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# WHAT THE FINANCIAL INDUSTRY DOESN'T WANT YOU TO KNOW

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## I've Met the Enemy, and the Enemy Is Me!

*When I'm left on my own, I'm my own worst enemy.*

—Ron Wood

I'm going to start with the single most important thing for you to understand if you're going to change your financial circumstances and create prosperity for yourself and your family. You're probably not going to like what I'm about to tell you, but here's something I can guarantee: your financial future depends on your ability to believe and accept what I'm about to reveal to you. In fact, I'm starting with this because without question it is absolutely the main reason that most people never achieve financial success.

The reality is that the biggest reason you've been held back financially is *you*. You are literally your own worst enemy when it comes to money and investing. Most people don't like to hear this, but let me remind you that this applies to everyone, including me.

It's important for you to understand some of the thinking and behaviours you have right now that are hurting your financial future, because once you're aware of them, you can change them. Sadly, most Canadians never take the time to try and learn anything about how investing, finance or money works. They simply listen to the "experts," hand their money over to others who claim to be professionals and hope for the best. To many people, investing and money management are some kind of voodoo magic, and they don't really understand it. It's too painful to try and learn it, so they avoid the topic—and their financial statements reflect this sad reality.

So why is it that so many investors are fearful of making decisions? Why do so many people avoid learning about simple concepts when it comes to investing and managing their own money?

This can be easily explained by what I call the “Financial Overwhelm Loop.”

## THE FINANCIAL OVERWHELM LOOP

As you grow up and get through high school and then possibly university or college or go directly into the workforce, you become acutely aware of all the financial things out in the world you know nothing about. You begin to hear about the stock market, RRSPs, mutual funds, real estate, taxes, corporations, stockbrokers, cash flow, contribution matching, market timing, diversification, dollar-cost averaging—the list is endless.

Predictably, since you've never formally been taught any of these things, they cause you anxiety and concern, because you have no idea what they are or what you should be doing about them. As you accumulate some money, you have a sense that you should be doing *something* with that money, but you just don't know *what* that should be. You begin to feel a sense of being overwhelmed by trying to figure out what to do. Fear and trepidation set in, too.

There doesn't appear to be any other logical solution. Your parents don't seem to be able to offer any intelligent advice and your friends don't seem to understand things any more than you do, so you do what most people do in this situation and turn to a financial advisor to ask for some help. And then it begins.

You feel a sense of relief as you hand your responsibilities over to an “expert” who will take care of your money. When you meet with him (or her, as the case may be), he sounds very smart and he gains your confidence that you've selected the right person.

Of course, since you don't know to ask, he doesn't discuss his compensation or how he is going to profit from working with you. Rarely is the nature of your relationship with him discussed in detail. All you know is that he is going to manage your money and grow it so that you can enjoy a wonderful retirement.

You then essentially ignore your financial situation, trusting it to someone else. You don't educate yourself, or learn about new products and services coming out in the marketplace. You don't pay a lot of attention to

the fundamentals of the markets. In fact, you can't, because you wouldn't know where to start.

But you carry on with your career or your business, your family and all the other priorities you have. Besides, you've got enough going on in your life, and the last thing you need to do is try to become a financial expert. You've never been good with numbers, and it's just not your skill set. You do what you need to do, your advisor manages your money, and everyone lives happily ever after. Right?

Unfortunately, most investors find out at some point that while this fairy tale is easy to believe, it rarely comes true. Eventually, out of nowhere, some kind of financial problem arises. There's a meltdown in the stock market, or interest rates are increased without warning, or your portfolio takes a hit for some reason that you're not clear on.

And here you are, looking to your advisor for help and reassurance. And what does he tell you? "Don't worry," he says. "Now is not the time to panic. We're in for the long haul, and now is a terrible time to pull out." He tells you that he thinks the market's about to come back, and tries to calm you down.

You're feeling trapped, because you don't have any idea how to interpret what's going on and you're blindly relying on someone you hope knows what they're doing. You're again feeling overwhelmed, because you don't know whether you should fire your advisor, or if you should stick with it "for the long run."

And this vicious circle continues over and over, blindly trusting others with your money and then failing to become educated so that you can make better decisions in the future. For many investors, this cycle repeats itself for their entire lifetime. Some investors switch advisors during a downturn, while others stick with theirs, hoping that at some point things will turn around.

