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## Points of Interest:

- Our minds protect us from the pain of admitting our mistakes.
- We tend to attribute good outcomes to skill and bad outcomes to bad luck.
- Hindsight makes us feel we knew the outcome before it happened.
- We have trouble accepting probability and attribute chance outcomes to our own actions.

## WANT TO BE A BETTER INVESTOR? START LEARNING FROM YOUR MISTAKES

**R**emember when a special teacher in your life told you it was good to make mistakes as long as you could learn from them?

It is probably one of the most important maxims for investors—and probably one of the most ignored.

The evidence that investors don't learn from mistakes is widespread. Every few years a new mania takes hold and investors bid up an asset class to unrealistic heights, such as in the dot.com stock market of the late 1990s or the recent residential real estate boom.

Or investors go through periods when all notion of risk is thrown out the window, and they are willing to pay high prices for securities previously seen as very risky.

### Learning biases

It seems our overly protective mental structures serve to shield us from the pain of admitting mistakes, some cognitive psychological research has found.

One protective attribute is called "self-attribution bias," or, to put it in plain English, "Flipping heads is skill, but flipping tails is just bad luck."

How many times have you purchased or sold a stock with a good result and told yourself it was a result of your own superior investment knowledge, while a loss on a stock you attributed to bad luck or the market?



Investment mistakes can hurt, but they are a golden opportunity to learn how to do it better the next time.

Another protective device is hindsight bias, the tendency to feel after the fact that we knew the outcome all along. Consider again the dot.com boom, when certain Internet stocks were priced at hundreds of times their projected earnings, vs. a typical average for the market of 12 to 14 times earnings.

Years after the bubble burst, many investors say they saw it coming, even though the majority participated in the bubble at the time.

### Probability angst

We also seem to have a hard time accepting that much of what happens in the

world is probabilistic, i.e., the world is uncertain and there is not always clear cause and effect.

We tend to associate probabilistic events in the world with our own actions, even though our actions likely had no effect on the real world outcomes.

Tests by psychologists have found that subjects engage in ritualistic and superstitious behavior to influence the outcome of a random action.

This happened after a subject had a chance positive occurrence early on in the

*(Continued on page 2)*

## KEEP A RECORD OF THE REASONS YOU USED IN BUYING AN INVESTMENT

(Continued from page 1)

test. From then on the subject associated his action with the random result. Rather than look at the percentage of times a particular strategy paid off, we are prone to fall into the illusion that an early positive correlation will continue into the future.

### Fighting your biases

There are several techniques an investor can use to better learn from past actions.

You should keep a record of decisions as they are

made, along with your reasoning.

When the outcome is known, you can go back and see whether your justifications had anything to do with the outcome, or whether you experienced a chance coincidence or were just plain wrong.

You can separate the outcomes four ways. If you were right, were you right for the right reason (in other words, did you display actual skill), or were you right but your reason was wrong, indicating chance? If you were



Keep records of your reasoning.

wrong, was it for the wrong reason (learn from it) or did you lose even though your reasoning was correct?

## WHEN SHOULD YOU TAKE SOCIAL SECURITY?

A crucial retirement planning decision for many workers involves deciding when to begin Social Security benefits.

Anyone can begin collecting as early as age 62, but that means the retiree receives a permanent reduction in benefits that can reach 25% or more.

Retirees can also wait until normal retirement age, which currently ranges from 65 and 10 months to 67, depending on the year they were born.

Or, if they choose to keep working or just want to delay Social Security, they can wait until age 70 and get a benefits increase of about 8% for every year they wait to take Social Security after normal retirement age.

### Choices, choices

There are some general guidelines. First, if you are still working, it makes sense to put off collecting your benefit. If you claim a benefit between age 62 and your normal retirement age, then benefits are reduced by \$1 for each

\$2 you earn over \$13,560.

Although you won't face that reduction due to earned income after full retirement age, you still may get taxed on your benefit, and the higher your other earnings, the more Social Security will be taxed.

If you are retiring as early as 62 and feel

you can't make ends meet without the benefit, you might want to think long and hard about retiring that young: you may not be financially ready to take the plunge.

Or, if you are retiring early but don't need the benefit, you may want to put it off for as long as possible so that you will eventually get a larger lifetime benefit.

### How long will you live?

If you knew when you were going to die, your deci-

sion would be much easier.

Someone who will die relatively young would do better to take Social Security at 62. Even though the benefit would be reduced, they would collect more payments.

However, if you live into normal old age you would collect more lifetime benefits by



Deciding when to take your Social Security benefit is a function of your income, age, and outlook on your health and longevity.

delaying Social Security until normal retirement age or beyond. For instance, you would have to live past about age 76 to justify delaying the benefit until 66. Keep in mind that actuarial tables show the average 65-year-old will live until

age 82 for males and 85 for females.

Social Security has a handy calculator you can use online at: <http://www.socialsecurity.gov/OACT/quickcalc/when2retire.html>.

*"If you are retiring early but don't need the benefit, you may want to put it off for as long as possible."*

## INTERNATIONAL STOCKS CAN HELP DAMPEN YOUR PORTFOLIO'S RISK\*

Foreign stock markets were on fire last year, handily beating the U.S. market and drawing the attention of domestic investors.

