WHAT TODAY'S INVESTORS GET WRONG ABOUT THE STOCK MARKET

The Wrong (Short Term) Mindset

Most investors simply have the wrong goalposts. When you hear about great stock market results, it's always about the home run hits. The big plays. The stocks that have multiplied.

These stories are fine and good; they are motivational. Even I've written about my first 10 bagger with Microsoft and have pride in the fact I even have/had a 10 bagger at one point.

But while my 10 bagger makes for a great story, it doesn't say much about my success as a lifelong investor.

There is no finish line for an investor, which means that:

- You can't lose
- Success should be defined differently

When I say there's no finish line, I mean that the only time we're not "allowed" to compound money is when we are dead. You can't take it with you. But you also can start a fresh investment at any time.

Because there's no finish line with your investing, you really can't lose even when it feels like you do. Anytime you lose money in the stock market, or perform much worse than the overall stock market, that's an opportunity to learn and become a better investor.

There's no rule that says your next 5 years of investing have to be poor just because your results were not great over your last 5 years, or even your last 50. We can all find the satisfaction in saving and investing, and letting that money compound.

Even Warren Buffett still compounded his wealth as the richest person in the world in 2008—and continued to compound it for decades longer. Buffett was simply in love with the satisfaction of delaying gratification and watching his wealth compound.

So if Buffett at age 90+ could do it, if Buffett at age 90+ could still find potential opportunities for his money in the stock market...

Then so can we.

Simply put, that's a can't lose situation.

Invest in a bad stock?

- Learning experience.

Invest in a new stock?

- New potential.

Feeling hopeless after losing so much money?

- There's more to life than money. The past is in the past. Life is constantly full of new beginnings, if you take the time to look around.

Defining Investment Success

While my 10 bagger with Microsoft makes for a great story, it doesn't say much about my true, long term investment success.

After all, this 10 bagger came while I was still early in the game. It was just a paper gain. Sure, I could've sold it to "lock-in the profit", but one of the major reasons I even achieved 10 bagger status with the stock is because I didn't do exactly that—I didn't sell.

Whether I kept the 10 bagger or sold to lock-in profits, the fact remained that in the growth stage of my investing life, I have no need to access this money—so why should I sell the stock unless I felt it's not a great investment anymore?

What does "taking profits" do for me if I'm reinvesting those profits anyways?

Other than telling great stories around the fireplace, what does it matter if I have fifty 10-baggers or zero, if I don't need to sell these gains right now?

What does it matter if I outperform the market by 30 points in one year, or underperform by 30 points the next, as long as I earn an acceptable gain by the time I retire?

As investors, we love to take snapshots in time of past successes, because they make for great stories.

But the real snapshot in time is:

1. Today
2. The End

For as long as you are alive and have stock market investments, you are a lifelong investor. And as such, the performance of any one stock is short-term in nature, especially in the grand scheme of most people's lives.

Stocks that last 80 years or longer are rare, and most will eventually get liquidated by investors in some form well before then. So then, we should not get caught up on the performance of any one stock over any period of time.

We need to extend the goalposts of our performance.

The past is in the past, and there's nothing we can do about that. But the future always brings new opportunities in the stock market—through new companies, old companies which find new life, or great companies that become cheap.

And so selling a stock right before it becomes a 10 bagger might be hard emotionally, but it could be the right move for your lifelong wealth if there's fundamental reasons to believe that stock can't compound capital at an attractive rate anymore.

Let's not let our personal goalposts affect the true goalposts that matter...

- Which is whenever we withdraw the money.

Whether our stock investments crash to the bottom or blast to the moon, keep in mind the true goalpost that matters. And if our investment thesis is still intact, we should not sell these stocks because of the emotions that short term, personal goalposts can bring.

Unrealistic Expectations

The odds that you'll buy a stock which performs well until the day you die are pretty slim. Most stocks eventually mature and decease (or get absorbed).

Just as no tree grows to the sky forever, no company rises up to dominate forever. All stocks reach some ultimate saturation point, where their prospects of growing faster than an economy become impossible unless that company is broken into smaller parts. It's simple numbers and math.

If a company grows at an incredibly high, above average rate for long enough, the numbers dictate that the company would eventually make up the entire world's economy. That's just not possible, and because stock prices follow company growth, the growth of a stock's price has an inherent upward bound limit.

I know it's not a popular idea, we all like to say that a stock's upside is unlimited, but it's true. At a certain size, a company can only grow so much more, and the same with their stock.

We should hold our investments for long enough that they can compound our wealth, regardless of short term goalposts, but also short enough that we've considered if most of its attractive compounding potential is gone.

