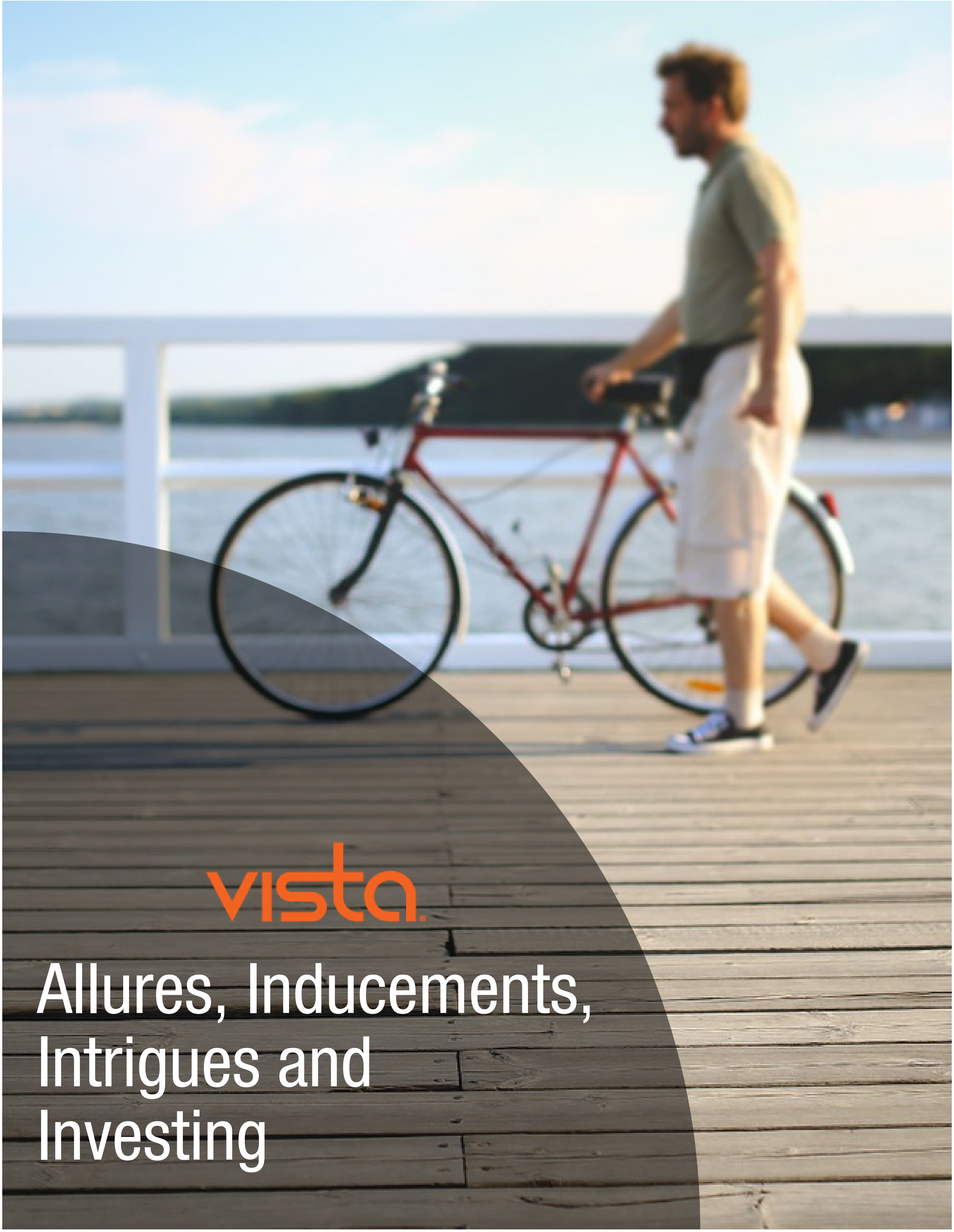


vista

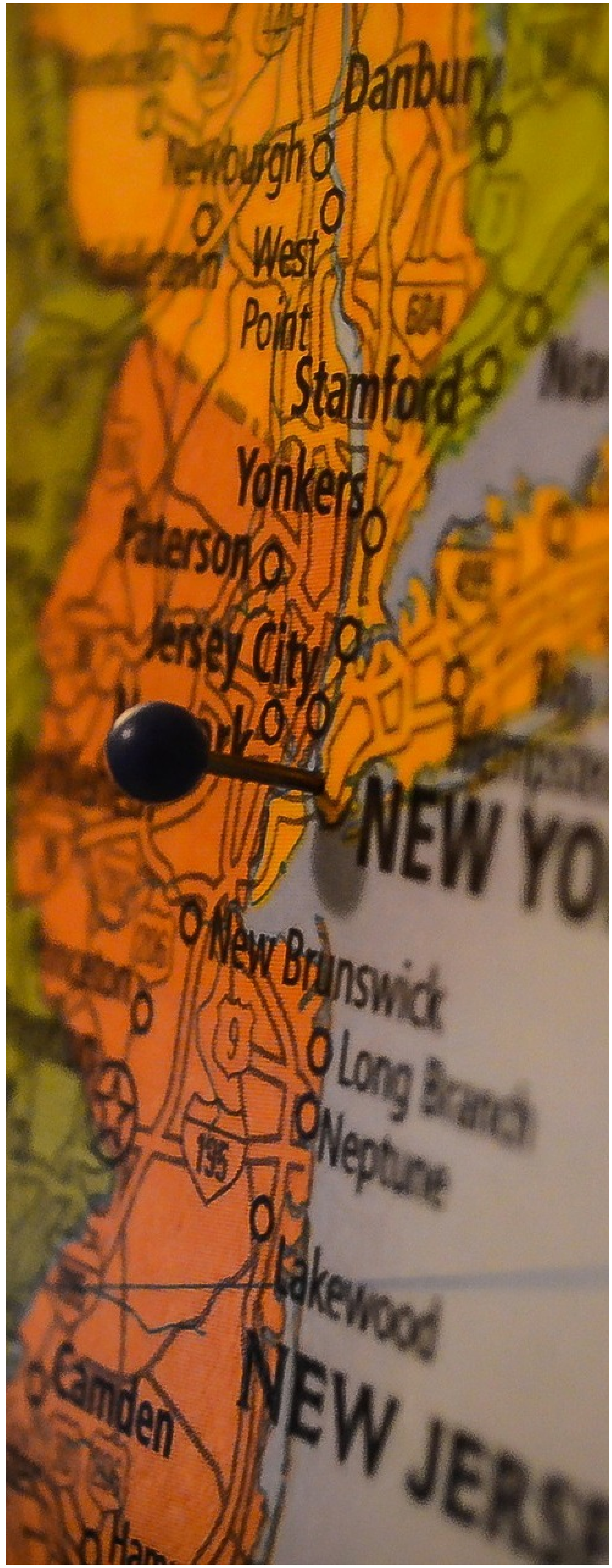
Allures, Inducements, Intrigues and Investing

