The Thoughtful Investor

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Removing Emotion from the Investment Decision

Forbes magazine writer A. Gary Shillings caused an uproar in the corporate world with his March 1, 2004 commentary advising companies to get rid of their investor relations departments, the folks that answer analysts' questions and develop annual reports and presentations. Catering to Wall Street is no guarantee of enhanced valuations and at its worst is an invitation to Enron-style fakery, Shilling maintained.

There's also evidence that getting to know a company actually makes for bad investing decisions. Familiarity with an investment does not breed contempt. It breeds confidence and over time that can turn into unreasonable confidence.

People tend to bet on the known quantity, the hometown favorite. They are more confident that the company they know well will do better than the one they are less familiar with. And, when they are proven wrong, reality takes a while to set in. There's always hope that the known entity will recover and regain its earlier luster.

Technical analysis, the study of investment opportunities that focuses solely on the numbers, is one way of moving away from the danger of expectations. By creating mathematical decision models based on absolutes versus perceptions, technical analysis attempts to remove emotions from the

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Redemption Fee Dangers

One result of the mutual fund scandals of the past six months is a proposal from the SEC to impose a mandatory 2% redemption fee on any withdrawals taking place within five days of a mutual fund deposit. The fee is meant to deter short-term trading that takes advantage of stale prices, such as those occurring in international funds.

There are a number of problems, however, inherent in the concept of a government agency imposing fees upon investors.

1) Short-term trading is not illegal.

Short-term trading is designed to take advantage of a temporary pricing imbalance and has widespread application in all financial markets. The problem arises in international mutual funds when shares are priced at the close of an overseas market, hours before the U.S. market closes. Because international markets tend to follow the overall trend of the U.S. market, an upward surge, or vice versa, in the last few hours of the U.S. market can be expected to be reflected in the opening of the foreign markets.

Thus an investor who buys an international mutual fund in the last hour of an up trading day can expect to see the value of that fund move up the next day as foreign markets follow the U.S. trend. The investor may chose to let that gain ride or quickly sell the position to lock in a profit.

2) A 2% redemption fee will not stop short-term trading.

When the discrepancy in pricing exceeds the penalty of a 2% redemption fee, investors will move to take advantage of the opportunity.

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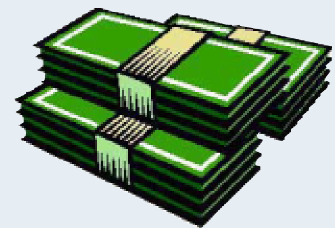
Sticking with Cash in Uncertain Markets



The hardest aspect of retreating to the safety of a cash position in uncertain markets is that some investment is inevitably going up, making investors feel that they are missing out on opportunities to profit. But there's another side to cash. If the market loses 50% in the next down move, it's comparable to your cash doubling in value. You can buy twice as large of a position at the market's lower value.

Warren Buffett is reportedly sitting on $31 billion in cash because he can't find attractive stocks and bonds to buy. According to Morgan Stanley, cash grew to 33% of Berkshire Hathaway's investment portfolio (on a market value basis) by the end of last year. That's the highest year-end cash position for Berkshire Hathaway since 1985, when cash climbed to 41% of the investment portfolio.

To amass a fortune, sometimes inactivity is best. Part of the reason is that it is always easier to lose money than it is to make money. A 25% market drop doesn't take a 25% gain to get back to breakeven. It takes a 33% gain. If you can minimize losses, you have more to invest at the market's low. And that is the classic way to amass a fortune. Buy low.

Lose Those Regrets

Death may be inevitable, but what doesn't need to be inevitable is dying with a list of regrets of the things you never got around to doing.

The old saying "where there's a will, there's a way", is truer today than ever. Many of the physical barriers and costs that may have made wishes prohibitive in prior years no longer exist. What do you really want to do? Have you always wanted to travel, to create some lasting memories or to experience new cultures? What is preventing you from fulfilling your fantasies?

Try making a list of all the reasons (or excuses!) why you haven't pursued your dreams. Then start figuring out how they can be overcome. For example:

- *Your spouse doesn't want to go.* Try negotiating—maybe you can have your choice this time and your spouse's choice the next. If negotiating doesn't work and the experience is very important to you, then consider going alone or with a friend or relative.
- *You don't want to go alone.* Before you let this argument keep you home, check with relatives and friends to see if they are interested in going as well. If you can't find an acquaintance who is interested, there are travel companies that specialize in tours for singles and older people. They can set you up with a compatible group to your destination.
- *Cost is a concern.* Group travel and pre-packaged tours are generally very cost-effective. Check out your local Elks, Rotary or Kiwanis Clubs to see if they have any trips planned. Your alumni association, church, local art museum or botanic gardens may also offer economical travel with a group of like-minded individuals. Explore Internet sites such as travelocity.com, expedia.com and lastminutetravel.com, and get on the email lists for major hotels and airlines, so that you can take advantage of special sales.

