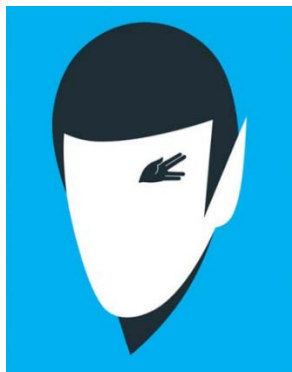


# “Lessons From A Vulcan: Why Spock’s Portfolio Does Better Than Yours”

*How to Make Smarter Financial Decisions in  
Up and Down Markets*



## **AAll San Diego Chapter**

November 8, 2014

Guest Educator: Kevne Sharpe, CFP®

# Today we'll cover....

- What is Behavioral Finance?
- Investor needs and risks
- Biggest Behavioral Challenges
- Emotional biases
- Why Spock?
- Processes under Uncertainty

# What is Behavioral Investing/Economics?

Behavioral economics is about bringing reality into economic analysis

Builds upon conventional economics, offering tools for understanding why people behave the way they do

People in traditional finance are rational. People in behavioral finance are normal

# Two Types of Investor Needs

Asset  
Based  
Needs



Income

Growth

Vulnerability to Loss

Behavioral  
Needs



Loss aversion

Peace of mind

Desire to participate in rising markets

# Assessing the Risk Landscape

Consider two types of risks:

\* Risks that are always present



\* Extraordinary risks



# Number of Dow Jones Draw Downs Per Decade

Significant declines are part of the fluctuation of the markets.

YEARS	NUMBER OF BEAR MARKETS	DJIA PERCENTAGE DECLINE
1900's	3	46%, 49%, 27%
1910's	3	24%, 40%, 47%
1920's	1	89%
1930's	3	23%, 49%, 41%
1940's	1	24%
1950's	1	29%
1960's	3	27%, 26%, 36%
1970's	2	45%, 27%
1980's	2	24%, 36%
1990's	1	21%
2000's	2	38%, 53%
<b>Total Bear Markets/Average Loss</b>	<b>22</b>	<b>37%</b>

*Past performance is not a guarantee of future results.*

# Realities of Math

## Gains Needed to Break Even

Amount of Loss	Return Required to Breakeven	# of Years to Breakeven with Annual Return of 10%
10%	11.1%	1.1
15%	17.7%	1.7
20%	25.0%	2.3
25%	33.3%	3.0
30%	42.9%	3.7
35%	53.9%	4.5
40%	66.7%	5.4
45%	81.8%	6.3
50%	100.0%	7.3

This chart is for illustrative purposes only.

## Some of the problems..

### Addressing our biggest behavioral investing challenges

Significant losses (2000-2002, 2008-'09)

