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Two Financial Mistakes People Make Over And Over Again

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Financial security doesn't happen accidentally. Just as an ounce of prevention is worth a pound of cure, avoiding these two mistakes can mean living a fulfilling life with peace of mind: This comes from feeling organized and in control, free from worry with more time spent with the people you love. Don't just turbocharge your financial affairs; optimize your life. To do so, avoid these common mistakes, repeated over and over again:

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1. USING THE WRONG BENCHMARK

Probably the most common mistake, and it's a big one

People who track the S&P 500 or any of the large indexes often cause themselves unnecessary stress and angst. They compare an index to their portfolio, and wonder why they aren't doing better.

There are indeed times when less really is more.

We won't get into the math of compounding and the impact of the timing of when returns are generated (see Mistake #5 and the sequence of return risk), but there will be times when a 6% average annual return on one portfolio and a 6% average on another portfolio end up with very different values.

Why Bronze Winners Are Happier Than Silver Winners

As the sister of a two-time Olympian, I found this comparison fascinating, and another example of **how perspective can give us joy or take it away.**

It's well known in psychology that a person's achievements matter less than how that person judges those achievements. For example, one employee might be thrilled with a 5% raise, until they learn that a colleague got a 10% raise. But when the person with the 5% raise expected a 3% boost while the one who got the 10% raise expected 15%, the former is clearly happier than the latter, despite the lower outcome.

In athletic competition, there are clear winners and losers. In the Olympics, one might expect that the athlete's happiness would mirror their achievement; with the gold medalist being the happiest, followed by the silver, and then the bronze. But as my ecstatic sister would have told you, this was not her experience at all. (She won bronze medals in Barcelona and Atlanta in 10-meter diving.) This phenomenon – in athletic endeavors or just life in general – can be explained by a concept called "counterfactual thinking" or imagining the outcome that didn't happen.

This means that people compare their objective achievements to "what might have been." The most obvious (counterfactual) thought for the silver medalist might be to focus on almost winning gold – nailing the dive perfectly with no splash, allowing the water to envelope her body. Not being on the top stand feels like she

lost.

The bronze medalist, however, might focus her thoughts downward towards fourth place, and realize she came very close to not winning a medal at all. The categorical difference between being a medalist and not winning a medal does not exist for the comparison between first and second place. We tend to bucket our thoughts, and it's because of this "apples to oranges" comparison that the bronze medalist – who is objectively worse off – would be more pleased with herself and happier with her achievement than the silver medal winner

> **So, we have a paradox of a man shamed to death because he is only the second-best pugilist or the second greatest oarsman in the world. That he is able to beat the whole population of a globe – minus one – is nothing; he has pitted himself to beat that one other person, and as long as he doesn't do that, nothing else counts.**
>
> James, William. The Principles of Psychology. 1892.

Please take note of the date of this book – proof that human nature hasn't changed!

In addition to how the math of returns works out, indices also make poor benchmarks because they rarely line up with your portfolio. To be a credible benchmark, the index and portfolio must have similar assets, similar holding periods, and similar weightings. It's important to compare apples to apples. Lots of factors make private portfolios different from a general index. Indexes are 100% one asset class or another, for example - all equities or all bonds or commodities. Your portfolio should be much more diversified and contain stocks, bonds, money market accounts, and maybe some real estate and other inflation hedges.

Also, you are likely adding and subtracting holdings throughout the year, so some of the money wasn't invested for the entire year. Your portfolio likely contains some cash-equivalent holdings, as well as some higher-risk assets. You may be more heavily weighted in one asset class than another. An index, however, rarely rebalances its holdings. It isn't overweighting or underweighting companies and it certainly isn't including cash in its calculations. The index is fully invested starting January 1st; the 401(k) you and your employer are contributing to is not. This makes comparing your portfolio to an index meaningless because the index isn't reflecting the type of assets and the amount of time you are invested in it.

Now, you might be saying, "Well, I'll just invest in an S&P Index fund and then I really will be getting the benefit of that index." That sounds great on the surface, but when you crunch the numbers, it is often a recipe for disappointment, and maybe even disaster.

