Trading Away Profits

(Continued)

while discounting the role of luck and outside factors.[5]

Consider how overconfidence affects investing. Successful investors overrate their abilities to anticipate trends, recognize mispricing and outmaneuver the market. The higher their overconfidence, the more they trade. Overconfidence also fosters illusions of knowledge and control: Investors misinterpret their research and believe their personal involvement in the trade will influence outcome. Overconfidence also prompts them to harbor unreasonable return expectations and make irrational buying and selling decisions.

The financial industry and ownership culture also encourage investors to trade more. The market exchanges and brokerages thrive on trading volume. Their marketing messages and opinions tendered through the financial media advocate stock selection, market timing and active trading. Even the most inexperienced investors have immediate and uncounseled access to the markets. If participation in self-directed retirement plans continues to grow and Social Security privatization becomes a reality, many more investors could be lured into the trading game.

Behind the research is a story of ignorance and self-delusion. Many novice traders don't understand market pricing, risk-return dynamics and portfolio design principles—or they choose to chase blind hope. Either way, the odds are stacked against them. Education, seasoned advice and discipline could help reverse their fate. ■

(4) "Do Investors Trade Too Much?", American Economy Review, December 1999, pp 1279-1298.

Terrance Odean's earlier study analyzed the trading records of 10,000 discount brokerage investors (1987 to 1993) to determine whether trading produced a positive net return after costs. He found that, on average, the stocks that account holders purchased actually underperformed the stocks they sold by a full two percentage points—and by almost four points when fees, commissions and bid-ask spreads were factored in.

(5) Brad M. Barber and Terrance Odean. "The Courage of Misguided Convictions: The Trading Behavior of Individual Investors". White Paper, Gradual School of Management, University of California at Davis, July 1999.

In My Opinion…

Robert J. Cole, Jr., CLU, ChFC, CFP®

The Dawn of a New Era???

I have just returned from the Financial Planning Association's 2005 Annual Retreat. This summit of the top planning people in the industry is always fascinating to attend. The four days are packed with speakers and presentations that represent the cutting edge of the financial services industry. One of the speakers, Bernard Lietaer, a professor of international finance and one of the people credited with inventing the euro currency, set the conference on its ear by announcing that, in his estimation, there is a 50/50 chance that the U.S. dollar will collapse in the next 15 years! He gave many reasons for this, all which sound plausible (you can read more on his opinions in his book, *The Future of Money*). The big question the audience was left with was—what does this mean in terms of today's planning?

I believe a new era of anti-materialism is coming. Those who understand this and begin-downsizing their lifestyles and focusing their wealth will fare much better. We are seeing the beginning of the end of an unprecedented era of narcissism and acquisitiveness. One only has to scan the cable network to see the multitude of advertisements for products all promising to give one a sense of completeness. After years of chasing these empty promises, people are discovering that **things** do not bring happiness. In her book, *Just Enough*, Dr. Laura Nash, a Harvard Business school professor, details that the new model of "success" has four dimensions to it—Achievement, Happiness, Significance and Legacy. To reach true fulfillment, one must balance their energies to each of these dimensions. Stephen Covey, in his new book, *The 8th Habit*, describes these areas as Body, Mind, Heart, and Spirit. The point is that lasting fulfillment is not based on any single dimension, but rather a combination of all. All of these have very little to do with material possessions.

With the geopolitical shifts that are occurring, it is a possibility that the United States may have peaked in its voracious pursuit of the material "good life". As a country, we must consume 80% of the world's total savings to finance our deficit spending. Consumer savings is at an all time low and consumer debt is at an all time high. The point is that, as a country, we have mortgaged the shop to the hilt in pursuit of things. One must wonder how long this can continue.