Long periods of low or no returns

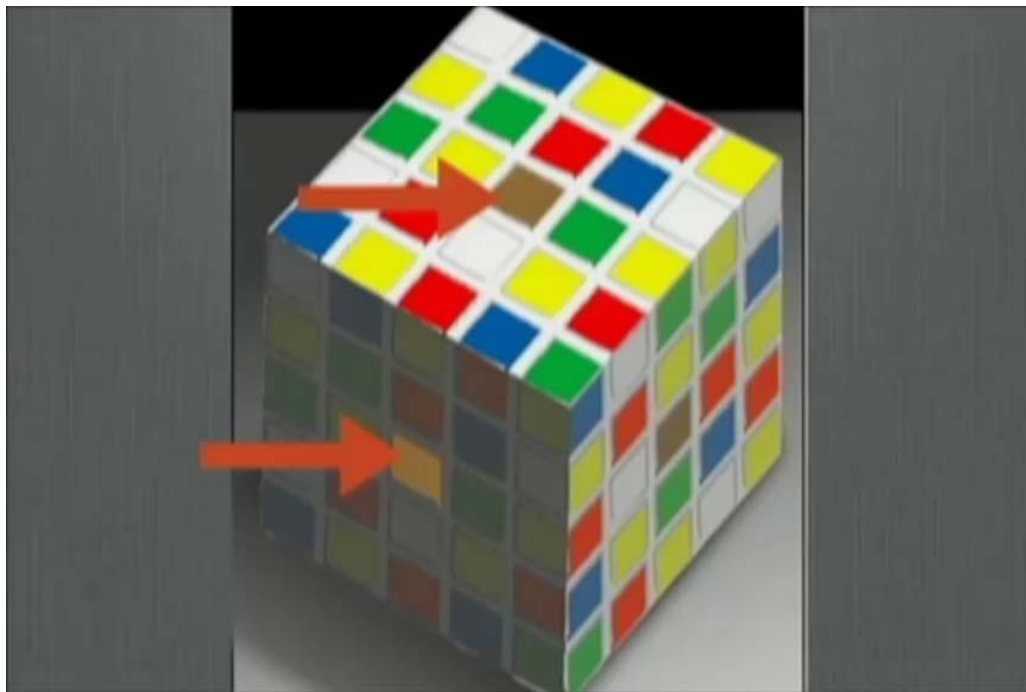
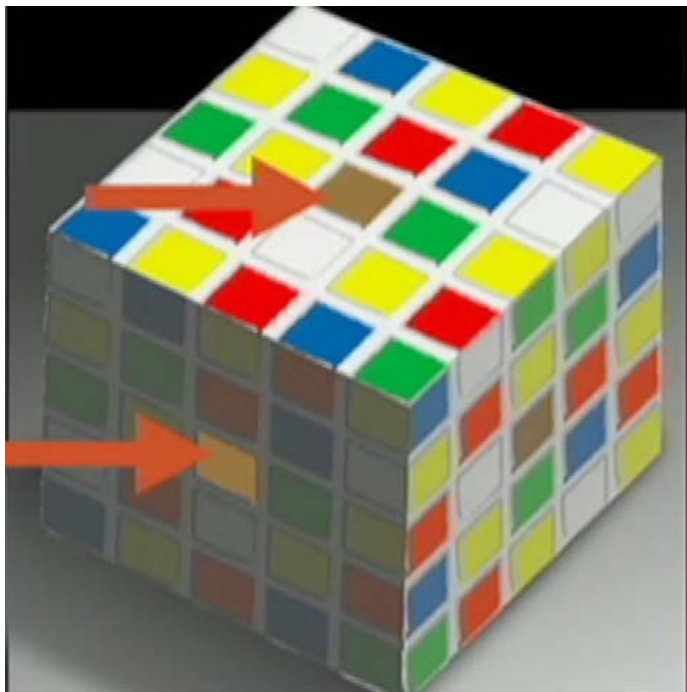
Inflation and rising interest rates

Not participating in asset bubbles (Japan, internet, housing)

Poor performance relative to broad benchmarks



# Our difficulty perceiving the problem



# Our difficulty perceiving the problem



# Me? Make a poor decision?

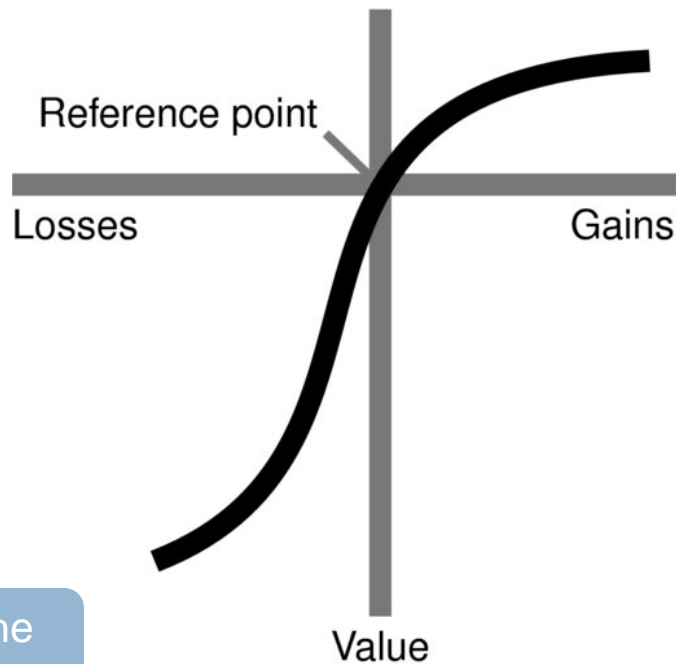
...Managing emotions is key!

