Fourth Quarter 2013

Investment Thoughts

This Issue

Dear Clients,

I have a sort of old-guys' hearing problem and was referred to the UW hearing clinic, where I saw the ENT specialist Dr. Green (in the billiard room, with the candlestick). She told me I'd had a significant loss in my left ear since my last checkup, and that she was going to take fairly dramatic action (which involved poking me in the ear with steroids). She informed me that the chance of success was about 25%, which I didn't think was too impressive. "Ah," she said, "but the chance of success if we don't try is zero."

When I returned for treatment #2, I told her I had developed an idea for this very story around her perspective on that 25% success rate. "What if," I asked her, "I could promise you something like a 98% success rate, but over a very long time frame – perhaps 20 years or so?" "No, no, no!" she said. "You've got it all wrong. I'm offering you the chance to get something back that you've already lost. You're offering me the chance to lose something that I still have."

And, Poof! Dr. Green pointed out to me what you, our clients, have been telling me for years. It is also what we've chosen to highlight in our featured article this quarter, and what Daniel Kahneman won the Nobel Prize in Economics in 2002 for: behavioral finance. It's essentially the study of how and when our emotions get in the way and interfere with decisions logic would tell us to make.

For example: suppose I offer to flip a coin and give you $1 if it's heads, you pay me $1 if it's tails. Assuming I don't pull a two-headed coin out of my pocket, it is a fair bet. Tests show the man on the street won't take the bet. OK, but what if I raise the stakes to my paying you $2 for heads against your $1 for tails? The majority of respondents still won't take the $2 bet, despite the odds being heavily slanted in their favor. If you are part of that majority and agree that taking the $2 bet is "too risky," don't feel bad - loss aversion is in our genes.

The following excerpt is taken from "Behavioral Finance in Action," a research paper by Shlomo Benartzi, Chief Behavioral Economist at Allianz Global Investors:

> "Yale economist M. Keith Chen did some ingenious preference experiments with capuchin monkeys in which they always finished up with one piece of apple. They got there in different ways, however, which affected the monkeys' preferences. Sometimes the monkeys started off with two pieces of apple, one of which was taken away. At other times they started off with none, and were given one piece. The monkeys strongly preferred the second scenario, and disliked the first, where one piece of apple was taken from them (Chen, 2006)."

Professor Benartzi goes on to discuss such concepts as immediate gratification, investor paralysis, and my personal favorite – inertia. (The complete paper can be found at http://befi.allianzgi.com/en/Topics/Documents/behavioral-finance-in-action-white-paper.pdf)

Our mission is to listen to your anxieties, and to weigh them against the pursuit of your financial goals. Our challenge is then not only to find a way to demonstrate that if we do the $2 vs. $1 coin flip 100 times, you WILL win, but to have you believe it whole-heartedly enough that you become part of the minority who is willing to undertake the bet. (And even more importantly, not to stop if 15 of the first 20 flips come up tails – at which point the chance of success immediately drops to zero.)

We hope you enjoy the article – given that it was published in 2009, it definitely qualifies as an "oldie but a goodie." And given the level of discussion it generated within the office, I suspect this isn't the last you'll hear from us on this topic.

Until then, wishing you a happy and safe holiday season from all of us at Buttonwood!

Sincerely,

Chris Bugg , Greg Rademacher and Jodie McLellan

"The Mistakes We Make—and Why We Make Them"
By: Meir Statman
Date: August 24, 2009

What was I *thinking*?

If there's one question that investors have asked themselves over the past year and a half, it's that one. If only I had acted differently, they say. If only, if only, if only.

Yet here's the problem: While we know that we made investment mistakes, and vow not to repeat them, most people have only the vaguest sense of what those mistakes were, or, more important, *why* they made them. Why did we think and feel and behave as we did? Why did we act in a way that today, in hindsight, seems so obviously stupid? Only by understanding the answer to these questions can we begin to improve our financial future.

This is where behavioral finance comes in. Most investors are intelligent people, neither irrational nor insane. But behavioral finance tells us we are also normal, with brains that are often full and emotions that are often overflowing. And that means we are normal smart at times, and normal stupid at others.

The trick, therefore, is to learn to increase our ratio of smart behavior to stupid. And since we cannot (thank goodness) turn ourselves into computer-like people, we need to find tools to help us act smart even when our thinking and feelings tempt us to be stupid.