Perhaps it's time for us to return to the example of the "Greatest Generation". Maybe we need to consider our true needs before we buy the third car, the fourth TV, the fifth cell phone. Do we *really* need to have the whitest teeth, the newest car, the biggest house, and the "lifestyle of the rich and famous"? For those who answer yes, I hope that they are saving a **lot** of money, because they are going to need it. For the rest of us, we should take a hard look at what it is you are trying to do with your life and how you are using your total wealth to support that objective. Things like relationships, good health, and a sense of contribution are all critical components to successful living. Sure, you will still need to build your financial wealth, but you should not do it in the vacuum of consumption, but rather in the context of supporting your life goals for the future. Our *Lifetime Solution™* process is designed to help you clarify your objectives and identify the activities that you need to pursue in order to support their accomplishment. It is only after such an in depth experience that one can truly define what "success" means.

It is being suggested that, fifty years from now, the U.S. lifestyle will more closely resemble that of Great Britain, with the operative concept being "downscaled". Rising energy costs, expensive health care, and a devalued dollar will all contribute to the need to make your assets go further than ever before. Will this be bad? I suggest no. Americans are wonderfully adaptive and resourceful people with good core values. We just need to ignore Madison Avenue's attempts to get us to spend it all today, pursuing a manufactured dream that leaves no one fulfilled but those who profit from selling it.

Until next time, that's my opinion….

Robert J. Cole, Jr., CLU, ChFC, CFP®
President

505 South Third St.
Suite 300
Louisville, KY 40202
(502) 589-1772
www.lifetimesolution.com

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Trading Away Profits

Self-delusion is an investor's greatest enemy.

THE DIGITAL AGE has put individuals in charge of their investment fate. Lured by high potential returns, more people are researching companies, picking stocks and trading through a discount broker or online account.

But the explosion of information and market access has not produced favorable results for many self-styled traders. In fact, those who actively trade their own accounts tend to pay a high price for the privilege of doing so.

In recent years, academic research has detailed this poor track record and identified reasons for underperformance.[1] Studies show that the most potent drain on portfolio return is excessive trading. Investors cannot keep their hands off their accounts. And the more frequently they trade (as measured by portfolio turnover), the worse their overall return. This strong link between higher trading and lower performance is well documented.[2]

Trading consequences

Excessive trading reveals a certain mindset and approach to capturing wealth. Many of these traits contradict prudent financial rules and investment practices. Consider these negative effects of excessive buying and selling:

- **Uncontrolled costs.** Frequent trading incurs higher fees, commissions and taxes—all of which knock substantial percentage points off gross return. High transaction costs can eliminate the benefit of a successful trading approach and make a losing strategy even more painful.[3]
- **Excessive risk.** Investors must place more aggressive bets to cover past losses and high expenses—and make such bets more often. A speculative mindset causes investors to develop higher return expectations and hold more concentrated positions. This lack of diversification exposes them to company risk and reduces the odds of holding stocks that benefit in a broad market advance.
- **Lack of discipline and process.** When looking for home runs, investors base their decisions on a stock's recent movement, media hype, selective research and other factors that don't advance long-term performance. Moreover, hypertrading encourages hasty decisions, which often renders the wrong trade at the wrong time.One study shows that active stock traders have a knack for selling stocks that are appreciating and buying stocks that have already peaked and are losing market value.[4]

The roots of temptation

At various times, everyone is tempted to make portfolio changes beyond rebalancing, liquidity generation, tax management and routine maintenance. Understanding the common causes of heavy trading can help you avoid the behaviors that destroy performance.

While several forms of cognitive bias encourage trading, research identifies overconfidence as the engine driving the speculative mentality. In general, people have a distorted view of their abilities—and apply the bias in their perceptions and decisions. They attribute success to their skill

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(1) Known as behavioral finance, this academic discipline explores the role of human psychology in financial management, market pricing and investment decisions.

(2) "Trading Is Hazardous to Your Wealth", The Journal of Finance, April 2000, pp 773-800.

Brad M. Barber and Terrance Odean analyzed trading activity and returns of 66,465 households with accounts at a large discount brokerage firm during 1991 to 1996. Their study found that, on average, households with common stocks turned over 75% of their account each year. The highest-trading 20% of the universe averaged a 250% turnover rate.