  Don't forget to ask for AAA, AARP or senior discounts if you qualify. For a really low-budget approach, and exposure to different peoples and cultures, consider volunteering for the Peace Corps (www.peacecorps.gov/index.cfm) or performing missionary work through your church.
- *Concerns about terrorism keep you at home.* You are still much more likely to be involved in an automobile accident at home than to become a victim of terrorism abroad. Use common sense and avoid countries that the Department of State has on its travel warning list (http://travel.state. gov/travel_warnings.html#h), but don't let fear keep you at home.

There's plenty of time for the rocking chair later. Right now, follow your dreams…and send us a postcard!

Removing Emotion from the Investment Decision

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decision process. But technical analysis still falls short if it fails to take into account the fact that the market reflects emotions far more than reality.

"Markets can remain irrational longer than you can remain solvent," said John Maynard Keynes.

A number of studies in the growing field called "Behavioral Research" maintain that part of the irrationality of the financial market results from investors' tendency to overreact to good news and under-react to bad news when it comes to investments they like.[1] No matter how many times the phrase "Past performance is not indicative of future returns" is repeated, past perception does dictate investor anticipations for future performance, impacting future returns. And it takes time to change those perceptions.

One evidence of this is in "hot stocks." The higher and more rapidly a stock moves, the more investors pour in to buy shares and the higher the stock price moves. Because investors tend to forecast a future not much different from the near past according to researchers David Dreman and Eric Lufkin, they expect the upward movement to continue and tend to hang on too long in the classic buy high, sell low mode. Familiarity contributes to the problem. The more an investor knows about a company or stock, the more confidence they have in the investment.

Bad news is often viewed as a one-time event and investor expectations are for a return to past performance. That is one reason many theorists believe it takes so long for a major bear market to play out.

A variation on the technical analysis approach to investing incorporates trend following into the decision model. While the absolutes of technical analysis may signal a buy or sell decision, until the trend changes, the investment position remains unchanged. This approach, which requires consensus between the trend and technical indicators, underlies many active management investment models.

[1] "Investor Overreaction: Evidence That Its Basis is Psychological" by David Dreman and Eric Lufkin. *Journal of Behavioral Finance.* 2000.

Match Loan Terms and Asset Life

Automobile loans are a classic example of a mismatch of asset and liability. The typical car loan used to be three to four years. Today, eight-year loans are common. Just as in home loans, the longer maturity means buyers can afford more car for less monthly payments. But unlike a home, a car depreciates the minute it's driven off the sales lot and continues to spiral downward with each year.

According to the Kelley Blue Book, a car loses 15% to 20% of its value each year. By year four, the average car is worth 50% of its original purchase price. The principal balance on an eight-year loan, however, is still at 59% of the original purchase price. In fact, throughout practically the full loan term, the borrower will owe more than the car is worth. If an accident happens and the car is totaled, or the borrower wants to buy a new car before the eight years are up, he will still be liable for the outstanding principal.

Rather than end up "upside down" on a loan, it's best to match the life of the asset with the loan maturity. Ideally when the loan is paid off, the asset still retains value.

Redemption Fee Dangers

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3) Arbitrage opportunities can be resolved through fair value pricing.

   Fair value pricing builds in expectations for how the overseas markets will react into the end of day pricing of the U.S. market to moderate or eliminate the catch-up gain or loss the next day when the overseas markets open. This is the solution recommended by academics and other authorities who have studied the problem.

4) A redemption fee is a very blunt weapon.

   It cannot discriminate between short-term trading and genuine need. Investors who have an unexpected need for their monies will end up paying for a solution designed to punish abusive trading.

   Long-term investors who make regular deposits to a mutual fund could find themselves liable for a redemption fee if they need to withdraw funds within five days of an automatic deposit or planned payment.

5) Redemption fees discourage investors from limiting risk in their portfolios.

   In a study of the S&P 500 over the past 10 years, there have been 404 occurrences where an investor waiting five days to avoid a 2% redemption penalty would have experienced a greater than 2% loss. 46 occurrences would have resulted in losses from 5 to 10% while 5 of these instances would have resulted in a loss of greater than 10%.

6) Mandatory redemption fees can limit the ability of Registered Investment Advisors to manage client accounts effectively.

