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Financial Perspective

What Behavioral Biases are Affecting Your Financial Decisions?

The fields of finance and economics assume that humans make calculated rational decisions; but, we don't. Fortunately most of our irrational decisions are minor, but others can have detrimental long-term consequences. Why do we make them? The answer may come from the relatively new field of behavioral finance which we define as the study of not-so-rational investment decisions.

There are dozens of reasons and underlying biases that cause people to behave irrationally, often against their best interests. Just knowing some of them may help you avoid mistakes in the future and possibly give you a financial edge. Here are just a few of the big ones, some of which are also applicable to other types of decisions.

1. Recency Bias. This one causes the most financial damage. Remember the fearful people in early 2009 thinking the Dow at 8,000 would continue all the way down to 2,000? Perhaps you were one of them. Recency bias means that we extrapolate the current trend well into the future. It causes people to buy near the top and to sell near the bottom, thinking that the trend will continue. Closely related to recency bias is **Availability Bias** in which people tend to give more credence to current events and new information than to the expense of the majority of the facts and the big picture.

Antidote: *Stop and remind yourself that no trend continues indefinitely. Look at investment fundamentals—are they reasonable and sustainable? Try to put news in perspective and think long-term.*

2. Confirmation Bias. We like to think that we carefully gather and evaluate facts and data before coming to a conclusion. But we don't, for the most part. We find facts to fit our pre-conceived conclusions. Any sales training 101 class emphasizes that people buy emotionally, then justify it with facts after the purchase. This also happens with our political views.

Antidote: *Seek out opinions and resources that don't support your opinion. On the financial side engage the services of a professional investment manager with a rigorous analytical process and robust information sources.*

3. Overconfidence or Optimism Bias. We like to call this the *Lake Woebegone Bias* ("where all the women are strong, the men are all good-looking, and all the children are above average"). We tend to think of ourselves and our decision-making ability as above average. Yet, we are only correct about 80% of the time when we are "99% sure."[1] Studies show that 80% of drivers say that their driving skills are above average.[2] We suspect that none of them drive I-5 when we do. Confidence and optimism are good things when it comes to investing and financial planning. However, too much of a good thing can cloud your thinking.

Antidote: *Ask yourself what can go wrong and realize that you are only one trade from a humbling wake-up call.*

4. Hindsight bias. Have you wondered why so many people now say that the events leading up to the creation of the Internet, the 2000 tech bubble, 9-11, or the 2008 market collapse were so obvious? They have hindsight bias, which stems from the innate need to find order in the world by creating explanations that allow us to believe that events are predictable. While it is helpful to learn why things happened, finding erroneous links between the cause and effect of an event may result in incorrect oversimplifications. Worse yet, if you forget how you came to those conclusions, you can develop a

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INSIDE

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Behavioral Biases . . . *Continued from page 1*

sense of overconfidence that you knew what others didn't and that you know what others don't.

Antidote: *Try a little humility by reminding yourself that if all the experts didn't see something coming, you probably didn't either; otherwise, you would have acted upon your information. Be the first to admit that you don't have all the relevant facts when making a decision.*

5. Anchoring. This is the inclination to hold on to a viewpoint and apply it as a reference point for making future decisions. A shirt marked by a retailer with an original price of $100 seems like a bargain when it is 30% off, but was it really worth $100 to begin with? Maybe it's really worth $50 or $60. Likewise, we do this with real estate and stock prices. Just because a stock was once $100 doesn't mean that it is worth $100 at today's fundamentals and earnings prospects. Many people today have anchored on to the Great Recession and the market downturn from 2007-2009. As a result they are still waiting for the next shoe to drop, thereby missing out on the recovery. Or, they hold onto an unprofitable asset waiting for it to "get back to even" because they think that is what it is worth.