- \* Herding tendencies
- \* Fear of missing an opportunity
- \* Action Bias

# Emotional Impact of Losses

What are the behavioral biases that work against us?

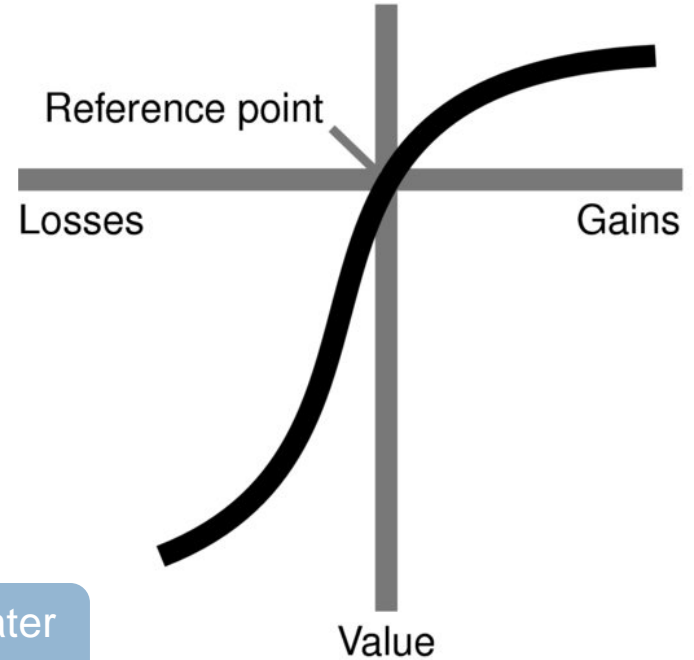
Financial losses are processed in the same areas of the brain that respond to mortal danger



# Emotional Impact of Lost Opportunities



Emotional impact of missed opportunities is even greater than the impact of experiencing losses.



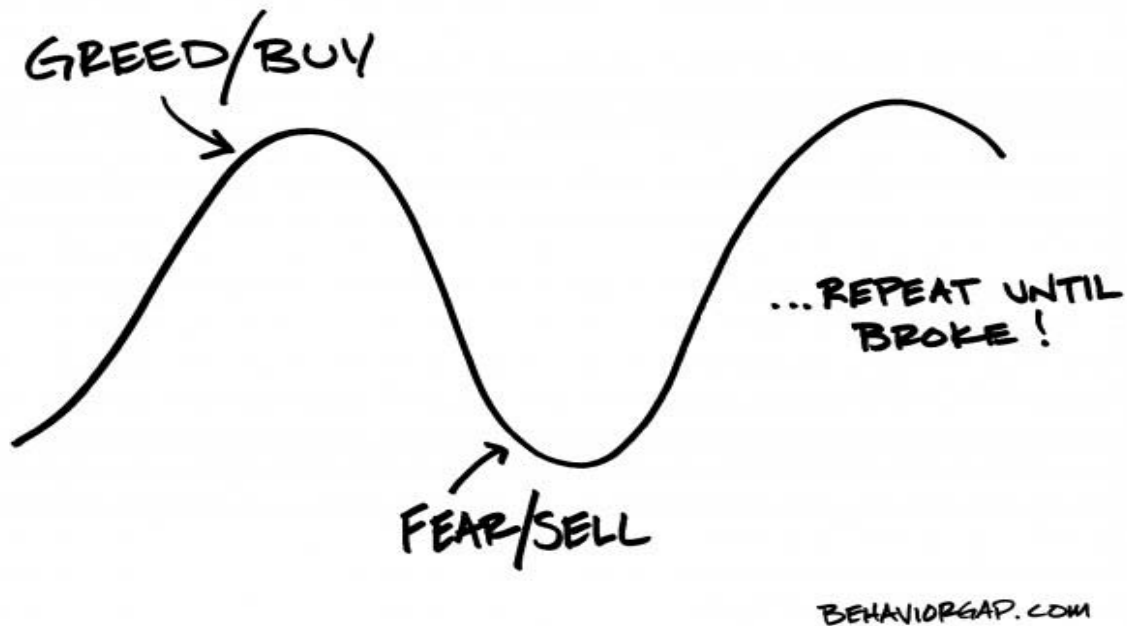
Or this lost opportunity.....