Take a look at the S&P 500 Envy chart below. We are looking at two $100,000 portfolios. One of them follows the S&P 500 exactly. The other is diversified so that it captures 65% of the up market and 55% of the down market. During up times, the S&P 500 portfolio returns more than the diversified portfolio. During down times, the diversified portfolio loses money, though not as much as the market-based portfolio. The diversified investor never seems happy as they see their portfolio first lose money, then trail the market benchmark. However, when all is said and done, it is the diversified portfolio that wins.

"S&P Envy"

Years	S&P 500 Index	Diversified Portfolio	
2000-2002	-37.6%	-16.3%	"I lost money"
2003-2007	+82.9%	+73.8%	"I didn't make as much"
2008	-37.0%	-24.0%	"I lost money"
2009-2017	+258.8%	+152.2%	"I didn't make as much"
2018	-4.4%	-4.6%	"I lost MORE money"
Total Return	+146.6%	+166.1%	
Growth of $100,000	$246,570	$266,060	"Diversification wins even when it feels like it's losing"

SOURCE: BLACKROCK: S&P ENVY.

BLACKROCK

And that data is before COVID-19.

Don't compare your return to a benchmark or try to beat the S&P 500. The return you need to meet your goals IS the benchmark. We meet them or we don't...over time. If a portion of the portfolio is underperforming, understand why and whether it could be temporary. Rebalance and make course corrections to align it to the original plan design. Eventually, with some attention and tweaking from time to time, this process should bring returns to the expected level needed to meet your objectives. This is the only thing you should worry about.

Mark Twain once said, "If you judge a frog by its ability to climb a tree, it will grow up thinking it is stupid."

People do this to themselves when they measure their progress based on how the S&P 500 did. As we learned from the example of Blackrock's S&P Envy: Be careful what you ask for. Measuring your progress against something you probably shouldn't want—a concentrated portfolio in one sector or asset class—may not just be counter-productive, it can make you feel like the Silver Medal Winner at the Olympics.

Stop doing that to yourself...and your advisor.

2. FOCUSING ON RETURNS INSTEAD OF OUTCOMES

The end game of a portfolio is to provide cash flow, and the growth of your cash flow over your lifetime and for the people you love.

Especially in today's ultra-low interest rate environment, the key is cash flow – not income. This mistake is similar to the third biggest mistake (using the wrong benchmark), but it's a little different. This has to do with sequence of return risk, where two investments with the same average rate of return end up with different ending values.

Check out the chart below: this might replicate what you add to your 401K each year. The first three columns show the same average rate of return while the fourth column shows a return that is less than half. The last column shows a rate of return we would all love to have, yet you can see the sequence of returns creates a very different (and unwelcome) outcome. It can lead to decisions that are made with the wrong information and end up derailing your overall plan. At the very least, you could end up not achieving the outcome you intended: less money and a lot more stress!

When 5% Return is Better Than 12%: *$10,000 Invested for Three Years*

Average Return	12%	12%	12%	5%	20%
YEAR 1	12%	-12%	24%	-35%	45%
YEAR 2	12%	24%	24%	25%	45%
YEAR 3	12%	24%	-12%	25%	-30%
Ending Value	**$37,793**	**$41,307**	**$33,243**	**$38,228**	**$31,867**

WEALTHCARE

One of my favorite authors, Nick Murray,[1] tells the story of two retirees are sitting on a bench feeding the ducks. The first one says, "My portfolio did really well last year. I realized over 6%." The second retiree says, "That's nothing. My portfolio came in at more than 11%!"

What neither one of them realizes is that neither portfolio is doing well enough to prevent them from running out of money. The first retiree might run out at the age of seventy-two while the second one hangs on until he is seventy-five, but they're both going to be destitute when they're 80.

It is not uncommon for people to review their portfolio and ask "What rate of return did we get" I believe this is the wrong thing to focus on. A better question might be: Will this portfolio provide enough cash flow to cover my rising expenses until I die?" That is the only true metric of a successful strategy. If a portfolio is not covering all of your expenses, it is not doing its job, no matter how impressive the return.

1 "Simple Wealth, Inevitable Wealth" by Nick Murray, Sixth edition, 2019.
for the S&P Envy chart – SOURCES: BLACKROCK: S&P ENVY; MORNINGSTAR DIRECT

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