NAVIGATING THE INVESTMENT MINEFIELD

ENDORSEMENT FOR *NAVIGATING THE INVESTMENT MINEFIELD*

The practical aspects of investments are still a void in our academic literature. Professors Baker and Puttonen have written this excellent and brilliant book to help introduce and elaborate the practical dimensions of investments. This book is a must read for any investor, finance practitioner, and business student. Frequent and common mistakes in investments and understanding risky products, among other topics, are well explored. Enjoy reading this book for developing better insights into the world of investment and wiser strategies. I strongly recommend this important book.

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NAVIGATING THE INVESTMENT MINEFIELD

A Practical Guide to Avoiding Mistakes, Biases, and Traps

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INVESTOR IN PEOPLE

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ABOUT THE AUTHORS

H. Kent Baker, CFA, CMA, is an award-winning author/editor of 33 books including *Investment Traps Exposed* and *Investor Behavior – The Psychology of Financial Planning and Investing*. With more than 40 years of investment experience, he offers a practical approach to helping investors achieve their financial goals. He has consulting and training experience with more than 100 organizations. He has helped train thousands of individuals to enter the investment profession. He is University Professor of Finance in the Kogod School of Business at American University and has eight earned degrees including three doctorates.

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> *Either write something worth reading or do something worth writing.*
>
> Benjamin Franklin

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INTRODUCTION

> *Investing is not nearly as difficult as it looks. Successful investing involves doing a few things right and avoiding serious mistakes.*
>
> John C. Bogle (Founder of the Vanguard Group, Inc)

People often lack the knowledge of how to successfully invest their hard-earned money. Given that high schools and universities typically don't teach basic investing principles, the fact that many people find investing so difficult isn't surprising. Investing can be complicated, it doesn't have to be. Although investing requires some specialized knowledge and skills, this fact doesn't mean that nonprofessional investors can't earn satisfactory investment returns. Sometimes the best advice is easy to digest. Successful investors must avoid making common investing mistakes, succumbing to behavioral biases, and falling into investment traps that litter the investment landscape. They must also understand and follow some basic investing principles. Unfortunately, as Benjamin Graham, a noted investor, economist, and writer once wrote, "Wall Street has a few prudent principles; the trouble is that they are always forgotten when they are most needed."

In his 2013 "Shareholder Letter," Warren Buffett, Chairman and CEO of Berkshire Hathaway and one of the most successful investors in the world, offers some basic advice.

> *You don't need to be an expert in order to achieve satisfactory investment returns. But if you aren't, you must recognize your limitations and follow a course certain to work reasonably well. Keep things simple and don't swing for the fences. When promised quick profits, respond with a quick 'no'.*

Buffett continues by noting that the:

> *"Know-nothing" investor who both diversifies and keeps his costs minimal is virtually certain to get satisfactory results. Indeed, the unsophisticated investor who is realistic about his shortcomings is likely to obtain better long term results than the knowledgeable professional who is blind to even a single weakness.*

You should be aware that Buffett started with less than \$10,000 and turned it into \$86.6 billion by early 2018. This example indicates that the knowledge you have can be more valuable than the initial amount of money you have. You can overcome barriers to getting rich if you're willing to work hard and learn.

Buffett's long-time business partner, Charlie Munger, remarks: "You don't have to be smart if you avoid the standard stupidities." To help make better financial decisions, you 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 you. Realizing that you're the problem 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 make mistakes and suffer, often unknowingly, from behavioral biases that affect their good judgment. They often expend considerable energy focusing on market returns and media reports as well as the gyrations of the Standard & Poor's (S&P) 500, 10-year bonds, and Nikkei prices. Although you can't control market prices, you can control your costs, risk level, and your own behavior. Therefore, you should focus on those elements when investing to avoid the standard stupidities that investors make.

Financial products are sometimes sold aggressively and persuasively. Unfortunately, the goal of many seemingly legitimate people is to separate you from your hard-earned money, not to help you achieve your financial goals. Investment frauds and scams are ubiquitous and lurk just around the corner. Although some investments may appear too enticing to pass up, you need to be constantly vigilant. Your task is to find out which financial products fit your investment plan and which don't.

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. In other words, this book can enable you to manage the investment aspects of your financial life in order to reach your goals. As Warren Buffett notes "You only have to do a very few things right in your life so long as you don't do too many things wrong."