# Marketers know.....



# Overcoming Behavioral Obstacles



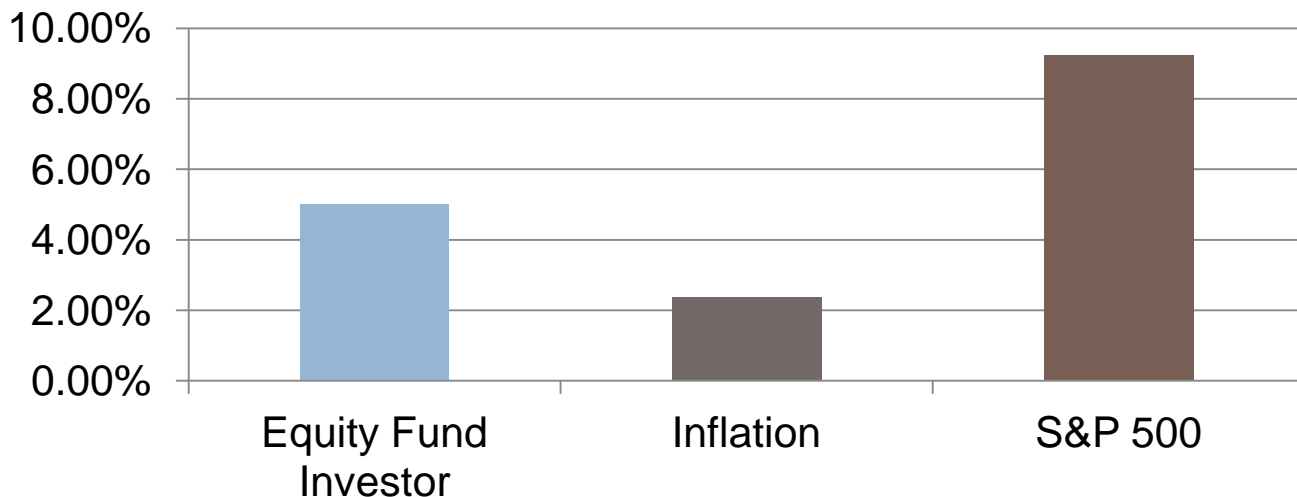


# DAL-BUMMER

Buy and hold investors tend to exit after market declines

## DALBAR Q.A.I.B.

20 Year Returns through 2013



## Some of the problems..

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# Scotty vs. Spock

## Scotty

**Irrepressibly human,  
allowing his emotions  
to rule the day**



## Spock

**Determined to suppress  
his emotions, letting  
logic drive his decisions**



\*The Little Book of Behavioral Investing”, James Montier, 2010



# *The Feel is Wrong*

“I suggest you avoid emotionalism and simply keep your instruments correct.”

-Mr. Spock

# When are we most likely to rely on our Scotty-Reactive System

When the problem is ill structured and complex.

When information is incomplete, ambiguous, and changing.

When the goals are ill defined, shifting, or competing.

When the stress is high, because either time constraints and/or high stakes are involved.

