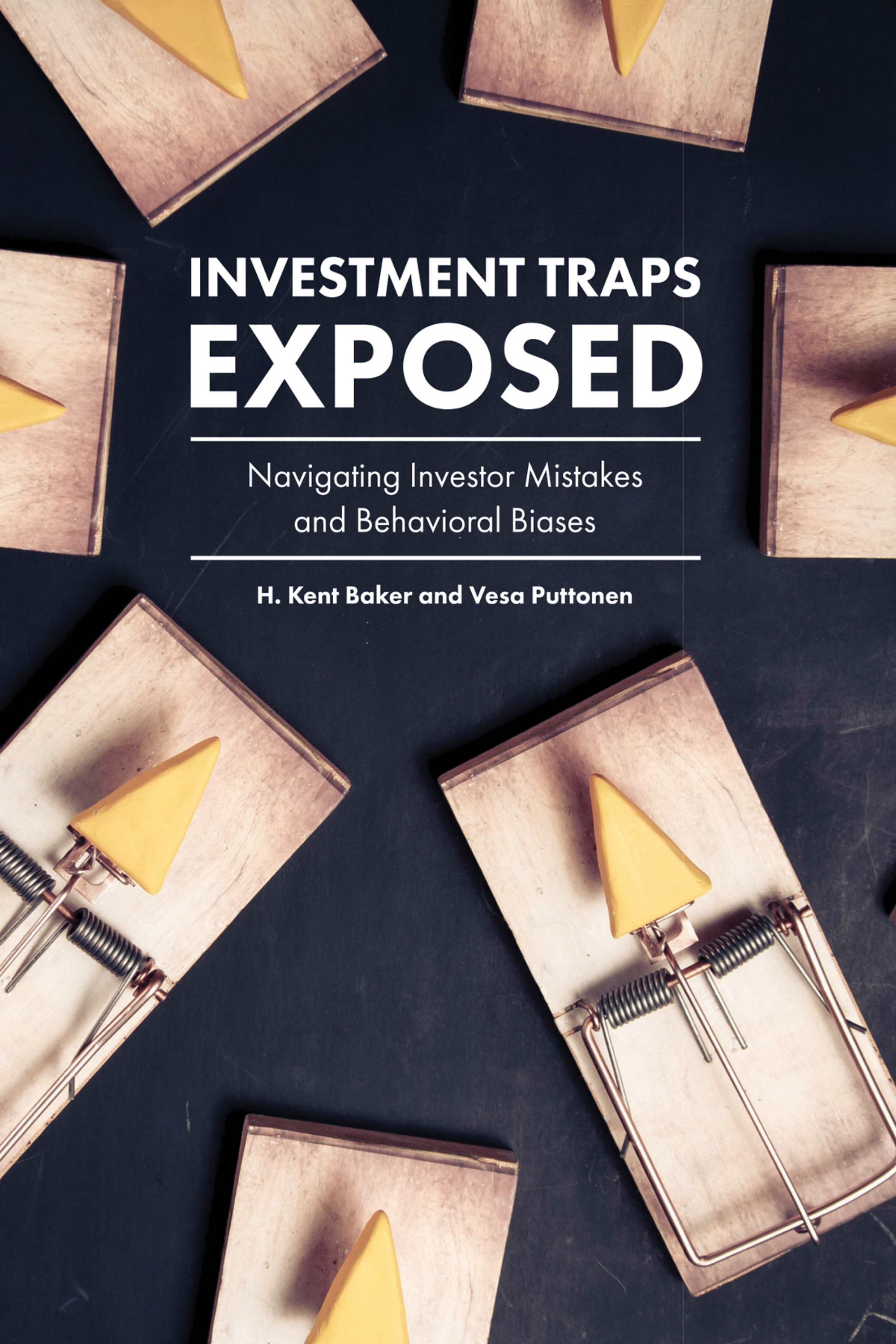

INVESTMENT TRAPS EXPOSED

Navigating Investor Mistakes and Behavioral Biases

H. Kent Baker and Vesa Puttonen

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INVESTOR IN PEOPLE

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> *The greatest part of a writer's time is spent in reading, in order to write; a man will turn over half a library to make one book.*
>
> *Samuel Johnson*

The observation aptly applies to *Investment Traps Exposed*: *Navigating Investor Mistakes and Behavioral Biases*. We owe a debt of gratitude to literally hundreds of authors whose work we read to provide a foundation for writing this book. We want to acknowledge the outstanding work by Elizabeth Caravella and Linda Baker, who diligently read each chapter providing thoughtful suggestions and edits to improve the book. Special thanks also go to Mikko Niemenmaa, Sanni Nissilä, Ilja Tauber, and Markus Weckman for research assistance in developing the various cases. We also thank our partners at Emerald Publishing Groups for their professionalism, especially Charlotte Maiorana (Senior Editor), Fiona Mattison (Editorial Assistant), and Jaya Chowdhury (Project Manager). We appreciate the research support provided by our respective institutions — the Kogod School of Business at American University and School of Business at Aalto University. Finally, we thank our families for their encouragement and support and dedicate the book to them: Linda and Rory Baker as well as Marika and Sandy Puttonen.

