The decision of the Nobel Prize committee to award this year’s economics Nobel Prizes to professors Eugene Fama and Robert Shiller confirmed some in the financial community.

“If you’ve been wondering whether it’s possible to regularly beat the stock market averages, you didn’t get any guidance from the Nobel Prize committee this year.”

In one corner is Shiller, “who argues that markets are often irrational and therefore beatable.” In the other corner is Fama, “the father of the view that markets are efficient...Mr. Fama’s followers believe that investors who try to beat the averages will inevitably fail.”

Ratner placed himself in Shiller’s corner because he “has met many investors who have consistently outperformed the market,” including Warren Buffet.

The decision of the Nobel Prize committee provides guidance on whether it’s possible to regularly beat the stock market averages. The committee said, in effect, that Warren Buffett and his peers may be investors who have consistently outperformed the market,” including Buffet.

Buffet is able to beat the market with unique information, insights, and low cost access and trading. But an observation that markets are beatable by the likes of Warren Buffett does not imply that they are beatable by all. Buffet cautioned ordinary investors not to jump too fast too fast from evidence that markets are not rational to a conclusion that markets are beatable by all.

Ratner reached the same conclusion: “Fortunately, Mr. Fama’s work on efficient markets did a favor for the small investor: it spawned low-cost index funds that replicate market averages. ... as the commercial says, when it comes to active investing, don’t try this at home.”

There is no guarantee that the strategies described will achieve their intended objectives. All investments involve risk, including the loss of principal and cannot be guaranteed against loss by a bank, custodian, or any other financial institution.

Sources: www.nytimes.com/2013/11/19/opinion/ratner-who-right-on-the-stock-market-myth.html?_r=0

“In this Issue
P2 Investing, Emotions and Your Brain
P4 Fama, Shiller, Nobel Prizes, and Confusion about Market Efficiency

Rational markets are markets where securities’ prices always equal their intrinsic values. Hard-to-beat markets are markets where some investors are able to beat the market consistently by exploiting gaps between prices and intrinsic values, but ordinary investors are unable to beat the market consistently. It turns out that Fama and Shiller agree more than they disagree. Both accept that markets are not always rational and both accept that markets are hard to beat by ordinary investors.

Don’t Ride The Emotional Rollercoaster

The chart above shows the emotional rollercoaster ride many investors suffer when markets oscillate. As the market moves up, investors tend to move from optimism to elation, but when the market wanes, elation turns to concern and nervousness, and some frightened investors end up devaluing from their well-thought-out investment plans. These deviations are investment mistakes which may be very difficult to recover from.

Disciplined investors, on the other hand, don’t get too excited during market upswings or too anxious during market downswings and they certainly aren’t swayed by the headlines. They stay focused and stick to their plans. This discipline keeps them from feeling the pains of regret.

Develop A Plan And Put It In Writing

Investment mistakes often stem from focusing on short-term performance, emotional decision making and the lack of a written Investment Policy Statement (IPS). Developed in close partnership with your financial advisor, your IPS guides how your portfolio will be managed. It documents important guidelines, such as the length of time you plan to invest, your risk tolerance, portfolio allocation and rebalancing schedule.

And as your goals and circumstances evolve, be sure to meet with your financial advisor to review and update your IPS.

Don’t Lose Sight Of The Forest For The Trees

I stumbled across a motivational poster recently showing a bridge spanning a lake in the middle of a forest. The tagline at the bottom read, “Discipline is the bridge between goals and accomplishments.”

This should be every investor’s motto, since in my experience discipline can be the bridge between the investment goals you set and the investment goals you accomplish. Here are some tips to help you stay disciplined.

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Diversification neither assures a profit nor guarantees against loss in a declining market.

Past performance does not guarantee future results and the principal value of an investment will fluctuate so that an investor’s shares, when redeemed, may be worth more or less than their original cost.

International and Emerging markets involve additional risks, including, but not limited to, currency fluctuations, political instability, foreign taxes, and different methods of accounting and financial reporting. As a result, they may not be suitable investment options for everyone.

