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7 Psychological Traps That Make You a Worse Investor

Sometimes when it comes to investing, volatile markets aren't your worst enemy. It's actually you. That's because money and logic don't always go hand in hand. Unfortunately, our brain often plays tricks on us, causing even the savviest of investors to make decisions that don't really make a lot of sense, from panic selling to ignoring opportunities.

In fact, the problem of psychological investing traps is so pervasive, there's a whole field dedicated to studying it called behavioral finance. Researchers in this discipline look at the way psychology affects how we make financial decisions, and some of what they've discovered is pretty interesting. Knowing about these traps can help you avoid them and make you a better investor.

Here are seven psychological traps to keep in mind.

Sunk Cost Bias: The sunk cost bias has to do with the all-too-common tendency to stick with something, whether a bad boyfriend or bad investment, long after it's clear that it's not worth it anymore. Still, because you've invested a certain amount of time or money, you're reluctant to give it up. In investing, you might end up hanging on to a stock long after you should sell it in the vain hope that you'll eventually come out ahead. But in these cases, it's better to cut your losses rather than to hang on to a loser.

Familiarity Bias: Most of us are biased toward those things that are familiar to us. We head to restaurants we've been to before and follow the same roads to work, because we know what to expect. With investing, familiarity bias involves favoring investments that are familiar to you. You might prefer to invest in the company you work for or big-name businesses that are in the news. This could cause you to overlook important opportunities you don't know that much about.

Continued on page 2

Do You Need a Buy-and-Hold Strategy?

The fact is that the market is an incredibly complex system. Investment returns depend on a wide range of factors — from who the company's chief executive officer is to inflation in China. Economists suggest that stock price changes exhibit what they call random walk behavior, meaning that future performance cannot be predicted based on past performance.

For the average investor, a buy-and-hold strategy is much more practical than a market timing strategy. While buy-and-hold investors will suffer in market downturns, by staying invested in the market, your investments will recover when the market recovers. While there is no guarantee that will happen, historically, the general direction of the market has been upward.

The benefits of a buy-and-hold strategy over a market timing strategy include: 1) It doesn't require constant monitoring of the market or the news. 2) It's less complex. You'll typically make far fewer trades with a buy-and-hold strategy. 3) There are fewer tax consequences. Since you have fewer trades, you'll have fewer taxable transactions. ❍❍❍

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7 Psychological Traps

Continued from page 1

Anchoring: Anchoring is the process of getting attached to a particular reference point — such as the price you paid for a stock — and using that to guide future decisions. Or you might fixate on a stock's previous high, even though that price was an anomaly. Anchoring is why you think you got a great deal when buying a $60,000 car for $50,000, even though the car is worth closer to $40,000.

Whether you're buying stocks or cars, anchoring involves using a single piece of information to determine what a stock or other investment should be worth while also discounting more relevant information, such as a company's fundamentals or broader economic trends. Unfortunately, avoiding anchoring is difficult, but considering all available information before choosing an investment can help.

Focusing Too Much on the Recent Past: Recency bias is the tendency to make decisions or judgments based on information that's relatively new or recent. For example, during times when the market is up, people may ignore or discount the possibility of a market decline. Or, if a certain category of stocks has done poorly recently, people may conclude that those stocks *always* have negative returns, even if the dip is an anomaly. As with other psychological investing, you can avoid this one by doing your best to consider the entire universe of information at your fingertips, not just what happened yesterday.

Following the Herd: While following trends might be fine for fashionistas, it's not always a smart investing move. Yet herd investing is an all-too-easy trap to fall into. If everyone is telling you that now's the time to get into a certain hot investment, you may feel you need to act fast so you don't miss out. But just because something is popular doesn't make it a good investment. Blindly following the herd without first consulting your own financial goals and plan doesn't make you a smart investor.

Overconfidence: Most of us like to think we're smarter than the average person, but when it comes to investing, you're probably not. Yet if you hit it big with a certain investment, you may attribute that success to your skill rather than what it really is — luck. That can cause you to repeat the same way of thinking.

Panic: Investing isn't for the faint of heart. When the market takes a sudden dip it's easy to panic, which can lead you to make bad decisions, such as selling at a big loss, rather than riding out the natural hills and valleys of investing. Making these emotionally driven choices can cost you a lot of money. When making investing decisions, make sure they're based on evidence, not your initial gut reaction to the day's events.