Antidote: *Try to find valid reasons for the anchor, and be open to new information if it contradicts your thinking.*

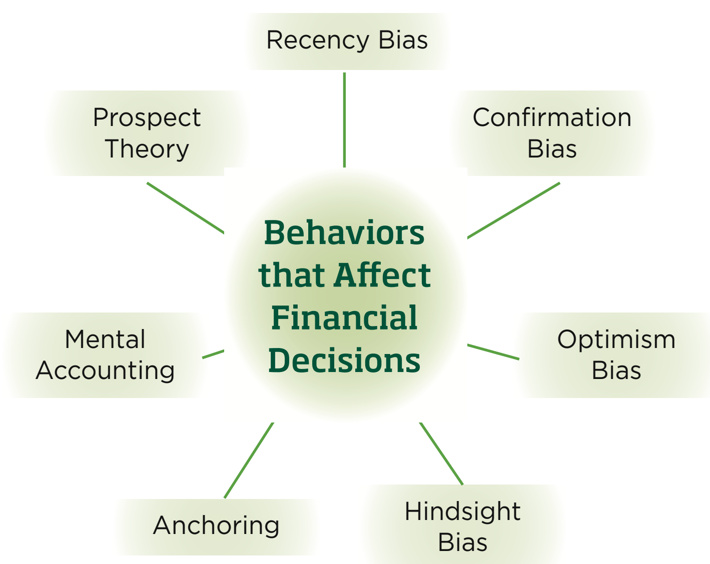
6. Mental accounting. Do you have separate pots of money for different goals? Or do you treat "found money" differently from earned money? If so, you are using mental accounting. It's not necessarily a bad thing when you invest more conservatively for your 16-year old's 529 college savings plan and more aggressively in your IRA which you won't need for another 15 years. It's quite another when you use different criteria for holding on to a losing investment and another set of rules for everything else. It's also not a good thing when you sock away money for a new car into a low-interest savings account or spend your tax refund on a vacation when you have high-interest credit card debts.

Antidote: *Recognize that money is fungible; regardless of its origins or intended use, all money is the same. Only your time horizon for each goal or an account's tax characteristics are different.*

7. Prospect Theory. This area of behavioral finance covers a wide range of behaviors. At its core, prospect theory contends that people value gains and losses differently. Numerous studies have shown that the joy of a $100 gain on a $100 investment is offset by the pain of a $50 loss on it after it hit $200. Prospect theory also helps explain why people hold on to losing stocks for too long and sell winning stocks too soon. To sell a loser too soon is to actually come face-to-face with a loss.

Antidote: *Before making an investment, ask yourself how you would feel and what you would do if your investment fell 25% or more. With your losing investments, ask if you would purchase that same investment today with what you know now. The odds are that you wouldn't, so why hang on to it?*

We are all human, so for most of us, money decisions are not always rational. If there is any common theme to the antidotes above it is to recognize the behavioral finance forces at work, gather information, ask questions of yourself, and think things through.



Congratulations, Brenna!

In this age of electronic everything—emails, photos, social media, websites, and more—it's always nice to get special documents via traditional mail. And so it was in mid-July when our own Brenna Baucum received her diploma in the mail from the College for Financial Planning for her CFP® certification completion. Two years in the making, Brenna spent many beautiful weekends, late nights, and time at the office taking the online courses, sitting for a series of five exams and completing a thesis.

All that remains now is her final comprehensive exam in November. Most long-time CFP® certificants, such as Larry, Mary, and Ron agree that the exam and curriculum requirements are far more rigorous today than when they earned their certification. Way to go, Brenna—we're proud of you!

Creating a Tax-Efficient Portfolio

The profession of accounting thrives in part because people don't like to pay taxes, and they try do whatever they can to minimize them, including taxes on their investment portfolios.

The easiest way to have a tax-efficient investment portfolio is to hold securities within qualified retirement plans and tax-deferred annuities. At least they are tax-efficient until it comes time to start taking withdrawals. For most people, retirement plans are limited in how large they can be, which means investors must invest outside of them. The question is, how can it be done tax efficiently?

At least four strategies exist to reduce investment income taxes, and a tax-efficient portfolio utilizes a combination of these strategies to minimize taxes.

Strategy	Tax Benefits
State and local government bonds	Tax-free interest in most cases
Long-term capital gains (on assets held longer than 12 months)	0% rate for those in the 10% & 15% tax brackets; 15% for those in the 25-35% brackets; 20% for those in the 39.6% bracket
Qualified stock dividends	Same as above
Low turnover (buy and hold)	No taxes until asset is sold, then capital gains rates apply

Typical mutual fund portfolios with **actively managed or index funds** provide excellent diversification across several asset classes, many fund manager choices, flexibility, and little or no transaction costs. However, dividends from their stocks and profits from their sales are paid out at year-end. Taxable bond interest is also paid as ordinary income. While this pay-as-you-go approach works well for most people, the timing of many gains in a particular tax year can be a problem for some investors.

