THE QUARTERLY REVIEW

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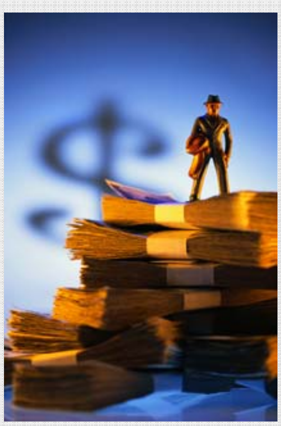
"To accept good advice is but to increase one's own ability."

Johann Wolfgang van Goether



"It is useless to reason someone out of a position she has not been reasoned into."

Jonathan Swift (Paraphrased)

Aubry Financial Group is excited to welcome a new member to our team.

With a bachelor's degree in Business Administration and Finance from Southeast Missouri State University, Mr. Jim Eustice has spent his entire career in the financial industry. Having been both a Chief Financial Officer and small business lender, he was one of the most respected small business lenders in the state of Illinois. As Jim began concentrating more of his time and efforts with small business owners, he developed a passion for helping them find financial protection and future security. Jim now has over fifteen years of experience helping small business owners take control of their financial futures.

Ten years into our friendship, I asked Jim to consider coming to work with Aubry Financial Group. With the experience Jim had gained while working with small business owners and his desire to see them financially secure, both he and I saw this as an opportunity of perfect fit.

Jim has now joined the Aubry Financial Group team and has quickly taken on the roles of Partner and Manager. Jim will head our Business Transitions department and has spent the past several months learning about our company and talking with individuals and business owners about how Aubry Financial Group can help them with their planning needs.

Jim lives in Ottawa, Illinois with his wife, Cathy, and their children, Sydney, Bryant and Carly. He can be reached by phone at (815) 313-1245 or by email at jim@aubrygroup.com. For Jim's full biography, please visit our website at www.aubrygroup.com/about/team.html.

Our main article for this newsletter is written by our Research Manager, Peter Brown. The article is about a topic that has received much publicity over the last several years – Behavioral Finance. Peter's article discusses why Aubry Financial Group sees *behavior management* as one the three determinants of financial success. It is a very thorough look, and enjoyable read, into why we as investors do the things that we do.

To your choices,

Mark J. Aubry, CEA, WMS

Behavioral Blind-Spots - Investing without Bias

When we speak with clients about financial success, we stress three main factors that ultimately determine the level of success: A customized financial plan, proper asset allocation, and behavior management. Customizing a financial plan and properly allocating assets are fairly straightforward in that they follow logical, scientific, and/or academic principles. It wouldn't make much sense to build a customized plan that put your investments in a 529 college savings plan if your children are already grown, nor would it make sense to allocate 75% of your investments to fixed income if you were in your early 30s. While there are exceptions to every rule, these two aspects of financial success have fairly clear-cut guidelines that we follow. As you might have already guessed, behavior management is not strictly limited to financial or economic principles and is largely an ambiguous topic. In my experience, this is not something taught in college nor a topic frequently discussed in the financial industry. This article will discuss behavior management to provide clarity and define its purpose in determining your financial success.

In 2002, Daniel Kahnemen, a psychology professor at Princeton University, received the Nobel Prize in economics for "having integrated insights for psychological research into economic science, especially concerning human judgment and decision-making." While psychology has influenced economic thought in the past, its importance to finance and economics is now recognized more than ever before. Behavioral finance (or behavioral economics) is a field of study that deals with human and social cognitive and emotional biases to better understand financial and economic decisions and how they affect market prices, rates of return, and the allocation of resources. Behavioral finance deeply integrates concepts of psychology, finance, and economics to understand the lack of rationality concerning economic agents.

There is almost an infinite number of topics concerning behavioral finance and economics – way too many to cover in this article. However, most topics stem from the cognitive biases or bounded rationality that affect our decision-making. Here is a list of just a few of the cognitive biases many of us have:

