



# QUARTERNOTES

July/August/September 2008



## Keep emotions out of your investing

**W**e'd like to think that, since the advent of modern portfolio management practices, investing in stocks and bonds has been a cerebral, analytical process with no room for emotion. The truth is that most investors, even institutional investors, are buffeted by emotional turbulence from time to time, and that truth is reflected in the volatility of the financial markets.

But if a little emotionalism when it comes to investments is unavoidable, too much emotion can be hazardous to your wealth. Here are some symptoms of financial behavior that is inconsistent with sound investment practice.

*Fear of flying.* Investors generally are motivated by fear or greed. Behavioral scientists have learned that, for many people, the pain of a loss is larger than the satisfaction from a gain of the same size. Similarly, some investors will accept larger risks to avoid a loss than they will in seeking a gain.

*Continued on next page*

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## Head over heart

There's been plenty of heart-stopping news in the business press this year, and that's not likely to change as we head toward the election. As our main article in this issue of *QuarterNotes* argues, it's important that your investment decisions be driven by your head, not your heart.

We recommend that you rely for advice upon those with experience in all types of markets, good and bad. That's where the professionals at PRIMEVEST can be of service to you. We can assist you with your portfolio management. Whenever you have a concern or question about investing your money, please give us a call. We are here to help.

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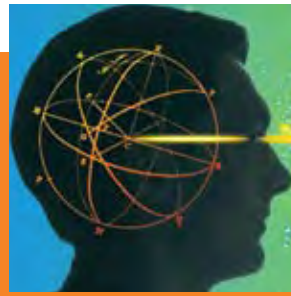
## "My brain made me do it"

The last decade or so has seen the emergence of the field of "behavioral economics," the academic study of why we handle money the way that we do. It's been observed that smart people sometimes make terrible money management decisions, and perhaps emotions can account for some of this apparent irrationality.

Now comes the new field of "neuroeconomics," which suggests that some of our money management techniques

are hard-wired into our brains. *Money* magazine editor Jason Zweig summarized the findings of both these fields in his 2007 book, *Your Money and Your Brain* (Simon and Schuster). Among the early conclusions about how the brain responds to economic stimulus:

- the anticipation of a gain and the receipt of that same gain are processed in two different parts of the brain;
- financial losses are pro-



cessed in the same area of the brain that responds to mortal danger;

- money gains and losses produce tangible, biological changes in the body, not just psychological ones;
- expecting an event (whether good or bad) is often more intense than actually experiencing that same event;

- someone who is making money from investments has neurological activity that cannot be distinguished from that of someone who is taking cocaine or morphine.

The most practical discovery may be that the brain tends to look for patterns. There is a natural urge to try to make predictions about the future, even when the available data are simply random. Uninformed guesswork should be resisted, because it can lead to poor investment decisions.

Keep emotions out *continued*

Taken to an extreme, fear of loss leads to complete investment paralysis. An excessively risk-averse investor may park funds in ultra-safe, but low-yielding, short-term investments until a buy decision is made, accepting long periods of low returns. Or winning investments may be sold off too quickly in an attempt to lock in gains, while losing investments manage to stay in the portfolio indefinitely.

**Herd instinct.** It's difficult to be a contrarian, to find value that everyone else has overlooked. Many people find it easier to go with the crowd, to own the current hot stock or hot mutual fund. If the investment does poorly, one has plenty of fellow sufferers with whom to commiserate.

But when "crowd" is defined as one's family and friends, the crowd's investment goals and risk tolerances may be very different from one's own.

**Hair-trigger reflexes.** Markets move on news. In many cases the first market response is an overreaction, either to the upside or to the down. Sometimes "news" has already been

reflected in the share price. The true importance of any news event can be discerned only over the longer term.

Generally, it's better to watch the market react to news than to be a part of the reaction. Remember that market dips may present the best buying opportunities, but they are also the toughest times, emotionally, to make a commitment to an investment.

**Betting only on winners.** Every year the personal finance magazines report on the best-performing mutual funds, implying that recent performance is a measure of quality. That may be one reason for the government-required disclosure for investment products: "Past performance is no guarantee of future results." The disclosure is required because it is true. High returns usually are accompanied by high risks; ultimately, those risks may undermine performance.

Abnormal returns, whether they are high or low, tend to return to the average in the long run. Investing on the basis of the very highest recent returns runs a significant risk of getting in

at the top of the price cycle, with a strong chance for disappointment.

