Are You Cut Out For DIY Investing?

Dan Bortolotti

The proliferation of home improvement shows on TV has spawned thousands of DIY renovators. Not long ago, only the handiest of homeowners would have attempted to install their own pot lights or build their own backyard deck. In many ways, it's an inspiring trend. But compare many of those DIY renos to the work of a trained electrician or carpenter and you'll appreciate that sometimes it really does make sense to hire a professional.

I've been an advocate of do-it-yourself index investing for some time, through my work with *MoneySense* magazine and my blog, Canadian Couch Potato. I still believe many investors with uncomplicated situations are capable of managing a simple index fund portfolio on their own. Indeed, I think anyone with less than $100,000 or so should seriously consider doing so, because it's awfully difficult to find an unbiased, fee-based advisor unless your portfolio is larger. And unfortunately, it's all too easy to find a commission-based mutual fund salesperson who will turn your wealth into his own.

But over the years, as I've corresponded with readers worked with them as clients, I've learned that DIY investing is much harder than it sounds. The financial author William Bernstein had this revelation, too. "I have written two books premised on the idea that anyone, given the proper tools, can do the trick," he wrote in The Investor's Manifesto. "I was wrong. Having emailed and spoken to thousands of investors over the years, I have come to the sad conclusion that only a tiny minority will ever succeed in managing their money even tolerably well."

I won't go that far, but experience has taught me DIY investors face a number of significant challenges—some technical, some behavioral. And unless they can overcome these obstacles, most would be better off working with a professional who provides unbiased advice for a reasonable fee. Here are the difficulties I see most often.

Analysis Paralysis

I've spoken with investors who have accepted the theory of index investing for months, even years, but have never taken action. Ironically, those who have done the most research are most likely to be deer in the headlights. They obsess over small details, or they can't resist timing their entry point: they want to wait for the U.S. market to cool off, or for interest rates to rise, or for some economic forecast to prove true. All the while they ignore the enormous opportunity cost of doing nothing. And the longer they wait, the harder it is to pull the trigger.

Focusing On Products

Successful investing is about saving regularly, keeping costs low, diversifying broadly, and sticking to a plan. Yet it's remarkable how many people believe the key to success is choosing the right products. That's like thinking the most important ingredient in your fitness plan is the right pair of shorts. For index investors, selecting appropriate ETFs is important, but whether it's this one from Vanguard or that one from iShares is a trivial decision. Product selection is probably 10% of the process in terms of importance, yet it can occupy the majority of investors' attention.

Resisting Simple Solutions

Total-market ETFs have made it possible to hold thousands of stocks in dozens of countries using no more than two or three funds, and with annual fees under 0.20%. Toss in a single bond fund and you've got a richly diversified portfolio that's super-cheap, easy to maintain, and likely to outperform at least 80% of professional money managers. But hardly anyone is content with that. Many DIY investors feel compelled to add unnecessary complexity—sector funds, exotic asset classes, their own stock picks—that end up sabotaging their results.

Unrealistic Expectations

Anyone who works with an advisor completes a risk tolerance questionnaire, and the process is revealing. Investors often say they want an expected return of 6% to 7% while also indicating they'll accept no more than a 10% loss in any given year. Those goals are incompatible. With bond yields so low today, a balanced portfolio of 60% equities and 40% fixed income probably has an expected return of about 5% before fees, and in a scenario like 2008–09 it could suffer a drawdown close to 20%. Unless investors understand these trade-offs they can't hope to carry out a long-term plan.

Ignoring Asset Location

Most people understand Canadian equities should be held in a non-registered account (if there's no registered room available), while bonds are best held in an RRSP or TFSA. But there are subtle "asset location" issues most DIY investors are unaware of—indeed, even many advisors pay no attention to these details. For example, U.S. securities are exempt from foreign withholding taxes in an RRSP, but not in a TFSA. And if you need to hold fixed income in a non-registered account, GICs are far more tax-efficient than bond funds. The cost of paying unnecessary taxes can have a much bigger impact than fund MERs or fees paid to an advisor, especially for wealthy investors.

Currency Conversion

Currency spreads at discount brokerages are outrageously high: on transactions under $50,000, a spread of 2.5% is not unusual. DIY investors who buy U.S. stocks or ETFs without taking steps to reduce the cost of currency exchange can easily lose hundreds of dollars on every transaction. One useful technique is "Norbert's gambit," which involves buying a cross-listed security on the TSX in Canadian dollars and selling it on a New York exchange so it settles in U.S. dollars. But it's hard to pull off unless you have a lot of experience trading with an online brokerage.

Inability To Tune Out The Noise

We all react emotionally to financial headlines: being fearful during a market crash or exuberant during a bull market is just part of being human. But successful investors need to restrain themselves from acting on those emotions. DIY investors face a tough challenge, because technology makes it so easy to trade: many brokerages now even let you buy and sell on your smartphone. A long-term portfolio doesn't need to be adjusted after every episode of Market Call, and there can be huge value in putting an advisor between you and your impulses.

Finding Professional Help

DIYers often ask me to recommend an investment advisor who charges by the hour, or one who will make specific investment recommendations they can implement on their own. The problem is, most licensed advisors want nothing to do with that business model. Even if they were inclined to work with do-it-yourselfers, they would face hurdles from their compliance departments.

Financial planners may work on hourly model, and they are helpful when clients are looking to manage cash flow, reduce debt, get the right insurance coverage, or plan for retirement. But many have limited knowledge about investing, and most are not licensed to advise on specific securities. If you're looking for someone to give you step-by-step instructions on how to design and implement an investment portfolio on your own, you're not likely to get it from a fee-only planner.

I encourage all DIY investors to read as much as they can about behavioural finance so they can learn to recognize these pitfalls: my favourite book on the subject is Why Smart People Make Big Money Mistakes, by Gary Belsky and Thomas Gilovich. It also helps to start small: open a TFSA with discount brokerage and get your feet wet with a few thousand dollars. And above all, have the humility to recognize when you may need the help of a professional.

Dan Bortolotti is the author of The MoneySense Guide to the Perfect Portfolio and creator of the Canadian Couch Potato blog (canadiancouchpotato.com). He recently partnered with PWL Capital (www.pwlcapital.com) to offer a flat-fee service for DIY index investors across Canada. Contact him at dan@danbortolotti.

MoneyTip

Follow The Big Money

We have gone on about the benefits of ETFs for some time now, so it is good to have some back-up:

In a recent survey of 567 high-net-worth investors, nearly two-thirds said that they plan to move money from mutual funds to ETFs.

(InvestmentNews)