Now, don't get me wrong—as I'll outline in the next chapter, I don't think that the entire financial industry is out to get you, or that you can't trust any financial advisor. While there are definitely some serious problems in the way that the system is structured (and works against the interest of the individual investor), I do believe that most of the people in the financial sector are honest and want to help you. Unfortunately, as you'll see, many of them don't even know the damage they're causing to their clients.

In any case, the point you need to get right now is that no one will take better care of your money than you will.

## PATH OF LEAST RESISTANCE

One of my key beliefs is that in life, when something negative happens to you, there are three primary ways in which you can respond.

1. **Blame.** One response might be to place blame on why the negative outcome occurred. For example, let's assume that an investor places \$10,000 in a stock that his stockbroker recommends. The stock goes to zero, and he loses his entire \$10,000 investment. He immediately jumps up and down, and points his finger at the broker, blaming him for putting him into a bad investment. Placing blame is the primary method in which most investors respond to losses.
2. **Justify.** Another response to a negative situation is to work to find good reasons for why it happened—investors attempt to justify the outcome. For example, a real estate investor who loses money suggests that the reason for the loss is that the market is soft, and there's not much he can do about something like that. The cause of the problem is out of his control, and he just shrugs his shoulders.
3. **Take Responsibility.** The third response to something negative is to take responsibility for the outcome. The investor accepts that the reason for the negative outcome was either in whole or part due to the actions (or inactions) that he personally took. If you look at the first example above, where the investor lost \$10,000, instead of blaming his broker he could instead look at what he did personally to contribute to the negative outcome (the loss).

Out of curiosity, how did you respond to the last loss that you took on an investment? When you checked your portfolio and saw that it has gone down several percentage points, did you blame anybody and anything but yourself?

If you look carefully at these three ways of responding to something negative, you'll notice that the first two—placing blame and justifying—put the power into the hands of someone or something else, and you cannot control the outcome. That's another way of saying that you are a victim.

You're really saying that it's not your fault, and therefore it must be the fault of someone or something else.

In the third response, taking responsibility, you are forced to step up and recognize what role you played in the negative outcome. Of course, most investors don't like to do this, as it's much easier to point the finger at someone else, or come up with a good reason (excuse) as to why things didn't turn out as hoped.

## Accepting This Important Truth

Until you are willing to identify and take responsibility for negative investment outcomes, you'll be powerless to stop them because you are putting yourself in the role of victim. Let me go back to the examples above to illustrate my point.

In the situation where the investor lost \$10,000 because he trusted his broker, it's easy for the investor to point at the broker and blame him. After all, the broker suggested that stock. But what role did the investor play? Or, more importantly, what role *could* the investor have played?

If the investor had been willing to be responsible and accountable, one of the things he likely would have done is tried to learn more about the investment that the broker was recommending. He would have played an active role in the investment, as opposed to just sitting back and hoping that his broker had made a good suggestion.

Blindly throwing money at an investment without understanding it is no different than placing a bet in Las Vegas. Any time you invest in something you don't understand, you're gambling, not investing.

In this case, the investor needs to accept responsibility for investing in something that he really didn't understand. By the way, this isn't the exception, this is the rule! Most investors are putting their money into investments in which they have no knowledge or understanding, so it's not surprising that most investors do not do very well.

In 2005, Ellen Roseman reported in the *Toronto Star* on a survey of Canadian investors in mutual funds that underlines this point. Of those surveyed, 60% didn't know what an "MER" was (it stands for "management expense ratio"), and 40% couldn't name the fund that they were invested in.

Think about that for a moment: 40% of the investors didn't even know what it was that their money was invested in! That's like having money invested in real estate, but not knowing in what city or province.

## THE H.A.P. INVESTING STRATEGY

I'm about to reveal to you the most popular investment strategy in the world today. It's particularly popular because it takes virtually no time to learn or to apply, and you can use it in any kind of investment vehicle. You don't even need a financial planner or stockbroker to utilize this strategy and, in fact, most investors do it themselves because it's so easy. It also happens to be the most popular strategy used by Canadians, and has been since the dawn of time. My guess is that at some point, you've applied this strategy yourself and perhaps still are.

What I'm talking about is the Hope and Pray (H.A.P.) Investing Strategy—what most investors are relying on to create their financial future and retire in comfort. It involves simply hoping and praying that things are going to turn out okay, but my guess is that if you're reading this book you already know that this is a fairy tale. The H.A.P. strategy hasn't worked for you.