Bandwagon effect — the tendency to do (or believe) things because many other people do (or believe) the same
Confirmation bias — the tendency to search for or interpret information in a way that confirms one's preconceptions
Narrow framing — by using a too narrow approach or description of the situation or issue
Hyperbolic discounting — the tendency for people to have a stronger preference for more immediate payoffs relative to later payoffs
Illusion of control — the tendency for human beings to believe they can control or at least influence outcomes that they clearly cannot
Loss aversion — the disutility of giving up an object is greater than the utility associated with acquiring it.
Familiarity bias — the tendency for people to express undue liking for things merely because they are familiar with them
Neglect of probability — the tendency to completely disregard probability when making a decision under uncertainty
Outcome bias — the tendency to judge a decision by its eventual outcome instead of based on the quality of the decision at the time it was made
Post-purchase rationalization — the tendency to persuade oneself through rational argument that a purchase was a good value
Reactance - the urge to do the opposite of what someone wants you to do out of a need to resist a perceived attempt to constrain your freedom of choice
Status quo bias — the tendency for people to like things to stay relatively the same

Most of us can immediately relate to some of these biases. Have you ever heard your wife or girlfriend rationalize buying that $100 dress because it was on sale from $200? Guys, we're not innocent either. "But we *really* needed that lawnmower with twice the horsepower than conventional lawnmowers!" – both examples of post-purchase rationalization. The fact is that cognitive biases significantly affect outcomes and they need to be addressed to be sure they are not adversely affecting your financial success.

Emotional attachment: One of my finance professors in college once said "if you become emotionally attached to your investment, it's time to cut it loose." Personally, I couldn't think of a better piece of advice. One of the most costly mistakes the average investor will make is the heavy disposition to cut their losses. Research has shown that once a stock falls below the purchase price, a majority of investors become hopeful which encourages emotional attachment. It's not about what you paid for it but rather what you can get for it today. Instead of worrying about covering lost ground, you should be asking yourself if your portfolio is balanced and/or optimized.

Loss aversion: Loss aversion refers to the tendency for people to strongly prefer avoiding losses than acquiring gains. This may seem obvious at first, but it's a little more complicated than strictly that. Say you are offered a gamble that involves flipping a coin. If the coin lands heads up, you will win $110. If the coin lands tails up, you will lose $100. Take a moment and think about what you would do.

Statistically, over 95% of all respondents to this question would *not* take this bet. The satisfaction lost from losing

$100 is greater than the satisfaction gained from winning $110. In fact, most people are unwilling to take a bet similar to this one unless the upside is twice as much as the downside. That means you would have to win $200 for heads up and lose $100 for tails up. I'm obviously getting the short end of the stick just satisfy you. Since satisfaction is "the fulfillment of desires, expectations, needs, or demands" (all of which are subjective and emotionally based), it's evident that we need to stop using our emotions to make mathematical decisions. We can relate this type of gamble to a financial market. A place where there is constant buying (accepting a gamble) and selling (offering a gamble), capitalists markets cannot exist if we all expected to both accept and offer gambles that give us twice the payoff.

Narrow framing: Framing refers to the ability to perceive events in such a way as to encourage certain interpretations and to discourage others. To better illustrate this concept, let's refer back to the loss aversion gamble as an example. Since 95% of people that respond would refuse this bet, we will assume that you responded no. What if I offered you this gamble 50,000 times? What would you do then?

If your answer is still no, then you are utilizing narrow framing. People that use narrow framing view each risk they take in life (be that an investment, insurance decision, etc) as an isolated and mutually exclusive event from every other risk we take. Our concern for current financial stability inhibits our ability to see the "big picture." The fact is that there is a 1 in 5,000,000,000,000 chance that you would actually lose money if you took this gamble 50,000 times. Your expected return for this series of gambles is actually $250,000. Doesn't seem like such a bad gamble now. After we start perceiving our investments as an aggregated series of risks, the day to day market activity becomes inconsequential.

Familiarity bias: Failure to properly educate people on the basics of investing is a wide-spread phenomenon. Too many people are approaching retirement without the necessary means to live a comfortable lifestyle. When faced with investment decisions, most people do what a close friend recommends or whatever feels comfortable. In consumption theory, there is a systematically perverse bias to buy products that are familiar. For example, when buying laundry detergent, would you rather buy Tide, All, Clorox, etc ., or a brand that you've never heard of? Most people are unwilling to do the research necessary to buy the best product and will just go with a name brand to avoid this uncertainty. This applies to investing as well: would you rather own a share of Exxon Mobil or a share of Deluxe Corporation? Most people would choose Exxon Mobil, and while a sound investment decision, Deluxe Corporation would be a far more worthwhile investment over the past year. Buying your employer's stock because it's familiar or holding more domestic stocks than international stocks are both examples of setting your portfolio up for failure. Proper diversification depends on uncorrelated risks to reduce volatility. Holding disproportionate amounts of your employer's stock or domestic equities will simply kill your diversification efforts by piling up correlated risks. Familiarity and passivity are the culprits to destroying diversification efforts. We need to learn to stop investing in "familiar" stocks and recognize that assets in Europe or Asia are just as good for you (if not better) than stocks in the United States.

