Investor'sEdge

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How to avoid the emotional pitfalls of investing

For many people, 2017 was a year characterized by steady portfolio growth with few market surprises. As President John F. Kennedy famously said, "A rising tide lifts all boats." The mood going into the New Year was also cautiously optimistic because of the strength of the economy and the solid fundamentals of many securities issuers.

This favorable trend continued into January—and was then interrupted by a sudden nosedive, followed by an extended period of market volatility. Regardless of the **causes** of what happened, you likely know the **effects**: a potential short-term change in your net worth and possibly an increase in your anxiety level.

This is natural and understandable. But what can be learned from the experience to help inspire feelings of calm resilience the next time unforeseen forces sweep through the markets?

Unconscious behavioral biases influence choices

Perhaps this is an opportunity for a quick overview of behavioral finance, which is a relatively new academic discipline combining elements of economics and psychology. And it is gaining greater attention from financial professionals and ordinary Americans since Richard Thaler of the University of Chicago was awarded the 2017 Nobel Prize for Economics for his contributions to this growing field of study.

Three years ago, an article describing some of the key principles of behavioral finance was published in this newsletter. The purpose was to help readers understand the emotional pitfalls often associated with investing. Let's briefly review the basics.

One of the primary behavioral biases investors may suffer from is **overconfidence**, which stems from the fact that people are not aware of what they do not know and tend to be overconfident when making decisions involving uncertain outcomes. Frequently seen with the overconfidence bias is **hindsight** bias and **illusion of control**. Hindsight bias leads to making decisions about future outcomes based on previous events. Illusion of control means that the person believes his or her ability, not chance or other external forces, was responsible for what previously happened.

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These two biases can combine to cause people trouble. Given that investors have enjoyed one of the longest-running bull markets in history, many may have mistakenly believed positive returns confirmed their own skill at security selection and asset allocation. Through a gradual process of portfolios becoming under-diversified as a result of these biases, these investors may have felt the consequences as volatility returned and investment values fell.

Another common behavioral bias is **framing**, which occurs when people process information based on the context in which it is viewed. An example may be when a person selects an investment based on hearing how it performed for a friend or family member, when the investment may, in fact, be inappropriate for that particular person.

Narrow framing occurs when people evaluate each portfolio holding in isolation, rather than in the context of the entire portfolio; this may also contribute to under-diversification.

A herd mentality based on the classic assumption of "safety in numbers" arises from a bias labeled **regret aversion** that can easily mislead people into a false sense of security. As more investors behave the same way (such as increasing individual allocations to risky equities during bull markets), people may feel pressure to follow suit or miss out on the opportunity—even though they may know their choices may not be right for their risk tolerance, time horizon or need for liquidity.

Goals-based planning offers relief

By definition, a bias is a behavior or thought rooted in unconscious or subconscious mental processes. This can make these behavioral finance issues challenging obstacles to overcome.

The first thing you can do is work with your financial advisor who can help you make well-informed decisions. Another good way to keep the insidious effects of biases and market volatility in check is to take a holistic approach to wealth management that includes goals-based planning.

Here's why. When you understand your financial situation and identify meaningful life goals, you are better able to plan for how to achieve those goals. Then, during times of market uncertainty, you can use your goals as benchmarks for success instead of worrying over short-term changes in market indexes that have little context for your financial life.

Your financial advisor can work closely with you to help you really know where you stand today and establish a course to help you achieve what is most important to you personally.

To avoid the emotional pitfalls associated with investing and plan for the future you want, call your financial advisor today.

Financial wisdom for vacation home owners

The dream of a vacation home can be compelling because of what it may represent to your family. In your mind, it has the potential to be a special place where deep bonds are forged, long-lasting memories are made and promises for the future are kept.

If you want to purchase a vacation home (or if you already own one), you can help make sure the reality of it lives up to your expectations by addressing two key issues: financial considerations and family dynamics. Heeding simple financial wisdom may be a practical way to manage these potential issues—so you can fully enjoy your vacation home.

Take a holistic approach to your financial goals

Should owning a vacation home be important to you, following a goals-based planning process can help identify and prioritize your financial goals. This includes looking at your overall financial picture to see how different goals and variables may affect your ability to live the life you envision. Learnings can be used to make well-informed decisions about funding your family vacation home. As a result, you gain clarity about your current financial well-being and confidence about your future financial security.

When taking a holistic approach to wealth management such as this, there may be times when credit is a practical source of funds for the dreams that are affordable to you. Borrowing money using securities as loan collateral instead of selling assets may offer a smart, yet untapped source of opportunity. It can help you gain the liquidity you need—while keeping your long-term investment strategy in place. You may also enjoy competitive interest rates and the flexibility to pay down the balance when you choose.

Of course, you have other ways to borrow, save and invest for your vacation home. You will want to review all possibilities carefully to ensure you are making the right choice.

Run your vacation home like a business

Vacation homes can provide many wonderful family memories, but they also create the potential for conflict. Quarrels may arise over financial obligations, responsibility for damage caused to the home and even about who gets to use the home during the best time of year.

To prevent these disputes from undermining family cohesion, you might want to treat the property as you would a family-owned business. For starters, you could create a governance board. This gives family members a forum for making decisions about running the home, such as how to handle maintenance and larger improvements. The board can also address nonfinancial issues, such as determining who can use the vacation home at any specific time.

You may also want to prepare for what will happen to the home after you are gone. As part of your long-term plan for your vacation home, you may want to place it in a trust and create an endowment to pay for the property in perpetuity.

As far as your cabin, cottage, chateau or castle goes, there may indeed be wisdom in taking a holistic approach to your financial goals and running your vacation home like a business—because it may help your vacation home be everything it is truly meant to be.