Avoiding psychological investing traps on your own can be difficult. Please call if you would like to discuss this in more detail. ❍❍❍

Don't Get Bitten By the Gold Bug

It is hard to watch the television or listen to the radio airwaves today without hearing how all of us need to buy gold. Most of the time, the message is you need to buy gold or precious metals in order to keep your family safe from the "thugs" on Wall Street.

The companies that are in the gold and precious metals business love to create fear. They use their consistent gloom and doom outlook for the world economies as a scare tactic to increase demand. The last time the gold industry ramped up advertising to the max was at the height of the 2008 financial crises. Like clockwork, the herd of worrisome investors fled to the gold market, helping to increase the price of gold over the next several years. Once everyone started to see the financial markets rebound (as they do after each crisis), the always-late and worrisome herd of investors fled back to the stock market. From August 2011 to November 2015, the price of gold crashed down by 42%. Gold can temporarily shine in the middle of a financial crisis, however, as a short- or long-term investment, I cannot and do not ever recommend it.

Smart investors look at a temporary financial crisis as an opportunity to buy good quality companies at a very cheap price. Let's look at how gold has done compared to the S&P 500 over the past 30 years:

Going back 30 years to June of 1986, gold was about $385 per ounce. Today, in June of 2016, gold is listed at $1,260 per ounce. That's about a 4% annual return with periods of high volatility. When you adjust for inflation, this comes out to about 1.8% real return. During this same time period, the S&P 500 went from $250.84 to $2,112.13.[1] That's about a 7.36% annual return before inflation. The risk of investing in gold is not worth the return. I will continue to recommend investing in stocks over the long-term with bonds to soften the ups and downs.

This month marks my 19th year of being in the financial services business. I have clients who are in their eighties and nineties who are beginning to pass down their assets to the next generation and so far, I haven't found a single client who wished he or she had owned more gold to pass on to their kin.

[1] www.macrotrends.net/1333/historical-gold-prices-100-year-chart (June 2016).

Sincerely,

Andrew D. Wade, CFP®
President

What's Your Risk Tolerance?

Risk tolerance is a term that comes up a lot when discussing investing, but what does it mean?

In simplest terms, your risk tolerance is the amount of volatility — or upward and downward swings in value — you can handle in your portfolio. It's a fairly straightforward concept.

The real challenge lies in determining your own personal risk tolerance. Invest more aggressively than you're comfortable with, and you may panic when your investments drop in value, causing you to sell at the wrong time. Invest too conservatively, and you'll likely end up frustrated when you don't see the gains you want.

Risk Tolerance Categories

Most people fall into one of three risk tolerance categories:

✔ **Conservative:** You have a low tolerance for risk and want to protect your existing investment, or principal.

✔ **Moderate:** You have a higher tolerance for risk than a conservative investor and are seeking to invest aggressively enough to generate a moderate return on your investments.

✔ **Aggressive:** Aggressive investors have the highest tolerance for risk. They are willing to accept the possibility of significant losses for the chance of earning a higher return.

Sometimes, these categories are further subdivided. For example, you might be moderately aggressive or moderately conservative.

Your Risk Tolerance

You probably have a general sense of what your personal risk tolerance is simply from reviewing the list above. But it's important to not just go with your gut when determining how much risk to take with your money. You could like to gamble big in Vegas, but your risk tolerance may be far lower when it comes to your retirement funds. Or, you may always drive five miles under the speed limit, but feel comfortable being more aggressive in your portfolio. In other words, your risk tolerance may be higher or lower than you think it is — and it doesn't necessarily correlate with your comfort for taking risks in other areas of your life.

To get a better sense of your own risk tolerance, ask yourself these questions:

✔ **What's my time frame?** Your risk tolerance is closely related to how long you plan to stay invested. Those with long time frames (a 25-year-old just starting to save for retirement or new parents investing for their child's college education) can afford to be more aggressive than someone who is already retired and needs their portfolio to generate a certain amount of income each year.

✔ **What can I afford to lose?** This is the amount you have available to invest that won't negatively affect other areas of your life if you take a loss. If your budget is stretched thin and you have a lot of

debt (or liabilities) and few other assets, you may not be able to lose much. If you have a high net worth and a lot of other assets, you can afford to lose more. Think of it this way: Don't invest the money you'd normally use for your mortgage payment or groceries.