Let me give you one example. Investors tend to think about each stock we purchase in a vacuum, distinct from other stocks in our portfolio. We are happy to realize "paper" gains in each stock quickly, but procrastinate when it comes to realizing losses. Why? Because while regret over a paper loss stings, we can console ourselves in the hope that, in time, the stock will roar back into a gain. By contrast, all hope would be extinguished if we sold the stock and realized our loss. We would feel the searing pain of regret. So we do pretty much anything to avoid that pain—including holding on to the stock long after we should have sold it. Indeed, I've recently encountered an investor who procrastinated in realizing his losses on WorldCom stock until a letter from his broker informed him that the stock was worthless.

Successful professional traders are subject to the same emotions as the rest of us. But they counter it in two ways. First, they know their weakness, placing them on guard against it. Second, they establish "sell disciplines" that force them to realize losses even when they know that the pain of regret is sure to follow.

So in what other ways do our misguided thoughts and feelings get in the way of successful investing—not to mention increasing our stress levels? And what are the lessons we should learn, once we recognize those cognitive and emotional errors? Here are eight of them.

No. 1 - Goldman Sachs is faster than you.

There is an old story about two hikers who encounter a tiger. One says: There is no point in running because the tiger is faster than either of us. The other says: It is not about whether the tiger is faster than either of us. It is about whether I'm faster than you. And with that he runs away. The speed of the Goldman Sachses of the world has been boosted most recently by computerized high-frequency trading. Can you really outrun them?

It is normal for us, the individual investors, to frame the market race as a race against the market. We hope to win by buying and selling investments at the right time. That doesn't seem so hard. But we are much too slow in our race with the Goldman Sachses.

So what does this mean in practical terms? The most obvious lesson is that individual investors should never enter a race against faster runners by trading frequently on every little bit of news (or rumors).

Instead, simply buy and hold a diversified portfolio. Banal? Yes. Obvious? Yes. Typically followed? Sadly, no. Too often cognitive errors and emotions get in our way.

No. 2 - The future is not the past, and hindsight is not foresight.

Wasn't it obvious in 2007 that financial institutions and financial markets were about to collapse? Well, it was not obvious to me, and it was probably not obvious to you, either. Hindsight error leads us to think that we could have seen in foresight what we see only in hindsight. And it makes us overconfident in our certainty about what's going to happen.

Want to check the quality of your foresight? Write down in permanent ink your forecast of tomorrow's stock prices. Do that each day for a year and check the accuracy of your predictions. You are likely to find that your foresight is not nearly as good as your hindsight.

Some prognosticators say that we are now in a new bull market and others say that this is only a bull bounce in a bear market. We will know in hindsight which prognostication was right, but we don't know it in foresight.

When I hear in my mind's ear a voice that says that the stock market is *sure* to zoom or plunge, I activate my "noise-canceling" device rather than go online and trade. You might wish to install this device in your mind as well.

No. 3 - Take the pain of regret today and feel the joy of pride tomorrow.

Emotions are useful, even when they sting. The pain of regret over stupid comments teaches presidents and the rest of us to calibrate our words more carefully. But sometimes emotions mislead us into stupid behavior. We feel the pain of regret when we find, in hindsight, that our portfolios would have been overflowing if only we had sold all the stocks in 2007. The pain of regret is especially searing when we bear responsibility for the decision not to sell our stocks in 2007. We are tempted to alleviate our pain by shifting responsibility to our financial advisers. "I am not stupid," we say. "My financial adviser is stupid." Financial advisers are sorely tempted to reciprocate, as the adviser in the cartoon who says: "If we're being honest, it was your decision to follow my recommendation that cost you money."

In truth, responsibility belongs to bad luck. Follow your mother's good advice, "Don't cry over spilled milk."

Where am I leading you? Stop focusing on blame and regret and yesterday and start thinking about today and tomorrow. Don't let regret lead you to hold on to stocks you should be selling. Instead, consider getting rid of your 2007 losing stocks and using the money immediately to buy similar stocks. You'll feel the pain of regret today. But you'll feel the joy of pride next April when the realized losses turn into tax deductions.

Buttonwood Holiday Hours

Due to the schedule of the New York Stock Exchange, Buttonwood Partners, Inc. will be closed on the following dates, giving us all time to enjoy our family and friends:

- November 28 (Thanksgiving Day)
- December 25 (Christmas Day)
- January 1 (New Year's Day)
- January 20 (Martin Luther King, Jr. Day)

On Friday, November 29th and Tuesday, December 24th we will be open from 8:30 a.m. until 12:00 p.m.