Emerging Markets represents securities in countries with developing economies and provides potentially high returns. Many Latin American, Eastern European and Asian countries are considered emerging markets. International stock markets represent the stock markets of developed countries (Europe, France, Germany, and the United Kingdom), S&P 500 and MSCI’s Domestic U.S. represented by MSCI EAFE Index (net div.), and Emerging Markets represented by MSCI Emerging Markets Index (net div.).

What about the three-year returns of 16.6%, 8.4%, and 9.3% for U.S., International and Emerging Markets respectively... does this mean International and Emerging Markets are not worth investing in? But if you take a broader perspective, everything changes: 10-year returns have been 7.5% for the U.S., 7.7% for International and 12.4% for Emerging Markets!

Not only have Emerging Markets and International stocks outperformed U.S. stock markets over the long term, they also provide diversification and helped contribute to greater wealth creation than an exclusively U.S. stock portfolio. Disciplined investors aren’t sidetracked by short-term performance and remain focused on their long term goals.

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2013 year-to-date returns for Domestic U.S. stock markets were 25.3%, International stock markets were 20.1%, and Emerging Markets stocks were 0.9%. Does this mean Emerging Markets (and maybe even International stocks) were poor investments? What about the three-year returns of 16.6%, 8.4%, and 9.3% for U.S., International and Emerging Markets respectively... does this mean International and Emerging Markets are not worth investing in? But if you take a broader perspective, everything changes: 10-year returns have been 7.5% for the U.S., 7.7% for International and 12.4% for Emerging Markets!

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Ideally, investing would be a rational, analytical process. You and your Financial Advisor would put together a prudent plan to help you achieve your long-term financial goals. Then you would go forth and lead your life and not spend much time thinking about your portfolio.

In reality, things rarely work out so neatly. Whatever the market is doing, however our portfolio is faring, we tend to respond emotionally. Unfortunately, emotions are not always an accurate reflection of what is really going on. Researchers have identified numerous ways in which our brains trick us into seeing the investment world one way, when in reality it’s often quite different. There are dozens of these behavioral biases — or mental short-cuts — and they can have an enormous impact on your portfolio if you aren’t careful.

To help you gain a better sense of how some of these biases may affect you, we’ve put together this brief questionnaire. We hope it will give you a new perspective on how you think about investing.

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**Diagram:**

In the diagram below, which line is longer?

- a. Line A
- b. Line B
- c. They are the same length

---

**Question 1:** A friend offers to make a bet with you on the outcome of a coin flip. If you accept the bet, and lose, you will owe your friend $10,000. What amount of money would you need to win before accepting the possibility of losing $10,000? Remember, you have a 50% chance of winning and a 50% chance of losing.

I would need a **50%** chance of winning $_________ to make this bet.

---

**Question 2:** You are considering buying your $1 million dream house. But because of a volatile real estate market, the house has a 50% chance of appreciating in value by $10,000 over the next 12 months and a 50% chance of decreasing in value by $10,000. All things being equal, you would:

- a. Buy the house
- b. Not buy the house

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**Question 3:** In retrospect, you think the Great Recession was:

- a. An unpredictable anomaly
- b. Something most experts should have seen well in advance

---

**Question 4:** In which situation would you feel more upset?

- a. You consider selling Investment X, but decide against it. Later, you learn you would have made $30,000 if you had switched to Investment Y.
- b. You sell all of Investment X and buy Investment Y. Later, you learn you would have made $30,000 if you had held on to Investment X.

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**Question 5:** The following countries in terms of what you think will be their market returns in 2014 from 1 (highest potential return) to 5 (lowest potential return). Then rank these countries in terms of potential investment risk from 1 (highest risk) to 5 (lowest risk).