# We don't naturally.....

- Systematically describe problems
- Record necessary data
- Synthesize information to create rules for decision making

# Heuristics

The intuitive, lazy, emotional, non-logical response to questions when posed. When pose a question that would require analytical thinking what we turn that question into instead.



# Time Machine

**We need to manage all 3 of us!**

**“Past You”  
Setup An Investment  
Plan**



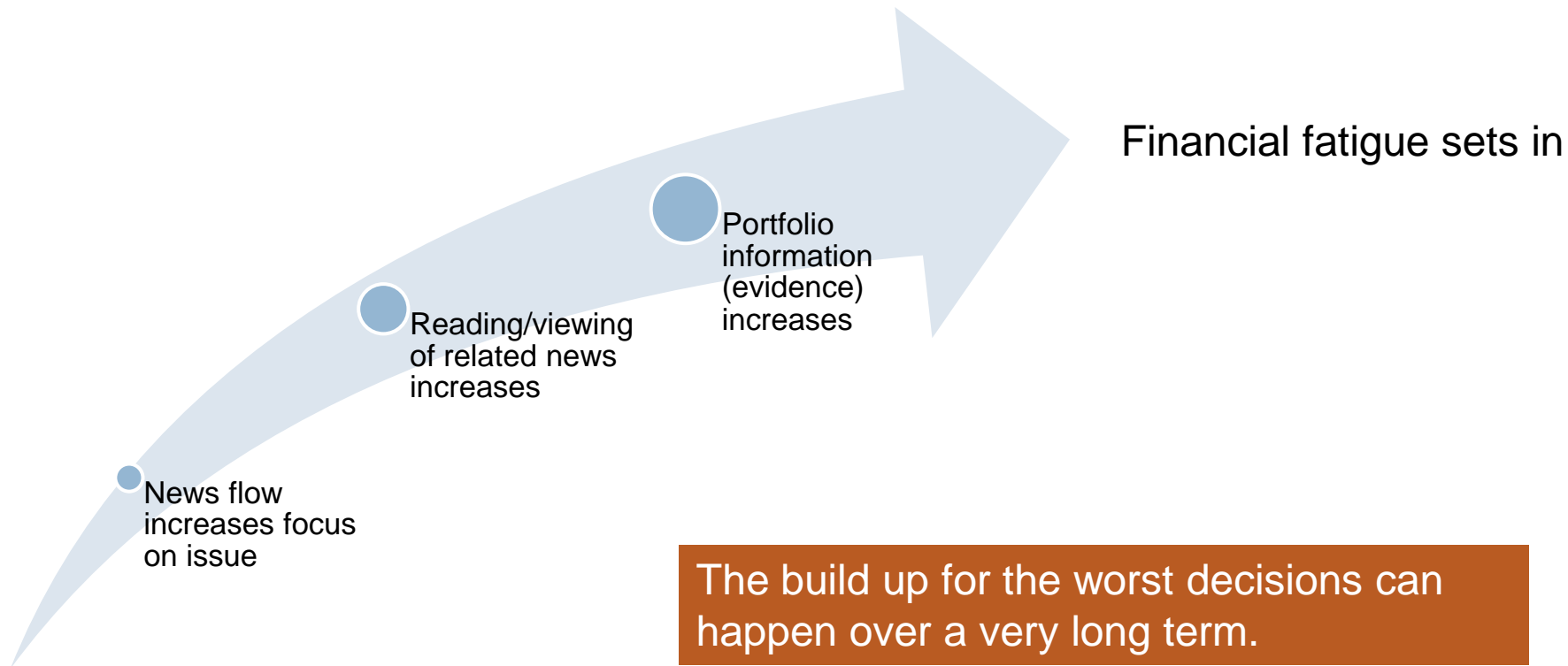
**“Today You”  
Wants To Buy  
Stuff**



**“Future You”  
Wants “Today You” to  
Save**



# Cumulative, Long Range, adverse information



# Decisions under uncertainty

1. Take an inventory of all viable options available for obtaining information, for experimentation, and for action.
2. List the events that may occur.
3. Arrange pertinent information and choices/assumptions.
4. Rank the consequences resulting from the various courses of action.
5. Determine the probability of an uncertain event occurring.