Hoping and praying is what you have to do if you decide to hand over your money to someone and let them take care of it. You have to hope they know what they're doing, and pray that they make decisions in your best interest and don't lose it all. It's truly a loser's strategy, and it's one that I hope you'll never apply after reading this book.

## VICTIM NO MORE

At this point, I hope it's clear why being a victim is so damaging to your net worth and your financial future, and I hope I've inspired you to decide that you're not going to choose to be a victim anymore. I'm also hoping you're recognizing why this discussion of psychology is as important, if not more important, than talking about investment principles, facts and figures!

If you're prepared to STOP being a victim with your money and investing, I have a very effective tool that I personally created when trying to overcome the desire to be a victim.

## Asking "What Role Did I Play in This?"

"What role did I play in this?" This is a question I created for myself many years ago, I find that it immediately takes me out of the victim mentality and plants me squarely in reality. It forces me to think about what role I've played in an outcome, and helps me avoid the trap of blaming and justifying.

Asking yourself this question forces you to be accountable for at least some portion of the outcome. The more you ask the question, and the more honestly you answer it, the more you begin to realize that you—not someone or something else—were primarily responsible for the outcome.

Let me again look at the \$10,000 investment loss to demonstrate the use of this powerful tool. In that case, when the investor lost his \$10,000 in the stock recommended by the broker, he was quick to condemn and blame the broker for making the bad decision.

However, if that investor stopped and asked himself what role he played, he would soon have to face the reality that *he* invested his money without understanding the stock. He would have to admit that he was blindly hoping and praying that the broker was going to do a good job. Thinking about it further, he'd likely come to the realization that if he had done some research on the stock and was able to ask intelligent questions, he may have been able to see a reason why that stock wasn't the best choice.

I certainly feel that the broker played some role here, since providing good advice is supposed to be part of the job. But when we're talking about an investor who doesn't even pretend like he wants to learn anything or be involved, it's rare that this situation works out well for everyone.

Let me emphasize this point by looking beyond the investment world and sharing with you what I believe is one of the most profound and important statements that I'll make in this entire book.

I believe that a direct indicator of how successful you will be in life (not just financially) is based on your willingness to be accountable for your results.

This applies not only to investing and money but equally to relationships and other areas of your life. For example, if you continually blame your spouse for the problems you have in your marriage, and you're not willing to step up and assume responsibility for some of your faults, then that relationship is doomed.

## **Taking Full Responsibility, No Matter What**

If you want to be successful, you must immediately begin assuming responsibility and being accountable for all the negative things that happen in

your life. The more that you can eliminate blame and justification from your vocabulary, the more successful you will be.

I often get challenged on this, because someone will say to me, “Well, my car got broken into last night, and they took my briefcase with my laptop. I lost all of my documents for the past three years. And you’re telling me this is my fault?”

Actually, yes I am. Before you decide to return this book, I’m not saying that you caused the break-in, but you did make several decisions that brought about the negative outcome. First, you decided where to park your car. That likely contributed to the outcome. Next, you left a valuable asset in the car, when I think most of us realize that’s usually not a good idea. You chose not to take the briefcase with you, wherever you were going. Maybe you felt you had a good reason for this—perhaps you were going for dinner with your spouse, or going to the gym. In any case, whether you had a good reason or not, recognize that you made the decision that led to the outcome. All of the documents for the past three years are gone. That would imply you didn’t have a backup of your documents. And whose responsibility was that?

Hopefully you’re getting the point here, and not resisting what I’m saying. Believe me, it has taken practice and time to get accustomed to taking responsibility in as many areas of my life as I can. But I also share with you that the moment I became accountable, my life changed. And you have the very same opportunity. You simply need to make the decision.

## **DON'T WORRY, THAT'S NOT YOUR ONLY PROBLEM**

If all of this weren't enough to contend with, the reality is that as human beings we are wired with instincts, habits and responses that have evolved over thousands of years, all with one purpose: to help us survive this dangerous world.

I'm not going to delve into a deep discussion about psychology, but I think it's important to help you recognize that the way our brains are wired is in direct conflict with good, fundamental investment habits. Put another way, the things that we do by instinct actually hurt us as investors. It doesn't seem very fair, but it's true, and becoming aware of such things gives us a fighting chance to work around these weaknesses instead of being blind to them as most investors are.