<table>
<thead>
<tr>
<th>Country</th>
<th>Potential Return</th>
<th>Potential Risk</th>
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</thead>
<tbody>
<tr>
<td>Peru</td>
<td>1,488.00</td>
<td>1,488.00</td>
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<tr>
<td>France</td>
<td>1,380.00</td>
<td>1,380.00</td>
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<td>USA</td>
<td>1,272.00</td>
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<td>Sweden</td>
<td>1,164.00</td>
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<tr>
<td>China</td>
<td>1,056.00</td>
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</table>

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**Question 6:** Thinking about how you drive your car, would you say you are:

- a. An excellent driver
- b. An average driver
- c. A poor driver

---

**Question 7:** On the radio you hear that there has just been a large earthquake in Freidonia, a country where you have invested some of your portfolio. Your first impulse is to:

- a. Sell your investments in Freidonia
- b. Invest more in Freidonia
- c. Do nothing

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**Question 8:** The correct answer is “c.” The lines are the same length. If you answered “a” or “b,” you are the victim of the famous Müller-Lyer optical illusion. Because of the effect of the arrows, you think you see something that doesn’t exist. According to the 1990 Nobel laureate in Economic Sciences, Daniel Kahneman, the mind works in two distinct ways:

- One is fast and intuitive (System 1)
- The other is slow and analytical (System 2)

Even if your analytical (System 2) mind knows the lines are the same length, your intuitive (System 1) mind sees different lengths and makes it impossible for you to see them in any other way. As investors, we tend to be more confident in our intuitive judgments, which makes them harder to override if they are analytically wrong. For example, we know a bear market is not the end of the world, but it still can be hard to resist getting caught up in the media noise and pessimism and making fast, emotional decisions.

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**Question 9:** Chances are you answered this question with a dollar figure somewhere between $20,000 and $25,000. Research by Daniel Kahneman and his colleague Amos Tversky found that the pain of loss is so great that we typically want to gain between 2 and 2.5 times as much as we put at risk. This is important for investors because it means you may naturally worry more about losses and be more preyed upon by them. Knowing this can help inoculate you somewhat in advance. If it is any consolation, experiments with Capuchin monkeys have also found that they are just as loss averse as humans.

**Question 10:** This is essentially the same question and the same odds as #2, but framed differently. Many of us would answer “a” and buy the house. By considering risk within a broader context, we often become less risk averse. $10,000 is a lot of money seen in isolation. But in comparison with a $1 million house, it seems much less significant. That’s why when you look at your portfolio, it’s not so much about whether the individual investments are up or down — but on the bigger picture. Are you on track to achieve your long-term goals?

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**Question 11:** There is no right answer to this question. Only you (and your insurance company) know how good a driver you actually are. But chances are you are an average driver. Yet in study after study, people tend to overestimate their abilities. For example, in a 1981 study, Olle Svenson found that 80% of respondents rated themselves in the top 50% of all drivers. In investment terms, this means that too many of us believe we are much better investors than we really are and we tend to overestimate the appreciation of this belief in a few successful years, while minimizing any failures. Since few professional money managers consistently and predictably beat their benchmarks, it is not just ordinary investors who suffer from overconfidence.

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**Question 12:** There is no definitively wrong or right answer, but if you answered “a” or “b” you may be susceptible to what is called “action bias” — the desire to act, especially in down markets or when there are bad news, even if doing nothing may be the wisest choice. Trying to time the markets or a particular investment, either by buying or selling at the right time, is something that is extremely difficult to do repeatedly. During the Great Recession, some investors panicked and wanted to do something, anything. Market gurus proclaimed that “buy and hold” was dead. Yet, looking back, we can see that staying the course may have been the wisest move for many investors.

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**Question 13:** If you answered “b,” you may tend towards hindsight bias — judging the past in light of the present. We try to make the best decisions we can with available information — and we should not ignore the lessons of history — but that doesn’t mean things will always turn out as we expect...or hope. When it comes to investing, even professional money managers and pundits have a very hard time predicting the future. Every January, USA Today asks top investment strategists to offer their outlook for the year ahead. At the beginning of 2008, before the worst of the Great Recession, all of the strategists predicted a bear market, while the S&P 500 estimated the market would increase somewhere between 3% and 9%. Of course we now know the S&P 500 Index declined by 57% for the year 2008.

