MCCARTHY GRITTINGER
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Lessons on Behavioral Finance

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“Happiness Equals Reality Minus Expectations”
– Rakesh Sarin, UCLA Anderson’s Paine Chair of Management

Dear Valued Friends and Clients:

In honor of Richard Thaler, the recent winner of the Nobel Memorial Prize in Economic Sciences, we thought a discussion on behavior finance would be timely and relevant. This field of study has provided great insight on how to better manage personal finances. We would be well served to understand some of his great insights into human behavior.

Thaler co-authored with Cass Sunstein the book *Nudge, Improving Decisions about Health, Wealth, and Happiness*. This book fundamentally changed how people save for retirement. The best part is this happened without any action from employees as governments and companies basically relied on people’s inability to control their impulses. To increase retirement savings for employees, companies simply changed their retirement plans from an initial “opt-in” election to an “opt-out” election. Before Thaler’s research, people would assume there would be a similar outcome. Same options should produce similar results. However, framing the option differently to account for our self-control issues has produced better outcomes.Bottom line: More people save for their retirement if the election is to opt-out as opposed to opt-in.

Our human nature is to only look for things to support our view. People rarely seek out evidence that contradict their views. People believe things are obvious only after the fact. The irony is the moment when people entertain other people’s views is after the event has occurred. With the knowledge of these few investor biases, hopefully investors can better prepare themselves for future investor experiences. Adjust expectations with the hope of increasing happiness.

Bias #1: Investor Loss Aversion

Companies are great at marketing happiness to consumers. Corporations recognize the power in perceived happiness from purchasing the product and our self-control problems (food, drinks, prescription drugs, cars, etc.). However, the responsibility of ultimate happiness after a purchase is with consumers, not the companies. In the happiness equation, expectations for new products at purchase are frequently higher than they should be. The most drastic example is buyers of winning lottery tickets. Even lottery winners are not guaranteed increased happiness.More money alone will not easily make us happy.

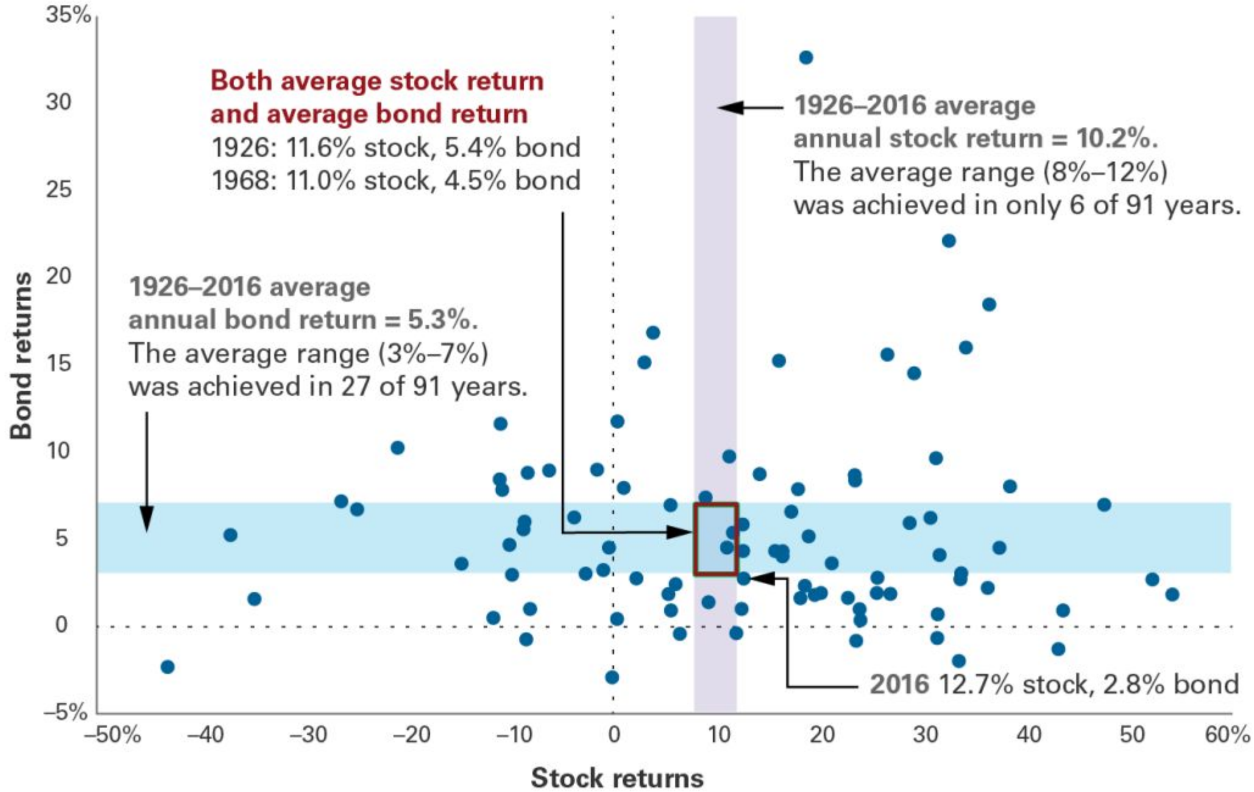
This brings us to the markets today. We have continued to see stock market values increase at an unexpected rate. Overall wealth has increased accordingly. We know from behavior finance that people are affected more by reductions to their wealth than to increases in their wealth. The recent rise in the stock market has been substantial. However, research would say that has not corresponded with a similar rise in feeling wealthy. Simply put – if the overall stock market returned to this year's starting point, most investors would feel a sense of overall loss. We are not saying this is going to happen, but if the stock market experiences a short-term decrease, investors need to prepare now for how their minds will react.

