Why Do People Make Bad Investments?

There are people who invested a few thousand dollars in Microsoft when it went public and saw their investments multiply in value 890 fold. And there are folks who invested millions with Bernie Madoff and lost everything in his Ponzi scheme. Ten thousand dollars in the initial Microsoft IPO would be worth $8.9 million today while ten thousand with Bernie would be long gone. Today we consider why do people make bad investments? Partly it has to do with the suitability of investments. *CBNC* features comments by Jim Cramer of *Mad Money* who says suitability is an **investment concept critical to buying stocks**. Cramer talked about when he was first introduced to the concept of suitability of stocks for a given person.

> *Did I ever consider that many people who called me and got my answering machine might not be ready for the stock of the hottest semiconductor company in the land, and that I was recommending it to them one-on-one without any sense of it was right for them?"*
>
> *Cramer replied that he thought it was obvious stocks came with no guarantees, a "caveat emptor" situation. The executive explained the worth of knowing what an individual investor wants based on what he needs out of a stock and the risks he is willing to take while investing.*

So, one reason people make bad investment is that they buy stocks that are not suitable for them and their degree of risk tolerance. In our recent article on **tips on how to start investing** we talked about having a rainy day fund so that you don't need to cash out a volatile stock on its downswing. Risky stocks when you have not cash reserve are bad investments.

Knowing How a Company Makes Its Money

An all too common problem with new investors is that they buy a stock that has just gone up in price without assessing its **intrinsic value**. When you are buying a stock for the long term you want a company that has a sound business plan and a plan that will remain viable into the distant future. Intrinsic value is based on forward looking earnings and so you need to understand what a company does to make money and how it will continue to do so. A famous example of a great investment gone bad is Kodak which was the king of the photographic film business and then everything went digital gutting their business model. This brings us to the concept of paying attention as you go.

Too Many Stocks to Keep Track of

If you buy shares of 3M, Boeing or Microsoft you want to keep track of what the companies are doing and how they are doing. Since these are stable stocks built for the long term you can check every quarter when their report arrives in the mail. On the other hand if you just bought the newest and hottest biotech stock you need to pay closer attention. Is its growth being propelled by the assumption that its newest drug will pass all FDA tests? If the drug fails in testing the stock may plummet. Potentially volatile stocks should be watched at least weekly and when they have provided a profit a little should be taken off the table as you don’t have a profit until you take it. If you have loaded up with too many volatile stocks to keep track of you may be making bad investments.

Too Good to Be True

When people invested with Bernie Madoff they trusted his history and the results they were seeing. Anyone who cashed out early in the game actually walked away with a profit. When Bernie produced too good to be true results smart investors would have asked questions, taken at least part of their money elsewhere to diversify or just gone elsewhere.

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