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Trust UPDATE

Stillman BANK

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Conquer the temptations of emotional investing

We like to think that since the advent of modern portfolio management practices, investing in stocks and bonds has become 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 four symptoms of problem emotions, financial behavior that is inconsistent with sound investment practice.

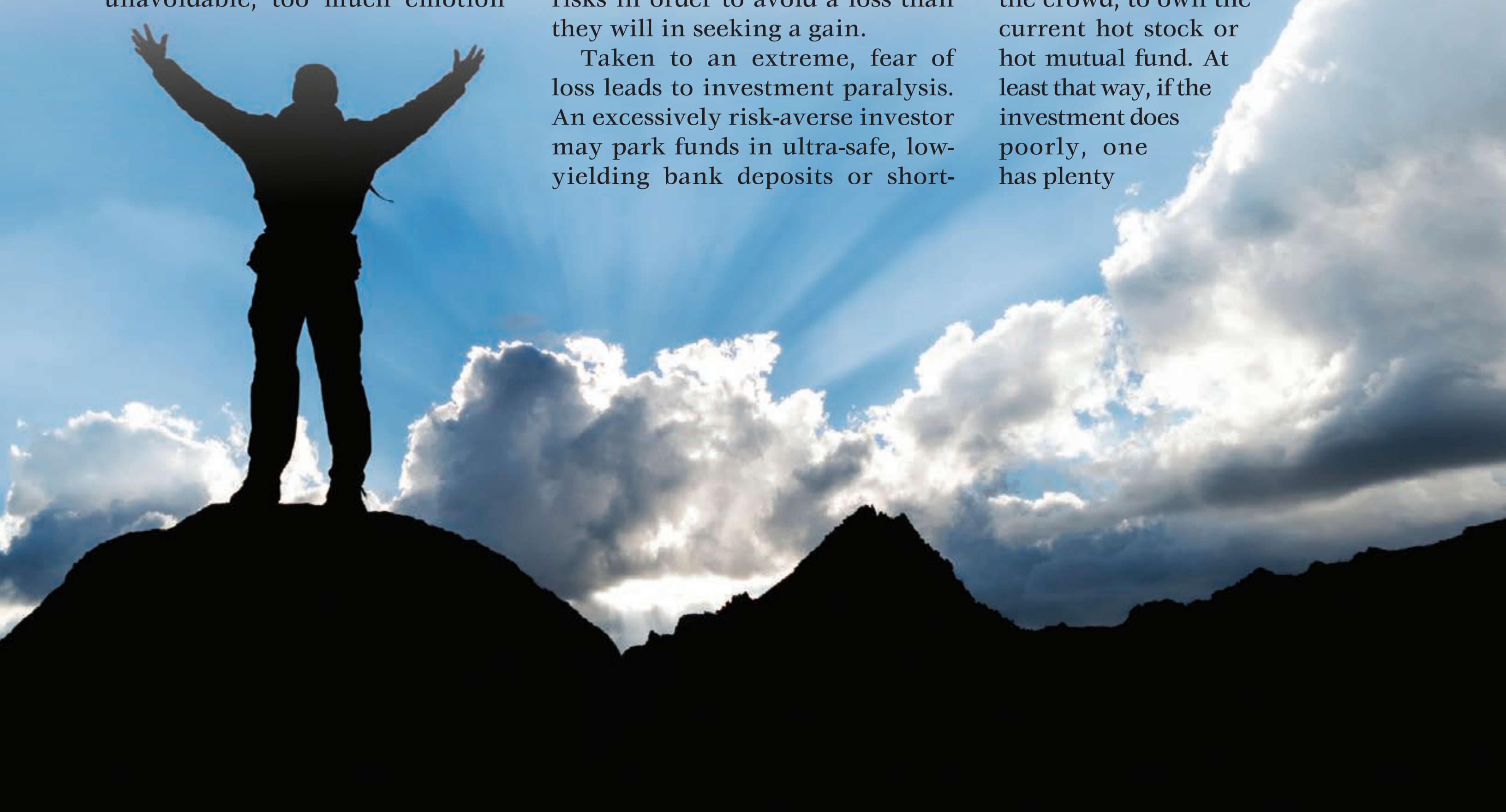
Fear of flying

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

Taken to an extreme, fear of loss leads to investment paralysis. An excessively risk-averse investor may park funds in ultra-safe, low-yielding bank deposits or short-term Treasury securities until a 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. At least that way, 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 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 up side or to the down. Sometimes "news" is only new to the general public, and it's already been reflected in the share price through trading by those with greater knowledge. The true importance of any news event can only be discerned 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're also the toughest times, emotionally, for making a commitment to an investment.

