, most notably healthcare, prescriptions, and utilities – which are of particular concern to retired individuals, bond yields continue to drop. This means less and less income in the face of rising costs of living. Getting a solid return on investment will be one of the major challenges of 2009.

Mistake #3 – Rates: nominal versus real

Perhaps the biggest area of misunderstanding is in the area of nominal vs. real. Bear with me for a minute and we'll straighten out this situation. Let us assume that your monthly budget was \$2,000. That included everything you needed to live, plus some discretionary spending. Let's say your paychecks each month added up to the same \$2,000. Now let's say that 5 years later your monthly salary has increased to \$2,500, and your expenses are the same \$2,000 they were prior. In this case, you'd have a nominal gain of \$500/month and a **real** gain of \$500/month since your monthly salary buys everything it did before **and** affords you \$500/month to save as well. Now let's flip it around and say that your salary increases to \$2,500/month, but your cost of living also increases to \$2,500/month. In this case, you'd still have a nominal gain of \$500, but no **real** gain since your salary still only purchased what it did previously.

Observed Inflation Rate	Tax Bracket	Return needed on investments to break even
5%	28%	6.94%
7%	28%	9.72%
10%	28%	13.89%

The chart above depicts some different rates of increase in the cost of living and what return on investment will be needed just to tread water. If you're seeing your cost of living going up by 7% a year (which is pretty average), then you need to make nearly 10% pre-tax on your investments just to maintain your po-

sition. Any less and you are losing ground. Multiply such a situation over 30 or 40 years and it is easy to see how not paying attention to this reality can put you behind the proverbial 8 ball. Remember what currency is. Nobody holds paper dollars because they simply want the pieces of paper. They hold them so they can trade them in for goods and services. It is not so much the number of paper Dollars you have, but **what they buy** that is important. Our firm spends a good deal of time computing our own in-house inflation metrics so we know what return on investment we need to achieve for our clients to keep them ahead of the increasing cost of living.

Mistake #4 – Pay no attention to the statement behind the curtain?

They can be anywhere from 2–10 pages (or more) and show up at your doorstep each month. Most people tend to either throw them in the trash or feed them to the shredder. What are they? They're your monthly account statements. While it's not always necessary or prudent to study every single line of these statements, you should review them. Why? First, they give you important information about your account such as the value and breakdown of your assets. Do you have cash in your account or are you fully invested? Particularly in the case of individuals who have IRAs and will need money for required minimum distributions, this is very useful information. You will also find out what your advisor is doing with your money.

This is particularly important when you've given discretion to your advisor. Discretion is a management style where the advisor makes trades on your behalf without your prior consent. If your advisor has discretion, then you need to be watching your monthly statements. Is the advisor constantly buying and selling (churning) the account? Are those transactions in line with your financial goals? Many times, clients give discretion to an advisor and there is never a problem. However, especially in light of some of the recent scandals with regards to money managers, it is prudent to keep an eye on things. Be your own advocate. Beware of an advisor who tells you to simply ignore monthly statements. Although in many cases the advisor says this trying to prevent the client from fretting over normal market fluctuations, it is unwise to completely ignore your statements. At the very least, you should be checking transactions to make sure that no mistakes were made. A simple typo in the number of shares to be purchased or sold can result in problems down the road for you.

Mistake #5 – Mutual Funds: Double-dipping?

Mutual funds are a popular way for small investors in particular to get exposure to a large number of companies. It is often imprudent for an investor to purchase shares of individual companies because the client doesn't have

enough resources to properly diversify the account. However, there are some important downsides to mutual fund investing which are often glossed over in both the print and television financial media.

Many mutual funds have a ‘load’. These funds require this load to be paid in order to invest in their fund. Sometimes the loads are paid up front and sometimes they are paid when the fund is sold. There are thousands of mutual funds and loads vary greatly depending on the type of fund. Some funds are ‘no-load’ funds and this is not an issue. It is important to understand the load if there is one and its impact on your investment. For example, let's say your advisor has recommended a fund that has a 5% front load. This load will need to be paid up front. If you're investing \$10,000 in this fund, you will pay \$500 just to get into the fund. This means your investment will need to appreciate nearly 6% just to get you to the break-even point. Given the historic normal stock market return of 6–8%, it is easy to see how a loaded mutual fund can put you at a distinct disadvantage.

Total Load/Fees/Expenses	Typical Annual Return	Months to Recover the Load
2.50%	7%	Approx. 5 Months
5%	7%	Approx. 10 Months
8.5% (Maximum allowed)	7%	Approx. 15 Months

Some funds also have transaction fees, which will need to be paid when you buy or sell your shares of the fund. These fees also subtract from your overall return. Many mutual funds also have what is called an expense ratio. This ratio is the amount of profit skimmed by the fund company for the costs of running the fund. Examples of these costs are salaries for the fund managers and related staff as well as office expenses. These fees can add up quickly. The above table will give you an idea of how long it will take to recover these fees under ‘normal’ market conditions.

