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PILOT WEALTH MANAGEMENT

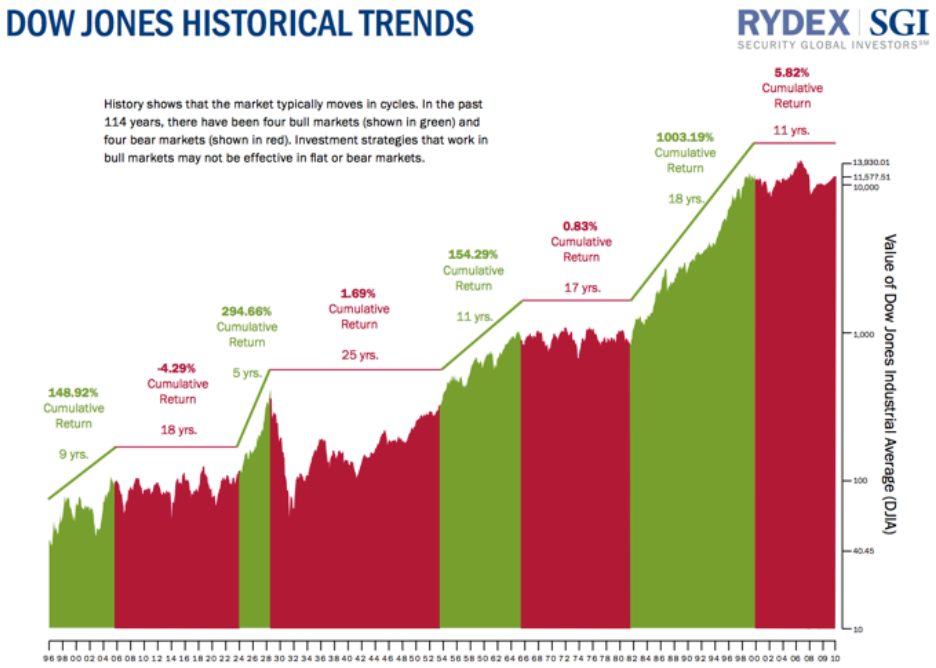
It is during times like these that one should develop an effective distraction from the headlines; be it honing the golf game, fly fishing for steelhead, reading *War and Peace*, or engaging in any other activity that doesn't risk capital.

Getting Out of Our Own Way

By Nick Fisher, Portfolio Manager & Rick Thomas, Business Advisor

As we are in the midst of a major correction in several asset classes (emerging markets) and one entire sector (energy), we thought it appropriate to revisit the principles of how we invest and in a manner, remind ourselves of what we should be paying attention to.

Over the last century there were four extended periods (8 years or longer) where annual stock market returns were abysmal. Each of these time periods share characteristics similar to today's market conditions – low interest rates, high relative valuations and general indifference toward risk. While on the whole our philosophy is to go long on holdings, the buy and hold strategy employed by many investors in this current environment is in complete disregard to the risk that is prevalent. We can't underscore enough how foolish this is. When these investors realize they can't count on "average" market returns of the recent past, they will experience real fear and anxiety (especially for those closer to retirement), which will then induce a further round of irrational and imprudent actions.



What can be learned from all this? That only through a rational investment strategy, impartial to the sentiments of Mr. Market and one that objectively accounts for changing market conditions will risk be reasonably accounted for. It begins with understanding human behavior, how it has developed over the millennia and most important to this discussion, how we can begin to mitigate the tendencies of our hardwiring. Even the greatest investors of our age are unanimous in the importance of investor temperament over intelligence.

One of the reasons the human race has survived throughout time is because it has developed an amazing risk aversion. The fight or flight mechanism hardcoded into our autonomic nervous system has served us well in keeping our species alive. As the human population was culled by natural selection, those still in the gene pool have been left with a highly evolved survival instinct. And yet it is this instinct that makes human beings poor investors.

