



Behavioral Problems

Human nature often compromises investment returns.

MODERN ECONOMIC thinking assumes that people make rational choices based on objective analysis. But practical experience offers contrary evidence. Investors often act on impulse, emotion and illusion—and pay a high price for their mistakes.

Behavioral finance is a relatively new academic field that explores the role of human psychology and social dynamics in financial decision making.⁽¹⁾ There's a wealth of insight available in this research. Many investors fail to reach their goals because they lack understanding or discipline. As they venture into unknown territory, their financial mis-cues can overwhelm their prudent planning.

You can improve discipline by knowing some of the major behavioral risks that tempt everyone. The following introduces some of the more common human errors identified in research. These include:

- **Mental accounting.** This refers to people's tendency to partition their finances into categories—such as current income, assets and future income—and treat each differently when making spending and investment decisions. This is why someone may exhaust income before selling an asset to raise cash.

Another example of mental accounting is when a retiree separates his portfolio into “safe” and “risky” categories, with the “safe” investments designed for principal protection and the “aggressive” investments intended for growth. Although his intent to strike a balance between downside risk and upside protection may be well-meaning, the approach often results in cost inefficiency and higher risk from overcommitment to a single stock or as-

set group.

The risk-return tradeoff is better managed at the portfolio level using the principles of Modern Portfolio Theory (MPT), which center upon a portfolio's overall risk and return traits rather than the performance of the individual components.⁽²⁾ This

results in more efficient mixing of assets and reduction of total risk for a given expected return—or an optimally higher expected return for a given risk level.

- **Availability bias.** This term was coined by psychologists Daniel Kahneman and Amos Tversky in their foundational behavioral finance research.⁽³⁾ It refers to how people use familiar events and information to assess the probability of a future

outcome. Rather than thoroughly researching a topic and weighing the information objectively, they turn to the most accessible sources for guidance. This is surely a reason why companies spend money on advertising and promotion.

Investors are using availability bias when they choose money managers based on industry reputation and performance ratings. People often form opinions on an investment firm, foreign market sector or investment strategy based on incomplete or tainted information.

You can avoid this bias by following accurate research that is presented in context by objective sources, including certain professional and academic journals.

- **Anchoring bias.** When estimating probabilities, individuals anchor on a specific value and then adjust it to account for other elements of the circumstance. Usually once the anchor is set, there is

Continued inside



(1) Researchers form theories about the role of social behavior, human emotion and cognitive bias on financial decision making. Behavioral finance applies both hard and soft science to theories of how people interpret information and act on it. Hard science methods include experimentation, factual observation and quantitative analysis. Soft science relies on qualitative research and subjective tools of economics, psychology and other social sciences.

(2) MPT proposes that optimal diversified stock portfolios exist, with each portfolio offering the highest expected return for a given level of risk. The strategy proposes diversification among lower-correlation stocks and asset groups.

(3) Amos Tversky and Daniel Kahneman, “Availability: A Heuristic for Judging Frequency and Probability”, *Cognitive Psychology*, Vol. 5, 1973, pp 207-32.

IRA Charitable Rollover

A direct gift avoids income tax on your distribution.

THE PENSION PROTECTION ACT of 2006 has opened another avenue for charitable giving with a tax savings twist. The new rule involves an Individual Retirement Account (IRA). If you have a sizable IRA, intend to make a charitable gift in 2006 or 2007, and want to bypass the income tax incurred on your IRA distribution, this tax provision is worth considering.

In the past, making a charitable contribution with IRA money usually incurred more tax cost than benefit. First, you had to liquidate assets and withdraw the cash from the IRA. Then you would write a personal check to the charity. At tax filing time, you reported the IRA distribution as income and claimed a charitable deduction for the same amount. However, even though the reported income and charitable deduction were equal, a higher tax bill usually resulted.

The reason is that income and deductions don't receive equal treatment in the tax world. For example, some retirees don't have enough qualified expenses to itemize their deductions, so their contribution does not appear on the tax return. Also, many taxpayers who itemize face income and deduction limits. They cannot deduct more than 50% of their personal income for gifts to a public charity (or over 30% of their gifts to private foundations).⁽¹⁾ In addition, higher income taxpayers also face limits on their itemized deductions.⁽²⁾ Thus, deductions are less valuable as income climbs.

To make matters worse, reported income from an IRA distribution can push you into a higher bracket and subject more of your Social Security income to taxation. Before the new pension law, the effects of these laws made giving from IRA distributions less attractive.