(3) The above-mentioned research documents the erosive effect of high transaction costs on return. The entire group of 66,465 accounts earned an average gross return near that of a value-weighted market index. But the average net return (after commissions and bid-ask spread) was 1.1% below the benchmark. On a risk-adjusted basis, the net return was 3.7% below the benchmark. The 20% of investors who traded most actively earned an average net return 5.5% lower than that of the least active investors.

Life Planning

The Value of Goal Setting In All Areas of Life

Goals Give Your Life New Direction

Planning is a very powerful tool—it is the key factor in achieving what you want in life. The reason is that the clearer the vision of your future becomes, the more it will motivate your behavior. When you imagine how you want to live and what you want to achieve, these images become the basis of your goals.

Think of your goals as targets—something to aim for. They give life direction. In addition, setting goals is a method of anticipating, planning, and preparing for the future.

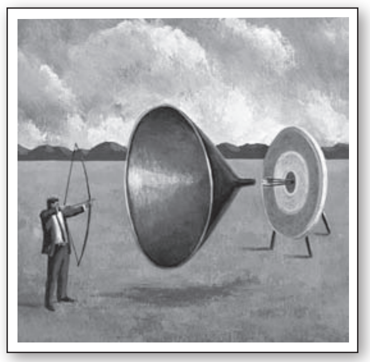
Goals are especially effective when you write them out. The process of forming your images into words makes your goals more specific, clearer, and even more compelling.

Goal setting is also an effective way of clarifying what is important to you and what you want your life to be like. You can then move toward those images in an intentional way.

You will derive many other benefits from setting goals as well:

- Goals provide a positive expectancy of the future.
- Goals stimulate personal growth and development.
- Goals will help you to focus on the desired end result and provide the motivation needed to bounce back from setbacks and disappointments.
- Goals facilitate "future thinking" by looking ahead and anticipating future needs and wants.
- Goals that are clear and purposeful keep you from getting side-tracked by someone else's agenda.

Despite these benefits, many individuals are reluctant to set goals. For them, goal setting has been unsuccessful. They miss their targets and then become disappointed and discouraged. For others, setting goals creates



internal stress by mentally switching a dream from the "want to" category to the "have to" category. They then begin to feel pressure to perform and experience fear of failure.

Nonetheless, goal setting is an essential component of the Financial Life Planning process. Therefore, it is important for you to adopt a fresh perspective on goal setting, and to align your financial goals with your personal values and priorities.

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Seven Tips to Setting Effective Goals

In *Getting Things Done*, author David Allen wrote, "We know that the focus we hold in our minds affects what we perceive and how we perform." As you visualize the lifestyle and quality of life that you would like to have in the future, remember that the secret to realizing your dreams is to maintain a "future focus."

In fact, the greater your understanding of what is important to you, the easier it will be to "paint a picture" in your mind of what you are working toward. Whatever you identify and claim for yourself will become the basis for your life goals. Therefore, consider these helpful tips to increase the effectiveness of your goal setting strategies:

■ **Tip 1:** Your goals must be meaningful to YOU. Lou Tice, who founded The Pacific Institute and created the Investment in Excellence program, teaches that goals themselves have little value unless they bring depth and meaning to your life as you work to achieve them.

■ **Tip 2:** Know what you want. Make sure the goal is something you really want. If your goal is something someone else said you should do, or is something you feel like you need to do, then it is unlikely to motivate and inspire you.

■ **Tip 3:** Build an image of the end result. Make it a practice to visualize reaching your goal. Continue to build a stronger and clearer picture in your mind. You will naturally move toward that which you think about.

■ **Tip 4:** Ask yourself if you are ready for change? Consider what life will actually be like when you

Continued on page 3

Why Global?

The international component in your portfolio.

Any time the U.S. stock market experiences a bullish period, investors begin to question their portfolio mix. In particular, they ask why they must keep a significant international component when the domestic stock market appears to be sufficient.