In summary, mutual funds can have many fees that are deleterious to the returns you will receive. In addition to all of these expenses, you will also need to consider that your advisor is getting paid for selecting these funds for you. Whether you're paying on an hourly basis, a flat fee, or a percentage of your assets, you end up paying twice – once to the mutual fund company and once to your advisor. These realities must be weighed when considering whether or not to permit your advisor to invest in mutual funds. As a general rule, we don't use mutual funds unless they are no-load, have no transaction fees, and have an expense ratio that when added to our advisory fee still allows the investment to have a high probability of meeting the client's objectives. Sometimes the bene-

fits of a particular fund outweigh the costs involved, and these decisions are made on a case by case basis, always with the objectives of the client at the forefront.

Mistake #6 – Too many eggs in one basket

Our economy is a complicated system of interrelated components. Add in the vagaries of the global economy, and the level of complexity becomes mind-boggling. There are literally millions of factors that affect the value of stocks, bonds, commodities, and other investments on a daily basis. That said, an investment portfolio's biggest asset can be flexibility and both the willingness and ability to adapt to changes as they occur. No more a time has this been important than during the past 14 months. This reality will continue to be paramount for the next few years – at a minimum. It is important that you consider these realities when discussing your portfolio with your advisor. Let's take a quick look at three of the major areas of diversification.

Index	2008 Performance	Years to recover assuming 7% annualized growth
Dow Jones Industrials	-33.81%	Approx. 6.5 Years
London FTSE	-31.30%	Approx. 5.8 Years
Shanghai Index (China)	-65.60%	Approx. 15.5 Years

Industry diversification – Selecting assets from a broad range of industries is crucial. The financial sector is a very good recent example of this. Many investors went completely into banks, brokerages and related firms over the past 5 years. At the time, the returns were excellent, and the risk was perceived to be minimal. Obviously, 2008 laid bare the fallacy of the justifications for this type of strategy. The losses have been staggering, and in some cases, total. Using diversification would have greatly mitigated these losses. Utilizing a top down approach, industries that are likely to thrive in a particular environment can be identified. It was employing this exact approach that we arrived at the undeniable conclusion that the financial sector needed to be avoided at all costs. We took advantage of this valuable information to position client assets accordingly.

Geographic diversification – Similar to industry diversification, it is also important to diversify assets according to country or region. Recessions and periods of economic downturn are often local or regional in nature, meaning that some countries will be affected more than others. While this does not apply to the current recession as much as it has in the past, some countries will

clearly be affected more than others. During this time it is crucial to identify and focus on the countries with the best economic fundamentals, the least exposure to the spreading toxic debt crisis, and then focus on the industries in those countries that are likely to flourish. In very general terms, using this approach, it becomes apparent that industries such as consumer discretionary products will not do well in the developing global economic environment.

Currency diversification – One of the major stories of 2007 and 2008 has been the vulnerability of the US Dollar. Other currencies such as the Euro have also run into credibility problems as governments around the globe have embarked on a massive monetary creation campaign in what we believe will be a less than successful attempt at arresting the slide of the world's major economies. It is now absolutely essential to diversify your assets from a currency perspective as the value of paper money is being called into question. Our investment strategies take this reality into account and we diversify assets across a variety of currencies including precious metals, particularly gold, whenever feasible. It must be noted that Gold was one of the few asset classes that posted a gain in 2008.

Mistake #7 – Who is your advisor working for?

Of all the missteps listed in this report, this one is perhaps the most important. It is imperative that consumers understand how their financial professionals are compensated for the services they provide to their clients. The bottom line is you work for who pays you. If an advisor is receiving a commission from a mutual fund company for getting you to invest in their fund, then that advisor's judgment is compromised. The advisor is no longer working for you, but now works for the mutual fund company. Such is the case with an advisor who also sells annuities, various types of insurance, and other products. If your financial professional tells you there is no fee for providing you with a service, then you want to know how they're getting paid. Ask them for a full disclosure of their sources of income. This will help you to identify and understand any potential conflicts of interest that may exist. It must be noted that just because there is a potential conflict of interest, that doesn't guarantee that you will have problems. However, given the events of the past year, do you really want to take the risk of being uninformed?

How do we protect your best interests?

Sutton & Associates operates on a fee-only basis. This means that all of our income comes from the fees paid by our clients. We work for them and only them. We receive no commissions or economic benefit from anyone else. This ensures our clients that they are getting unbiased advice. And unlike many

other financial firms, we act as a fiduciary and as such are both morally and legally obligated to act in our clients' best interests. We conduct an annual review of the quality and cost of brokerage service provided by any Custodians we use to ensure that our clients are getting the best brokerage commissions and trade execution possible. To put it simply, we are your advocate in all matters pertaining to your financial well-being.

If you are interested in how we do business, please take a moment to visit our website www.suttonfinance.net There you will find additional information about our firm, its core beliefs, and the services we provide our clients. You will experience firsthand why we are not a typical financial services firm. You can also give us a call at (484)788-4936 and we'll be happy to arrange a no obligation consultation to review your portfolio and answer any questions that you might have about the particulars of your financial situation. All information you provide is held in the strictest of confidence.

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