For a buy-and-hold investor, it is possible to create a very tax-efficient portfolio that consists entirely of tax-free bonds—often called **municipal bonds or "munis."** However, these miss the upside of stocks and also the higher yield that can be obtained in other kinds of taxable bonds. Sometimes, it's possible to pay the taxes on the income from a taxable bond and still net more than from a tax-free bond.

However, you could add **individual stocks** to the muni bond portfolio for more upside. The tax liabilities on them are incurred only when the stock is sold or when a dividend on it is paid. The problem with this type of portfolio is that it would take a large amount of money to diversify across different asset classes, bond credit ratings, and bond maturities.

Enter **exchange-traded mutual funds (ETFs);** while they are similar to index funds, they have very low turnover and trade more like a stock. Unlike a stock, they are diversified pools of many different stocks in a particular asset class. They are not actively managed, which avoids the year-end capital gains distribution problem of regular mutual funds. Buying and holding them are partly what make them tax efficient. You decide when to incur the taxable capital gains by deciding when to sell. However, unlike actively-managed and passive index funds, you have trading costs for every purchase and sale.

To better serve our clients, we are creating tax-efficient portfolios. They consist of tax-free bond funds, ETFs, and actively-managed funds when the right ETF or index fund cannot be found. Their risk and reward characteristics are similar—but not identical—to our other portfolios with the same asset class weightings.

These aren't appropriate for everyone, especially for those below the 28% federal marginal tax bracket. Many of our clients have large built up gains in their existing portfolios, so there is also the tax cost of selling existing holdings to buy into a new portfolio. We would be happy to work together with you to assess your individual portfolio needs, and discuss whether or not this strategy might be right for you.

The Team Advantage™

Larry Hanslits, Mary Way, and Ron Kelemen and are independent CERTIFIED FINANCIAL PLANNER™ certificants. Together with Investment Advisory Associate Brenna Baucum, they jointly serve their clients as a team with over 82 years of combined experience. They work on a fee-only basis and do not accept any third party compensation or finder's fees. Their practice focuses on wealth planning and investment management for professionals, business owners, and retirees. They are advisory associates of The H Group, Inc., one of the largest independent fee-only registered investment advisory firms in the Northwest with 10 professionals in six offices with over $700 million under active management.

About Larry Hanslits, CFP®

In practice since 1985, Larry merged his practice with Ron's and Mary's in 2011. He sits on the investment policy committee of The H Group, Inc., provides advanced estate planning case writing services to attorneys nationwide, and is a teacher and a judge for the financial planning scholarship competition at Oregon State University.

About Brenna Baucum

Brenna joined the practice in 2013. She is a licensed investment advisory associate and completed her CFP® educational requirements from the College for Financial Planning. She is a member of the Rotary Club of Salem, the Women's Leadership Group, and a board member of the Chemeketa Community College Foundation.

About Mary Way, CPA, CFP®

Mary joined the practice in 1995. She is also a non-practicing CPA with 16 years' experience in banking, business, and finance. She is President of the 185-member Rotary Club of Salem, and like Ron, a past president of the Willamette Valley Estate Planning Council.

About Ron Kelemen, CFP®

In practice since 1981, Ron is the author of *The Confident Retirement Journey*, a financial columnist for local medical and dental societies, and a contributing author of three financial planning reference books. He is frequently quoted in the national press and professional journals. He is active in Rotary and several non-profit organizations.

Page 1 photo courtesy of Caren Ann Jackson

Team Update

Happy summer! We're having a good one, and we hope that you are, too. We've been as busy as ever with client update meetings, new clients, process improvements, and ramping up our recruitment process for an additional financial advisor. We are delighted to have **Natalie Brown** return as our summer intern to help with some longer range data management projects.

Michelle celebrated her first anniversary with us and it is a delight to reflect back on all of her innovations, office enhancements, and client scheduling improvements. As a Colorado transplant, she's been enjoying the delights of summers in Salem and the Oregon coast.

Debbie and Bob attended the Sisters rodeo and US Open Golf Tournament at Chamber's Bay, WA. The big news is the announcement of son Pete's engagement. The big day will be next January in Sisters.

Brenna briefly celebrated the arrival of her diploma from the College for Financial Planning, but is back at it now reviewing for her intensive November board examination which will give her the honor of putting CFP® after her name. In between, she goes camping and cans batches of jam and pickles. Tomatoes are next!