Their doubt intensifies when foreign markets are producing losses or meager gains. During these times, investors should revisit the philosophy and reasoning that first shaped their portfolio strategy.

Investors should diversify globally for the same reasons they diversify in the U.S. A well conceived portfolio owns many assets to minimize the impact of an isolated misfortune or cyclical downtrend. Some companies go broke and leave investors holding worthless stock. Industries rise and fall in subjection to a multitude of unpredictable factors. Asset groups move in and out of favor with investors.

Most investors understand the danger of owning a one-dimensional portfolio. They don't hold only XYZ common stock, or buy only high technology companies, or even invest in a single asset group, such as U.S. large company stocks. They diversify to eliminate specific risks. If you position assets well, your total return will reflect only those risks which cannot be eliminated.

Experienced investors also know that diversification reduces the impact of economic cycles in a portfolio. Despite the confident forecasts of analysts and other experts, no one has developed a time-proven method to determine which securities, industries or asset groups will produce the best returns in a particular period.

If this risk reduction principle applies to investing in the domestic market, why would global investing be different? It's not. And in fact, spreading risk across several economies can *add* stability to a portfolio.(1)

Historically, the financial markets of developed nations have followed different rhythms, as one rises and another falls. Since this timing is unpredictable, you should consistently hold a mix of assets and markets, and avoid concentrating in one asset group, industry, country or region.

Developed markets

Many investment advisors recommend having Western Europe and the Pacific Basin—the world's other highly developed economic regions—represented in a global portfolio. Over the long term, these stock markets have produced about the same annualized returns as the U.S. market.(2) While economic performance among the major nations is similar, their equity markets have not historically performed the same from year to year. Combined in a portfolio, this dissimilar performance actually stabilizes the total return over time.

A global investor holds these foreign markets not for higher performance, but for more *stable* performance. This global approach helps a portfolio avoid the extremes in either direction. When the U.S. economy is humming, lower returns abroad may offset an above average gain at home. But the opposite applies when the American market drops. At that time, investors will be relieved to see dissimilar performance at work in their portfolio.

If you concentrate only on the top performing asset group, you'll overlook how diversification is minimizing portfolio volatility. Diversification of markets accomplishes the goal of reducing risk while maintaining a reasonable return. This is the foundation of a sound investment policy.

Keep a portfolio perspective. This means choosing a comfortable risk level, then accepting its historical average annual return. Diversification implements this formula. But diversification works only for those who practice it. ■

Goal Setting Tips

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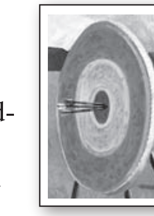

achieve your goal. Are you ready to accept the end result? Often individuals don't achieve their goals because subconsciously they don't want to deal with new circumstances or their self-image does not allow for the change.

■ **Tip 5:** Is there a conflict? Evaluate whether or not your goals conflict with one another or with the goals of someone close to you. This knowledge, even on a subconscious level, can prevent you from moving towards your goal. Once you acknowledge the conflict, then you can look for ways to resolve it.

■ **Tip 6:** Decide on a time frame (maybe). Some goals should not have a deadline because a time limit can cause stress and decrease the joy of the journey. For some types of goals, target dates and deadlines are appropriate and motivating. But for other types of goals, deadlines can stifle creativity and possibility thinking.

■ **Tip 7:** Make a wish. Goals often begin as a "wish" for yourself, for your family, for your job, for your retirement, for your community, and so on. It is your opportunity to dream BIG. When you dare to dream big, you step out of your current reality and open up your awareness to resources, solutions, and opportunities you never thought possible!

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(1) International investing can pose other risks, including currency fluctuation, different accounting and reporting standards, market liquidity, political risks and regional factors. Past performance does not guarantee future results. (2) The S&P 500 and EAFE (Europe Australia Far East) indexes, both of which represent the broad markets, have produced similar annualized return and risk levels since 1970. While their total returns are similar, the returns in any given year are usually quite different. (It is assumed that currency differences equal out over the long term.)