In fact, this realm is a fascinating field that continues to develop. Behavioural finance and behavioural economics are fast-growing areas of

knowledge that apply scientific research to the study of economics and the investment world, and attempt to identify the reasons why investors do seemingly irrational things. Personally, I've always been intrigued by what causes people to do the foolish things they do. Why do people hold onto a stock well after it's dropped, and has little hope of ever coming back? Why do investors buy real estate at the very top, thinking they're getting in at the bottom, when the market indicators clearly are saying otherwise?

## Recognizing Investor Biases

I refer to each of these problematic instincts as “investor biases,” because you have a natural bias to respond in a certain way when presented with a specific scenario. A bias is simply a false assumption or judgment you've made that isn't based on fact or truth. Investor biases are automatic reactions that you likely have to specific investing situations that are based on an emotional response, not an intellectual one.

It's worth noting here that a powerful psychological influence is at work twenty-four hours a day on all of us, which helps explain some of the strange things we do, not just with our money but in other areas of our life as well.

Psychologists have proven that the human mind only does something for one of two primary reasons: a desire to either (1) obtain pleasure or (2) avoid pain. And they've proven that our instinct to avoid pain is stronger than our desire for pleasure. In other words, your brain will go out of its way to avoid pain, regardless of whether there's an opportunity to obtain pleasure. The avoidance of pain overrides your desire to obtain pleasure, and this is something that's hard-wired into us as human beings.

What does this have to do with investing? Everything. Your psychology will dictate your investment success more than anything else you can learn or understand. That's why I feel it is appropriate to spend just a few moments on this.

### Investor Bias #1: Aversion to Loss (The Need to Be Right)

One of the most powerful human instincts ingrained in us is that each of us has some deep desire to be right about the decisions we make. We gain a sense of pleasure when we are correct. Conversely, when we are wrong, we experience some degree of psychological pain, and therefore we try to avoid being wrong. Again, remember the two things our brain is constantly seeking out: experiencing pleasure and avoiding pain.

To demonstrate this bias, consider an investor who buys a stock at \$1.00. After a couple of weeks, she checks her account and finds that her stock is down to \$0.85. What does she do? If she's like most investors, she holds onto her position and uses a number of reasons (excuses) to rationalize that decision:

1. "I've already taken the 15% loss, so selling now locks that in and that would be foolish."
2. "The decline is temporary and the stock's going to come back."
3. "It's a good company and the market isn't seeing the potential." (And she tells herself this, even though she has never reviewed the company's financial statements or prospectus.)

What's really going on here is quite simple. Subconsciously, the investor is trying to avoid a painful experience. As a result, she's avoiding the decision to sell at a loss, because she would have to admit that she was wrong and that creates pain, which she is desperate to avoid.

Most investors aren't even aware of this inner dialogue going on, but the net result is that they decide to keep holding the stock, which usually means that what could have been a short, quick pain turns into a long, dull, slow pain that lasts for weeks, months or even years.

If you're not sure whether you are vulnerable to this bias, consider the following scenarios based on the excellent work of Van K. Tharp in *Trade Your Way to Financial Freedom*.

Given the following two options, which would you choose?

1. A sure loss of \$15,000
2. A 20% chance of no loss at all, and an 80% chance of a loss of \$20,000

If you're like 80% of the population, you would select the second option. The problem is, the second option works out to a larger loss because, on average, the second option produces a loss of \$16,000 (i.e.,  $20\% \times \$0 \text{ loss} + 80\% \times \$20,000 \text{ loss} = \$16,000 \text{ average loss}$ ). Therefore, the first option is the one that a professional investor would choose.

The reason that most people choose the second option is because it provides some potential of avoiding loss. Most investors would prefer to take the risk that the market is going to come back and help save them

from the loss. Unfortunately, this leads to a larger loss, which then makes it even more difficult to get out.

Let's try another example. Which of the following options would you choose?

1. A sure gain of \$15,000
2. An 80% chance of \$20,000, and a 20% chance of no gain at all

Again, about 80% of the population chooses the first option in this case—the sure gain. However, the second option is actually the best, because the gain in that case would be \$16,000, which is higher than the sure gain. Taking the sure gain violates the investing rule of letting your profits run.

Most investors are afraid of losing, and end up taking a profit whenever they can. This satisfies their need to be right, and helps avoid the loss. Unfortunately, being blind to the bias at play means that they are likely making poor investment decisions, even though their decisions may seem logical.

I've felt this very bias many times, and none more than when I bought Nortel in 2000, the year of the dot-com collapse. I bought Nortel at \$80 per share, after it had come down from \$120 per share, on the advice of a broker that I had at the time. Because I thought I was such a brilliant investor I decided to use leverage (using a margin account), and borrowed money from the brokerage so that I could buy even more stock. I bought three times the amount of stock that I had the money for, because that would mean I'd make triple the killing!