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Nobel Prize Winning Economist Daniel Kahneman and Amos Tversky began studying human behaviors in relation to decision-making and economics in the 1970s. They theorized and have subsequently proven several biases that have become widely adopted, birthing a new field of study in Behavioral Economics. One such behavior that Kahnemen and Tversky documented was a natural aversion to risk, or what has become commonly known as loss aversion.

To illustrate, consider a study that was conducted by a group of university researchers from Stanford, Carnegie Mellon and Iowa. The participants in the study included normal functioning people and people with a damaged limbic system of their brain, the result of which suppresses their emotional responses to various stimulus. In the study, participants were given twenty dollars and asked to play a simple gambling game that involved multiple rounds of coin tosses. If they won a coin toss, they earned two dollars and fifty cents. If they lost the coin toss, they had to pay one dollar. The participants could also choose not to play in any given round, in which case they kept their dollar. Logic tells us that the best strategy was to take the gamble in every round of the game, since the return on a win was much higher than the potential loss, and the risk in each round was 50-50. Further, the participants were explained ahead of time the odds and the likelihood of gains the more they played.

The results were quite telling. The emotionally impaired participants outperformed the normally functioning participants, winding up with an average of $25.70 versus $22.80 at the end of the game. In examining the results of the study, the players with compromised limbic brain functions used the most logical strategy, investing in 84% of rounds while the normal brain function participants invested in just 58% of the rounds.

In other words, those with normally functioning brains earned a return on their money of just 14%, underperforming the expected return by nearly half. Those with compromised brain functions earned a return of 28.5%, more than double the return of the normal brain functioning group. Why was this so? Put

simply, the normal brain functioning participants made illogical decisions. After losing a round (and consequently one dollar), they chose not to bet the next round nearly 60% of the time even though they knew that the best strategy was to play every round, regardless of the outcome. The participants with hindered emotional response chose not to bet only 30% of the time (Spencer, Jane. "Lessons from the Brain Damaged Investor." WSJ. 7/21/2005).

Just as in the study, loss aversion costs investors significant future returns. Investors who perceive increased risk and are worried about the loss of their capital consistently sell when stock prices are falling and fail to buy when prices are low, even though as the graph on page 1 illustrates that is the best time to buy. Investors wrongly see lower prices as higher risk, and higher prices as lower risk.

What this study underscores is that in regards to the markets, the quality that Mr. Market places on a stock should be inversely related to risk. In other words, the higher the stock price, the more risk the investor must assume. The lower the stock price, the less risk.

To this point, Howard Marks had this observation in his latest memo:

> *When everyone believes something is risky, his or her unwillingness to buy usually reduces its price to the point where it's not risky at all. Broadly negative opinion can make it the least risky thing, since all optimism has been driven out of its price.*
>
> *And, of course…when everyone believes something embodies no risk, they usually bid it up to the point where it's enormously risky. No risk is feared, and thus no reward for risk bearing – no "risk premium" – is demanded or provided. That can make the thing that's most esteemed the riskiest.*
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> *This paradox exists because most investors think quality, as opposed to price, is the determinant of whether something's risky. But high-quality assets can be risky, and low-quality assets can be safe. It's just a matter of the price paid for them.*

