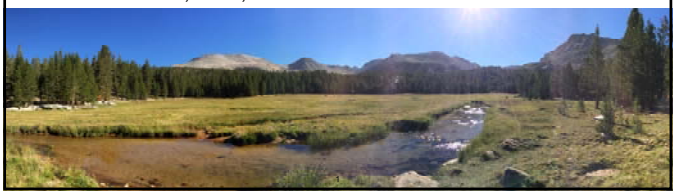
It's Your Money, Class 8:

Money & Your Mind

Carl Lachman, MBA, CFP®



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Are we always rational when it comes to money?

Yes or no?

Why?

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No! We're irrational about money!

- We spend more when we use credit cards instead of cash. (15% more!)
- We buy things on impulse we don't need. We confuse "wants" and "needs" when it comes to spending money.
- We assume if the stock market has been going up, it will keep going up. And if has been going down, it will keep going down.

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Why are we irrational?

- We lack knowledge.
- We lack discipline.
- But, we also have brains that are wired in a way that causes trouble with our investing.

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Money & Your Mind

- **Part 1: Are we good investors?**
- Part 2: What about us makes investing difficult?
- Part 3: What do we need to do to be better investors?

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Are we good investors?

Yes or no?

Why?

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Investor report card

Example: annualized returns for 20 years through 2013.

	Index	Investor	Difference
Equities	9.22%	5.02%	-4.20%
Bonds	5.74%	0.71%	-5.03%
50/50 Portfolio	7.48%	2.87%	-4.61%

Average investor gets an "F".

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Investor report card

Portfolio value at start:	$500,000
50/50 index portfolio after 20 years:	$2,226,037
50/50 average investor portfolio after 20 years:	$880,531

Average investor underperforms by $1,235,506!

That's missing out on more than 50% of the possible growth!

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Our actions hurts performance

Performance of the S&P 500 Index, 1970-2013

Missing only a few days of strong returns can drastically impact overall performance.

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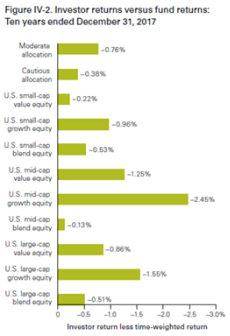
Vanguard study shows we receive lower returns than the funds we invest in.



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Recent Nobel Prize Winner

Dr. Richard Thaler
University of Chicago, Economics

1.) Two types of people: economists and humans.
2.) The humans think like humans, economists don't!
3.) Humans are impatient, inconsistent, and distracted by irrelevant factors.
4.) Financial behavior is largely a problem of self-control.

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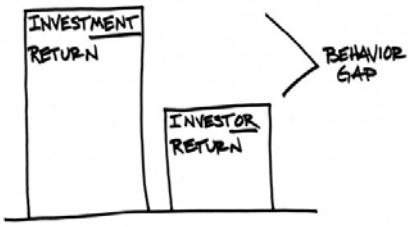
Behavior Gap by Carl Richards



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- Part 1: Are we good investors?
- **Part 2: What about us makes investing difficult?**
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What about us makes investing difficult?

Any thoughts?

Ideas?

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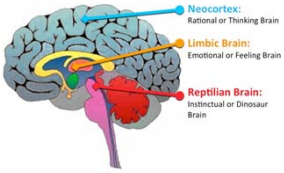
Why is investing difficult for us?

Our brains are wired to our investing disadvantage:

1.) **Reptilian brain**: brain stem.

2.) **Feeling brain**: limbic system.

3.) **Thinking brain**: neocortex.



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Why is investing difficult for us?

Our brains are wired to our investing disadvantage:

1.) **Reptilian brain**: brain stem. Bodily functions. Automatic.

2.) **Feeling brain**: limbic system. Emotions. Reactions.

3.) **Thinking brain**: neocortex. Decisions. Problem solving.

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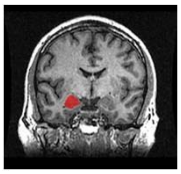
Trouble from the feeling brain

The **amygdala** in the limbic system is the control center of emotions.

- We follow our instincts.
- We let emotions take over.
- We think more information is better.
- We take mental shortcuts.
- We are influenced by the media.