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1

NAVIGATING THE INVESTMENT MINEFIELD

We don't have to be smarter than the rest. We have to be more disciplined than the rest.

Warren Buffett, Chairman and CEO of Berkshire Hathaway

The investment world can be a scary place. During the past decade, investors have faced many challenges including the sub-prime mortgage crisis, a deep recession, a slow economic recovery, wars, terrorism, and much more. Investors also face a vast array of investment options with many vying for their business. However, some of those providing these "opportunities" seek to take advantage of investors. Although most investors realize they are fallible, they often have no clear idea why or what they can do about it. No wonder people often view investing as overwhelming and intimidating, especially if they attempt to tackle this task on their own. Although most individual investors are not experts, they still must take responsibility for their actions and financial lives. To be successful, investors must avoid many pitfalls along the way or risk making errors that affect their wealth.

Given the complex and challenging world of investing, what chance do less savvy investors have navigating the investment minefield and emerging unscathed? The answer is not much unless they recognize the investment traps that are strewn along their path and deliberately avoid these financial landmines. They also need to separate investment fads from tenets that stand the test of time. This, of course, is easier said than done. Awareness may lead to a small improvement in actions and decisions but any effect is likely to be short-lived unless someone can change or remove the cause of the biased actions.

In the world of investments, a *trap* is something that can lead to losses of capital or opportunities to make productive investments.[1] Although succumbing to such traps is unlikely to be fatal, it can seriously harm personal wealth, affect achieving financial goals, and damage self-esteem. However, investors can be their own worst enemies. They suffer from many behavioral or psychological biases that affect their judgment and decision-making. A *bias* is nothing more than the predisposition toward error.[2] Thus, a bias is a prejudice or a propensity to make decisions while already being influenced by an underlying belief.

Unfortunately, many individuals make rash financial decisions and commit investing sins. They make mistakes, display behavioral biases, and fall victim to investment traps because they lack the knowledge, experience, or self-discipline to make better choices. Investors may be unaware of why they make the investment decisions that they do. Poor decisions can result from bad advice, the wrong advisor or decision methodology. Many novice investors also devote little attention to understanding investing and the choices available to them. They may even spend less time managing their portfolios than planning a vacation or buying a car!

Making sound investment decisions is part of being financially literate. *Financial literacy* is the ability to understand how money works in the world: how people earn or make it, how they manage it, and how they invest it to create more wealth. Financial literacy also refers to the set of skills and knowledge that allows people to make informed and effective decisions and utilize all of their financial resources.[3] Financial literacy should command attention because many people are inadequately organizing their finances to ensure their own well-being. Johnnie Dent, Jr., author, lecturer, and motivational speaker, notes, "Financial illiteracy is like being in a rain storm and trying to jump in between the raindrops... eventually it all catches you at the same time." A lack of financial literacy costs Americans billions of dollars every year.[4]

Becoming financially literate typically requires many hours of study and effort generally achieved over a long period. Although becoming financially fit may seem daunting, it is not a pipe dream, so long as someone is willing to seek some assistance. Although even knowledgeable investors make mistakes, let psychological biases affect their decisions, and tumble into investment traps, they do so far less often than less savvy investors. Those investors with less know-how need to sharpen their financial saw.

To help make better financial decisions, investors need to be aware of two enemies: one is external and the other is internal. External enemies involve those who try to deceive unsuspecting investors by setting investment traps. The other, and possibly more dangerous enemy, lies within investors themselves. Realizing that novice investors can be their own worst enemy can be frustrating. As Benjamin Graham, the legendary investor, scholar, and teacher, once wrote, "The investor's chief problem — and even his worst enemy — is likely to be himself." Successful investors avoid self-victimization. All investors suffer, often unknowingly, from behavioral biases that affect their sound judgment. Ultimately, yielding to either foe, be it internal or external, affects your wealth and welfare.

The purpose of this book is to help you recognize and avoid common investing mistakes, behavioral biases, and investment traps that can ensnare investors, affect sound judgment, and reduce wealth. The advice provided can help you rein in the emotional saboteur within you and enable you to become a more money savvy and successful investor. Following good financial