Navigating the Investment Minefield begins by discussing the importance of becoming financially literate about the investment world. Chapter 2 highlights common investing mistakes that many investors make including financial professionals. Making mistakes is part of the learning process, but repeating those mistakes disregards what you've learned. Chapter 3 discusses behavioral biases that can be detrimental to wealth. Both chapters also provide practical advice on how to lessen making mistakes and succumbing to behavioral biases. The remaining chapters examine eight investment traps, illustrated with real-life examples from all around the globe, and provide insights and guidance on how to mitigate them. Successful investors recognize and avoid these costly traps. Thus, the investment world doesn't have to be a scary place if you're well-prepared to face it.

As Warren Buffett notes, "Investing is simple, but not easy." Following the investing principles and advice provided in this book can help you rein in the emotional saboteur within you and enable you to become a more money-savvy and successful investor. Learning how to invest wisely can help you manage your money with greater confidence and to reach your financial goals. Heeding good financial advice is critical when making any investment decision and this book offers such advice. As Lao Tzu, an ancient Chinese philosopher, once wrote, "The journey of a thousand miles begins with one step." Much ground needs to be covered, so let's get started.

CHAPTER 1

NAVIGATING THE INVESTMENT MINEFIELD: DON'T BE INTIMIDATED BY THE WORLD OF INVESTING

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

Warren Buffett (American Business Magnate, Investor, and Philanthropist)

When you think about investing, what words come to mind? If you're like most investors, these words are likely to be overwhelming, intimidating, and scary. To many people investing is a four-letter word because they think they'll be overwhelmed by financial jargon and hours of tedious research. They remember that during the past decade, investors faced many challenges including the subprime 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. They are aware that some of those providing these "opportunities" seek to take advantage of them. 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, intimidating, and scary especially if they attempt to tackle this task on their own. Although most individual investors aren't experts, they still must take responsibility for their actions and financial lives. To be financially successful, you must avoid many pitfalls along the way or risk-making errors that affect your 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 isn't much, unless they recognize the pitfalls along the way and deliberately sidestep these financial landmines. Investors need to avoid making rash financial decisions and committing investing sins. They also need to separate investment fads from time-tested investment principles. Accomplishing this task is easier said than done but it's worth the effort.

Investors face three major challenges: (1) making mistakes, (2) displaying behavioral biases, and (3) falling victim to investment traps because they lack the knowledge, experience, or self-discipline to make better choices. Making mistakes is part of investing, especially for novice investors. As Irish poet and playwright Oscar Wilde once noted, "Experience is simply the name we give our mistakes." Although you can't travel back in time to fix your mistakes, you can learn from and avoid repeating them. Thus, mistakes provide the stepping stones to learning.

People can also 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. Thus, a bias is a prejudice or a propensity to make decisions while already being influenced by an underlying belief.

Investors can also fall into investment traps. In the world of investments, an investment *trap* is something that can lead to losses of capital or opportunities to make productive investments. Although succumbing to such traps is unlikely to be fatal, it can seriously harm your personal wealth, affect achieving financial goals, and damage self-esteem.

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 beginning investors also devote little attention to understand 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. Financial literacy should command attention because many people are inadequately organizing their finances to ensure their own well-being. A lack of financial literacy costs people tens of billions of dollars every year.

> 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.
>
> Johnnie Dent, Jr.

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 isn't a pipe dream, as long as you're 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.

WHERE TO BEGIN

Investors sometimes find themselves in a similar position as Alice from Lewis Carroll's *Alice's Adventures in Wonderland*. Coming to a fork in the road, she asks the Cheshire cat:

> *Alice: Would you tell me, please, which way I ought to go from here?*
>
> *Cheshire cat: That depends a good deal on where you want to get to.*
>
> *Alice: I don't much care where.*
>
> *Cheshire cat: Then it doesn't matter which way you go.*
>
> *Alice: So long as I get somewhere*
>
> *Cheshire cat: Oh, you're sure to do that, if only you walk long enough.*

> A goal without a plan is just a wish.
>
> Antoine de Saint-Exupery

The moral of this story is to start at the beginning – knowing which way to go. As Yogi Berra, the famous New York Yankee and member of the Baseball Hall of Fame, once said: "You've got to be careful if you don't know where you're going, 'cause you might not get there." Unlike Alice, investors should base their investment decisions on clear goals and then determine the appropriate path for achieving them. Unfortunately, many investors get caught up in the latest investment fad or focus on short-term investment returns instead of following a plan designed to help them achieve their long-term goals.

Investors can follow several paths to achieve their financial goals. One path is to "go it alone." If you're intent on managing your investments, you want to be sure that you're qualified to do so. Another path is to use the services of a qualified professional. Working with a financial advisor and knowing how to do your own financial planning aren't mutually exclusive. Even if you decide to use the services of a financial advisor, you should have at least a basic knowledge about personal finance, especially investing, so that you understand the advice you're receiving and know what questions to ask. Just because you work with an advisor doesn't mean that you can abdicate your own responsibility. A third option is to use a robo-advisor. These new digital platforms can manage a portfolio for only a fraction of the cost of a human financial advisor but involve several drawbacks.