✔ **How well will I cope with market swings?** If your stomach does flip-flops whenever you hear that the Dow is down — and then up again — you may not cope well with volatility, or the natural movement of the market. If you can accept the idea that the market may go up and down in the short term but that it trends up over time, you may take a more sanguine view of day-to-day market fluctuations and feel more comfortable with taking risk.

✔ **How experienced am I with investing?** The last question you should ask yourself has to do with your general knowledge of investing. Just as novice mountain climbers don't start out by scaling Mount Everest, new investors shouldn't get their feet wet by investing in complex investments. Start small, get comfortable, educate yourself; and if you achieve success, you may eventually attempt more complex investing. But keep in mind that more complicated doesn't necessarily mean better when it comes to your money. Most people are able to achieve their goals simply by investing in traditional asset classes like stocks, bonds, and cash.

Still not sure what your risk tolerance is? Please feel free to call. ❍❍❍

Control Your Spending

If you're trying to increase savings, remember that savings are directly tied to spending — the less you spend, the more you have to save. Some tips to help you reduce your spending include:

✔ Analyze your spending for a month. Give serious thought to your purchasing patterns, looking for ways to reduce spending. Over a long time period, even reducing your spending by modest amounts can accumulate to significant sums.

✔ Go over major expenditures also. When was the last time you comparison shopped your auto or homeowners insurance? Have you checked mortgage rates lately to see if you should refinance? Have you reviewed strategies to reduce your income taxes?

✔ Make a spending plan and put it in writing. Budget for all major expenditures and resolve not to purchase items that aren't in your budget.

✔ Throw out your credit cards (or at least hide them for a while). Most people find it more difficult to spend cash than to charge a purchase. So, for the next couple of months, only purchase items with cash.

✔ Don't purchase items over a fairly low dollar amount until your second shopping trip. How often have you purchased something on impulse, only to realize when you got home that you really didn't need it? To control those impulses, compare price and value on your first shopping trip. Then go home, think about whether you really need the item, and purchase it on another trip.

✔ Think carefully before making major purchases. Often, upkeep and maintenance will add to your costs. Consider a less-expensive car or a used car. Keep your car for four or five years instead of getting a new one every two or three years.

✔ Figure out the maximum amount you can afford for a house and then buy one substantially less expensive than that. Not only will you save on your mortgage payment, other costs associated with owning a home will be lower. Living well within your means is one of the best ways to ensure you have money left over for saving.

Learn to clamp down on your spending, and your savings should increase. Please call if you'd like help in this area. ❍❍❍

How to Set Savings Goals

Below is a simple seven-step plan that you can use to set — and reach — your savings goals.

1. Select goals. Before you start saving, it helps to know what you are saving for.

2. Determine how much you need to save. Don't just choose a random number — research how much you'll actually need.

3. Consider your timeline. Your timeline will have a direct impact on how aggressively you need to save.

4. Determine how much you can set aside each week or month. This allows you to adjust your savings as your budget allows.

5. Automate your savings, if possible. You'll likely find it easier to stick to your plan if you can automate your savings.

6. Choose the right way to save. Depending on your goal and your timeline, you have different options for savings.

7. Watch your money grow. Once you have your savings plan in place, keep an eye on how it is doing. You will need to periodically review your results and make adjustments as necessary. ❍❍❍

Financial Thoughts

Total health-care costs for a typical family, including employer and employee costs, have almost doubled in the past 10 years, from $13,382 annually in 2006 to $24,671 in 2015. Of that $24,671 cost, the employer pays $14,198, employee-paid premiums cost $6,408, and employee out-of-pocket costs equal $4,065 (Source: Milliman Medical Index, 2015).

The percentage of people who remain in the workforce at age 65 or older increased from 10.9% in 1994 to 18.7% in 2014 (Source: Bureau of Labor Statistics, 2015).

A recent study found that individuals who grew up relatively poor held significantly more value stocks than growth stocks in their portfolios. Older investors tend to be more value oriented than younger investors. Investors with higher levels of education and income are more likely to exhibit a preference for growth stocks. Investors whose income is hurt more by economic downturns prefer growth stocks (Source: *Journal of Financial Economics*, August 2015).

Another recent study found that a large part of the long-term variation in stock prices is due to unexplained factors rather than economic changes. However, more than 99% of the movement in bond prices is correlated with the economy's movements (Source: *AIER Issue Brief*, June 29, 2015). ❍❍❍