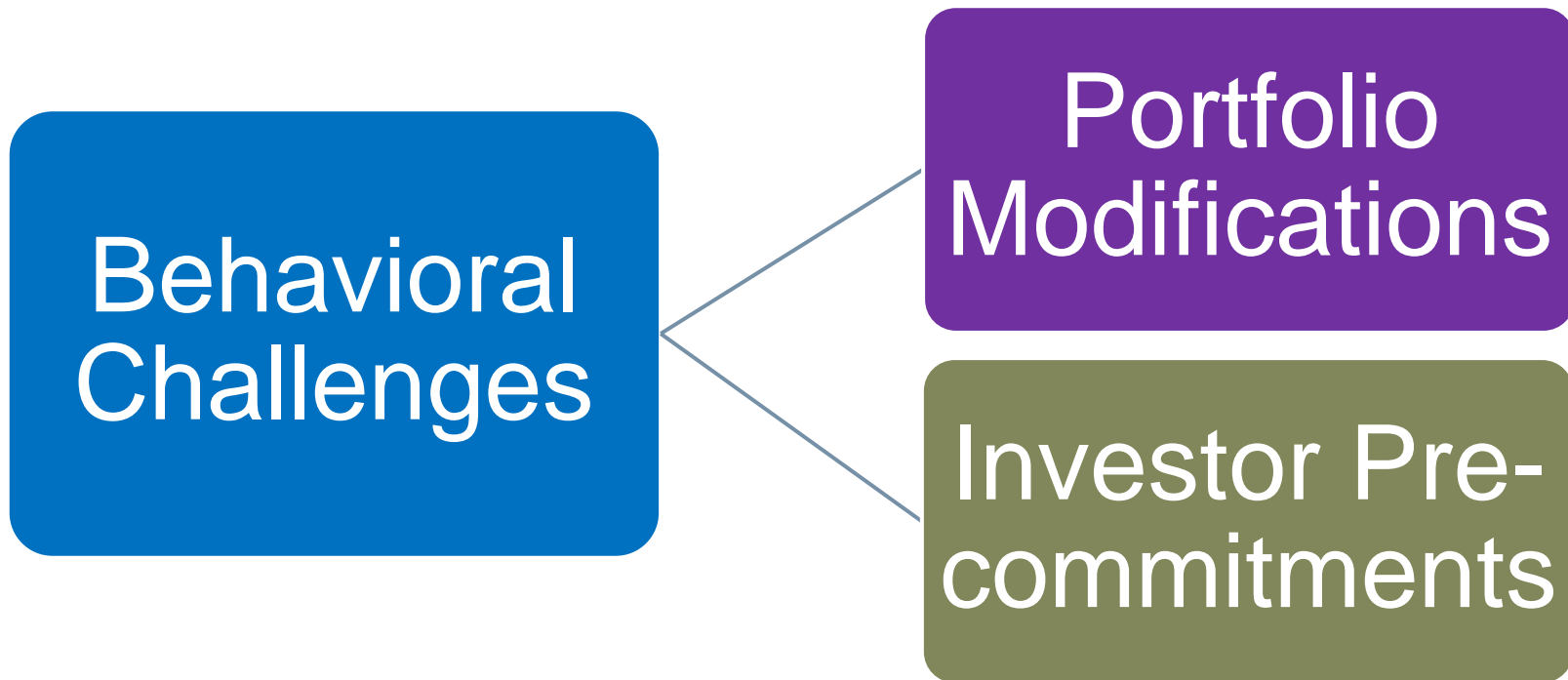
# Portfolio construction should match investor asset based and behavioral needs

