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The Savvy Investor

Four Big Investment Myths

Market myths and half-truths abound in the stock market. Much of what people think they know about the market is flawed. People lose money in the stock market because they make too many mistakes based on these myths.

Myth 1: Buy Low and Sell High

A cheap or falling stock is usually no bargain. Rather, it is just a weak one. Just because a stock fell from $40 to $20 does not mean it will ever reach $40 again.

It is frequently better to buy those stocks that are moving higher. That's because stocks tend to move in cycles and those that are rising tend to continue to rise. Those that are falling tend to continue to fall.

Myth 2: Buy and Hold

This recommendation frequently makes sense, but not if carried to extremes. It's true that many excellent stocks drop and then recover after a few months. But others take five years or longer to recover, and some never do. **If you made a mistake, sell the problem stock or fund and move on.**

Myth 3: Be Conservative as You Age

Conventional wisdom says that you should become more conservative as you get older. A common rule of thumb is that the percent of your investments in bonds should equal your age, and the remaining money placed in equity (stocks and stock funds). At age 60, you would have 60% in bonds, 40% in stocks.

While you might want to become more conservative as you get older, ***age* should *not* drive your investment strategy. Instead, your *objectives* should determine your investment strategy.** If your objective is that you need income and can not afford to lose money, than you might want be heavily invested in bonds. Similarly, if you are looking for growth and can afford the risk, you might be invested only in stocks and stock funds – even at age 80.

Letting age drive your investment strategy – rather than your objectives – can give you investment volatility and returns that don't match your temperament and needs.

Myth 4: Look at Price-to-Earnings Ratio

A favorite tool of investors is the P/E ratio. This is the price of the stock divided by the company's earnings per share. Conventional wisdom is that stocks with low P/E ratios are better values than higher P/E stocks and these should be favored.

But there are two problems with this approach:

1. A low P/E means that the stock price dropped, and perhaps with good reason. If so, it might also have little prospect of recovering. (See Myth 1.)
2. There are many good companies with consistently high P/E ratios.

Here's a better tool. Rather than looking at just the P/E ratio, look at the P/E/G ratio. This is the P/E ratio divided by the annual growth rate of the company.

Fast growing companies with new products and ideas will have higher P/E ratios but lower P/E/G ratios. (Low P/E/G ratios are good.)

As an example, consider two companies, A & B, with identical P/E ratios of 20. Company A has a growth rate of 2%/year and Company B is growing 20%/year. The P/E/G ratio of A is a whopping 10.0, but B is only 1.0. Which do you think is a better bargain? I would pick B (because of its lower P/E/G ratio).

If you'd like to know about other investment myths that can reduce your returns and ability to sleep well, please contact us.