SOME LESSONS I HAVE LEARNED:

Dr. Daniel Kahneman, a tenured psychology professor, NOT an economist, was the 2002 Nobel Prize winner in Economics. Dr. Kahneman affirms many of the beliefs and opinions I have come to over the last 46 years. Here are some of them, for whatever good they might be. I quote him directly in some places, but mostly write from my own experience based on his stimulus.

Behavioral economics, Dr. Kahneman' specialty, is a hot topic in financial planning circles. Those of us in practice a long time have learned that many of the beliefs and assumptions our clients bring to us are just not true! The first one is that people will be rational in their financial affairs. Not so! We humans are very emotional about our money. These emotions often control our actions, and we do foolish things, such as buying when stock prices (and those of other financial assets, like residential real estate) are at all time highs and then becoming discouraged and selling when our holdings "go on sale" and fall steeply in price. This is in lieu of taking advantage of lower prices to add to our holdings. I am in the only business I know of where people knock down the doors to buy my merchandise when prices are at all time highs, and then run away when that merchandise is marked down 50%!

Kahneman claims that the biggest, most common error is what he calls "narrow framing;" looking at investment problems in isolation from the entire portfolio and total financial circumstances. Professional financial advisors know that we cannot possibly manage a portfolio without having losers. We plan for this certainty by diversifying our clients' portfolios in order to reduce risk. Depending on individual circumstances; age, net worth, income, period of life, family obligations, etc., we craft a portfolio which will allow the client to meet their life goals. Dr. Kahneman urges investors to take a "very broad view and to begin with strategic decisions; how safe you want to be and feel; what basic allocation of your assets is comfortable for you; and the other points necessary given your own circumstances." He urges investors to not spend time trying to guess what a particular stock is going to do or to worry about trends of particular economic indicators or industries. I agree!

Individual "mistakes" are not an unexpected consequence of owning an investment portfolio. They are inevitable! Investors, or their professional investment managers acting for them, must periodically "weed the garden," removing investments which are not living up to expectations or which have reached unjustifiable levels. Most investors do the opposite, all too often aided by their commission paid brokers, selling their winners while holding on to their losers, not being willing to "take a loss." Of course, the losses already exist! Recognizing them and replacing them with better opportunities is what professional investment managers get paid to do. Dr. Kahneman points out that, psychologically, this tendency makes sense since when one sells for a profit they feel good about it and "pat themselves on the back." In contrast, in selling for a loss one accepts "immediate punishment" for making a poor choice, or for having their investment advisor make a choice, that went bad. It is not at all surprising that we humans would rather reward ourselves than punish

ourselves. The research suggests that this understandable behavior is really very costly. We do much better selling our losers and hanging on to the winners. This is a good example of "normal" behavior leading to bad outcomes.

Kahneman also points out the tendency of investors to take too narrow a view, which also leads them to ask for the wrong advice. They ask about specific stock investments or strategies without giving their advisors or potential advisors the necessary details about their particular situation; the risks they are carrying and will be comfortable with, their status in life, etc. etc. This often happens to me on the cruise ships and I resist answering these type questions until I know their whole story. People should ask about their own big picture, and always consider specific decisions and their impact in the context of their overall situation and objectives.

I had a good example of this on a cruise several years ago. An elderly gentleman, came to the podium after my lecture on Global Investing and called me "a fool," suggesting that I was not informing my audience of "the most attractive investment" available; namely buying euros and shorting the US dollar. I pointed out that this is speculation, not investing, and I do not discuss speculations with my audiences, where I normally have many senior citizens who are rightfully risk adverse. I also pointed out that his framework was too narrow, that the euro had indeed been going up for some months, but that it originally came out in 2000 at 1.17 to the dollar, dropped into the eighties in a couple of years, then began a rally. The euro was $1.25 then, some years later it is still 1.27 to the dollar. I don't believe I was/am a fool!

I will raise a related point we financial planners see all too often. People have portfolios which are significantly undiversified, typically far too heavy in one industry or in the company they work for. For emotional reasons they refuse to sell any of "their" stock(s). In these situations I always point out that "I realize you love your Lilly stock (headquartered there in Indianapolis) but you need to understand that your Lilly stock does not love you!" Expanding on this, people also like to buy stocks they are familiar with; in their geographic area; in their industry; in their country, etc. They feel they know more about these companies than those from elsewhere. They may or may not. But it is a strong bias and, carried too far, usually delivers poor results.

