

## IAP FINANCIAL ADVISOR

## INSIDE THIS ISSUE:

*The urge to "get even" often prevents rational decisions by investors.* 2

*The stock market may not be completely efficient, but it's efficient enough, says Kenneth French.* 3

*Rich investors return to mutual funds, the Dow's "rule of 5" fails in 2005, and more.* 3

*Saving breeds more success than investing well.* 4

## Points of interest:

- Focus on recent events distracts investors from their real goals.
- Stock prices tend to grow along with the economy.
- Long-term perspective sheds a different light on market "crashes".

## DOES IT MATTER WHAT 2006 WILL BRING?

The U.S. stock market could fall this year due to higher interest rates, unless it rises because the Federal Reserve stops raising rates.

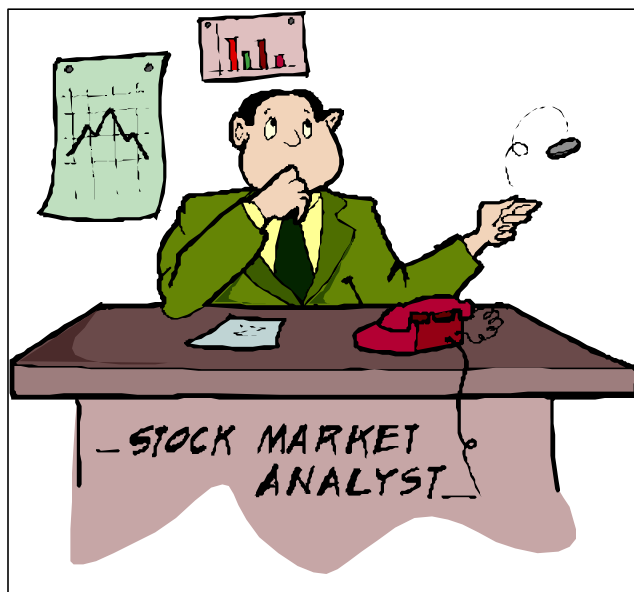
The bond market may rise as money flows out of stocks in search of higher bond yields, or it could fall if foreign investors shift money out of the United States.

Foreign stocks may fall because they have appreciated so much in recent years, although they could rise if foreign economies continue their rapid expansion. Then again, everything may fall if oil goes up in price, unless, of course, oil prices drop (in which case, everything could also fall along with oil).

This is the time of year when market pundits make oracular pronouncements about the year to come. Everyone has an opinion and, in the end, nearly everyone ends up being wrong because some event or trend comes along that blindsides them.

For most investors, it doesn't really matter. The truth is, only investors who plan to sell everything and spend the proceeds within the next 12 months have any real stake in what the markets do in 2006. In that case, they shouldn't be invested anyway: they are taking too much short-term risk.

Have you retired in the last several years? Your investment horizon could easily be 20 years or more. Are you



**Don't spend your time predicting where the market will go in a particular time period.**

in the middle of a working career? Then you are more interested where stocks will be in 2036 than you are in 2006. Just starting out of college? Forget about the markets this year and just shovel as much money as you can into a retirement account.

No one can predict what will happen to financial markets this year, but the prediction over the next 20 years is a little easier: it is likely (although not guaranteed) that stocks will be worth more in 2026 than they are today.

How much more, again, is anybody's guess, but it is reasonable to assume the economy will grow over the long term, and that stock prices will follow.

There has not been a losing 20-year period in the U.S. stock market (as measured by returns on the Standard & Poor's 500 Index) going back to 1926, when accurate statistics began. Returns varied, of course: an investment in the S&P 500 in January 1929 averaged 3.1% over the next 20 years. Getting started in January 1985 would have produced average annual returns of 13.2%.

We tend to focus on recent events, such as the bear market of 2000-02, which was brutal enough that some investors haven't yet recovered their losses. But a look at a longer time horizon helps. For instance, look back at the

*(Continued on page 2)*

## LONG TERM PROSPECTS ARE USUALLY EXCELLENT

(Continued from page 1)

stock market crash of 1987, a very scary event that wiped out more than one-quarter of the U.S. stock market's value in just one trading day.

Despite that terrific collapse, someone who invested in the S&P 500 just before the crash would have seen their portfolio grow by an average of 10% per year since then.

Of course, you increase your short-term risks by concentrating in one area of the investment markets. Instead of just buying large U.S. stocks like those that make up the S&P 500, it is better to allocate money over the world's stock, bond and commodity markets.



## THE URGE TO GET EVEN OFTEN TRIPS UP INVESTORS

(Editor's note: This is the next in a series on cognitive errors and emotional biases that hinder investment success).

Selling a losing investment is one of the hardest things many investors can do.

In a recent survey, some investors said it was harder to sell a loser than it was to admit lying to a spouse.

This is a symptom of one of the basic emotional biases that affect investors: loss aversion.

Many studies show that losses have a much greater impact on our psyches than do gains. One study of investor behavior estimated that a loss has 2.5 times the impact of a gain of the same magnitude.

That makes it hard to book a loss, even when it is the most rational move an investor can make.

### 'Get evenitis'

Many times an investor will hold onto a losing stock for much too long, with the vague hope that the losing stock "will come back" and the investor will get even before selling.

This type of thinking

stems from a related mental phenomenon, avoidance of regret. Selling the loser solidifies in the investor's mind that a mistake has been made and that the investor is responsible.

If a stock eventually returns to the price at which the investor bought it, he feels he has "gotten even" and never made a mistake.

