How to keep emotions out of investing

Think about the letter K.
Are there more words that start with the letter K, or more that have K as the third letter in the word?
Because it is generally easier to recall words that start with a particular letter rather than those with the letter embedded, most people are likely to answer that there are more words that start with K. In fact, there are more with K in the third position.

“Ease of memory” has been found to influence decisions and introduce errors, including errors in making investment decisions. This example is found in Thinking, Fast and Slow by Daniel Kahneman, who won a Nobel Prize in 2002 for his work in behavioral economics. This is a field of study that looks for explanations in psychology for why markets and market participants at times seem to act in an irrational manner.

Fast thinking is intuitive thinking, according to Kahneman, while slow thinking is contemplative and deliberative. Fast thinking incorporates easily accessed understandings and tends to be more emotional. Fast thinking operates automatically, with little effort, and may inadvertently introduce unconscious biases into the decision. Slow thinking, concentration before decision, is not immune to the problem of bias. However, errors with emotional roots may be reduced when decisions are made through a process rather than by instinct or hunch.

Continued on next page

Avoidable errors
Navigating today’s volatile financial markets is no picnic. It’s been a long bull run for stocks, but the economy hasn’t been keeping up. There’s an avalanche of data to digest, and no reliable shortcuts to sound investment decisions.

This issue of QuarterNotes looks at some of the findings about investor psychology from the new field of behavioral economics. Several of the common ways in which investors let their emotions interfere with their investing are discussed.

We can be an important resource for you in keeping your portfolio management on the coolly rational path. Call on us today!

Martina Klabo
Vice President, Financial Advisor CFP®, ChFC®
Harborstone Investments & Insurance Services
P.O. Box 4207
Tacoma, WA 98438-0207
Voice: 253-589-8396
Fax: 253-583-8684
martina.klabo@ceterais.com

Ralph Kowal, MBA
Vice President, Financial Advisor
Harborstone Investments & Insurance Services
6019 Lake Grove Drive SW
Lakewood, WA 98499
Voice: 253-589-8396
Fax: 253-583-8684
ralph.kowal@ceterais.com

QuarterNotes is written by The Merrill Anderson Company. Cetera Investment Services LLC and The Merrill Anderson Company are not affiliated.

Securities and insurance products are offered through Cetera Investment Services LLC (doing insurance business in CA as CFGIS Insurance Agency), member FINRA/SIPC. Advisory services are offered through Cetera Investment Advisers LLC. Neither firm is affiliated with the financial institution where investment services are offered. Investments are: • Not FDIC/NCUSIF insured • May lose value • Not financial institution guaranteed • Not a deposit • Not insured by any federal government agency. Advisory services may only be offered by investment adviser representatives.

© 2016 Cetera Investment Services LLC, member FINRA/SIPC. All rights reserved.
The investment context
Behavioral scientists, including Kahneman and his colleague Amos Tversky, have described many money management mistakes that people make, mistakes that are sometimes characterized as being emotional instead of rational. For example:

Anchoring. When investors evaluate their holdings using reference points that don’t have relevance to future performance. For example, what one paid for a stock or how long it has been held may have tax significance, but it tells one nothing about how appropriate the stock is in one’s investment mix.

Confirmation bias. Investors tend to notice information that supports their existing beliefs, and they more often overlook inconsistent or contrary data. This is directly parallel to the idea that belief creates blindness.

Disposition effect. Selling winners too quickly, and holding on to losers for too long, are both loss-avoidance behaviors that undermine long-term performance. These are the consequence of the fact that most people get more pain from a loss than they do pleasure from a gain.

Frame dependence. Similar to anchoring, frame dependence takes into account data, such as previous high share prices, that don’t relate to the fundamental prospects for a security.

Overconfidence. People believe in their own abilities, and they tend to be optimistic investors. Empirical studies have shown that much of this confidence is misplaced, that when individuals trade stocks, the shares they sell do better, with surprising regularity, than the ones they buy. Interestingly, men tend to be more overconfident than women.

Investors need to be aware of these kinds of behaviors so that they can avoid them, and avoid portfolio underperformance. If it turns out that some of the behaviors are essentially involuntary, guard needs to be doubled.

The alternative: asset allocation planning
Contrary to the belief of some investors, the key to successful investing isn’t picking the best stock, and it isn’t jumping in and out of the market, guessing at the peaks and the valleys. The better course is to invest for the long term with an asset allocation plan that optimizes risk and reward. With a balanced portfolio approach to asset management, one can get much of the potential gain that the market offers, while keeping the potential for loss to an acceptable minimum.

As you assess your own investment portfolio, keep these points in mind:

▲ Look at your whole portfolio. Don’t focus on extremes, the winners and the losers. Total portfolio return is the target. Sound diversification among and within asset classes is the key to steadier returns.

▲ Reduce your risk as your time horizon shortens. As you approach retirement or other key dates for tapping into your portfolio, you may want to reduce your exposure to riskier securities. Still, remember that withdrawals last a long time, and you will need some inflation protection.

