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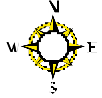

The Emotion of Money

Why Smart People Do Dumb Things

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The Trust Company of the South is a fee-only independent trust company and financial planning firm focused on serving the needs of affluent individuals, families, and non-profit institutions.

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Chances are you've never heard of Daniel Kahneman, Amos Tversky, or Robert Cialdini. They aren't regulars on CNBC or featured in *Fortune* magazine. They aren't considered investment gurus like Warren Buffett or Peter Lynch. But if you aspire to be a successful investor, you would do well to learn from them. Kahneman and Tversky shared the 2002 Nobel Prize in Economics (though neither is an economist — both are psychologists) for their work in what has come to be known as "prospect theory."

Kahneman & Tversky found that instincts are often an investor's worst enemy. "People have an illusion of control over events, such as the stock market, that are fundamentally unknowable," says Kahneman. "Overconfident, emotional decisions tend to be poor ones." Kahneman's research indicates such factors lead to holding onto losing investments and selling winners. "People become more optimistic when the market goes up and more pessimistic when the market goes down." In other words, the complete opposite of "buy low–sell high."

Robert Cialdini, also a psychologist, authored *Influence*, a book often recommended by Warren Buffett's alter ego and Berkshire Hathaway vice-chairman Charlie Munger. Cialdini provides excellent insight into the dynamics and influences of why people do what they do, especially as it pertains to financial decisions. The thesis of Cialdini's work is that the human mind is forced to constantly make so many decisions that we look for efficiencies (he refers to as "click/whirr" decisions) wherever possible. In the vast majority of cases these "click/whirr" shortcuts assist us in navigating everyday life. However, in some cases our "click/whirr" responses can be exploited by profiteers.

During fifteen years in the wealth management profession, I've seen several recurring themes that work against investors. Here are some examples of "conventional wisdom" one might do well to avoid:

The Hot Hand: Left to their own devices most people tend to invest in the fund, stock, or asset class that has superior *recent* performance. Perhaps this is due to some psychological desire to associate with success. While counter-intuitive, the reverse approach of buying undervalued assets usually meets with greater success. Indeed, only in the stock market do high prices attract shoppers who are willing – even anxious—to pay more than the last guy for the same item of merchandise.

The Emotion of Money (con't)

Overconfidence: Human nature being what it is, people tend to emphasize their successes, whether it's NCAA tournament picks or stock picks. There is also a tendency to translate expertise in one field to another completely unrelated field. Building a successful company and becoming a world renowned physician are noteworthy accomplishments, yet it is unwise to believe such success provides the person with unique insights into the world of investing.

Midas Touch: Often people select an investment advisor in the mistaken belief that the advisor will make them rich. The overwhelming majority of wealth is attained either through career success or inheritance, or some combination of the two. Advisors who claim to possess a Midas touch don't play to the better angels of our nature.

Following the Herd: This probably makes sense if you are a wildebeest, but often works against investors. Unlike a predator, the market doesn't single out just one investor for the kill. The principle of social proof means we look to others to determine appropriate behavior, especially if we are unsure of what we should do. When a lot of people are doing something it validates the behavior. The most common everyday example of this can be found at a formal dining table and being unsure of which utensil to use (Mrs. Gaddy's 6th grade cotillion not withstanding!) or watching a semi-formally attired group determine how to best eat fried chicken. The principle of social proof no doubt contributed to the late 90's tech bubble.

Lack of Humility: People aren't eager to admit mistakes, let alone ones that cost them money. There is much truth in the adage "we see things not as they are, but as we wish to see them." Investors need to be disciplined without anchoring themselves to prior assumptions.

One of the most valuable services we provide is our ability to remove emotion from the financial decision-making process. Greed and Fear, like Horsemen of the Apocalypse, stand ready to deter you from your goal of financial security.

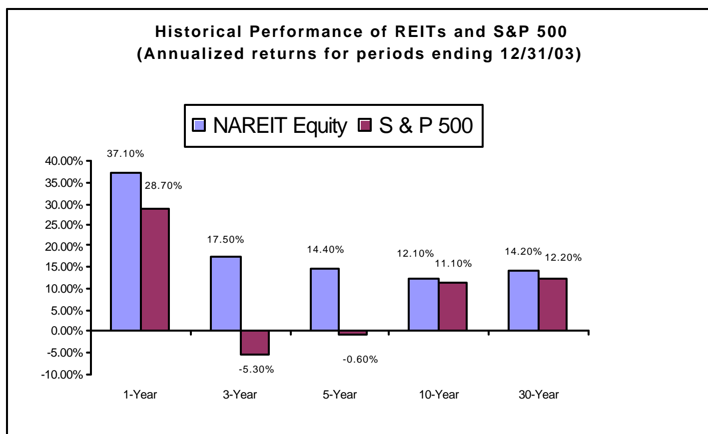
- Mike Palmer, CFP®

Linda Paul Celebrates 10 Years with TCTS

I am sure almost everyone reading *The Compass* knows Linda Paul, our friendly and resourceful Asst. Personal Trust Officer. **We are pleased to celebrate Linda's 10th anniversary with Trust Company.** In addition to assisting on personal trust/investment agency matters, Linda manages our tax reporting function.

