

Three Dangerous Traps Investors Face

There's a lot you can't control when you're investing. Putting your money in securities necessitates some risk taking. You probably aren't managing the companies you own, or the governments you lend to yourself, so you have to trust managers and politicians to do that. And you'll never direct consumers and taxpayers, so revenue streams are completely out of your control. There are though, things you can do to put yourself on sounder footing. In July of 2004 I wrote:

Compound Interest and You

Here's a compound interest story that should help you and your spouse. Let's assume a hypothetical \$10,000 investment with a 7% annual return for 20 years. Investor A draws the 7% (\$700) each year for living expenses. At the end of 20 years, the original \$10,000 in capital remains in place, and \$14,000 in simple interest has been drawn for living expenses. The end value in capital and interest drawn is \$24,000. Now let's assume hypothetical Investor B invests the same \$10,000 at the same 7%, but draws nothing and simply let's the money compound for 20 years. Well, \$10,000 compounded at 7% for 20 years has an end value of \$38,696. You will see that \$14,696 (\$28,696 – \$14,000) represents interest on interest. Over half of the long-term total return for Investor B reflects interest on interest. Unfortunately, compound interest is not a concept that is well understood by most investors.

To their everlasting sorrow, most investors not only lack a basic knowledge of compound interest, but also lack patience and dividend/interest religion. Many are greedy, trade way too often, and are in debt. For the record, I have no debt. I buy for cash. I have never employed margin and tend to own the

investments I make for a long, long time.

So the three traps I explained that can harm your investing success are

- Being greedy
- Trading too often
- Being in debt

Greed will inevitably ruin your patience. Trading too often will generate fees you can't afford. And using debt to buy investments, while not a mortal sin, can turn your gains into losses so fast it'll snap your neck.

Focus your investing on compounding, and work to avoid the three traps.