Q4 2008
Volume 1, Issue 4

The Pretirement Press

PERPETUAL WEALTH ADVISORS
Your success. Your security. Always.

Perpetual Wealth Advisors, L.L.C. 933 Garrett St. #201 Atlanta, GA 30316
www.perpetualwealthadvisors.com newsletter@perpetualwealthadvisors.com 404-380-1977

Intro

Testing Our Rationality

As we head toward the end of the worst economic year that many of us remember, I thought it might be a good idea to walk through some of the findings of a relatively new field of economics called behavioral finance. The underpinnings of traditional economics are all grounded in one assumption, that humans are rational and will always make the best decision in a situation based on what they value most (profit, pleasure, or public progress, for example). The field of behavioral finance throws that assumption on its side. It instead presumes that humans make mistakes in evaluating certain circumstances and more importantly, that those mistakes are made somewhat predictably, based on flaws in our way of thinking. Of particular interest is the way that some of these quirks affect our decision making in the areas of business, finance, and financial markets. If we can understand some of the irrational decisions people make, and more importantly, why they make them especially in tumultuous times, perhaps we can prevent them on some level. Of course, preventing mistakes and irrational thinking is one of the core responsibilities of a financial advisor, but I continue to believe that ongoing education is another role. So, while this newsletter is a bit different than that of previous quarters, I hope the educational value remains nonetheless. ■

In This Issue

Heads I Win, Tales You Lose

Why It's Never Your Fault

Studies have shown that people tend to weight arguments that agree with their views higher than those arguments that oppose them. Similarly, investors tend to take credit for successful investments, but blame something out of their control for poor investments. These principles, called belief perseverance and biased self-attribution, respectively, tend to reinforce our beliefs and increase our confidence over time because they allows us to remember our wins and support our decisions while forgetting our losses and disregarding contradictory views. It makes us feel that we're better investors than we are because gains are brilliant moves and losses are not our fault. It also leads us to believe that our individual investments are better than they are because we virtually hear the positive news flow at a higher volume than the negative. All of this can lead to overconfidence, poor decision making, and inability to realize a bad investment. ■

Overconfidence & Underperformance

Let's say you want to buy a new car and you'd like to buy American, so you do some homework and head on down to the GM dealership. You have an idea of what you want to buy and how much it's worth to you. You've probably taken into consideration things like MPG, warranty, reliability, maintenance schedule, as well as some aesthetic factors. Maybe you do some comparison shopping, some bargaining, and when you ultimately pull the trigger, you're feeling pretty confident that you made the right decision.

Now let's say that instead of buying a GM car, you decide you want to put the same amount of money into GM, the company. More often than not, a common investor looks at the price of the stock and, if it's relatively low (in comparison to where it used to be, or in comparison to other well-known stocks), it looks cheap. The investor doesn't know much about the company, how much money it makes, or what percent of the company a share of stock represents. Yet, just by looking at the price, we have the same confidence we had as when buying the car and think we're getting a bargain that no one else understands.

Studies have shown that investors who believe they have superior knowledge tend to underestimate the risk in their investments which can later lead to panic selling if its value falls too far. Additionally, they trade more, but earn lower returns due to trading costs. Finally, when they don't have any basis for the true value of company's stock, they don't have a rational way to evaluate when to sell. They are to forced base sell decisions on emotion or another arbitrary price instead of a fundamental plan. These combine to produce lower than average returns on higher than average risk investments, the opposite of what investors should be seeking. ■

The PWA Top 10

Common Investing Mistakes

To err is human. To err in investing is costly. Here's a list of some of the most common errors investors make and why you should avoid them.

1. **Having a hard time selling an investment at a loss.** It's only a loss if you sell, right? Not really. We should only care what investments will do in the future and how they relate to our other investments and goals. If an investment is a bad fit, it should be sold, whether there's a loss or not. (There's also a tax advantage to selling losers!!).

2. **Chasing performance.** Everyone knows the goal is to buy low and sell high. But how many times do we buy the "hot" stocks or funds? Overweight tech funds in 2000? Emerging markets and commodity funds in 2008? We all know how that turned out.

3. **Over-trading.** The more you trade, the more of your wealth goes to your broker and to Uncle Sam. Develop a long-term plan and stick to it and you'll minimize transaction costs and short-term gain taxes.

4. **Allocating too much to one investment.** We've seen even blue chip companies go out of business in 2008 seemingly overnight. Make sure no more than 10% of your wealth is in any one company. Less than 5% is even better.

Please see *Top 10* on page 4

The Agony Of Defeat

Why It Hurts So Much To Lose

In one of the questionnaires that PWA gives to new clients to gauge their risk tolerance, we ask them to choose between certain gain or the possibility of greater gains with a higher expected value. We then ask the same question in reverse, asking for a choice between a certain loss or the possibility of greater losses. The questions go something like this:

1) *If you had to play the following game, which of the following four options would you select:*
   a) You win $4,000
   b) You have a 50% chance of winning $10,000 and a 50% chance of winning nothing.
   c) You have a 25% chance of winning $40,000 and a 75% chance of winning nothing.
   d) You have a 10% chance of winning $200,000 and a 90% chance of winning nothing.