The Brazilian stock market gained 44%, Germany 22%, China 96%, and India 47%. The U.S. market, as measured by the Standard & Poor's 500 Index, gained just 3.5%.

And that was not an isolated, one-year event: foreign stocks on average have outpaced domestic stocks over the last five- and 10-year periods.

Some investors undoubtedly will begin chasing those returns, but is that the reason to invest internationally?

### It's about risk

Those investors miss the key reason for international investing—reduction of risk through diversification, says Karen L. Lewis, a finance professor at the Wharton School.

Despite the globalization of world financial markets, international stocks still offer

a significant diversification benefit, she found in a recent academic study.

Foreign stocks still move differently enough from U.S. stocks that their inclusion in a portfolio helps to dampen its volatility.

"The bottom line is that there still are benefits to international diversification in 2007 and 2008," Lewis says.

### Benefits still there

Conventional wisdom has held that international stock market diversification has diminished as it has become easier for investors to put their money anywhere in the world.

But Lewis says her research showed that over the past 20 years "the covariance between foreign markets and the U.S. market has increased only slightly" and that the volatility of foreign markets has actually declined.

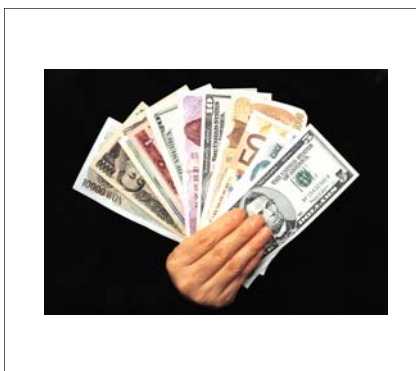
She says a U.S. investor

can reduce the volatility of a portfolio by 15% by mixing in foreign stocks.

To do this it takes a foreign stock allocation of about 20%, she says.

She warns that investors can't get the same diversification by using American Depository Receipts—foreign stocks that are listed on U.S. exchanges.

"The diversification properties of (ADRs) are inferior to investing in foreign markets directly," she concludes.



Foreign stocks still offer diversification to U.S. investors.

*"Those investors miss the key reason for international investing—reduction of risk through diversification."*

\*The returns data in this article was generated with third party information and MPM is not responsible for its reliability.

## TAX PROS BALK, GOLDEN YEARS, & MORE

Taxpayers can't count on their tax professionals to go along with them on questionable claims due to new Internal Revenue Service penalties.

The IRS wants tax preparers to disclose to the agency any position taken on the return that the preparer does not think is more likely than not to be correct.

Even disclosing the problem doesn't get the preparer off the hook if there is no reasonable basis for the disclosed position.

Tax preparers face minimum fines of \$1,000, or half the preparation fee, for violations of the new rules.

### Costly retirement

Retirees and those facing retirement expect to spend more than ever to cover expenses, a survey by Sun Life Financial found.

Escalating health care prices have pre-retirees who are in their 50s anticipating an average of \$578,000 in total retirement spending.

Those in their 60s and 70s predict spending of up to

\$652,000, Sun Life said.

### Peer pressure

Even more than losing money, investors fear that they will miss out on what their peers are doing, according to a new study by researchers from Stanford and Duke universities.

They found that investors "herd" around high flying investments, which enables them to feel like they are not left out of a winning strategy.

In fact, losing doesn't hurt as much in this case, as long as peers are also losing money.

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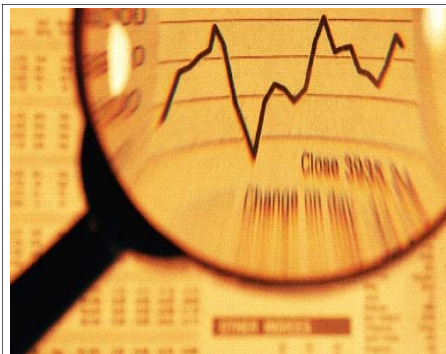
## ACTIVELY-MANAGED FUNDS PAY A PRICE FOR FOLLOWING THE MARKET

Investors buy actively managed stock mutual funds because they are looking for a portfolio that will beat the stock market.

Winning in this case usually means getting a higher return than is offered by broad stock market indexes, such as the Standard & Poor's 500 Index.

By definition, then, a portfolio manager who wants to beat the market has to invest in a manner that is different from the market, either by holding a different mix of stocks, or by timing when certain stocks or market sectors are bought and sold.

Such strategies entail some expense, because the fund manager can't simply buy and hold the same stocks as the stock index, but must do more trading and work to differentiate the portfolio.



Is your money manager doing his job or merely replicating an index at higher expense?

A new study of active management has found that some investors who think they are buying a fund with potential to beat the market instead are buying a "closet index" fund.

Martijn Cremers and Antti Petajisto of Yale University studied the composition and performance of U.S. stock funds between 1980 and 2003 and found that upwards

of 30% of the funds, with assets of \$1.3 trillion, were closet indexers in 2003.

They found few closet indexers among funds back in 1980. But in the 1990s, as closet indexing increased, it had an effect on fund performance, the study found.

Between 1990 and 2003, the average annual returns on funds identified as closet indexers underperformed the market by anywhere from 0.64% to 1.41% per year.

This difference pretty much corresponds to the average costs of running actively-managed mutual funds.

Investors who want to avoid under-performance should stick to true passive funds, which can operate with very low expense and therefore return to investors more of the market's gains.

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