### One cure for emotional investing

To reduce the temptation to make investment decisions emotionally, we recommend *asset allocation development* in portfolio management. Short-term price movements in the financial markets are notoriously difficult to predict, but over longer time frames relationships between asset classes have been observed and quantified. The division of a portfolio into asset allocation classes such as stocks, bonds and others has a major influence on long-term performance. The risks and rewards of each class can be balanced to potentially optimize portfolio performance. Still, such an approach does not guarantee gains or insure against investment losses.

Investing is our business. We take it seriously, but not emotionally. We don't claim to be infallible, but we are well informed and able to help you implement strategies consistent with your needs and financial objectives.

**M**eet Al Parish, a professor of economics at Charleston Southern University. He lives in a very fine home in a secluded neighborhood, graced with fancy tilework, hardwood floors and a hand-carved staircase that winds upward to cathedral ceilings. The house is filled with luxury goods, and Al wears a Rolex watch. Obviously, he is very rich.

Would you like him to manage your investments?

Mr. Parish managed money for many people and for the University. He did not actively solicit new customers, relying instead upon word of mouth from his existing client roster. Many people found his low-key, “no pitch” approach refreshing in a today’s high-pressure-sales world. Parish did not promise outlandish returns. In fact, one of his clients reported that Parish said that “he didn’t want people to put money in there that they couldn’t do without.”

That turned out to be very good advice, because it has emerged that Parish’s clients may have lost all or most of the money entrusted to him. Problems first emerged when the University asked for a \$1.5 million withdrawal in the fall of 2006, and Parish couldn’t make the payment. An SEC investigation in February 2007 found discrepancies in the accounts. According to Court records, at one point Parish had 599 active investors, with a collective balance of nearly \$524 million, in the accounts that he managed. But investigators couldn’t find any assets. The Parish investment program may have been a classic Ponzi scheme, in which early investors are paid off from funds contributed by later investors, and there are no underlying investment assets.

Last October Parish pled guilty to three counts of fraud with federal prosecutors. In April he pled guilty to state charges in Charleston.



## Financial self-defense

Always investigate before you invest.

### The only reliable defense is a good offense

How can you avoid the fate of Parish’s unfortunate clientele? Keep your guard up and take nothing for granted. Here are three steps for starters.

*1. Develop a coherent investment strategy, one tailored to your own circumstances.* In the abstract, setting personal investment goals in terms of income, growth and safety sounds easy. In reality, it isn’t. If you’re a growth-minded investor, for example, certainly you would rather double your money in one year instead of six. Are you willing to risk everything for the sake of a possible (but improbable) quick payoff? Income-oriented investors must make similar judgments.

The development of realistic investment goals is worth the effort, not only for its own sake but also because the results promote a healthy skepticism that con artists dread.

*2. Select investments to fit your goals.* Don’t settle for what someone wants to sell you. Even in these times of economic uncertainty, good, solid investment opportunities exist. But they won’t come knocking at your door. You must seek them out yourself or engage a professional representative to research them for you.

*3. Choose a professional representative as carefully as you would select a million-dollar investment.* If you can devote only limited time to the business of investing, good advice is the best buffer against bad or downright larcenous advice. We don’t claim to be the only source of sound investment guidance. There are others, and you may want to talk with them as well as with us.

Like to explore the question of financial self-defense further? We’re at your service.

### Trite, but true

When people read these common-sense rules they tend to say, “Of course, that’s obvious.” If only they would follow them!

- Never send money to a stranger on the basis of a telephone call.
- Don’t take promises of extraordinary investment returns at face value. If the promoters knew an easy way to make a fortune, why would they share the secret?
- Don’t be hustled by high-pressure tactics. The investment world is not going to run out of good opportunities in the next 20 minutes.
- Beware of those who claim that they’re doing you a favor because you’re a member of a certain organization, church or professional group.
- Don’t assume that state and federal regulators can protect you fully from investment scams and frauds. As the story in this article vividly illustrates, by the time that the law catches up with the person who took your money, the money may be gone.

## JUST ASK US

### **What is the single most catastrophic financial risk I face that I can insure against?**

For most Americans, the answer is the cost of long-term care, which may be 60 times more likely than a car-accident lawsuit, according to some studies.

### **What does long-term care cost?**

According to the Met Life Mature Market Institute, the average annual cost of a private nursing home room in 2006 was \$75,190, up 7.3% since 2004. An assisted-living facility cost an average of \$35,616 for a year, up 17.6% from two years earlier.

### **When should I buy long-term care insurance?**

Generally, this insurance is purchased by those who are 55 to 65. You want to purchase the insurance before you develop any medical condition that might make you uninsurable. The earlier you begin, the lower the premiums will be. On the other hand, the earlier you start, the longer you probably will pay those premiums before making a claim. According to the Department of Health and Human Services, those over age 65 have a 40% chance of spending some time in a nursing home.

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