Source: USA Today, December 31, 2007

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**Question 14:** Regret can play a significant role in how we behave as investors, especially when it results from a past decision that did not turn out well. This means that most of us would probably feel more upset if we experienced the situation in answer “b.” Taking an action that turns out poorly usually leads to more regret than failing to do something beneficial. This difference between a loss and a missed opportunity is one that can haunt many investors. Knowing this about yourself may make future losses a little less painful or even help you not worry quite so much about potential losses.

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**Question 15:** There is no right answer to this question, at least until January 1, 2015 (remember that the future is uncertain and never fully known). But how you responded may provide some insights on your behavior as an investor. Financial science suggests that there should be a strong correlation between risk and potential return. In other words, you should have rated as riskiest the country you believe will have the highest returns in 2014 — and as lowest risk the country you believe will have the lowest returns in 2014 — and vice versa. But if you rated your top performers as lower risk, you may be engaging in “representativeness” — essentially estimating the likelihood of something by comparing it to your existing mental models. Intuitively, many investors think a thriving, peaceful and successful country should generate stronger market returns than one wrecked by unrest and a bad economy. But history and data suggest otherwise. For example, over the last 10 years, from 2002 – 2012, the three top-performing global markets — Columbia, Peru and Brazil — were not paragons of stability and innovation. Meanwhile, the U.S. was only the 39th best performing market. This is why it is so important to diversify broadly and globally...and not try to make picks and predictions, especially ones based on representativeness.

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Understand how your brain reacts to news and events, to the ups and downs of markets, to gains and losses, can help you better inoculate yourself from short-term emotional decisions that may get in the way of your future success. Stick to your plan and work closely with your Financial Advisor. His or her wisdom, experience and perspective can help you stay focused and on track.
Ideally, investing would be a rational, analytical process. You and your Financial Advisor would put together a prudent plan to help you achieve your long-term financial goals. Then you would go forth and lead your life and not spend much time thinking about your portfolio.

In reality, things rarely work out so neatly. Whatever the market is doing, however our portfolio is faring, we tend to respond emotionally. Whatever the market is doing, however our portfolio is faring, we tend to respond emotionally.

In which situation would you feel more upset?

[ ] a. You learn that the S&P 500 estimating the market would increase somewhere between 3% and 9%. Of course we now know the S&P 500 Index declined by 37% for the year 2008.

[ ] b. You sell all of your investments in Freedonia and buy Investment Y. Later you learn you would have made $30,000 if you had held on to Investment Y.

[ ] c. Do nothing

Chances are you answered this question with a dollar figure somewhere between $20,000 and $25,000. Research by Daniel Kahneman and his colleague Amos Tversky found that the pain of loss is so great that we typically want to gain between 2 and 2.5 times as much as we put at risk. This is important for investors because it means you may naturally worry more about losses and be more pained by them. Knowing this can help inoculate you somewhat in advance.

In retrospect, you think the Great Recession was:

[ ] a. An unpredictable anomaly

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This is essentially the same question and the same odds as #2, but framed differently. Many of us would answer “a” and buy the house. By considering risk within a broader context, we often become less risk averse. $10,000 is a lot of money seen in isolation. But in comparison with a $1 million house, it seems much less significant. That’s why when you look at your portfolio, it seems so much on the edge whether the individual investments are up or down — but on the bigger picture. Are you on track to achieve your long-term goals?

There is no right answer to this question. Only you (and your insurance company) know how good a driver you actually are. But chances are you are an average driver. Yet in study after study, people tend to overestimate their abilities. For example, in a 1981 study, Ole Svenson found that 80% of respondents rated themselves in the top 50% of all drivers. In investment terms, this means that too many of us believe we are much better investors than we really are and will not act on the anticipation of this belief in a few successful years, while minimizing any failures. Since few professional money managers consistently and predictably beat their benchmarks, it is not just ordinary investors who suffer from overconfidence.

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In which of the following countries in terms of what you think will be their market returns in 2014 from 1 (highest return) to 5 (lowest return). Then rank these countries in terms of potential investment risk from 1 (highest risk) to 5 (lowest risk).

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In the diagram below, which line is longer?

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“The Bridge Between Your Goals and Accomplishments” continued from page 1

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