Optimal  
Portfolio  
Design

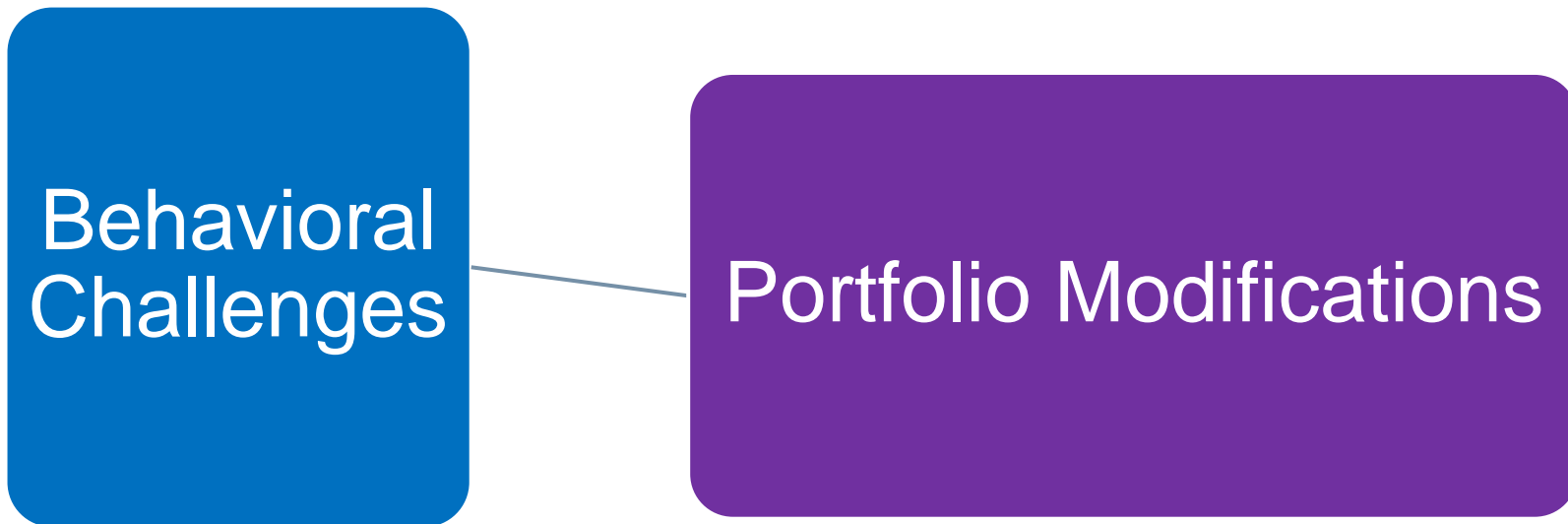


This is a fundamental change in portfolio design from traditional models that seek benchmark centrality.

## Suite of solutions



## Behavioral Challenges – Portfolio Modifications



# Glass Half Empty...?

	Half Gains/Losses	Full Gains/Losses
<b>Starting Value</b>	<b>\$100,000</b>	<b>\$100,000</b>
Year 1	-6%	-12
Year 2	-11%	-22
Year 3	14%	28
Year 4	5%	10
Year 5	3%	6
Year 6	8%	16
Year 7	4%	8
Year 8	-19%	-38
Year 9	13%	26
Year 10	2%	4
<b>Ending Value</b>		
<b>Average Return</b>	<b>1.3%</b>	<b>2.6%</b>

This chart is for illustrative purposes only and are not representative of any specific investment or mix of investments.

## Suite of solutions

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**Behavioral  
Challenges**

**Investor Pre-  
commitments**



# Establish Pre-Commitments

- 1) Break down the issue into manageable, objective pieces**
- 2) Understand the data**
- 3) Recognize your inner Scotty**
- 4) Summon your inner Spock**

# Black Friday

On Black-Friday, people rush into stores.