Betting only on winners

Some 85% of the new money going into domestic equity mutual funds goes to funds with MorningStar ratings of four or five stars, according to one estimate. This may be one reason that the government requires this disclosure for investment products: Past performance is no guarantee of future results. The disclosure is required because it is true. High returns are usually 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.

The alternative approach

To avoid impulsive decisions that may be tainted with emotion, one needs an investment plan. The best way to moderate the impact of stock and bond volatility in difficult markets is to own some of each. Assets do not move up down in lockstep. When stocks rise, bonds may fall. Or at other times, bonds also may rise when stocks do. The movements of each asset class can be mathematically correlated to the movements of the other classes. Portfolio optimization involves the application of these relationships to the investor's holdings.

An asset allocation plan is a program of disciplined diversification. To oversimplify, there are three steps:

Step One. Determine the expected return from each asset category—stocks, bonds and cash. Expected returns may be determined for subcategories as well—small company stocks, corporate bonds, intermediate maturities and so on.

Step Two. Decide which combination of these asset classes offers the best return for a given level of acceptable risk.

Step Three. Given target allocations, select investments within each class for the portfolio.

Expected returns need to be linked to the investor's time horizon. Longer time horizons give the investor more time to recover from bad years, more chances to be in the market for good years.

Our investment services for you and your family

We have a variety of individually tailored investment services to meet the needs of our clients, from simple custody and agency accounts to full asset management with a trust. Our aim is to provide that quantity of service with which each client is most comfortable, which best meets each client's need.

Investment management account. We'll listen to your goals and help you to map out a personal investment strategy. Then we'll create a diversified portfolio—including stocks, bonds and cash—that is consistent with your objectives, income needs and risk tolerance. You'll receive regular progress reports.

Revocable living trust. A trust is similar to an investment management account, with pluses. Plus full financial management in the event of your incapacity. Plus probate avoidance. Plus protection of your beneficiaries beyond your lifetime.

IRA rollover. You can defer income taxes on a lump sum distribution from a qualified retirement plan by arranging for a rollover of the money directly to an IRA rollover. The usual IRA rules will apply. Our asset management specialists can help you to develop an IRA investment program that makes the most of tax deferral while dovetailing with your other investments.

For more information on our investment planning and management capabilities, please arrange to speak with one of our asset management specialists. ☐

Black swans

For centuries Europeans knew to a certainty that all swans were white. The scientific truth came from simple observation—thousands of swans had been sighted; there had never been an exception to the rule; there was no reason to think that there ever would be an exception.

Until 1697. That's the year that a Dutch explorer, Willem de Vlamingh, recorded seeing a black swan on the west coast of Australia. In a moment, centuries of experience were swept away, and the idea that all swans were white evaporated.

This phenomenon has been adopted by market theorists as a metaphor for the fundamental unpredictability of financial markets. In *The Black Swan* (2007), Nassim Nicolas Taleb characterizes such events as:

- rare, outside the realm of our normal expectations;
- extreme, with an extraordinary impact; and
- retrospectively predictable; that is, no one saw it coming, but now we see how we might have.

What's more, if a highly probable event fails to occur, that also would be a black swan. Taleb suggests that it is human nature to assume that past events will repeat themselves, and so provide guidance for how to adapt in the present to influence the future. In reality, the most important events are rare, predictable only in hindsight, and so planning for them is not possible.

A different sort of investment risk

Monday, October 19, 1987, was probably a black swan. That was the day that the Dow Jones Industrial Average lost nearly 25% of its value. Roughly $1 trillion evaporated from the total value of U.S. stocks. The stock returns of the prior 201 trading days were wiped out that day, and it took 320 trading days to recover fully.