Whether a company's compounding stalls because of its size, or because managers make continuously poor decisions with capital, or because its main industry is becoming irrelevant—we should watch our stocks and sell them once it is obvious this is the case.

This is more of an art than a science, for sure, but it's a great simple tip to keep in mind.

Diversification for Buy and Hold Investors

Investors should not ignore how critical good portfolio management is. I've written before about how the ideal portfolio turnover for a fundamental, buy and hold investor is around 10% - 20%. This can result in some unexpected implications.

In short, portfolio turnover indicates how many stocks an investor is selling in any given year. For an investor dollar cost averaging once a month (buying one stock per month), a portfolio turnover of 20% implies an investor sells 2.4 stocks per year (20% * 12 new stocks per year).

Say that we started investing at age 25 with the goal to do so until age 65.

That would be 480 months of buying stocks; for starters, let's assume each one represented a different stock. With a 20% turnover, we'd still be adding 9- 10 stocks per year. Over 40 years, that's a portfolio of 360- 400 individual stocks.

That's a pretty big portfolio, and it shows what might happen if you:

- Are great at picking high performing stocks
- Limit your turnover, and
- Hold your stocks for a long time

These things are just bound to happen. And since many great stocks do eventually become expensive (and perhaps lose their attractiveness as an investment), you might find yourself buying more and more different stocks as you go along. And that's totally fine.

You basically want more irons in the fire, for more chances of finding those best-of-breed, decades long compounders. Those are hard to come by if you're limiting yourself to just 15-20 ideas.

The Dangers of the Concentrated Portfolio

There's no doubt that the greatest investors of all-time leaned on making big bets on their highest conviction picks. However, I've come to the conclusion that having a concentrated portfolio like this is probably not the right solution for the average investor, and certainly not for most. Warren Buffett has had a lot to say about the topic—my favorite is the punch card technique.

Buffett says that it's a great idea to approach picking stocks as if you had a punch card with only 20 spots, and each time you bought a stock you punched a hole in one spot. If we really had this restriction on ourselves with our stock picking, you can be sure we'd be extremely careful about the stocks we buy.

It's a great idea because it leads to really spending a lot of time on researching the company and reinforces the idea of investing with a margin of safety.

Having high conviction about a stock is one thing, but having an excessively high level of overconfidence (especially with little experience) enough to make a huge bet on that conviction can lead to a lot of future humble pie.

One of the best arguments for a diversified portfolio over a concentrated one is that it tempers the negative effects of overconfidence by not allowing any one mistake (or error in analysis) take too much of a chunk out of your portfolio.

Then there are the emotions of a concentrated portfolio. Trust me—it's SO easy to say that you won't get emotional when your stocks face volatility.

It's hard to really portray the disappointment of having an entire portfolio where stocks that used to be up 20%, 30% or 50% are now at breakeven or at a loss; it makes you feel like the time (years) you invested with the stock were worthless. And then imagine doing that when the stock market is roaring, but your portfolio is down due to a bad concentrated bet.

Investing is supposed to be a pleasant experience where you can sleep peacefully at night, and know your hard-earned savings are being put to work and continue to grow over time. When you get extreme volatility in your portfolio, which is almost always magnified in a concentrated one, that joy of investing gets robbed and can turn you off forever from the stock market. That's a particularly somber thought.

By building a more diversified portfolio, you can alleviate your future self from some unnecessary stress, and that's worth it's weight in gold particularly when times get tough, and particularly if it keeps you in the game.

Giving Up From Overwhelm

The stock market can seem completely overwhelming. Wall Street is full of contradicting advice everywhere you turn, and it can get confusing and disheartening, especially if you start to not do so well.

If you take away one overarching lesson(s) from this report, it's:

- Don't fret your past.
- Be patient.
- Stay humble.
- Let the companies compound for you.

I think one of the greatest disservices an investor could do for themselves is to micromanage their portfolio and fret about always beating the market. Your goalposts are yours and yours alone; and they aren't even the same goalposts as everyone else's (since we all started and will die at different times).

Countless successful investors, when asked at the end of their life what their secret was, have said it was to buy great companies and hold them for a very long time.

That's it.

And it's easy to say and hard to practice, which is why we need to remind ourselves of these lessons all of the time.

Trust me, I'm guilty of forgetting this probably more than anyone else. I'm totally addicted to checking on my portfolio and assessing relative performance.

But, at the end of the day, I feel that I'm better than most at not reacting to these emotions (and my forgetfulness) because I have a few rules of thumb in place, which include those I've mentioned on turnover and diversification.

Hopefully you can take something from this today and use it to improve your own future performance.

And enjoy it.

Because at the end of the day (and the rest of your life), that's all that really mattered anyways.