▲ Don’t expect history to repeat itself. Comparing the stock market today to earlier periods will not prove helpful in making investment decisions. The time in which we live is unique, and our responses to the opportunities and challenges that lie ahead must be guided by today’s realities, not past cycles.

Let us help you
Finding good help for investment management is no easy matter. It’s a bit like selecting a doctor or a lawyer. You have to find someone you can trust, someone with whom you feel comfortable.

That someone should be us. We offer unbiased investment advice, designed with the needs of you and your family in mind. We utilize a team approach to investment and financial management, with professionals from a range of disciplines to provide you with a complete financial management solution.

If you haven’t yet taken advantage of our services for investors, we invite you to make an early appointment to learn more about our offerings.
When should one start one’s Social Security benefits? Full retirement age is 66 for those now approaching retirement, so that’s the age at which one may claim 100% of one’s benefits. Early retirement benefits may begin as early as age 62, but are reduced by up to 25% from full benefits. What’s more, those benefits will be reduced if the recipient has too much earned income (more than $15,720 in 2016). On the other hand, should one defer benefits until later, an 8% bonus may be earned each year until one reaches age 70, for a maximum increase of 32%. The spousal benefit is 50% of the earned benefit.

In 2000 President Clinton signed the “Senior Citizens Freedom to Work Act.” The most important change in that legislation was the elimination of the earnings test for those who have reached their full retirement age. In other words, one no longer needed to actually retire in order to collect full Social Security benefits. Another less-noticed change was giving those who reached retirement age the option of suspending their benefits in order to earn additional credits.

Married couples with two earnings records could use these new rules to enlarge their potential combined Social Security benefits. In a surprise move, Congress last November phased out some of these strategies. Those who already have implemented them are not affected.

File and suspend
One popular strategy has been for the higher-earning spouse, usually the husband, to file for benefits at age 66, but then suspend those benefits to earn additional credits. The spouse would be allowed to collect her spousal benefit, even though the husband wasn’t collecting his. File and suspend has not been eliminated, but during the suspension period the spousal benefit will no longer be available (nor will a child’s benefit). The new rule goes into effect 180 days after the law was signed by President Obama on November 2, 2015. Only those who reach age 66 before that date may file and suspend their benefits under the old rules until that date.

First claim a spousal benefit, then switch
A spouse with an earnings record may claim his or her own benefit or the spousal benefit, but not both. Normally, one would choose the higher benefit. But the old law allowed for switching benefits in midstream. One could first claim the spousal benefit, allowing the earnings credit to grow until age 70, then later switch to one’s own earned benefit.

This option has now been limited to those who reached age 62 by December 31, 2015. In other words, no one born in 1954 or later will have this choice.

The number of people using these strategies has not been quantified, but likely was growing as more and more boomers retired. Elimination of these choices was projected to reduce Social Security shortfalls by about 1%.

Planning your retirement income
Are you comfortable with your retirement income planning? Perhaps we can help. We’ve helped many people with the transition to financial independence. We would be pleased to be of service to you.

It’s not too late for 2015 IRA contributions!
If you already have made your IRA contribution for the 2015 tax year, congratulations! Now is the perfect time to go ahead with your contribution for 2016. The sooner you contribute, the longer your IRA will have to grow. If your 2015 contribution hasn’t been made, you should get to it before you file your 2015 tax return.

IRAs are still not universally available. See the table at right for the phaseout ranges, which are based upon modified adjusted gross income. Contribution limits are unchanged from last year, $5,500 for the traditional or the Roth IRA, $6,500 for those 50 and older.

<table>
<thead>
<tr>
<th>IRA Deduction Phaseout Ranges</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Filing status</strong></td>
</tr>
<tr>
<td><strong>Traditional IRA</strong></td>
</tr>
<tr>
<td>Married, filing jointly, contributor is an active participant in an employer plan</td>
</tr>
<tr>
<td>Married, filing jointly, contributor not covered by an employer plan</td>
</tr>
<tr>
<td>Single or head of household</td>
</tr>
<tr>
<td>Married filing separately</td>
</tr>
<tr>
<td><strong>Roth IRA</strong></td>
</tr>
<tr>
<td>Married filing jointly</td>
</tr>
<tr>
<td>Single or head of household</td>
</tr>
<tr>
<td>Married filing separately</td>
</tr>
</tbody>
</table>

Q. Is there anything I should know about the tax deal Congress passed in December?

A group of tax provisions became known as the “tax extenders” because they had to be periodically renewed. The provisions couldn’t be made permanent, the thinking went, because their impact on the federal budget deficit was too severe.

In December Congress made many of these provisions permanent. Among those of interest to individual taxpayers:

▲ Qualified distributions from IRAs directly to charities;
▲ State and local sales tax deductions;
▲ Enhanced American Opportunity Tax Credit;
▲ Enhanced child tax credit; and
▲ School teacher expense deduction.

The new law also provides that computer equipment and software will now be qualified expenses for 529 education accounts. The 529 ABLE plans for special needs beneficiaries also were modified, as the state residency requirement was eliminated.

See your tax advisor to learn more, if any of these are of interest to you.