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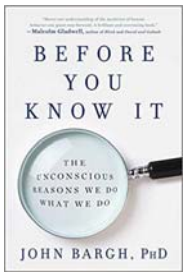
We follow our instincts

Should we trust our gut?

Bargh writes, “we tend to trust our gut reactions more than our rational ones because they happen so quickly we think they must be true.”

Instincts are good at life-or-death choices, but not investing.



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We follow our instincts

One of our instincts is to act.

We have a built-in bias toward action.

We think it is wrong to just do nothing.

Yet, doing a whole lot of nothing is often exactly what long-term investing is all about. Sitting and waiting, often for years.

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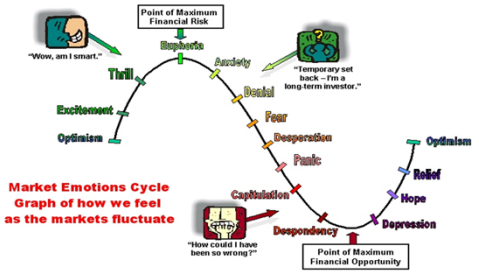
We let emotions take over



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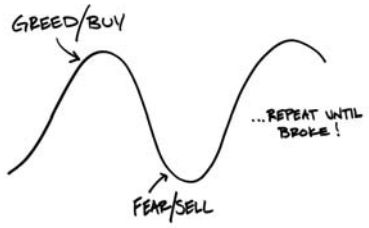
Repeat Until Broke! Carl Richards



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We let emotions take over

Emotions can cause poor decision making.

Don't make a decision when angry, for instance. Don't impulsively react to fear or disappointment.

Step back, do something else, let some time pass, and make a list of pros and cons.

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We let emotions take over

We really hate embarrassment. We hate it more than losing money.

In 1996, Dr. Thaler stated,

What investors fear more than losing money is having to say…

"What an idiot I am!"

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We let emotions take over

Remember that fear is one of the most basic emotions.

The fear of financial failure AND fear of physical harm *have the same response and effect in our bodies!*

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We think more info is better

Sometimes we think if we just do some more research or reading or get another adviser's opinion, we will finally know what to do.

However, we usually we get overwhelmed by too much information.

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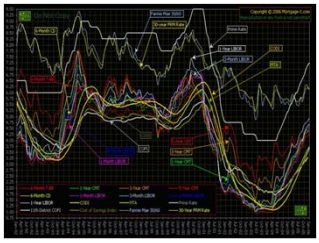
We take mental shortcuts

We get overwhelmed by data, so we use shortcuts.

We can only analyze 5-9 variables, at a maximum.

This graph has so much information, that our brains immediately try to simplify it.



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We take mental shortcuts

Our brains burn 1/4th of the calories our bodies use each day.

Our bodies are always trying to get us to <u>think less</u> to conserve energy!

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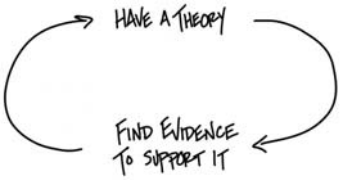
We take mental shortcuts

We filter information and are biased to whatever confirms our preconceived ideas.

This is confirmation bias, as shown by Carl Richards drawing.



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We take mental shortcuts

We forget the longer past and are unduly influenced by recent results.

This is recency bias.

Which should we focus on? Carl Richards

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We take mental shortcuts

We go with what others are doing and thinking.

This is herding bias.

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We are influenced by the media

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The media sells greed

The investment entertainer Jim Cramer has used the following tag line for marketing his books, TV shows, and podcasts. He says…

"You Can't Afford To Miss It!"

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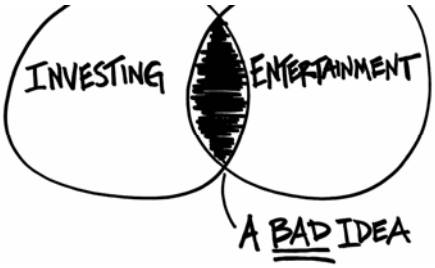
A Bad Idea – Carl Richards



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The media sells fear

- It's a **blood bath** on Wall Street today!
- The financial markets are in **freak-out mode**!
- The company is **too big to fail!**
- The stock market is **crashing**!