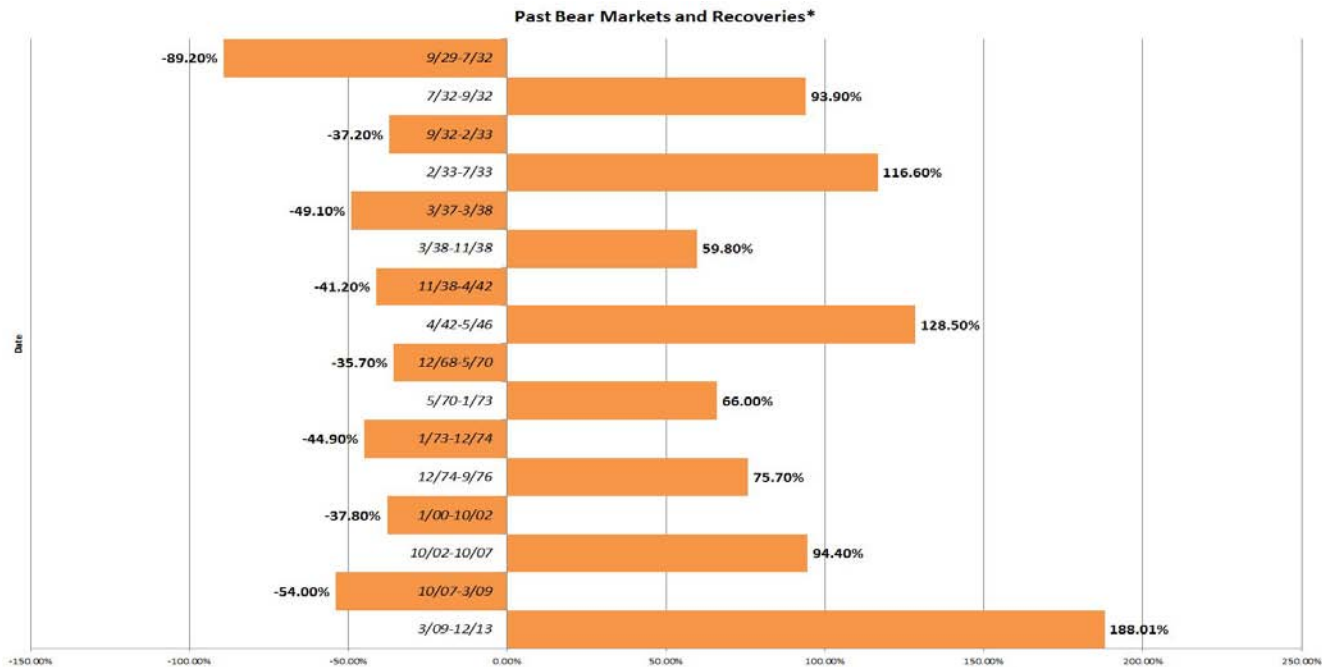
When stocks sink, and prices are at bargain levels, people rush to get out, instead of rushing to get in!



# Pre-Commitment - Significant Declines

The more extreme market declines become, the more extreme following market rebounds are likely to be.

Seven prior instances of declines of 30% or more in the Dow Jones Industrial average, average rebound of 90.7%. Average duration of 2 years.



This graph is for illustrative purposes only. It describes a theoretical account invested in the Dow Jones Index with dividends reinvested, if that were actually possible. However, no one can invest in an index, and this does not describe any accounts held by Toews Corporation either now or during the periods of time described in the graph. Someone's actual performance would be different than this graph, depending on when he/she made his/her initial investment, the fees associated with transactions, and other economic and market

# Pre-Commitment for Significant Losses

When Markets Face Steep Declines

Our  
Commitment is to:

Rebalance Portfolio into Assets with Steep Declines and Take Advantage of “Black Friday” Sales Prices

## Some of the problems..

Addressing our biggest behavioral investing challenges

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# Summary

- 1) Take time to make decisions**
- 2) Summon your inner Spock**
- 3) Create a plan and make pre-commitments**
- 4) Have an objective financial ally**
- 5) Stick with the plan**

*“Your net worth to the world is usually determined by what remains after your bad habits are subtracted from your good ones.”*

- Benjamin Franklin