Benefits

The new law enables you to make a charitable gift directly from your IRA, without having to personally handle the IRA distribution. Known as an IRA charitable rollover, the direct transfer bypasses the reportable income and charitable deduction routine on your tax return while also eliminating exposure to the income and itemized deduction rules discussed above.⁽³⁾

The IRA gift amount is treated the same as a cash distribution for purposes of satisfying all or

part of the required minimum distribution (RMD) applied to IRA owners over age 70½. So, you can satisfy your annual RMD and avoid the risk of higher income or reduced deductions and tax credits. The rollover is also available to those who don't itemize or wish to avoid exposing more of their Social Security to taxation. Another possible benefit is that the IRA charitable rollover may not be subject to state income tax, depending on the particular state's rules.

Conditions

Of course, tax benefits always come with strings attached. Here are the qualifying points:

- The IRA owner must be over age 70½.
- The gift must come directly from the IRA (via account check from custodian) and not be handled by the taxpayer at any time.
- Donor can exclude only the first \$100,000 of the IRA transfer from gross income. (Amounts above this are treated as income.)
- Contribution can go only to qualified public charities, community foundations and private foundations that meet conduit rules.⁽⁴⁾
- Donor should obtain a written receipt from the qualifying charity.
- Charity cannot provide any benefit in return for the contribution.
- IRA owner cannot itemize the IRA transfer on his/her tax return. (The transaction does not appear on the return, either as income or charitable deduction.)
- If the IRA contains both pretax and aftertax money, the contribution is treated as originating from pretax sources.
- The gift must be transferred from your IRA by 2006 or 2007 year end to qualify for those years. (The rule expires after 2007.)

The IRA charitable rollover is a good strategy for anyone who plans to give to a qualifying charity and has a large enough IRA to do so. The decision could reduce your reported income and avoid exposure to various deduction limits and higher tax brackets—all resulting in a potentially lower tax bill following the good deed.

Also, if you have another type of retirement account, such as a 401(k), you might consider rolling over the funds into a traditional IRA, then making the charitable gift from the new account.⁽⁵⁾ Converting the plan to an IRA opens up the tax advantages to you as well. ■

(1) This is known as the percent limitation rule. Although gifted amounts over 50% of income can be carried forward to future tax years, the future deduction amount is lost in the event of death.

(2) The phased-in reduction of itemized deductions is known as the 3% floor. Before 2006, taxpayers with adjusted gross income above \$150,500 (joint married) or \$75,250 (married filing separately) had to reduce their itemized deductions by 3% of the amount their reported AGI exceeded the limits stated above. For 2006 and 2007, the limit on itemized deductions is eased by one third.

(3) In a conventional rollover, the taxpayer can withdraw money from the IRA and transfer to another IRA within 60 days without the distribution being treated as income.

(4) IRA transfers don't qualify if made to donor-advised funds, private nonoperating foundations or split interest trusts (such as charitable lead or remainder trusts). To make gifts to these entities, one must follow the traditional method of personally taking the distribution, gifting the money, then reporting the income and claiming the charitable deduction on the tax return.

For a private foundation to meet the conduit rules, it must pay out 100% of the contributions received in its tax year by the 15th day of the third month after the close of the tax year, and also meet its regular 5% distribution requirement.

(5) This article does not offer a complete treatment of the new IRA charitable rollover rule. It should not replace qualified legal, tax or financial advice. Consult your advisor(s) before taking any action.

Behavioral Problems

(Continued)

a bias toward that value.

For instance, even the most prudent investors may anchor their overall return expectations to the U.S. stock market's long-term average. When the market drastically deviates from the average, investor confidence weakens. After a prolonged period of abnormal returns, some investors begin adjusting their long-term views to match recent experience, despite the fact that the variance is not unusual.⁽⁴⁾

• **Confirmation bias.** Investors tend to seek out and interpret information in a way that confirms what they want to believe. Moreover, they reject or downplay information that challenges their opinion. Investment firms may play to this weakness by highlighting certain research to support their positions while ignoring conflicting evidence.

Strains of confirmation bias circulate through the financial media. For example, pundits refer to a stock's price-earnings (P/E) ratio or the market's average P/E to predict the future. When the ratio moves above the long-term average, they warn that the market is overvalued; when the P/E is below the average, they predict that the market is poised for an advance.