Larry and Laurie enjoyed a visit from their daughter Jenna over the 4th of July weekend. She has worked for Georgia Pacific in Atlanta Georgia for the last year. They've made excellent progress on landscaping projects around the house and improved their golf scores. Laurie won the low net score of her division at the Illahe Member Guest tournament.

Mary started the summer off with a bang. She and husband Steve attended the Rotary International Convention in Sao Paulo, Brazil followed by a few days in the beautiful city of Quito, Ecuador and a cruise around the Galapagos Islands for five days. She was inducted as president of the Rotary Club of Salem and is having a fun time—and, in our humble opinion—doing a great job.

Ron and Kathy bicycled with friends in the Alsace region of France for a week, where it was over 100 degrees every day of the ride. They cooled off during a four-day hike with daughter Shanti and her boyfriend in the Cotswold region of England. As you read this they are visiting daughter Skyler in Boston and listening to her boyfriend sing with the Boston Pops at the Tanglewood festival.

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How Solvent is Social Security?

By Brenna Baucum

Is Social Security going broke? To hear some politicians, one would think that it is. Actually, the newly-released Social Security Trustees Report for 2015 shows that the long-term payment projections have improved by one year over last year's report. Also, the combined Old Age, Survivors, and Disability Income Fund (OASDI) has a $2.8 trillion surplus, an increase of $9 billion over last year.

Even with the tidal wave of baby boomers entering retirement, and assuming that Congress does absolutely nothing, currently-scheduled benefits can be paid in full through 2034. Furthermore, the reserve is projected to grow this year due to an improving economy.

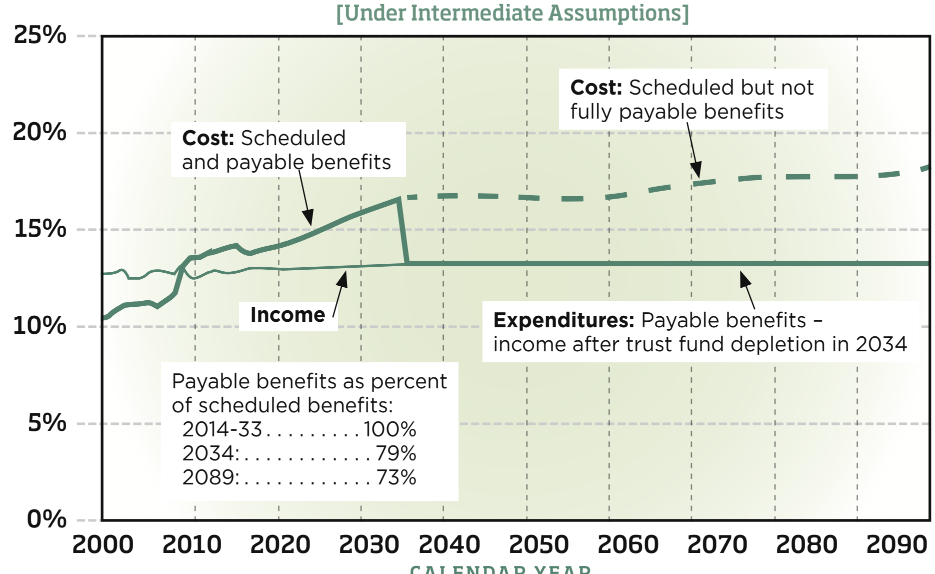
What happens in 2034? The OASDI Trust Fund of special issue treasury bonds would be depleted and only 79% of scheduled/promised benefits could be paid, financed entirely by payroll taxes.

The biggest challenge facing Congress right now is the depletion of the Disability Fund (DI); a serious but not unsolvable problem. The OASI fund, on the other hand, is expected to remain healthy until 2035. The chart reflects both funds.

Even if you aren't an actuary, the report has some interesting tables and graphs, including what it would take to fix the problem in terms of an additional payroll tax. (Answer: 2.68%, a slight improvement over last year). For light summer reading on the beach go to www.ssa.gov/oact/tr/2015. Meanwhile, we would be happy to discuss your Social Security questions and run some projections for you.

OASDI Income, Cost, and Expenditures as Percentages of Taxable Payroll

[Under Intermediate Assumptions]



Source: 2015 OASDI Trustee Report