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The media sells fear

By appealing to our emotions, the media increases viewership and increases advertising revenue, but also causes us to make poor decisions.

Dr. Thaler and his student Werner De Bondt hypothesized in the 1980s that *"**people tend to overreact to unexpected and dramatic news events, driving stock prices out of whack.**"*

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The media to the rescue

Jim Cramer was famously interviewed in February, 2009, and stated that investors should sell enough investments so that they had all the cash they needed for 5 years.

Guess what happened a month later...

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The media to the rescue

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Fortune experts wrong.

10 recommended companies' value 10 years later

Broadcom BRCM	$237.13	$35.99	-88.8%
Charles Schwab SCHW	$36.38	$ 15.14	-58.4%
Enron ENE*	$72.56	0	-100%
Genentech DNA**	$37.53	$95.00	153.1%
Morgan Stanley MWD	$88.25	$24.74	-72.0%
Nokia NOK	$53.25	$8.74	-83.6%
Nortel Networks NRTLQ.PK	$76.75	$ 0.03	-100%
Oracle ORCL	$36.88	$23.27	-36.9%
Univision Communications UVN***	$56.63	$36.25	-36.0%
Viacom VIA	$69.00	$36.22	-47.5%

If you had invested in all 10 stocks, you would have had a return of **-46.6%** over those ten years.

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Barron's experts wrong.

Trailing the Market

Our 10 stock selections for 2011 fell 6.9% on average, compared with a 1.9% drop in the S&P 500, dragged down by GM, JPMorgan and United Continental.

Company/Ticker	12/30/10 Price	Recent Price*	% Change
ExxonMobil /XOM	$73.36	$79.87	8.9%
United Continental/UAL	24.01	19.71	-17.9
JPMorgan Chase /JPM	42.23	32.22	-23.7
Barrick Gold /ABX	52.60	49.59	-5.7
Wal-Mart Stores /WMT	54.07	57.98	7.2
Cisco Systems /CSCO	20.23	18.57	-8.2
Pfizer /PFE	17.49	20.19	15.4
General Motors /GM	36.82	20.98	-43.0
Entergy /ETR	70.80	70.61	-0.3
PepsiCo /PEP	65.12	64.33	-1.2
Average			-6.9%
S&P 500			-1.9%

*As of December 8, 2011 *Source: Bloomberg*

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CNBC experts wrong.

Jim Cramer in March 2008 said that Bear Stearns was fine. 6 days later it was bankrupt.

Power Lunch said Lehman Brothers was “No Bear Stearns!”, but it was bankrupt 3 months later in 2008.

The Faber Report said Merrill Lynch had no need to raise additional capital, but ran out of money 5 months later and was bought by Bank of America.

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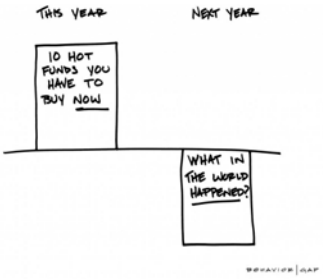
What happened? Carl Richards



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Real experts don’t give away their best ideas.

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Trouble from the feeling brain

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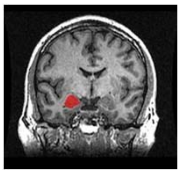

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Money & Your Mind

- Part 1: Are we good investors?
- Part 2: What about us makes investing difficult?
- **Part 3: What do we need to do to be better investors?**

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What should we do to be better investors?

Any thoughts?

Ideas?

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What do we need to do?

To be better investors, we need these six things:

1.) **Discipline**

2.) **Diversification**

3.) **Allocation**

4.) **Rebalancing**

5.) **Minimize costs**

6.) **Accountability**

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1.) **Discipline**: follow a disciplined investment strategy.

- Think through your strategy at a "quiet time".
- Write down your strategy and commit to it.
- At times of high emotion, stick with your strategy.

Success in investing doesn't correlate with I.Q. Once you have ordinary intelligence, what you need is the temperament to control urges that get other people into trouble in investing.

Warren Buffett

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1.) **Discipline**: follow a disciplined investment strategy.

Dr. Thaler wrote with Dr. Sholomo Benartzi of UCLA business school…

"Investors hate losses more than they love gains, and they focus too much on the near term, even when it comes to long-term investment goals, like retirement."