Update on Chris' Schedule

Back in the Fall of 2009, as I approached my 62nd birthday and was meeting with many of you about your pending retirements, I started to get the question, "What's next for you, Chris?" So I wrote you with this crazy notion that, while I wasn't going anywhere soon, I was going to start avoiding the office on Friday afternoons, if not the entire day.

Perhaps "crazy" is the wrong adjective, because it still sounds like a lovely idea, but it was certainly naïve. For while I'm still writing pieces for our newsletter, more often than not it's a Friday afternoon that I'm doing so.

And so I've decided to give answering the "What's next?" question another shot, and want to share my Plan B for 2014 with you. I'm still not going anywhere soon, as I've committed to our team for at least the next four years, and I suspect it will be even longer before I'm ready to walk away completely. (Peggy is wonderful at reminding me how much I love what I do!) That being said, I am going to see if I have any better luck skipping out on Thursdays than I've had on Fridays.

It's possible my 4-day week (or my occasional trip, be they for business or pleasure) will make it more difficult for you to come see me, but I actually hope it gives more of you the chance to meet with Greg and/or Jodie – and that you take advantage of that opportunity. And if you ever can't find me in the office, please don't hesitate to ask them your question – it's what I do when I don't know the answer to something!

For contact information, please see the full list of our email addresses and phone numbers on the last page of this newsletter.

Jodie Out of the Office

Hello everyone! I wanted to let you know that I will be out of the office for a significant amount of time (due to a surgical procedure) starting November 20th. It's not for a face lift, nor is it a life-threatening condition, but it is a procedure that I will be happy to have behind me.

Even though I will be out of the office for 3-6 weeks, I will be checking email and doing work from home as early as November 25th, which means I will respond to emails and phone calls as quickly as possible. If you do need immediate help, please contact Linda, Chris or Greg and they will take care of you.

I won't be allowed to do much (can't lift anything over 5lbs), but I plan to watch a lot of Turner Classic Movies and bake a lot of cookies for the holidays. My goal is to be back in the office starting the week of December 16th. So we'll still be able to welcome in the New Year together!

Care to save a tree?

If you would prefer to receive our newsletter electronically, just let us know and we will send it via email each quarter.

Email linda@btnwd.com or call 608-827-6405.

Please also contact us if you would like information about online account access and/or receiving your statements electronically.

No. 4 - Investment success stories are as misleading as lottery success stories.

Have you ever seen a lottery commercial showing a man muttering "lost again" as he tears his ticket in disgust? Of course not. What you see instead are smiling winners holding giant checks.

Lottery promoters tilt the scales by making the handful of winners available to our memory while obscuring the many millions of losers. Then, once we have settled on a belief, such as "I'm going to win the lottery," we tend to look for evidence that confirms our belief rather than evidence that might refute it. So we figure our favorite lottery number is due for a win because it has not won in years. Or we try to divine—through dreams, horoscopes, fortune cookies—the next winning numbers. But we neglect to note evidence that hardly anybody ever wins the lottery, and that lottery numbers can go for decades without winning. This is the work of the "confirmation" error.

What is true for lottery tickets is true for investments as well. Investment companies tilt the scales by touting how well they have done over a pre-selected period. Then, confirmation error misleads us into focusing on investments that have done well in 2008.

Lottery players who overcome the confirmation error conclude that winning lottery numbers are random. Investors who overcome the confirmation error conclude that winning investments are almost as random. Don't chase last year's investment winners. Your ability to predict next year's investment winner is no better than your ability to predict next week's lottery winner. A diversified portfolio of many investments might make you a loser during a year or even a decade, but a concentrated portfolio of few investments might ruin you forever.

No. 5 - Neither fear nor exuberance are good investment guides.

A Gallup Poll asked: "Do you think that now is a good time to invest in the financial markets?" February 2000 was a time of exuberance, and 78% of investors agreed that "now is a good time to invest." It turned out to be a bad time to invest. March 2003 was a time of fear, and only 41% agreed that "now is a good time to invest." It turned out to be a good time to invest. I would guess that few investors thought that March 2009, another time of great fear, was a good time to invest. So far, so wrong. It is good to learn the lesson of fear and exuberance, and use reason to resist their pull.

No. 6 - Wealth makes us happy, but wealth increases make us even happier.

