The Jentner Report

Wealth Management Strategies from Jentner Wealth Management Winter 2012

Investors can improve decisions by adjusting for memory flaws

If true that you can improve performance by learning from the past, then the weak link in this process may be memory, according to recent neuroscientific research. A bad memory will distort our recollection of past financial decisions and outcomes, making it harder to learn proper lessons from them.

Neuroscience experiments have identified two memory flaws. First, we may not properly store information. Second, stored information when recalled is often distorted by common cognitive biases.

Too much information

Research has shown that our brains simply do not have the capacity to hold in long-term memory every detail of experience. Short-term memory retains events and facts for a while, but eventually only a general outline and a detail or two stay with us.

When we recall those memories our brains reconstruct them based on what it has stored. But it also fills in with information from our current beliefs and knowledge, a process that often distorts the memory of the original event.

Transience, a memory phenomenon where information is lost the longer it is stored, may explain why investors who have experienced long periods of calm markets are shocked when a crisis period ensues: the vividness of their memories of previous crises has faded. They may panic and sell their investments because they don't fully remember how quickly markets recovered in the past.

Absentmindedness also can affect your memory: you may hear a long, detailed recommendation about an investment, but miss the warnings of potential risks.

Blocking the bad

Researchers also say we often block salient information with other information. For instance, it is more common to remember pleasant experiences than unpleasant ones. For investors, that can mean recalling winning decisions but not fully remembering the losers.

However, highly traumatic memories seem to persist in our memory more than others. The Depression generation never got over their stressful memories of the 1930s, and were generally more risk-averse when investing than were later generations.

Overcome your limitations

Investors can overcome these memory flaws by using written investment policies and keeping investment diaries. An investment policy documents your goals, risks, and rules and limits for investing. Frequent consultation with it can prevent you from making short-term investment decisions that conflict with your long-term goals.

An investment diary should include all of your reasons for making decisions to buy or sell. You should note all of the reasons for a trade, your goals, and then the outcomes. Such a record will help you find out whether your wins are due to skill – or just plain luck.

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The President's Word

Why you should keep investing in 2012 (and even up your ante)

Any investor should be willing to admit 2011 was a crazy year for the markets. It included weather and nuclear disasters in Japan, a deadlock over finances in Congress that led to a downgrade of U.S. debt, and a major crisis in Europe that threatened to blow apart the European Union and end the Euro as a currency.

The third quarter saw world markets swoon to bear market levels, only to recover swiftly in October, which turned out to be the best month for investors in 20 years.Withdrawals from mutual funds indicated that many investors fled the market altogether after being pounded with headlines predicting economic disaster and even another Great Depression.

It's never different

Even though the Chicken Littles will tell you it's different this time, a look back at market history over the last 61 years suggests otherwise.

- The Standard & Poor's 500 stock index has increased by 11% compounded annually, despite 10 bear markets and 10 recessions.
- Think the 2008 financial and auto bailouts were unprecedented? You forget the $293 billion savings and loan bailout in 1989, the $10 billion bailout of New York City in 1975, the first bailout of Chrysler in 1980, the bailout of Lockheed in 1971, and many others.
- Unemployment topped 8% in seven different years, 9% (not counting 2011) in five years, and 10% in three years.
- European debt crisis got you down? How about the Latin American debt crisis of the 1980s, the Japanese asset bubble burst in the 1990s, the Asian debt crisis in 1997, and the Russian debt crisis of 1998?
- Over this period one president was assassinated and attempts were made on three others. We had terrorist attacks in New York, Washington D.C., and Oklahoma City.

Wars and conflict

The United States fought in five wars, faced the Cold War and the Cuban Missile Crisis. Society was entangled by the Civil Rights, Black Power, Equal Rights, Gay Rights, and Environmental movements. These events and trends roiled the markets. Yet at the end of the day, $1 invested in big U.S. stocks in 1950 is worth about $600 today. Think times are tough today? Yes, they are, but they've been tough – even tougher – in recent history.

What's your job?

Your job as an investor is to control your emotions, don't do anything rash, remain diversified, and stay the course. That's how you reap a decent long-term return.

It is true that many investors have made next to nothing for five years running – mainly due to the 2008 bear market. But that trend is unlikely to continue. Long periods of high volatility and underperformance by the stock market have always been followed by extended periods of outperformance and lower volatility.

Will this time be different? Perhaps – anything is possible. But a look back at history suggests that the odds are on the side of long-term investors who vow to weather short-term storms.

Bruce A. Jentner, President
Jentner Wealth Management

Financial smarts decline steadily for investors over 60

Just at the age when Americans must make hard decisions about deriving income from investment portfolios, handling distributions from retirement accounts, and picking the right health insurance plan, their understanding of financial concepts begins to decline, a new study shows.

Financial literacy seems to decline at a rate of about 2% each year after age 60, say finance professors from Texas Tech University and the University of Missouri.

At the same time, confidence in the ability to make decisions does not decline, say Michael S. Finke, John S. Howe, and Sandra J. Huston: "Increasing confidence and reduced abilities can explain poor credit and investment choices by older respondents."

The literacy test

Other studies have shown that cognitive abilities and math skills necessary for making money decisions tend to decline with age. Their study uses a 20-question test to see if corresponding financial knowledge changes as individuals age. The questions dealt with money, credit, investment, and insurance decisions, as well as basic knowledge necessary to make decisions in those areas.

The most financially literate responders were between 45 and 49: they answered an average of 63% of the questions correctly. At age 70, however, the average rate of correct answers was 45%, and by age 80 it was just 31%.