Dr. Kahneman points out that "sensible clients will actually want their professional investment advisor to make these decisions." We are supposedly qualified to do so and generally make these choices better than the clients can. The markets are cruel indeed, and soon weed out those advisors who are not qualified to do so. He says, "merely being dispassionate about the outcome gives advisors a big advantage in getting things right. It is clear from the research on that the majority of individual investors are out of their league. They tend to be hyperactive; they churn their accounts (churning means overtrading); and they do not even know how well they are doing!" My experience suggests this is largely correct.

Kahneman also points out that most investors think of risk in terms of downside risk of loss. They are concerned about, and often exaggerate the maximum amount they can lose. Professionals define risk in terms of variance, the degree of volatility in a stock or portfolio, called "beta." This does not discriminate gains from losses. There is misunderstanding and miscommunication with the public because of these very different views on risk. I believe veteran Certified Financial Planners ™ understand where their clients come from on risks, but very often other investment professionals do not.

He also discusses the risk of underperformance, of not being with the pack when markets are running away on the upside, such as the U.S in the late 1990s, and U.S. residential real estate in recent years. He points out this is "why individuals typically get in too late. Everybody else is getting rich and they are the only ones not getting rich." At this point it is very late in the game and when these folks do get in, it may well be time to get out. He points out that "people are prone to think that the world has changed, and they do not appreciate that the end is near." An old adage holds that the four most dangerous words in Wall Street are; "it's different this time!" He also brings up the fact that; "losses loom larger than gains in people's minds, and that causes them by and large to be too risk averse. (So) risk aversion thus causes the price of equities to be relatively too low." This theory is probably true.

Another distinct problem is communication. This is a two way street. Investment managers generally are good at keeping in touch with their clients. The norm is a quarterly newsletter and a quarterly call. In my own case, when the markets are tumultuous, as they now are, I call monthly. When they are quiet, I call bi –monthly.

Clients who pay for services with commissions are another story. Brokers are notorious for their reluctance to contact their clients when times are tough or things have gone wrong. During my six years as a NYSE branch manager in the 1970s for Robert W. Baird and Co., I was constantly harping on my brokers to call their clients. This was needed especially during the 1973-75 bear market. But there is another side to this problem. Clients do not call their brokers either. If your account is inactive and little or no revenue is being generated for your broker, human nature is likely to put your account and your situation at a low priority. If you need help, advice, or just a shoulder to lean on, you can and should contact your broker. Many times I have gone through my mutual fund statements only to find that a client has sold a particular position without contacting me. Often the timing or the selection is a poor one; a better solution to their cash flow problem was available, if they had just asked. In my opinion though, there is no excuse for a commissioned broker to fail to contact his active clients at least twice each year. But inactive clients can usually get any service they need by initiating a contact.

Dr. Kahneman suggests that many investors pay too much attention to their holdings. He suggests that "the best advice is to do little and don't think too much. Leave it to your investment advisor and don't check your results too frequently as

that may cause you to make mistakes." This advice assumes you have a sound portfolio of quality securities which fit your investment profile. This brings us to the electronic financial press. CNBC and its ilk on both TV and radio are not in the business of advising you how to invest your money, they are in the business of selling advertising! They are usually very short term in their focus and many investors watch or listen daily. You can learn things from them, but their normal focus on the near term; today, tomorrow, next week, or next month. This near term focus will probably cost those who act on it a lot of money.

The latter part of the above advice flies in the face of my own monthly or bi-monthly updates, but we rarely focus on individual holdings during these calls. Dr. Kahneman suggests the optimum time frame between reviews is thirteen months based on available research. On the other hand I normally recommend buying good stuff, holding on for the long term, at least three to five years, and weeding the garden twice a year. Of course, a paid investment advisor is constantly looking for weeds in their clients' gardens, and we periodically weed out poor performers or overpriced holdings from all their client accounts as seems appropriate.

On the topic of professional investment managers, who are often knocked since "The average mutual fund underperforms the overall stock market!" Of course they do! They are, collectively, the market! And the market does not pay management and execution fees. However, and this is a big however, the larger and more successful long term mutual funds, those to whom investor funds flock over long periods of time, actually outperform the stock market averages by four percent! Two families of funds that illustrate this point are the American Funds and the Templeton Funds. After subtracting two percent for management and administration fees, shareholders net two percent better than the market. In this illustration, we ignore sales fees, which are, in my mind, fees for advice and guidance and are not relevant to this particular point. Individually managed accounts by the top managers can do slightly better than this as there are no administrative costs.

We are quite proud of our affiliated investment managers based in the U.S. Midwest far from the money centers where "the crowd" is often doing the wrong thing. Please call or write us to explore your own situation.

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