TRADING IS HAZARDOUS TO YOUR WEALTH

CAPE TOWN:Fact - as you trade shares more frequently, so your chances of losing money increase. As a group, those individuals who don't trade their shares frequently outperform active traders by nearly 33% per year over extended periods of time. This was proved in a study by Barber and Odean with the title,"Trading is hazardous to your wealth". It was published in the Journal of Finance in 2000 - for those who believe in active trading, it is worth a read.

MORE INFORMATION IS NOT HELPFUL

We are constantly being bombarded with information about shares, commodities, currencies and economies from around the world. It is now possible for a private individual who is willing to spend a bit of money every month on subscriptions, to be as well-informed about financial events as many governments were in the 1990's. Unfortunately, this access to news increases our levels of self-confidence when we make investment decisions which actually reduces our potential investment performance. This overload of information makes it nearly impossible to distinguish valid investment information from market noise - otherwise known as news. Some of the best investors make it their business to follow a few key variables and proactively isolate themselves from "noise" that could detract from their investment decision making ability. I believe that is one of the reasons why Warren Buffett is so successful - he lives in a remote part of the US and does not really use computers – except to play Bridge with friends in other cities.

One of the keys to becoming a successful investor is to understand your investment universe and to learn how to distinguish between relevant investment information and noise. As a start, more than 90% of financial news will not help you make better investment decisions. In addition, what might prove useful information to one person's investment strategy could be irrelevant to yours. This is particularly important if you aim to grow your capital through market trading rather than long term investing because there are so many different styles of trading.

BUY & HOLD IS BETTER

Those who do not trade actively, generate an average return that is 7% per year higher than active traders. Ironically, active traders would do better if they invested in the index and ignored their investments thereafter.In fact, only 2% of active traders actually beat the market over the long term. The primary reason for this poor performance by traders is overconfidence in their own ability to "read" markets.

Many share traders are deeply sceptical of the investment advisors, stock brokers and the investment industry in general. They typically prefer to manage their own investments and derive comfort from the fact that they are masters of their own destinies. Some of these people are very successful entrepreneurs who have built their wealth from nothing. Therefore one can understand why they are sceptical that anyone could do better with money than they can.

Self-reliance and scepticism of investment markets can be very valuable characteristics for investors. In fact, many of the best fund managers share these characteristics. However there are other characteristics that are required to be a great investor. The fact that you are not part of the market "herd" can also work to your detriment, especially if you are intelligent and successful in another field of business. This is especially true if you have a very strong mathematical ability because you could be deceived into thinking that the market can be predicted. To me, the best example of this lethal combination is the group of investment superstars (including Noble prize winning economists) who started, built and eventually destroyed an investment firm called LTCM. They had absolute conviction in their ability to predict the market and took massive bets based on their views. When the market eventually moved against them, they were wiped out. Ironically, their views on the direction of the markets were proved correct but many months later.

This example and many others should provide valuable lessons to us all. If you are an active trader, you need to measure and monitor your investment track record to ensure that you are not financially damaging yourself and your family. Barber and Odean’s study showed that active traders are often overconfident in their abilities and regularly trade shares to their own detriment. More worryingly, they are not really aware of their underperformance because they are so confident in their ability that they don’t measure themselves.

It is important to understand that it is the costs and frequency (or timing) of trading rather than the actual portfolio selections that cause active traders to underperform over the long term. This was clearly illustrated by LTCM. In my view, most active traders would be better served by selecting a few good investments and holding them for extended periods or even better buy the appropriate indexed investments.