To discuss planning for a vacation home or other major life goals, please call your financial advisor.

Holistic wealth planning includes cash management

When you plan for your long-term goals, such as enjoying a comfortable retirement, supporting worthy causes and leaving a legacy for your family, you may be focusing your attention on strategies to help produce investment growth and income.

Yet your goals-based planning efforts are also supported by an essential, but sometimes-overlooked, wealth management topic: *cash management*. In fact, there are three key reasons to consider the role cash plays in your life and how to plan for the cash that may be necessary to meet your current and future cash needs.

Stabilize your income stream
If you are retired or you depend on your portfolio for part of your income, cash management solutions can offer efficient access to your cash and help smooth out your income stream.

Improve your liquidity
There may be expenses in life we do not anticipate, such as a major repair, a medical emergency, or a job or business loss. Holding sufficient cash may help you prepare for the unexpected.

Gain financial flexibility
By allocating some of your portfolio to cash, you can act quickly when an investment or business opportunity presents itself.

When you include cash as part of your overall wealth management plan, you may also find it beneficial to employ a methodical "three-bucket" approach used by many institutional investors:

Operating cash

With a zero- to six-month time horizon, the purpose is to meet daily cash management needs (such as paying bills or living expenses). Liquidity and safety of principal are the primary requirements, so the focus is on low-risk options that provide immediate access to funds.

Please note that retirees and others who do not have a steady source of earned income may want to extend the cash allocated for operating cash purposes to 12 months or even longer. This prolonged cash cushion can help protect against market volatility or being forced to sell investments at an inopportune time.

Core cash

With a six- to 12-month time horizon, the purpose is to provide occasional access to funds for periodic near-term needs (such as holiday gift giving, a semiannual insurance premium or an annual vacation). Liquidity is a secondary requirement, so the focus is on low risk and incremental yield.

Strategic cash

With a 12- to 24-month time horizon, the purpose is to accomplish major, longer-term cash goals (such as paying college tuition). Liquidity requirements are identified ahead of time, so the investment focus is on optimized risk and returns.

We can help you fill these buckets with a variety of cash management solutions that may be appropriate for your liquidity, risk and return requirements. One or more can be used to create a custom cash management plan to help meet your immediate and near- and long-term needs.

A standby line of credit, such as one backed by eligible securities in your portfolio, can also help create liquidity, particularly in emergencies. Typically, there is no setup cost or ongoing fees. Plus, interest rates and repayment terms are often advantageous. A good rule of thumb is 24-36 months of living expenses.

There is an old proverb that says "cash is king" when negotiating a favorable deal. While there may occasionally be some truth to that age-old adage, it can honestly be said that cash can play a noble role in your wealth planning efforts as well.

To learn more about cash management strategies and solutions, please call your financial advisor.

Asset-based lending may not be suitable for all investors. You must maintain sufficient collateral to support outstanding loans. Before using such products, you should read the Margin Disclosure Statement or line of credit literature and regulatory disclosures to ensure you understand the risks involved.

Lending services are offered to clients by different entities. Our firm and/or your financial advisor may receive compensation in conjunction with offering or referring these services.

A successful family business deserves a succession plan

If you own a family business, you work hard every day to make it successful. Beyond the money you earn, it is a source of personal pride. And you likely feel a strong sense of responsibility to the customers you serve and the employees who depend on you for their livelihoods.

So if you want to exit your business to enjoy a well-deserved retirement—and keep your business going after you leave the scene—it is essential to plan for business succession.

Unfortunately, your peers in the business owners’ world have a mixed record in creating a full wealth-transfer plan. In fact, just 39% of them have such a plan in place, according to the *Business Owners & Wealth Transfer* report from RBC Wealth Management.

For your business—and your family—to continue to be successful financially, you need to begin your succession planning by considering the human side. Talk to family members about their wishes. Who really wants to be involved in running the business? What are their personal and financial goals? And how can you be fair to others who may not want to work in the business but still deserve some of its financial benefits?

Once you have answers to these and other pertinent questions, you can look into the legal and tax aspects of business succession planning. Essentially, you can sell the business or you can give it away. And you have many different ways to transact a sale or make a gift.

To sell your business, you might consider a buy-sell agreement. This is a legal contract that obligates the parties to the succession plan. It can also be structured to create liquidity at the needed time, establish a fair price/create the market for your business, fix the value of your business for estate tax purposes and ensure business continuity.

Other ways to transfer your business may include establishing a grantor retained annuity trust or an intentionally defective grantor trust. You may also consider structuring your business as a family limited partnership or a limited liability company. These strategies may help you transfer your business to heirs.

Should you have philanthropic intentions for your business, a charitable remainder trust may offer a mechanism to create income for you as well as to accomplish your legacy and estate planning goals. A family foundation may be another alternative to explore if you have charitable wishes for your business.

Of course, these are just a few basic ideas. Succession arrangements are often complex. Especially since your business may be one of your largest retirement income assets and a significant estate planning consideration. Be sure to consult with your tax and legal advisors to make sure you are picking a plan that is appropriate for your business and family circumstances.

Once you have your plan in place, you may well feel a strong sense of relief. After all, your family and your business are undoubtedly two of your greatest priorities. When you have taken care of both, you will know your life—and your wealth—has been meaningful for yourself and others.

To learn more about the financial and investment aspects of business succession planning, or to request a complimentary copy of Business Owners & Wealth Transfer*, please call your financial advisor.*

Our firm does not provide tax or legal advice. All decisions regarding the tax or legal implications of your investments should be made in connection with your independent tax or legal advisor.


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