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Beware Hot Picks

Investing articles may not tell the whole story

On any given Sunday you'll likely find an article in the business section of the paper that discusses the performance of a hot stock or mutual fund or touts a new strategy for investing in a certain narrow segment of the market.

While each article has its own flavor, a common theme prevails: This investment has done well in the last 6-12 months and looks like it could continue to do well. The recommendation, whether explicitly stated or not, is often this: Get in now; don't miss out! And it's not just the Sunday papers that take this approach. Dozens of television commentators and thousands of bloggers ardently recommend investments day in and day out, often based only on strong recent performance.

Hindsight doesn't count

Two big problems plague these articles. First, they rely on perfect hindsight and questionable foresight. Yes, a mutual fund that returned 40% last year stands out, but expecting a repeat performance this year is another matter. Assuming that last year's winner will continue to outperform this year is like expecting a craps player in Las Vegas who has rolled five 7's in a row to just keep rolling them.

Recent past performance is simply not a reliable indicator of future success. As Warren Buffett has said, "The investor of today does not profit from yesterday's growth."¹ Spotting outperformance after the fact is simple, but predicting it in advance is more a matter of luck.

The second problem is not about what's in the articles, but what is not. By focusing exclusively on the allure of specific stocks or mutual funds, many articles completely skip over the fundamental planning steps that should happen first. Writing an investment policy statement helps an investor define financial goals and determine one's ability, willingness and need to take risk in the market. Without this plan in place, choosing specific stocks or funds is premature at best, like buying kitchen cabinets before having a home to furnish.

There's no such thing as an average investor

Many people don't need to be 100 percent invested in the stock market. A mid-career professional may only need to be invested 90, 80 or 60 percent in stocks with the remainder in bonds, while a retiree with greater need for current investment income may be better served with a portfolio that's more heavily weighted in bonds. There's no formula that fits all investors; every situation is completely unique. An investment policy statement brings these individual needs into focus.

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Once the asset allocation is set, the equity portion of the portfolio should be diversified across different asset classes, such as large cap and small cap, foreign and domestic, and growth and value. Diversifying reduces the exposure to poor performance in any single asset class and evens out performance in a variety of market conditions.

A carefully-considered investment policy statement, prudent asset allocation and a diversified portfolio can provide valuable protection against fickle markets and the hindsight-based stock picks of Sunday columnists and know-it-all neighbors.

¹<http://investing-school.com/history/52-must-read-quotes-from-legendary-investor-warren-buffett/>

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