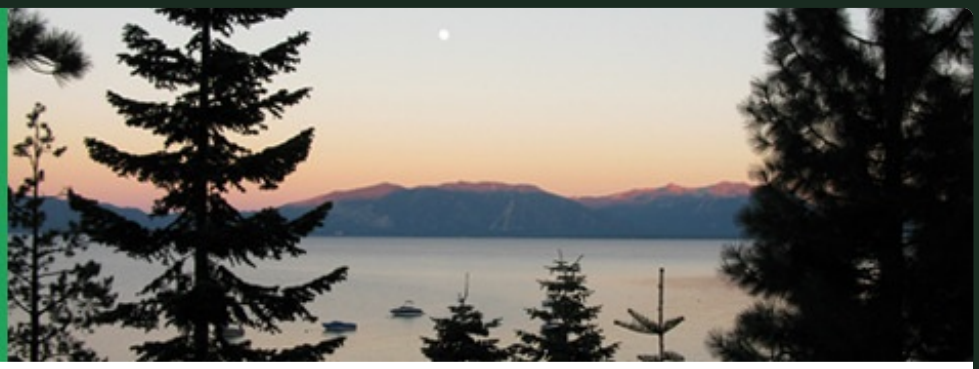
Hathaway Financial Services



Why We Do What We Do!

Here we go again! With market indexes hitting record highs, and news sources creating often unnecessary concern, investors are once again left to wonder, where are the markets headed?

Modern Finance Theory is built on the Efficient Market Hypothesis (EMH). EMH basically states that competition between investors lead to markets that are rational and efficient. In reality, we know that this is not always the case. Markets sometimes become irrational, create bubbles, and burst. To better understand markets, an area of study has evolved that seeks to incorporate the more emotional side of the markets. This area is called Behavioral Finance (BF). Behavioral Finance seeks to understand the seemingly irrational behavior patterns investors engage in and why. Not only can these irrational thought processes create inefficiencies in the markets, they can also derail individual investors from achieving their goals.

Understanding the concepts underlying BF can help investors stay the course in difficult times. It can help them focus on what is specific and unique to their investing needs, and tune out that which is not relevant to their particular situation.

What causes us to behave erratically and how can we ensure we don't fall prey to these irrational thought processes? Below is a list of a few of the more relevant behaviors we should be on the lookout for when making our financial decisions.

Framing: How information is presented to us matters! Research consistently shows that our aversion to loss is much stronger than the joy we feel from gain. Consider these two statements:

1. You have a 90% chance of funding your retirement goal.
2. You have a 10% chance of failing to fund your retirement goal.

Although these two statements are exactly the same, most will react significantly more negatively to the second statement. This is due to the fact that we generally give much more weight to loss than we do to gain. Consider framing when reading headlines such as this: S & P 500 down 2%! This statement is meant to alarm you, but giving this headline further thought will give you a different perspective. If your investments gained 10% last year, and then lost 2%, your gain is still healthy. While no one likes to see markets correct, downturns don't need to be viewed as a cataclysmic event. If fact, they actually contribute to healthy markets.
Keeping framing in mind, and how it affects us individually, is crucial to maintaining a rational

decision making process.

Heuristics: We use heuristics when we have a difficult decision to make and the “cognitive load” is too great. To speed up the process, we ignore available information to short-cut to a quicker decision. This can cause sub-optimal outcomes in our financial decisions when we don’t understand the options and choose the easiest route. Be aware of this, and weigh your options thoroughly or get the help of a trusted advisor to make them for you.

Mental Accounting: MA causes us to put money in different “mental buckets”, when in reality, all assets of ones financial life should be accounted for equally. MA is the reason lottery winners often end up claiming bankruptcy, as they view their winnings as free money. Many treat the receipt of a bonus the same way; as money to be spent, when in reality it is needed to save for their goals.

Mental accounting may also be to blame when you hear someone at a social event talking about how well their investments have performed. They may be focusing on one investment, while ignoring the performance of their portfolio as a whole.

Disposition Effect: DE causes us to tend to sell investments only if we can realize a gain, and can cause us to hold on to losing stocks too long. Even though we all hate to admit we made a mistake, it is sometimes better to cut your losses. In fact, losses realized in a taxable account can even be beneficial to your year-end tax statement.

Representativeness: Causes us to put more weight on recent experience than long-term averages. This tends to make us think the very recent past will continue indefinitely into the future, which can cause us to be at risk of large losses in bull markets, and lose out on great opportunities in bear markets. Stepping back and evaluating long-term history and averages is very beneficial in these situations.

Herd mentality: We know we are in herd territory by how loud the commentators on the investment channels are yelling! We all know this concept, but it is tough not to be tempted when the hysteria gets to this level. Don’t fall for it; it almost always ends badly!

Always remember: Measuring your success to your own goals instead of arbitrary external ones has immeasurable benefits. It personalizes the whole endeavor and connects your investments to your goals, making it real and tangible to you. Research also shows that goals-based investors are more likely to stay the course during tough times and even save at higher rates, since what they are chasing is so personally meaningful.

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