Bias #2: Investor Mental Accounting

Many investors will look at their account balances today and assume this is their starting point of wealth. This is partially true. You can sell assets at that price and receive those funds. However, what it does not account for is immediate future growth or loss. Market returns are lumpy. Your current value today should not be expected to always be above today's starting value. This concept can be illustrated in an example:

Assume you invested $1,000 into a diversified portfolio and the market return expectation for this portfolio is 6% growth, but after year one, that portfolio rises by 30% to $1,300. Most people would still apply the 6% expectation to the $1,300. In reality, that 6% should be adjusted downward for the immediate future years.

See the chart below for a history of market returns. The chart is a good reminder of market's lumpy returns. Rarely is the annual return at the long-term average. Investors have seen large recent gains, so expectations should be adjusted downward for the immediate future. If expectations for future returns are lowered, investors have a better chance for a happy outcome.



Source: *Vanguard*

Notes: Represents each calendar year from 1926 to 2016 (91 points = 91 years) plotted at the intersection of that year's stock return and that year's bond return. The vertical shaded area contains all years whose stock return was between 8% and 12%. The horizontal shaded area contains all years whose bond return was between 3% and 7%. Stock returns are represented by the Standard & Poor's 90 Index from 1926 through March 3, 1957; the S&P 500 Index from March 4, 1957, through 1974; the Dow Jones Wilshire 5000 Index from 1975 through April 22, 2005; the MSCI US Broad Market Index from April 23, 2005, through June 2, 2013; and the CRSP US Total Market Index thereafter. Bond returns are represented by the S&P High Grade Corporate Index from 1926 to 1968, the Citigroup High Grade Index from 1969 to 1972, the Lehman Brothers U.S. Long Credit AA Index from 1973 to 1975, the Bloomberg Barclays U.S. Aggregate Bond Index from 1976 to 2009, and the Bloomberg Barclays U.S. Aggregate Float Adjusted Index thereafter

Bias #3: Investor Overconfidence

Things go badly and it is human nature to want to intervene. This fight or flight mindset in the body enables humans to mobilize with a lot of energy rapidly in order to cope with perceived threats to survival. The problem is this automatic response is not always accurate. Especially with investments, research says we tend to misconstrue causality and overestimate our ability.

Investors read an investment article on the internet.This article scares them into thinking something bad is going to happen to their portfolio if they do not act. Natural human reaction is to rush to do something without much further analysis. Our fight or flight response frequently causes more financial harm than good. The power is knowing that this is natural and recognizing it when it happens. Armed with this knowledge, investor expectations will be adjusted and happiness will hopefully be increased.

Takeaway

Today's markets are filled with uncertainty. Are they more uncertain than in previous times? Probably not. Will it be easy to look back after future events unfold and think we should have known something? Yes.

Humans are constrained in their ability to optimize decisions. Complex choices require humans to exercise control over our biases. How does Thaler recommend investment decision makers overcome these biases and exert more self-control? Build a process that is based on sound economic principles, simple enough to be repeated, and most importantly a process you can revisit and depend on during stressful, emotional times.

Happy Thanksgiving

We are thankful and blessed to have such wonderful clients whom we have the privilege of working with every day. Our best to you and your families and friends this Thanksgiving week. May your Thanksgiving reality be greater than your expectations increasing your overall happiness this year!

We appreciate your business and look forward to talking with you soon.

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