Test yourself

How financially literate are you? Here are some questions from the test:

1. Savings account and money market accounts are most appropriate for **A.** Long-term investments, **B.** Emergency funds and short-term goals, **C.** Earning a high rate of return.

2. To reduce the total finance costs paid over the life of an auto loan, you should choose a loan with the **A.** Lowest monthly payment, **B.** Longest repayment term, **C.** Shortest repayment.

3. On which type of loan is interest never tax deductible? **A.** Home equity loan, **B.** Adjustable rate mortgage, **C.** Personal vehicle loan.

4. The benefit of owning investments that are diversified is that it **A.** Reduces risk, **B.** Increases return, **C.** Reduces tax liability.

5. The main advantage of a 401(k) plan is that it **A.** Provides a high rate of return with little risk, **B.** Allows you to shelter retirement savings from taxation, **C.** Provides a well-diversified mix of investment assets.

6. To ensure that some of your retirement savings will not be subject to income tax upon withdrawal, you should contribute to a **A.** Traditional Individual Retirement Account, **B.** Roth IRA, **C.** 401(k) plan.

7. If you have an insurance policy with a higher deductible, the premiums will be **A.** Higher, **B.** Lower, **C.** The same.

8. Which policy provides the most coverage at the lowest cost for a young family? **A.** Renewable term life, **B.** Whole life, **C.** Universal life.

Answers: 1-B; 2-C; 3-C; 4-A; 5-B; 6-B; 7-B; 8-A.

Societal Snapshot

Social Security makes up the majority of retirement income for 60% of Americans and accounts for almost half of the income of retirees in the top 40% of household income. Congressional Budget Office projections show that Social Security can meet its obligations through 2038. After that, says the CBO, it will pay 80% of promised benefits.

Even the affluent struggle

Some 14% of workers who earn $100,000 or more live from paycheck to paycheck, says CareerBuilder, a job search firm. Its survey found that many upper income workers last year either dropped or cut contributions to 401(k) and other employee savings plans.

Average gains

There is no such thing as "average stock market return" on a calendar-year basis, says Vanguard. Yes, the annual average return on the Standard & Poor's 500 stock index was 9.9% from 1926 through 2010, but that doesn't mean it delivered a 9.9% return in any particular year. In fact, in only 6 out of the last 85 years did the average's return come close to that 9.9% average. Vanguard says: "Financial markets, particularly stocks, are inherently volatile over the short term."

Who are the 1%?

The Occupy Wall Street protesters say the richest 1% take advantage of everyone else. But who are they? Federal Reserve statistics indicate they have $9 million of household wealth and/or annual income of more than $700,000.

Dangerous activity

Many an academic study has shown that too much activity leads to poor investment results. Market observer Fred Schwed Jr. knew this when he wrote in 1940: "Your average Wall Streeter, faced with nothing profitable to do, does nothing for only a brief time. Then, suddenly and hysterically, he does something which turns out to be extremely unprofitable. He is not a lazy man."

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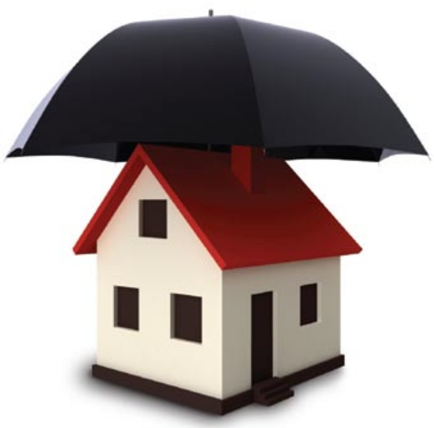
Insurance is vital, but don't make these buying mistakes

Deductibles, exclusions, premiums, terms, riders: the jargon and complexity of insurance baffles many consumers. Unfortunately it also leads to insurance mistakes. Here are some of the most common; all of them can imperil your financial plan. Use this list as a checkup for your own needs (and talk to your financial planner and insurance professional before making any rash decisions).



Buying too little

Homeowners run the risk of not being able to rebuild their homes if they carry too little replacement coverage. Young families often fail to get enough life insurance to cover expenses for survivors if a chief breadwinner dies early.

Buyers of cash-value life insurance are frequently seduced by the "investment" aspects of the policy. However, in many cases long-term investments can be made more cheaply and tax effectively outside of life insurance.

Ignoring potential liability can be damaging. When was the last time you saw someone who was injured go to court for less than $1 million? A $1 million umbrella liability policy may cost as little as $200 a year and will supplement your homeowner's and auto policies.

Ignoring disability

Although a young family should have adequate life insurance, an even bigger risk is loss of income due to a long-term disability. Workers under 65 have a greater chance of becoming disabled than of dying. A disability policy can be invaluable if this happens.

Buying narrow coverage

Too many consumers succumb to sales pitches or specialized insurance policies. Burial insurance, cancer insurance, accidental death insurance and others may seem cheap, but that's because they are unlikely to pay off. Instead, a good life insurance policy will handle such eventualities.

Over-filing

Filing small claims, especially on a homeowner's policy, may cause higher premiums or even cancellation of insurance. Consider your policies as disaster coverage rather than a piggy bank for small repairs and damages. Self-insure for small items by increasing your deductible, which will result in a lower premium.

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"Financial life planning provides better wealth management by asking smarter questions, listening more carefully and applying sound financial and investment strategies to help you achieve personal and objective goals. It is not something different or new; it's simply planning the right way."