A loss of that magnitude was completely unprecedented, but it happened anyway. The closest similar event, the 13% decline of October 24, 1929, presaged the Great Depression. That fact sparked much commentary as 1987 closed about whether history was about to repeat itself. Ironically, the massive loss of 1987 was the harbinger of the greatest bull market in history! Not only can we not predict black swans, but also we can't even understand their true significance!

Portfolios constructed on the probabilities of returns of various asset classes cannot take black swans into account. Risks presented by such events may be growing larger as the financial sector of our economy gains dominance over the business sector.

The risk of missing out on the upside

Business professor Javier Estrada, of the IESE Business School in Barcelona, Spain, quantified the effect that black swans can have on investment returns. He studied the Dow Jones Industrial Average for the period from 1900 through 2006. Black swans are not necessarily negative—there are equally rare and extraordinary days on the upside as well. Looking at the best 100 trading days, the lowest return was 3.9 standard deviations above the mean. Statisticians will tell you that suggests such a return should be seen once in 83 years—yet that return or better occurred 100 times in the course of the study.

To translate Estrada's findings into dollars, $100 invested in the DJIA at the beginning of 1900 would have grown to $25,746 by the end of 2006. However, if the investor had missed just ten days of that 107 years, the investment would have grown to only $9,008, a reduction of 65%. Miss the 20 best days, and the portfolio grows to only $4,313. Finally, missing the 100 best days of the 29,190 in the period under study, one-third of one percent of the trading days, results in a loss of capital, as the terminal wealth would be just $83.

Of course, there are black swans on the downside as well, as Estrada documents. If you could keep all the best days and avoid just the ten worst days, terminal wealth jumps to $78,781. If you accurately predicted the 100 worst days and avoided them, your $100 would grow to an astonishing $11,198,734!

And it's not just the U.S. stock market that exhibits such behavior. Estrada went on to document similar results in foreign markets as well. He concludes: "A negligible proportion of days determines a massive creation or destruction of wealth. The odds against successful market timing are just staggering." ☐

The wrong way to amend a will

Esther Sullivan executed her will in January 2006. The will was notarized properly and had the required two witnesses. Esther divided her estate between her grandson, Joseph, and a former employee, Tara Jean. The nature of the employment was not disclosed by the court, but Tara Jean was named as personal representative of the estate. She would be responsible for collecting the estate's assets, filing the tax and probate forms, and distributing the assets.

By 2008 Esther had a change of heart. On a photocopy of the original will, she wrote across the top "[t]he Will dated January 19, 2006 is void and to be replace[d] with this and all written in changes." A variety of alterations were penciled in, the most consequential of which was naming Joseph the personal representative instead of Tara Jean.

Not yet completely satisfied with her handiwork, in October 2010 Esther downloaded a will form and completed it by hand. This time, in addition to naming Joseph as personal representative, she made him the sole heir of all of her property, "after her debts are payed (sic)." Interestingly, Tara Jean witnessed Esther's signature on the 2010 will.

After Esther died, Tara Jean offered the 2006 will for probate. Joseph objected, and he submitted the 2008 and 2010 alternatives as being more consistent with Esther's final intentions for her property.

Both the lower court and then the appellate court held that the statutes governing wills must be strictly adhered to. The same formalities that apply to creating a will apply equally to its revocation. Neither the 2008 nor the 2010 will was executed with witnesses to Esther's signature, so these wills failed the test. Alternatively, the appellate court held, a will may be revoked by a "revocatory act on the will," including "burning, tearing, canceling, obliterating, or destroying the will or any part of it" Such an act must be done to the original will, not to a photocopy of it.

Without the required witnesses, the 2008 and 2010 documents amounted to nothing more than notes for making a future will.

During the appeal, Joseph argued that Tara Jean had breached her fiduciary duty to the estate by offering the 2006 will for probate when she herself was a witness to the 2010 attempted revocation. Unfortunately, the Court held, he brought that argument up too late to be considered.

Making a will is an important privilege, one that remarkably few people ever take advantage of. Cases such as this one show the importance of having a lawyer's assistance, to be certain that all the legal niceties are satisfied. If you haven't made your will—or if it has become out of date—an early consultation with your estate planning advisors is a must for 2016. ☐