# Quarter Notes

Second Quarter 2011

## How to avoid emotional investing

### Don't just do something; stand there!

We'd like to believe that the financial markets are coldly rational, carefully weighing all data as it becomes available and translating it into sound prices. That's the essence of the *efficient market hypothesis*. But whether the markets are truly efficient or not, they are made up of individual investors, and those investors can't be coldly rational all the time. Emotions are bound to creep in to the decision process.

Proof of the reality and importance of investor emotions may be found in a new study published in the *Journal of Wealth Management's* spring edition, "Preventing Emotional Investing: An added Value of an Investment Advisor." Authors Philip Z. Maymin and Gregg S. Fisher studied the records of all client contacts from 1993 to mid-2010 at a New York investment boutique. Some 1.5 million client "touches"—via phone,

### Keep your cool

Experience can be a difficult teacher. Better to learn from the mistakes of others than to have to acquire those lessons firsthand. That's the idea we explore in this issue of *QuarterNotes*, that you can improve your own portfolio management skills by understanding the errors that others may have made.

Another way to dodge problems is to rely upon those with more experience for advice and counsel. That's where the professionals at PrimeVest can be of service to you. Whenever you have a concern or question about saving and investing your money, please give us a call. We are here to help.

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e-mail or letter—were analyzed. The findings were not surprising.

- Client touches were highest at the outset of the relationship, declining to a steady level.
- Higher market volatility led to spikes in client touches.
- Spikes in touches led to more aggressive trading, which was otherwise quite rare.

What that tells us is that in their periods of aggressive trading, the firm's clients were reacting to what already had happened; they were not focusing on the future. In other words, they were buying low and selling high. Consistent with that interpretation, a 2009 study of Taiwanese investors found that aggressive trading by individual investors resulted in an underperformance of roughly four percentage points per year. Cooling investor impulses, then, may be an important value added by an investment advisor.

## The asset allocation alternative

To reduce the temptation to make investment decisions emotionally, we recommend having a plan for *asset allocation* in portfolio management. Short-term price movements in the financial markets are notoriously difficult to predict, but over longer time frames, relationships between asset classes have been observed and quantified. The decision about how much of a portfolio should be dedicated to stocks, bonds and other asset classes has a major influence on the long-term performance. Some studies have shown asset allocation to have a greater impact than security selection on investment results. The risks and rewards of each class can be balanced so as to optimize portfolio performance. Still, such an approach does not guarantee gains or ensure against investment losses.

Investing is our business. We take it seriously, but not emotionally. We don't claim to be infallible, but we are well informed and able to help you implement strategies consistent with your needs and financial objectives.

## Mistakes of the emotional investor

Theorists in behavioral economics have identified a number of basic, recurring judgment errors, attitudes that investors should guard against. Here are two examples.

*Bad reference.* Two investors, A and B, each own 100 shares of the imaginary XYZ company. Assume that today that company's share price fell from $160 to $150, so that each investor has a paper loss for the day of $1,000.

Now add this fact: A paid $125 per share for his holding, while B paid $175. In coldly rational terms, that shouldn't make a difference, but for many people it does. Investor A had enjoyed a paper gain, and though the gain is reduced, he's still in net positive territory. Investor B has a paper loss, and that loss is getting larger. Many investors have trouble with that.

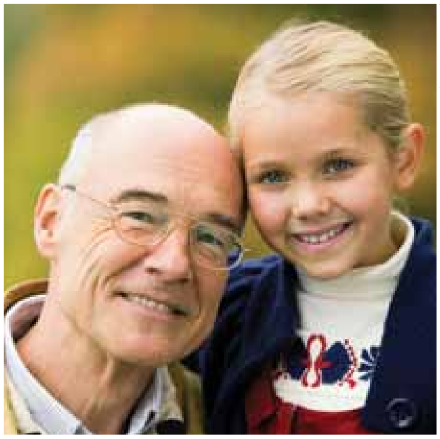
Whether the XYZ company remains a good investment is not a function of daily price movements, and it certainly is not a function of purchase price. Because investors generally prefer to avoid realizing losses, they are more likely to sell their winners when they need to raise cash. In this example, A is more likely to sell than is B, despite B's increasingly painful position. This decisional approach can impair portfolio performance.

*Sunk costs.* Imagine that you have received a gift of a $250 theater ticket. On the day of the performance, the weather turns very bad. Do you go to the theater or stay home?