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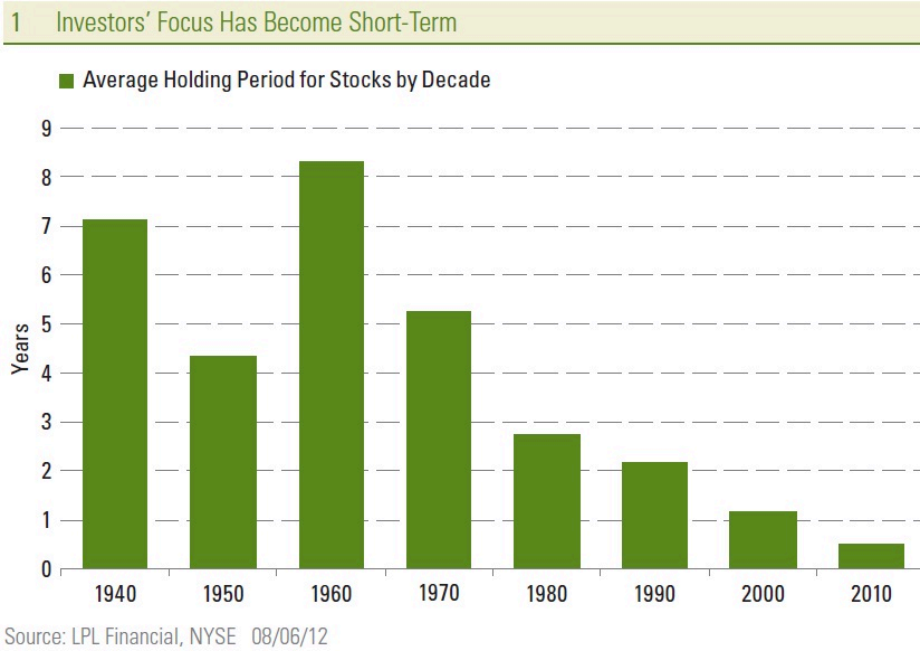
For a further explanation of how complex the behavioral mechanisms are in their influence over our choices: In his seminal book *Influence: The Psychology of Persuasion*, Robert Cialdini, PH.D., provides a brief illustration in the first chapter on how price can influence perception of value. A friend who owns a jewelry store is baffled when trying to unload some jewelry that wasn't selling well mistakenly prices the closeout jewelry at double the normal price only to have their entire stock sell out completely soon after the price increase. The customer's response to the price increase illustrates the relationship we assume between price and value. The science behind this is explained in studies performed by Harvard social psychologist Ellen Langer where she proved that in spite of our expanse of intellect, we are just as likely to respond in a manner more akin to instinct. Langer calls this stereotyped behavior and it governs much of how we respond to our environment.

All of these predispositions and influences, combined with the hyper-flow of information in today's market, this state of rationality has become more and more difficult to achieve and even harder still to execute. In fact, we can see how short-term investors have become with investments being held for less than a year on average compared to a 5+ year average holding period of 40 or more years ago.



A host of investors with legendary success (Buffett, Munger, Pabrai, Spier and others) have acknowledged their own bias to loss aversion and due to the natural stock market volatility have taken dramatic steps to avoid making irrational decisions. These steps include:

1. Getting rid of the Bloomberg terminal in their office
2. Removing the Yahoo finance bookmark from their computer to avoid getting stock quotations
3. Stopped watching financial news networks during market hours
4. Stopped inputting trades while the markets are open
5. Limited presentation of investor portfolio results to only once per year
6. Moving away from New York so as not to be enticed by Wall Street analysts
7. Refusing to sell a stock until a minimum of 2 years have passed

Rick Thomas, Business Advisor and partner, steelhead fishing on the Bogachiel River on the Olympic Peninsula.

These and many more subtle disciplines have been developed by the greats over the years to combat the risk aversion and the emotional influences of fight or flight. And yet as obvious as these steps may be to you and I, an overwhelming majority still fall prey to the emotions and either buy in, or get out at exactly the wrong times. All of which begs conversation around the last discussion point on investing behavior – this type of investing discipline can be really difficult. If you examine the first graph again, the period of activity where one should be buying are marked by substantially longer periods of conditions where one must be patient.

The simple truth is this is very hard to do and even many of the smart and promising value investors fail to buy when prices are down and sell when assets are fully valued. It is during these times that one should develop an effective distraction from the headlines, be it honing the golf game, fly fishing for steelhead, reading *War and Peace*, or engaging in any other activity that doesn't risk capital.

It can't be repeated enough – when prices go down, we should be happy to buy and not succumb to fear, sitting out a round as opposed to staying in the game when the odds of success have improved substantially with lower prices. For our own part and with these reminders in front of us, we will continue to invest on our client's behalf and remain steadfast in the knowledge that we have done so with their best interests in mind.

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