Linda moved to Burlington in 1993, with her husband, Ken, who is a business professor at Elon University. Linda and Ken moved from Memphis, where she served as a paralegal in various corporate legal departments for 11 years. Linda is a native of Oklahoma and attended Oklahoma State University (Go Cowboys!). She and Ken have four children and eight grandchildren between them.

Please join us in congratulating Linda on ten great years (send congratulatory emails to: lpaul@tcts.com). We are fortunate to have a team of dedicated professionals who are passionate about providing our clients with the very best service.



Asset Class Correlations

	REITs	S&P 500	MSCI EAFE	LB Agg Bond
REITs	1.000			
S&P 500	0.292	1.000		
MSCI EAFE	0.125	0.304	1.000	
LB Agg Bond	0.062	0.069	0.032	1.000

Prudent Investor Act: The Fiduciary's Bible

Our firm recently received a request for proposal (RFP) from a $50 million foundation. RFPs are the means by which institutional groups solicit asset management for their funds. RFPs normally contain information regarding the size of the portfolio, any special accounting requirements, and a copy of the investment parameters or investment policy statement.

I was intrigued by two components in the RFP: the entity's investment policy explicitly prohibited real estate investment trusts (REITs) from the portfolio and their view of indexing.

First the REIT issue. Why the foundation prohibited them, I'm not sure. It's certainly possible they own large parcels of diversified, income producing real estate outside of their investment funds, but I would be surprised if this were the case. I find the exclusion of REITs interesting for two reasons: (1) academic research indicates REITs possess favorable characteristics (exceptional portfolio diversifier, favorable long-term returns) as part of a fully asset allocated portfolio and (2) the foundation board appears to have crafted an investment policy statement inconsistent with the guidelines described in the 3rd Restatement of Trusts / Uniform Prudent Investor Act.

Let's explore the REIT issue. The appropriateness of REITs as a separate asset class in portfolios is hardly debatable. *{The exclusion of REITs also excludes investing in the S&P 500 (which currently contains six REITs) – more on that later}.* Several academic studies have determined REITs reflect real estate returns in a more timely fashion than appraisal-based indexes. REITs provide identical liquidity to publicly-traded common stocks and most importantly from a fiduciary perspective possess a very low correlation to US stocks and bonds (see chart, opposite page). Recent performance demonstrates the wisdom of including REITs, but the long-term performance is equally impressive (see chart). The weight of evidence is hard to refute. If fiduciaries are to follow the guidelines of modern portfolio theory advocated in the UPIA and the 3rd Restatement of Trusts then REITs merit a seat at the table.

In addition, the RFP also contained the following response to an inquiry about index funds: *"Currently, there are not index funds used in the Fund. In the past the Trustees have shied away from using index funds because they felt we were buying expert investment advise, which should generate better investment returns than an index fund."*

This position is common, but one we believe is fundamentally flawed. As a fiduciary, every investment decision should be made with careful consideration to the 3rd Restatement/ Uniform Prudent Investor Act; it is true North. Ignoring UPIA puts one at odds with four Nobel Prize winners, not a favorable position for those ever deposed for breach of fiduciary duty. There is no shortage of case law on the point. While departure from the investment guidelines established by the 3rd Restatement can be justified by special circumstances, such departure greatly increases the burden to justify the strategy in question and increases the personal liability assumed by the endowment or foundation board. Unfortunately, endowment and foundation boards often fail to apply perhaps the most important premise of the UPIA:

"...fiduciaries and other investors are confronted with *potent evidence* that the application of expertise, investigations, and diligence in efforts to 'beat the market' in publicly traded securities ordinarily promises little or no payoff, or even a *negative payoff*. Empirical research reveals skilled professionals have rarely been able to identify under-priced securities (that is, to outguess the market with respect to further return) with any regularity..."

As with REITs, passive asset management or indexing has a role in fiduciary asset management. It's just as important as diversification *within* and *across* asset classes.

- Mike Palmer, CFP®

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Quote of the Quarter

"Let this case send an important message: We will not tolerate any sort of corruption in an official proceeding. If you are John Q. Citizen or Martha Stewart or Peter Bacanovic we are going to go after you."

- David Kelley, U.S. Attorney, following the conviction of Martha Stewart on conspiracy and obstruction of justice charges. Stewart, who will be sentenced in June, faces up to 20 years in prison.

New at www.tcts.com

A Fiduciary Focus, an article by Mike Palmer, is posted on our website. Discover why the conflicts of interest associated with brokerage firms is avoided through the use of a client-aligned wealth management fiduciary.

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