Soon after I had bought it, it dipped to \$60 per share, and I spoke to the broker. He told me that he thought it was headed back to \$120, and that this was just a temporary decline. I quickly agreed (recognizing now that it was because I was looking for a reason to avoid selling) and held on. The stock started to climb back up, making me feel great pleasure that I had made such a genius decision. It slowly moved back up towards \$80, but never made it. The rise in price was temporary and soon it was headed back where it came from.

When the stock dropped again like a rock, I was forced to sell my major position at \$12 (on margin). The pain of being wrong was intense. I blamed the broker at the time, since it was he who convinced me to hold on. I had a gut feeling I should sell, but I overrode that thought and stayed in . . . only to lose all of my money on that investment.

In hindsight, this was one of my greatest learning experiences as an investor, because it taught me the lesson of accountability, and made me realize first-hand how dangerous the need to be right can be to an investor.

As a side note, it is usually when we take a loss or make a mistake that we truly grow and evolve as investors, because it is through those experiences that we learn how the investment world really works.

## Investor Bias #2: Overconfidence

Another dangerous bias that many investors experience is that of overconfidence. It comes in many forms, but the result is that an investor makes decisions out of courage or false belief that they know more about the situation or strategy than they really do.

You've probably heard of the studies that show that when surveyed about their driving abilities, 80% of all drivers rank themselves as "better than average." Of course, this is impossible. Clearly, many of those surveyed are incorrect and would actually fall in the category of "poorer than average." But most drivers are not willing to accept this, and assume that they are better drivers than they really are—they are overconfident in their abilities on the road.

Yet another cause of overconfidence is the *illusion of control*. Many investors falsely believe that they have more control over a given situation than they really do, leading them to make decisions based on poor assumptions.

As a look into how profits are made by taking advantage of human biases such as the illusion of control, let's consider the lottery industry. As you probably know, when you are buying a ticket for Lotto 6/49, you have the choice of allowing the computer to select your numbers or choosing your own "lucky numbers" for the draw. What do you expect most people prefer to do?

As you'd expect, most people would prefer to choose their own numbers because they feel they're better in control of their odds of winning, yet logically we know that the odds are identical whether you choose your own numbers or they're randomly generated by a computer.

It's actually quite humorous to think that we have better control of the outcome of the lottery if we are able to choose our own numbers, but this is something that most people never even stop to think about.

And you can bet the lottery industry reaps billions of dollars of profit as a result.

The truth is, as human beings, we want to believe that we're in control of what is going to happen and that we can influence outcomes such as winning the lottery or investing in a stock that goes up in value. However, the cold, hard fact remains that when it comes to money, the only way to create success and prosperity for yourself is to understand what you're investing in and to reduce (to the best extent you can) the biases and instincts that are constantly working against you.

And as a last comment regarding overconfidence, another challenge also can develop that many investors don't see coming: the challenge of being successful out of the gate. Early success, sometimes referred to as beginner's luck, is often the worst thing that can happen to an investor. It causes newbie investors to quickly think they're more capable and talented at investing than they really are. Early successes often lead investors to take bigger and bigger risks, putting them in a position where they end up taking a loss they can't afford. This is why it is so important to be aware of these biases, and recognize them when they begin to show up in your investing efforts.

*Aversion to loss* and *overconfidence* are two of the most powerful biases that you will likely need to wrestle with on your path to investment success, so be on the lookout for them.

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In this chapter, my goal was to help you understand why it is that from the outside looking in, so many investors seem to do things that do not make a lot of sense and appear to be irrational. The reality is that as human beings, we are vulnerable to emotional and biased decision-making, and this can be disastrous when those decisions are about our money and finances.

Successful investors recognize that investment decisions need to be based on practical, proven investment principles, and spend time not only learning solid strategies but also paying attention to their own emotions and biases.

In an ideal world, we could eliminate our emotions from any decisions we made that involve money. But the reality is that this is impossible. Your

goal shouldn't be to eliminate emotion from your decision-making, but rather on managing your emotion and identifying when you're letting it seep into your investment decisions.

Managing your emotions and biases is the internal challenge that we all face. However, in the next chapter, I'll introduce you to the external challenge that's also waiting for you, and I'll warn you now: what we're about to go into is a much more challenging adversary than your own emotions and internal dialogue.

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