Now imagine instead that you paid for the $250 ticket yourself. Do you go?

Studies show that many people are more likely to brave the elements if they have paid for the ticket themselves, and they are more likely to stay home if the loss is a gift ticket. This is an example of the sunk cost fallacy, in which a decision on spending the next dollar is determined in part by how much has been spent so far. This is also known as throwing good money after bad.

In investing, this behavior is manifested when people are unwilling to face a mistake and realize a loss. In evaluating any investment, the key point is not how much was invested in the past, but, what are the prospects for the future?



| New estate tax numbers | | |
|---|---|---|
| Year | Federal estate tax exempt amount | Top federal estate tax rate |
| 2011 | $5 million | 35% |
| 2012 | $5 million | 35% |
| 2013 | $1 million | 55% |

Source: Internal Revenue Code; M.A. Co.

## Is your will now out of date?

Good news for many on the estate tax front. In 2011 and 2012, only estates larger than $5 million will owe any federal estate tax. For married couples, when the estate passes to a surviving spouse, normally there is no federal estate tax at all. Also, the top estate tax rate will be at a historic low of 35%. Back in the 20th century, some estates experienced a 60% marginal estate tax rate.

Unfortunately, this $5 million exemption level and reduced tax rate last for just two years. As the law stands today, the amount exempt will fall back to $1 million in 2013, and the top rate will zoom to 55%, with a 5% surtax for some estates. Although many observers expect Congress to renew the $5 million threshold, President Obama's budget forecasts a return to a more modest $3.5 million exempt amount.

What do these shifting tax laws mean for you and your family?

### A matter of interpretation

One routine estate planning approach for a married couple is to have two trusts, a marital deduction trust and "bypass" trust. With this arrangement, all federal estate taxes may be deferred until the death of the surviving spouse. Compared to a simple, "all-to-spouse" plan, the family should enjoy a doubled estate tax exemption ($10 million, if both the husband and wife die before 2013).

However, there may a problem with such a plan at the moment. To reduce the need for frequent will revision to accommodate changing tax laws, estate planning lawyers sometimes use word formulas in wills instead of numbers to divide an estate. For example, the bypass trust might be funded "at the amount exempt from federal estate tax." For a $2 million estate, back when the exemption was $1 million, that formula would put half the estate into the marital deduction trust, half into the bypass trust. Now, with the enlarged exemption, the entire estate might pass to the bypass trust, disinheriting the spouse entirely. Is that what is really wanted? Could this ambiguity trigger a will contest?

If your will or trust provisions include formula clauses, you'll want to schedule an early meeting with your estate planning advisors.

### More issues

Other factors to be taken up in an estate planning meeting:

*State death taxes.* Although most states have eliminated their estate and/or inheritance taxes, about 20 still impose them. Typically, state death taxes begin to bite at much lower wealth levels than the federal estate tax. If you live or own property in one of these states, your estate planning will need to take that into account.

*Changing circumstances.* Have there been any marriages, divorces, births or deaths in the family since your will was drafted? If so, new beneficiary provisions may be appropriate.

*Changing assets and changing values.* Does your will mention assets that you no longer own? Have asset values changed markedly, up or down, since the will was drafted? These developments will need to be factored into your testamentary plan.

### Prudent asset management

Doing one's estate planning can trigger an evaluation of personal investment management strategies as well. That's where we may be able to make a contribution to your planning. If you have questions about your portfolio planning, please give us a call.

## Just ask us

I'm going to inherit property from a relative who died in 2010. What do I need to do about the taxes?

The vast majority of estates will be covered by the retroactive federal estate tax, which included a $5 million exempt amount. That's good, because the typical assets in such estates received a basis step-up at the owner's death, to fair market value, even though no estate tax will be due. That should mean you will face lower taxes on the capital gain when you decide to sell the property

The largest estates will likely opt out of the estate tax. Heirs of those estates will take a carryover basis in their inheritance; that is, the tax basis of assets will be the same as it was in the hands of the decedent. Basis adjustments of up to $1.3 million will be made by the estate executor.

For some estates larger than $5 million, the choice of whether to pay an estate tax now or have heirs pay higher income taxes later will be tricky. Contact the estate's executor if you are uncertain what course of action was taken.

If you were named the executor of a 2010 decedent's estate, you'll need prompt professional tax advice on how to proceed.