   To avoid incurring a redemption fee in a client's account through rebalancing or responding to changes in market condition, the advisor will have to track or limit when investments and withdrawals from the fund can be made. This could be prohibitively time consuming and costly for advisors to administer, particularly smaller firms.

7) There is no study that indicates that there is an industry-wide problem of abusive mutual fund trading that passes higher costs onto buy-and-hold investors.

   Mutual funds already have the ability to impose redemption fees of up to 2% for whatever time period they chose. If the fund does not feel short-term trading is adversely impacting shareholders, it should be up to the fund to set the policy, not a government agency.

On a philosophical basis, the redemption fee proposal is a move by a government agency to give long-term shareholders greater rights than short-term investors by requiring one class to reimburse the other for the theoretical cost of short-term trading. It's somewhat akin to declaring that day traders should reimburse longer-term shareholders for undocumented costs.

We urge you to contact your legislators to let them know that a 2% redemption fee has the potential to do far more harm to investors than it will help. For contact information on your Senator or Representative visit www.senate.gov or www.house.gov.

Capitalizing on Low Capital Gains Taxes

The hardest part of having a winning investment is sometimes cashing out. After all, the lower your initial purchase price, the more you are going to end up paying in capital gains taxes. But putting off the

tax bill may be increasing your risk by concentrating too much of your portfolio in one position. Another reason to consider selling a position with substantial long-term gains may be your outlook for the Presidential election in November.

Tax reform under the Bush administration included the reduction of long-term capital gains taxes to 15% from 20% in May of 2003. The reduction doesn't expire until December 31, 2008; however, among candidate Senator John F. Kerry's promises is a roll back in the Bush tax cuts that favored the "rich." While the capital gains rate hasn't been mentioned specifically, it's often seen as a tax break for wealthier individuals.

If Senator Kerry is elected president, there is the possibility of legislation being passed retroactive to January 1, 2005, making now a good time to take a hard look at moving out of investments with substantial capital gains.

Did You Miss Opportunities to Lower Your Taxes?

According to IRS studies, the 2003 tax return took the average taxpayer more than 28 hours to prepare, making it the most complex to date. Complexity aside, the secret to making certain you don't pay more than needed on your taxes is good record keeping, particularly when it comes to miscellaneous deductions.

Taxpayers can write off a number of work-related and miscellaneous expenses that exceed 2% of the taxpayer's adjusted gross income. But many individuals miss the opportunity to take advantage of the write off because (1) they don't know what is deductible and (2) they don't keep good records. Now that your 2003 taxes are behind you, make a resolution to keep track of miscellaneous expenses in 2004. You'll be surprised at how quickly they add up.

Allowable deductions fall in three general categories: unreimbursed employee expenses, tax preparation fees and "other" expenses. The IRS has a very coherent explanation of the allowed deductions, as well as what is not allowed, on its website at www.irs.gov/publications/p529.

Unreimbursed employee expenses must be:

- Paid or incurred during your tax year,
- For carrying on your trade or business of being an employee, and
- Ordinary and necessary.

This can include:

- Depreciation on a computer or cellular telephone your employer requires you to use in your work.
- Dues to a chamber of commerce if membership helps you do your job.
- Dues to professional societies.
- Education that is work related.
- Home office or part of your home used regularly and exclusively in your work.
- Job search expenses in your present occupation.
- Legal fees related to your job.
- Licenses and regulatory fees.
- Medical examinations required by an employer.
- Occupational taxes.
- Passport for a business trip.
- Subscriptions to professional journals and trade magazines related to your work.
- Tools and supplies used in your work.
- Travel, transportation, entertainment, and gift expenses related to your work. (Generally, you must file Form 2106 or 2106–EZ to claim these expenses.)
- Union dues and expenses.
- Work clothes and uniforms if required and not suitable for everyday use.
- And more….

Allowable tax preparation costs include of tax-preparation software, tax publications, copying your returns, paying for return-receipt postage or overnight delivery, as well as the costs of having a professional prepare your tax return.

Other expenses must be "reasonably and closely related to" a taxpayer's income-producing efforts, such as investment-related fees, or costs to manage or maintain property that provides you some extra earnings. Expenses for hobbies that earn you money can be written off only to the amount of income provided by the hobby. Investment-related fees include management fees, service charges on dividend reinvestment plans and trustee's fees you paid for your IRA.

New Look to Our Newsletter

There's a new look to your quarterly newsletter, but the focus remains the same — to provide you with practical information on investing and managing your finances.

As always, we welcome your comments on articles in the newsletter as well as ways we can better meet your needs. Please don't hesitate to call if you have a question.

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