> The best way to measure your investing success is not by whether you're beating the market but by whether you've put in place a financial plan and a behavioral discipline that are likely to get you where you want to go.
>
> Benjamin Graham

Regardless of which path you take, the process begins by establishing your financial goals. In general, the basic goal of investing is to build wealth. Once you're wealthy, you need to retain your wealth. Being "wealthy" differs from person to person and depends largely on your state of mind and lifestyle. Perhaps, being wealthy means having no financial constraints on activities, surpassing a certain asset threshold, or not having to work again. Whatever your definition, building wealth is a key goal.

BEING A DO-IT-YOURSELFER

Taking a do-it-yourself (DIY) or self-directed approach entails managing your own money, including your investments. For most, planning their financial well-being including retirement has become a DIY proposition. Why? People typically don't work for organizations that offer much in the way of financial or investment advice. Hence, you need to develop competency in personal finance. Even if you work for an organization that provides a retirement plan, the financial landscape has shifted away from defined benefit pension plans to defined contributions plans, which are now the dominant plan form in the private sector. With a *defined benefit pension plan*, an employer promises a specified monthly benefit on retirement that is predetermined by a formula based on the employee's earnings history, tenure of service, and age. The employer bears the risk of providing these fixed payments. By contrast, in a *defined contribution plan*, employers and employees make fixed contributions into an individual account, which are then invested. The employee determines where to invest these funds and hence assumes the investment risks and rewards, not the employer. Thus, knowing how to do your own financial planning and investing is more important than ever.

> It takes half your life before you discover life is a do-it-yourself project.
>
> Napoleon Hill

Well-informed individual investors can often do quite well on their own, especially if they have a carefully crafted investment plan and diligently execute it. Unfortunately, many people unwittingly sabotage their chances of meeting their financial goals by violating the terms of prudent investment plans. On their own, novice investors tend to underperform the markets in which they invest. A DIY approach can be fraught with danger if you lack the specialized knowledge and discipline necessary to succeed in today's highly competitive financial markets. Emotions play a big role because DIY investors often do exactly the opposite of what they should. For instance, investors might attempt to "time" market movements, engage in inadequate diversification, pay high and unnecessary fees to managers and advisors, and use borrowed money in an attempt to gain higher returns.

Yet, despite numerous pitfalls, you can avoid or at least reduce making common investing mistakes and succumbing to behavioral biases. You can also avoid being duped into investment traps by becoming more informed about financial matters in general and investing in particular. One of the biggest risks you face is failing to educate yourself about which investments can help you achieve your financial goals and how to approach the investing process. As Benjamin Franklin once said, "An investment in knowledge pays the best interest." Warren Buffett echoes this sentiment when he remarked, "The most important investment you can make is in yourself."

Nothing is more likely to pay off than gaining financial education and engaging in the necessary research, study, and analysis before making investment decisions. As Peter Lynch, the former manager of Fidelity Magellan Fund, notes, "Average investors can become experts in their own field and can pick winning stocks as effectively as Wall Street professionals by doing just a little research." A lack of knowledge and awareness could result in regrettable financial decisions that diminish your wealth. If you aren't an informed or intelligent investor, others can and will take advantage of you. If you don't believe this statement, just ask the person with a "this can't happen to me attitude," who has fallen victim to investment fraud.

> Invest in yourself. Your career is the engine of your wealth.
>
> Paul Clitheroe

Don't underestimate your abilities or potential or cut corners when learning how to become a successful investor. You need to learn basic principles before investing. With sufficient time devoted to learning and research, you can become equipped to handle your own portfolio and investing decisions. As H. W. Lewis writes in his book *Technological Risk*, "Those who are unwilling to invest in the future haven't earned one." In fact, you might be better off being a DIY investor, even if you currently lack competency, than working with an incompetent or conflicted advisor. Much of investing involves applying common sense and not being swayed by emotions. Billionaire investor Warren Buffet once observed that "You don't need to be a rocket scientist. Investing isn't a game where the guy with the 160 IQ beats the guy with 130 IQ." He also stated that "You don't need extraordinary intelligence to succeed as an investor."

WORKING WITH AN ADVISOR

Another path to helping you achieve your financial goals is to use the services of a qualified professional such as a financial planner, an investment advisor, or a wealth or money manager who has the requisite knowledge, skills, and abilities. Although differences exist among these individuals, we'll simply call them financial advisors. Unfortunately, much