"It is hard to prevent oneself from believing what one so keenly desires..."

- Jean-Jacques Rousseau

Why does our natural behavior get in the way of successful investing? Can we train ourselves to be better investors? The psychology of investing is important to all of us, and yet it is very complicated because we all come to it from different backgrounds and beliefs.

We humans all have our foibles, and the better we understand them, usually the better we can invest. It's a little like watching someone drive across the country. We don't know what route she'll take, but the better we understand the roads and her preferences, the higher the probability that we can predict her route. This letter will address a few aspects that we run into frequently, both as investment professionals, as well as with our clients. We are, after all, only human.



Projection Bias

"We shoot where the wabbit was."

- Elmer Fudd

One of the strongest biases we have is projecting current conditions out until the end of time. Is the market going up? It will probably continue to do so. Is it just so-so? It will probably continue to be middling. This bias is especially challenging when the markets are dropping. As humans, we're wired for fight or flight when things get challenging, and when the markets drop in value, our tendency is to think that they will keep dropping, requiring us to take action.

Unfortunately, that is exactly the type of behavior that harms our portfolios. By pulling out of a dropping market, we are extremely likely to not just miss the bottom, but the recovery as well, because markets react so quickly and powerfully. Not participating in recoveries can have a direct negative impact on meeting financial goals.

To illustrate this power, missing

only the best 15 days in the stock market during the last 45 years would have reduced its return from 10.5% to 8.1% *per year*. On a $10,000 investment, that equates to ending up with $894,000 instead of $333,000 at the end of that 45 year period! That is 15 days out of a total of approximately 9,900 trading days.

Overconfidence and the Illusion of Control

“The truest way to be deceived is to think oneself more knowing than others."

- Francois de La Rochefoucauld

We tend to have a great deal of faith in our own intuitive reasoning, judgements and cognitive abilities. In a recent study, a group of workers agreed to participate in a lottery at their office (no, this didn't happen at Vista).

- Half of the participants were sold a lottery ticket for $1.
- The other half were also sold a lottery ticket for $1 but were allowed to pick which ticket they wanted.
- A week later, just before the drawing, each participant was asked for how much he or she would be willing to sell his or her ticket.
- The average selling price for those who were randomly assigned a ticket was $1.96.

- The average selling price for those who picked their ticket was $8.67.

Did any ticket have a higher likelihood of being a winner? Of course not, but the participants who got to choose their ticket thought that they knew more than the others, and that their ticket commanded a premium price. The same goes for investors.When an individual has convinced himself that he should buy a particular stock, there is a high probability he will continue holding it even if the company's outlook suddenly changes.

Loss Aversion

“There is nothing more deceptive than an obvious fact."

- Arthur Conan Doyle, *The Boscombe Valley Mystery*

Our minds are wired to put fear (and other emotions) ahead of rational thought.

- A group of people were given $20 each to bet on coin tosses.
- At the beginning of each round they were given the option of making a bet for $1.
- If the coin came up heads, they won $2.50.
- If it came up tails, they lost their $1.

Since the payoffs were completely unknown and random, it would have made sense to bet on every round. However, only 50% of the participants who lost a round went forward and bet on the next toss. Also, the longer the experiment lasted, the less likely participants were to take a chance by betting.

Checking our investment portfolios often has been proven to yield the same effect. The more we see the market drop, the less likely we are to hold our positions, even though we know that stocks tend to increase in value over the long-term.

And, That’s Not All

"The fool doth think he is wise, but the wise man knows himself to be a fool."

- William Shakespeare (*As You Like It)*

Are these the only behavioral issues we need to deal with in successful investing? Unfortunately, no, they are not. We tend to be overly optimistic, avoid regret, frame outcomes narrowly in the beginning, and then conclude that the subsequent large swing was logical and expected.

How does Vista deal with this? One way is by investing broadly based on overall markets, rather than thinking we are smarter than everyone else and attempting to beat the market in concentrated positions. Another is by researching historical market movements and basing our portfolios on them. Another is by being very careful in changing our portfolios and requiring a majority of people to agree on a change before implementing it. Keeping good records about our decisions and

periodically reviewing them also helps.

Finally, we spend a great deal of time making sure that each Vista client has the portfolio that not only matches their risk tolerance, but also gets them to their financial goals. At the end of the day, that's what really matters.

Thanks

We hope this is helpful. As always, we look forward to any questions or comments you may have. Thank you for your trust in Vista.

Your Vista Wealth Management Team

Additional Disclosures

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