This view is based on selective use of data. Academic research does not provide convincing evidence that the market's average P/E can reliably predict the direction of stock prices.⁽⁵⁾

• **Clustering illusion.** Investors may identify patterns within the random noise of the market, or correlations between stock prices and business indicators.⁽⁶⁾ This is quite common among technical analysts and market timers who are continually developing new theories and trading models.

These patterns appear only in backward analysis and rarely hold up to future events. They are, in fact, research anomalies that occur when a large amount of historical data is statistically analyzed. With the advancement of computing power and growing availability of market data, one should expect even more clustering analysis in the future.

• **Outcome bias.** Some people judge the quality of their investment choices by results rather than strategy and principle. How can you argue with success? A results-oriented approach may seem practical for investors, but it sets a dangerous precedent because people often don't understand their risk exposure until potential losses become *real* losses.

The best defense against outcome bias is to understand how markets work and avoid temptations to stray from a well-conceived investment plan. Evaluate all investment "opportunities" impartially, considering the merits of both confirming and disconfirming evidence.

• **Hindsight bias.** Hindsight is often misused as a predictive tool. It's easy to draw conclusions now about past market cycles, sector performance, the economy's direction, or winning/losing stocks. Hindsight bias tricks an investor into believing that the signs were obvious all along, when in reality, the signs are obvious only in retrospect.

Unfortunately, many individual and institutional investors rely on past experience to predict the future. Their rules-of-thumb rarely pay off, however. While we can all learn from mistakes, one should remember that investments deal with the unknowable future. The best approach to managing uncertainty is to diversify across many asset groups

and markets, based on your ability to accept risk that is both quantifiable and manageable.

• **Fear of regret and loss aversion.** People often experience intense grief after realizing they made a poor financial decision. This pain is so intense for some that they will avoid realizing a loss. Investors also demonstrate loss aversion by keeping too much of their portfolio in cash and fixed income vehicles to avoid the inevitable volatility of stock ownership.

The remedy is to follow a portfolio maintenance strategy that emphasizes asset mix, not performance of individual securities or asset groups. Rebalancing is one example of a dispassionate approach to managing value fluctuation in your portfolio.⁽⁷⁾

Continued on back



Do you know someone who is really smart, but makes really dumb decisions with money? These individuals are likely to be successful in other endeavors, but their financial lives are out of kilter. Here are a few examples:

• Joan has a great job and earns a six-figure salary. Even though she gets a generous raise each year, she can't seem to be able to save and invest for her future.

• Three years ago, John received a large inheritance from his grandmother. If well managed, her generous gift could provide John financial security for the rest of his life. However, he feels anything but secure. The responsibility of financial stewardship has challenged his self-confidence and triggered anxiety attacks and depression.

• Tina recently graduated from law school and landed a position in a top firm in San Francisco. Although she was offered a very competitive starting salary, she finds that it is inadequate to meet her living expenses, car payments, and student loan payments. After all the sacrifices she has made to reach this career goal, she is angry and frightened about her financial outlook.

• Tim wants to micro-manage the family budget and it is driving Karen crazy. They have been married five years, and Tim's attention to their money matters is becoming increasingly obsessive. To assert her independence in this relationship, Karen frequently goes on shopping sprees.

• Ken checks the market several times a day. On down days, he is filled with anxiety about his shrinking retirement nest egg. Recently, after several days of steady declines, the Dow precipitously dropped another 300 points. Ken immediately called his broker and demanded that she sell every one of his investments and put the proceeds into a money market.

You can probably relate to one of these descriptions because nearly everyone has or has had a complex and difficult relationship with money. As these examples illustrate, "financial success" depends on a lot more than on how much money you have!!

The point to remember is that self-knowledge is essential to understanding and improving your relationship with money. When you earn, spend, and invest your money in ways that are "smart" and also compatible with your underlying values and priorities, you will then experience a sense of financial satisfaction and success.

© 2006 Money Quotient®, Inc. All Rights Reserved.

(4) This illustrates recency bias, which is the opposite of anchoring. People can give too much weight to recent experience and extrapolate recent trends that are at odds with long-term averages.

(5) Based on analysis of average P/E ratios for the S&P 500, measured over 275 quarters between 1936 and 2005. (Meir Statman, "Confirmation Bias", Cognitive Bias Series, The Monitor; www.imca.org)

(6) Attribution bias is a close relative of both clustering illusion and confirmation bias. People seek out order when observing random events. They also want to assign causes to effects, especially when they can take credit for the success.