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1.) **Discipline**: follow a disciplined investment strategy.

Even a short, written plan will decrease worry. Carl Richards

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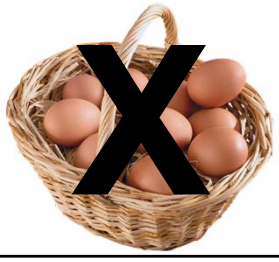
2.) **Diversification**: you need a variety of investments.



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2.) **Diversification**: you need a variety of investments.

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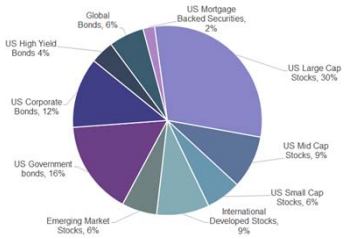
3.) **Allocation**: create a plan for the variety in your investments.

This is just an illustration of a portfolio allocation. It is not a good allocation for your portfolio.



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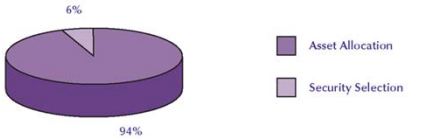
3.) **Allocation**: the variety plan is the most important decision.

Asset Allocation vs. Security Selection: What's Really Important?

Asset Allocation is the most important decision and determines over 90% of an investment portfolio's long-term returns and short-term volatility:



SOURCE: Brinson, Gary, Randoph Hood and Gilbert Beebower. 1986. "Determinants of Portfolio Performance" *Financial Analysts Journal*.

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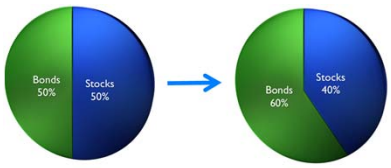
4.) **Rebalance:** at least twice a year, get back to targets.



Sell 10% bonds
Buy 10% stocks

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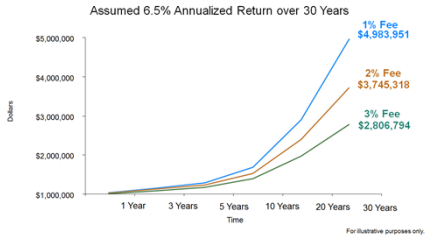
5.) **Minimize costs**: save money on fees and taxes.



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5.) **Minimize costs**: save money on fees and taxes.

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6.) **Accountability**: select the right kind of advisor.

- Ask First!
- What is their experience?
- What is their education?
- Are they licensed to sell you something?
- How do they get paid?
- Are they held to the fiduciary standard?

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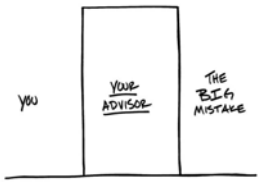
6.) **Accountability**: select the right kind of advisor.

Your advisor can stand in the way of your big mistake.

Carl Richards



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What do we need?

To be better investors, we need these six things:

1.) **Discipline:** write down your investment strategy.

2.) **Diversification:** have a variety of investments.

3.) **Allocation:** create a plan for your variety of investments.

4.) **Rebalancing:** at least twice a year, get back to targets.

5.) **Minimize costs:** save money on fees and taxes.

6.) **Accountability:** select the right kind of advisor.

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Money & Your Mind

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Thank you!

Contact me for a free meeting.

Carl Lachman, MBA, CFP®
Vice President
Eclectic Associates
1021 West Bastanchury Rd. #120
Fullerton, CA 92833
714-738-0220
clachman@eclecticassociates.com

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Eclectic Associates' Mission:

To help our clients achieve peace of mind about their money and their future.

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Carl Lachman, MBA, CFP®
Vice President
714-738-0220
clachman@eclecticassociates.com

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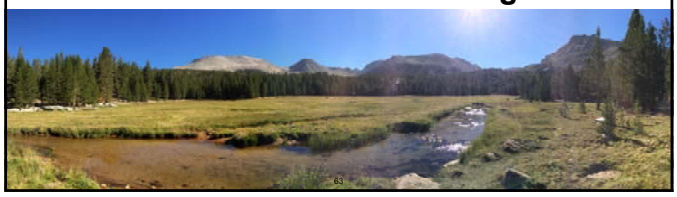

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