2) *If you had to play the following game, which of the following four options would you select:*
   a) You lose $4,000
   b) You have a 50% chance of losing $10,000 and a 50% chance of losing nothing.
   c) You have a 25% chance of losing $40,000 and a 75% chance of losing nothing.
   d) You have a 10% chance of losing $200,000 and a 90% chance of losing nothing.

> *"…investors feel the pain of loss almost twice as much as they feel the pleasure of gain."*

The selection on the first question is not very relevant to the principle of loss aversion. What is relevant is that in the majority of cases, clients have chosen an answer with less certainty in question 2 than they do in question 1. That is, they're willing to take a higher amount of risk to avoid certain loss than they are to realize certain gain. This follows with a line of research which determined that investors feel the pain of loss almost twice as much as they feel the pleasure of gain. This results in an aversion to loss and leads investors to do seemingly irrational things like not wanting to sell investments at a loss even if it means giving up potentially bigger gains by selling and reinvesting in better investments. If you've ever found yourself emotionally attached to a losing position, you're probably experiencing loss aversion. ■

Fool Me Once Shame On Me

Why Performance Can Be Misleading

How long would a mutual fund manager have to beat her benchmark index by 1% annually for you to feel confident that she'll continue to beat that benchmark in the future? For many people, the answer is 3 years, or maybe 5 years. The tendency to find patterns in data based on small sample sets and to overreact to the supposed truths defined by those patterns is called "representativeness". Assuming that 5 years of mild outperformance indicates a repeatable pattern is an example of representativeness. Statistically speaking, to be 90% confident in the mutual fund manager's outperformance, she'd have to beat her benchmark by 1% for 37 years!!! Another way to think about this is that in a world of 10,000+ mutual funds, isn't it likely that a few of them will outperform for several years in a row? In any 5 year period, there will always be someone who has a great 5 years when you're looking at thousands of managers. But that doesn't mean those same managers will continue to have success. It's likely to be a different set over the next five years.

Please see *Performance* on page 4

Top 10 from page 2

5. **Buying low-priced stocks because they're low-priced.** If a company is worth $100 million and has 1 million shares of stock outstanding, they're stock will be worth $100 per share. If they're worth $100 million and have $100 million shares, they're stock will be worth $1 per share. Both companies are worth $100 million and the $1 per share stock is no cheaper than the $100 per share.

6. **Under-estimating risk.** Any stock can go to zero. If 2008 has taught us anything, it has taught us that. When buying individual stocks, we must understand that 100% of our money is at risk.

7. **Creating a portfolio and then not following it ("set it and forget it").** Investments require attention. Portfolios need to be rebalanced. Plans and strategies need to adjust to changing goals. Choosing a buy and hold strategy out of laziness is a recipe for disaster.

8. **Buying an investment because it's "down a lot".** Cheap stocks can get cheaper. And they usually do (See Lehman Brothers stock below). Looked cheap at 30 in March 2008. Even cheaper at 0.

Chart above shows Lehman Brother's stock price from 2007 to its bankruptcy declaration in 2008

9. **Looking for instant results.** An investment plan to achieve long-term goals with a short-term focus is doomed to fail.

10. **Holding your employer's stock.** How many people this year have lost their job and their retirement fund at the same time? Don't be one of them. The sum of your future paychecks is enough to have riding on one company. ■

Performance from page 3

So, when investors are selecting funds for their 401k's based on the 1, 3, and 5-year returns of the available funds, they're just chasing good performance, not necessarily making a good bet that the past performance will continue. In fact, if you look at the prospectus of those actively managed mutual funds, every one of them will include a line like "past performance is not an indicator of future results." If the fund managers themselves are telling you that, it seems like making investments based solely on past performance isn't very rational. Yet that's likely the primary method by which investors select their mutual funds.

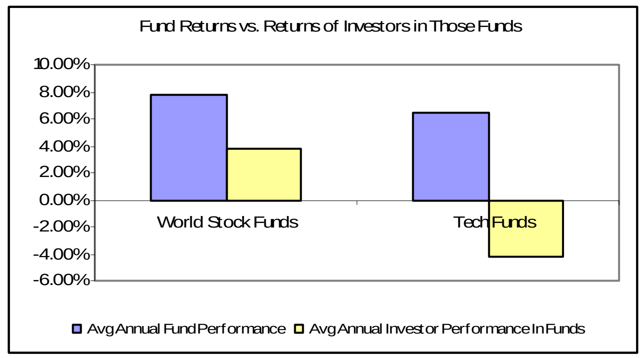
Instead of selecting based on past performance, investors are usually better served selecting low-cost index funds that don't try to beat their benchmark index, but instead try to replicate it. Then, their focus can be on creating a portfolio that matches the returns they need to achieve their goals over the long term rather than selecting mutual funds that they hope will outperform. Since index fund managers aren't chasing performance and trading excessively, you also get the benefit of lower fees (since there's less work on the manager's part) and more tax efficiency (since there's less trading and distribution of gains). ■

Time To Moooove

The Perils Of Following The Crowd

As much as we tell ourselves that when everyone else is selling, it's time to buy and when everyone else is buying, it's time to sell, it's very difficult to execute this strategy. Humans have a tendency to act as a herd. When everyone else is selling, it's too scary to buy. When everyone else is buying, we don't want to miss out on gains, so we don't sell. The result is that despite knowing what we should do, we're often paralyzed to actually act on it.