(7) To rebalance, you sell overweighted assets and acquire underweighted assets. Returning to the target allocation reinstates your investment policy and helps you better manage market uncertainty. It also encourages dispassionate decision making that results in acquisition of assets that are declining in value—and sale of assets that are rising in value.

Behavioral Problems

(Continued)

• **Illusion of control.** Investors often assume they have more influence over their investment success than they actually do. (This may require the help of other biases.) They take credit for investment gains while blaming losses on factors outside their control. Resisting this illusion requires an understanding of the risk components (such as market, company size and financial strength) that account for most of a stock's return. It's also useful to know the commanding role that human error plays in triggering needless investment losses.

• **Overconfidence effect.** People with specialized knowledge in market sectors, industries or professions may believe their skills enhance their stock picking ability. This view typically begets overconfidence, which encourages excessive trading activity in an account. Research shows that excessive trading incurs higher costs and larger doses of risk while driving down net returns below the market average and below the average returns earned by less active investors.⁽⁸⁾

Experience is the most potent remedy for overconfidence. But it also can inflict pain and reduce your wealth. The wiser course is to understand the difference between speculating and investing—and avoid the get-rich-quick trading mentality.

These are only a few of many cognitive errors affecting investment decision making. We have all fallen victim to some of them. But we don't have to learn every investment lesson the hard way! Strive to know financial truths, form a solid investment policy, diversify your portfolio to control risk, and develop discipline to stay the course. These behaviors can improve the odds of building long-term wealth in the financial markets. ■

(8) Brad M. Barber and Terrance Odean. "Trading Is Hazardous to Your Wealth", *The Journal of Finance*, April 2000, pp 773-800.

Barber and Odean have specialized in the trading behavior of individual investors. They researched the returns of tens of thousands of households with accounts at a large discount brokerage firm during the late 1980s and most of the 1990s.

In My Opinion...

Robert J. Cole, Jr., CLU, ChFC, CASL, CFP®

Let's "Retire" the Word Retirement...

Over the past several months, our industry journals are crammed with articles about helping clients with their retirement. The television is full of investment firms offering products designed to live your "golden years" in a secure manner. Yes, it seems that the baby boomers are going to indeed lead the next charge into "retirement".

But I have noticed an interesting thing about this moment. The common definition of the state of "retirement" doesn't seem to fit my practical experience. We see images of kindly elders fawning over grandkids, all in smiles as they spend countless hours of leisure. There are those pictures of smiling couples engaging in the freedom of idleness. I am sure that these scenes do in fact have moments in the daily lives of those of us fortunate enough to have passed age fifty-five, but my work with real people shows that they are indeed only moments.

In the "old days" (of fully insured pension plans), a worker was expected to put in his years, then move on to the front porch (and the rocking chair) to "disengage" from society—very few of them making it to age seventy five. Then came several seismic shifts. First, companies changed to the 401k plan and asked the employees to foot most of the cost of funding the retirement plan. But the baby boomers were going to have none of that. They were busy spending all their assets (and borrowing the rest) to gross up their possession of stuff. Today, as they approach the Golden Years, many of them are in debt up to their ears and express grimly that they will have to work "the rest of their lives" just to pay the bills. Looks like there will be no "retirement" for this group. I just hope they have a skill set that someone wants to hire.

The next revolution came from those who did save enough money. It seems that this group had no intention of sitting on a porch. Many of them took second "jobs", but did so on their own terms. Part-time consulting, scaled back flex-time, and plenty of time off are all part of this scenario. The statistics tell us that staying "engaged" in this manner improves health, expands social networks, and builds mental and physical capacity. These people are busy, but loving it.

So where are the Rocking Chair people? I think they are gone forever and I say good riddance. Medical science continues to stretch out the life expectancy and I can't think of a worse way to spend it. I think it is time for our industry to quit painting retirement as some nirvana in the future and get people to take a hold of their lives today. Yes, you will need resources to do this, one of which is financial. But you will also need energy, health, friends, and hobbies to make it work. I look around and see many examples of people who have lead balanced lives in all of these areas and continue to live their lives "on purpose". Work, while an important component to the path of actualization, is not an end to itself. It is never too late to expand the other areas of your life. Live today for what it is, and drop the word "retirement" from your vocabulary. You are already there...

Until next time, that's my opinion.

Robert J. Cole, Jr., CLU, ChFC, CASL, CFP®
President