John found out today that his wealth fell from $5 million to $3 million. Jane found out that her wealth increased from $1 million to $2 million. John has more wealth than Jane, but Jane is likely to be happier. This simple insight underlies Prospect Theory, developed by Daniel Kahneman and Amos Tversky. Happiness from wealth comes from gains of wealth more than it comes from levels of wealth. While gains of wealth bring happiness, losses of wealth bring misery. This is misery we feel today, whether our wealth declined from $5 million to $3 million or from $50,000 to $30,000.

We'll have to wait a while before we recoup our recent investment losses, but we can recoup our loss of happiness much faster, simply by framing things differently. John thinks he's a loser now that he has only $3 million of his original $5 million. But John is likely a winner if he compares his $3 million to the mountain of debt he had when he left college. And he is a winner if he compares himself to his poor neighbor, the one with only $2 million.

In other words, it's all relative, and it doesn't hurt to keep that in mind, for the sake of your mental well-being. Standing next to people who have lost more than you and counting your blessings would not add a penny to your portfolio, but it would remind you that you are not a loser.

No. 7 - I've only lost my children's inheritance.

Another lesson here in happiness. Mental accounting—the adding and subtracting you do in your head about your gains and losses—is a cognitive operation that regularly misleads us. But you can also use your mental accounting in a way that steers you right.

Say your portfolio is down 30% from its 2007 high, even after the recent stock-market bounce. You feel like a loser. But money is worth nothing when it is not attached to a goal, whether buying a new TV, funding retirement, or leaving an inheritance to your children or favorite charity.

A stock-market crash is akin to an automobile crash. We check ourselves. Is anyone bleeding? Can we drive the car to a garage, or do we need a tow truck? We must check ourselves after a market crash as well. Suppose that you divide your portfolio into mental accounts: one for your retirement income, one for college education of your grandchildren, and one for bequests to your children. Now you can see that the terrible market has wrecked your bequest mental account and dented your education mental account, but left your retirement mental account without a scratch. You still have all the money you need for food and shelter, and you even have the money for a trip around the country in a new RV. You might want to affix to it a new version of the old bumper sticker: "I've only lost my children's inheritance."

So here's my advice: Ask yourself whether the market damaged your retirement prospects or only deflated your ego. If the market has damaged your retirement prospects, then you'll have to save more, spend less or retire later. But don't worry about your ego. In time it will inflate to its former size.

No. 8 - Dollar-cost averaging is not rational, but it is pretty smart.

Suppose that you were wise or lucky enough to sell all your stocks at the top of the market in October 2007. Now what? Today it seems so clear that you should not have missed the opportunity to get back into the market in mid-March, but you missed that opportunity. Hindsight messes with your mind and regret adds its sting. Perhaps you should get back in. But what if the market falls below its March lows as soon as you get back in? Won't the sting of regret be even more painful?

Dollar-cost averaging is a good way to reduce regret—and make your head clearer for smart investing. Say you have $100,000 that you want to put back into stocks. Divide it into 10 pieces of $10,000 each and invest each on the first Monday of each of the next 10 months. You'll minimize regret. If the stock market declined as soon as you have invested the first $10,000 you'll take comfort in the $90,000 you have not invested yet. If the market increases you'll take comfort in the $10,000 you have invested. Moreover, the strict "first Monday" rule removes responsibility, mitigating further the pain of regret. You did not make the decision to invest $10,000 in the sixth month, just before the big crash. You only followed a rule. The money is lost, but your mind is almost intact.

Things could be a lot worse.

"We should be careful to get out of an experience only the wisdom that is in it and stop there lest we be like the cat that sits down on a hot stove lid. She will never sit down on a hot stove lid again and that is well but also she will never sit down on a cold one anymore."

- Mark Twain

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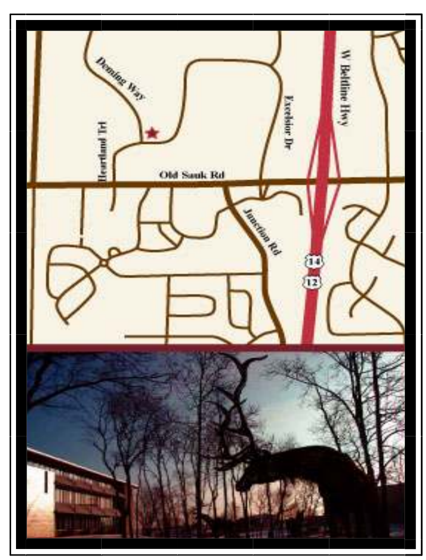

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