Because of this herding predilection, in tough times like we've experienced this year, many want to pull back on their investments. They either sell, or more likely, stop buying more. The effect can be seen in a study done by Morningstar in which they compared the 10-year return of a number of mutual funds with the average return that investors in those mutual funds experienced over those 10 years. In 93 world stock funds, the average return over the period was 7.71%, but investors in those funds only returned 3.78% on average. This is because investors tend to buy (high) in good times and sell (low) or stop buying in bad times. The result is even more extreme looking at returns in tech funds over the timespan that surrounded the popping of the tech bubble. 28 funds returned on average 6.40%, but investors actually lost 4.15% on average.



One way to avoid the herding effect is to develop a financial plan and stick to it despite short-term volatility in the stock market. Instead of investing in an open-ended attempt to maximize your returns without concern for risk, a plan helps you invest for your goals with the least amount of risk necessary. Though it's easy to forget, achieving your future goals is really what investing is all about. ■

Markets

The First Time, All Over Again

These are unprecedented times in the stock market. That is, for those with a short memory. Yes, I think we can all agree 2008 has been painful. And, I'll also agree that the rate of decline in stocks is as fast as it's ever been. But it was only five years ago when we last saw the market 50% down from it's previous high. It's hard to remember just how bad things got after the tech bubble popped, unemployment began to spike for the first time in a long time, the Fed had rates so low they seemingly couldn't go any lower, Sept. 11th made it seem like the days of economic growth were over, and the airline industry was in shambles. Headlines issued toward the bottom of the market in 2002 illustrated the pessimism that should be familiar to those following the market today. "Fear of free fall in the market" - US News and Word Report, 2002. "Most Americans have lost faith in the market" - Associated Press, 2002. It was a different bubble that popped (tech vs. housing), a different world crisis (terrorism vs. credit), a different confidence problem (corporate scandal vs. banking system), and a different transportation industry at rock bottom (automakers vs. airlines). But, five years ago like in all previous downturns, just when it

Please see *Markets* on page 6

Perpetual Wealth Advisors, L.L.C.
933 Garrett St. #201
Atlanta, GA 30316

Phone:
404-380-1977

Fax:
404-474-1629

E-Mail:
newsletter@perpetualwealthadvisors.com

Your success. Your security. Always

We're on the Web!

Visit us at:

www.perpetualwealthadvisors.com

PWA's president, Tom Nardozzi, is a CERTIFIED FINANCIAL PLANNER™

Markets **from page 5**

seemed like it could never get better, it suddenly did. Expectations were so low for the future that there was nowhere to go but up for the market. I'm not saying we're there yet, since the market almost always overshoots to the downside in bad times, but it's likely that there is a light at the end of the tunnel, and that it is not an oncoming train.

Henry David Thoreau once said that "a heart is forever inexperienced." The reason is that when it comes to emotion, we humans have short memories and a hard time learning. Whenever we feel pain, it feels like the worst ever felt. As the behavioral finance topics above have shown, when it comes to investing, humans do it more with their heart and their emotions than with their brains and their rational thoughts. For that reason, I believe the amateur investor is also forever inexperienced. Understanding that, avoiding some of the common pitfalls, and staying in touch with a good financial advisor can help many overcome the emotional impact on investing.

I'll leave you with a recent quote from arguably the best investor of all time, Warren Buffet. He recently said, "A simple rule dictates my buying: Be fearful when others are greedy, and be greedy when others are fearful. And most certainly, fear is now widespread, gripping even seasoned investors." There are two key take-aways from this quote. First, if you're scared, you're not alone. And second, Warren Buffet is buying stocks. In an economy filled with bad news, that's pretty darn uplifting. It's almost certain that better times lie ahead. Until then, I hope you and your family have a wonderful holiday season. ■

The Pretirement Press is a PWA's quarterly newsletter to clients. If you have comments or suggestions for future newsletters please contact us at newsletter@perpetualwealthadvisors.com. If you're not a PWA client, but received this newsletter and would like to be on our mailing list, please send an email to subscribe@perpetualwealthadvisors.com with Subject Line: Add Me. As always, if you or someone you know are interested in PWA's comprehensive planning, asset management, decision support, or tax prep services, please contact us to set up a free consultation. It's a small amount of effort to start down the journey to perpetual wealth.