Of course, this is a fallacy because it does not take into account the time value of money. The investor could have freed up the capital that was tied up in the losing investment and put it to work in something else gaining value.

### Reframe the decision

One way to fight this tendency to hold onto a loser is to reframe the decision to sell.

Rather than admitting

that you are selling to recognize a loss, you can trick yourself by realizing that you are merely

"transferring your assets" to a better investment.

This trick is known as "hedonic editing" to cognitive psychologists. It stems from research that shows investors prefer some scenarios to others.

Investors who suffer from "get evenitis" can also push themselves to make a rational decision by asking whether they would invest new money into the losing stock.

The investor should ask herself whether her particular stock, out of all of the thousands of investments available, represents the best current opportunity for making money.

If the answer is no, as it usually is, she can feel justified in taking what is left of her invested capital out of the stock and putting it somewhere else.



**Losses hurt more than gains feel good, so investors often make irrational decisions in order to avoid loss.**

*"Some investors said it was harder to sell a loser than it was to admit lying to a spouse."*

## SMART INVESTORS CAN'T BEAT EFFICIENT MARKETS

As the stock market swings wildly up and down day to day and week to week, it seems hard to believe in the concept of an "efficient market."

After all, what's so different about the world today that prices should jump, when last Friday they fell through the floor?

Active investment managers use this argument when justifying their own search for undervalued stocks.

"Undervalued," in this case, means the market has not been efficient in assigning correct prices to those stocks.

So what is an investor to do? Act like the market is efficient, says Kenneth French, a finance professor at Dartmouth University who has published extensive research on market efficiency.

Although he concedes that the market is not entirely efficient (87.32% efficient, he facetiously told one interviewer), it is efficient enough that very few investors can beat it consistently.

"Do I think it's a good use of my time to try to identify mistakes in the market?"

he asked in an interview with CFA Magazine. "Absolutely not. First, it's not clear I have any skill at it. Second, even if I have some skill, I'm sure there are lots of people who are better than I am. Should all those smarter people try to beat the market? I think the answer for almost all of them is also no."

French compares it to a poker game in Las Vegas with 10 people. Suppose you join the game and think you are smarter than half of the others. That doesn't mean you will make money; the smartest player will.

"To him, I'm just one more sheep to fleece. And he'll be even happier if I've fooled myself into thinking I will make money, because that will make it even easier for him to take mine," French told the magazine.

As in poker, a handful of professional investors will beat the market, he said. However, identifying and investing with those few will not help other investors make a killing.

Once a winning manager is discovered "whatever skill



**The stock market isn't perfect but it's efficient enough to negate most active investors' effort.**

she has usually gets diluted as the investors chase returns and assets under management grow dramatically, he said.

More important, that winning manager will raise her fee, he said.

"Why do investors think that they should be able to capture the rents that some extraordinary money manager is able to provide?" he asked. "The manager will capture them. As soon as there is evidence that she can beat the market, the manager does things that allow her to capture the rent; there is no reason for her to share it."

*"...a handful of poker players and professional investors will win."*

## RETURN TO FUNDS, FIVE RULE FAILS, & MORE

Wealthy investors may be losing their faith in alternative investments and switching some money back to mutual funds, a recent survey found.

The Spectrem Group said investors with net worth of more than \$5 million increased the portion of their assets in mutual funds to 11% last year from just 6% in 2003.

Meanwhile, money allocated to managed stock accounts declined to 23% from 26%.

The amounts allocated to hedge funds, commodities,

limited partnerships and private equity also declined.

### **Fifth year folly**

Another Wall Street tradition fell in 2005 along with the market itself.

Previously, the Dow Jones industrial average had a strong gain in every year that ended with a five since the average began in 1896.

However, 2005 put that rule out of business: rather

than a gain of any type, the index lost 0.6%.

### **Hedge fund hostages**

Hedge funds may be trendy, but they are a lot harder to get out of than mutual funds.

Most hedge funds make investors stay with the fund for a specified time or pay a penalty.

One large fund, Citadel Investment Group, recently began imposing penalties to hold onto investors scared by losses, *The Wall Street Journal* reported.



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## IT IS HOW MUCH YOU SAVE, NOT HOW WELL YOU INVEST

Retirement investors usually emphasize the wrong factors when trying to build their portfolios, a new study by Putnam Investments concludes.

Investors using IRAs and tax deferred accounts operated by their employers often focus on investment selection.

Instead, they should focus on contributions, because the amount they put into their accounts makes a far bigger difference than their investment style, the study says.

Putnam looked at three different methods of managing investments in a retirement account: rotating among top-performing mutual funds every three years, using index funds in different asset classes, and having access to a perfect crystal ball that foretold which funds would be the best performers.



Having a crystal ball would be nice, because its owner would be able to invest in the top funds and avoid the worst. The crystal ball approach produced a 6% increase in returns over a 15-year period, Putnam found.

The other two methods offered improved returns at a lesser rate.

However, increasing the annual savings rate from 2% of salary to 4% had an impact

90 times greater than using a crystal ball, Putnam found.

It used a hypothetical 401k account owner who started saving in 1990 at age 28, and had a salary that year of \$40,000 that increased by 3% per year. The employer matched 50% of the first 6% in contributions.

The saver used six mutual funds and never rebalanced or changed them.

If he saved 2% of his salary, he would have had \$39,800 in 15 years. But saving 4% would have built the account to \$79,500, while saving 8% of salary helped him accumulate \$145,700.

"The conclusion of this study is simple, but too often ignored," said David Tyrie, Putnam's director of retirement services. "Saving more is the most powerful way to end up with more."