Overconfidence bias: Overconfidence refers to the human tendency to be more confident in one's behaviors and attributes than one ought to be. The following list describes a few of the overconfidence issues many of us face:

19% of people think they belong to the richest 1% of all U.S. households

82% of people say they are in the top 30% of safe drivers

80% of students think they will finish in the top half of their class

68% of lawyers in civil cases believe that their side will prevail

74% of professional fund managers believed they had delivered above-average job performance; the remaining 26% believed they had delivered average performance

Simply put, the majority of people are overconfident in at least one aspect of their lives. In investing, overconfidence is usually associated with high turnover and low levels of diversification. The combination of these two factors is deadly to a portfolio. Confidence is an important psychological support tool, but rationality and logic must provide a foundation for it. Don't be afraid to ask for help or admit lack of knowledge.

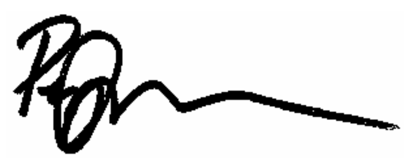
Bandwagon effect: The bandwagon effect refers to herding behavior which describes how individuals in a group can act together without planned direction. The term pertains to the behavior of animals in herds, flocks, and schools, and to human conduct during activities such as stock market bubbles and crashes, street demonstration, sporting events, episodes of mob violence, and even everyday decision making, judgment, and opinion forming.

FROM THE RESEARCH DESK...

Most of us can remember the rise of the tech bubble and its subsequent bursting. Trillions of investors' dollars were lost, yet this wasn't the first time financial markets had experienced this type of herding behavior. The Great Depression and Black Tuesday are just a few of the many cases that exhibit how detrimental the herd mentality can be. So why do we repeat these mistakes over and over? The first reason is the social pressure of conformity. The mob mentality has been proven to be a powerful force because people have a natural desire to be accepted by a group rather than be an outcast. A second reason is the logical mistake that it's unlikely such a large group of people could be wrong. Even if you have a suspicion or lack of knowledge concerning the trend, you're likely to follow anyway, believing they know something that you don't. This doesn't strictly apply to investors either – financial professionals often experience herding behavior. If the trend ends up working, the client is satisfied. If it doesn't, then the advisor tries to justify his or her actions by pointing the finger at all the other financial professionals who got it wrong.

The costs associated with herding behavior are enormous. For starters, investors that follow a herd will generate a large amount of turnover in their portfolio just to follow the "hot" sectors or stocks. If an investor hears that technology stocks are the best investments right now, he or she is likely to dump most of their available capital into the technology sector. If they hear medical companies are the new trend, they are likely to dump their technology stocks for medical sector investments. Besides the fact that the investor probably missed out on the prime period to own whichever stocks are "hot," the high turnover will quickly erode capital gains due to transaction costs – somewhere in the 5-8% range on average for this frequency of trading. Moreover, the biggest detriment the investor faces with herding behavior is erroneously overvalued stocks. The term that describes this type of security overvaluing is irrational exuberance (coined by Alan Greenspan in reference to the tech bubble). In simple terms, irrational exuberance describes how people are so absurdly enthusiastic about their new ownership interests that they cause massive overvaluing with completely illogical growth and earnings estimates. In the mid to late 90s, irrational exuberance was perpetuated by the herding financial professionals, the media, and novice investors who expected technology stocks to take off and never look back, all the while ignoring financial crises that had happened domestically in the past and currently in other countries (i.e. China, Japan) due to this same exact behavior. When everyone realizes that the market value of their securities are 3 to 4 times the book value of the corporation and earnings will never grow fast enough to keep up, the herd mentality continues in the opposite direction to correct for its complete lack of responsibility. This is the proverbial "bursting" of the bubble, leaving many investors with only a fraction of their investment capital left. It's hard to seeing the effects of such a large crash, but it exposes the harsh realities of leaving a sound, long-term investment strategy out of the picture.

Chances are that we've all been guilty of some of these biases, and it's easy to see how detrimental they can be to our assets. A mistake you never knew you were making could end up flipping your financial stability upside down. The bottom line is that Aubry Financial Group is here to help you with one main goal in behavior management – correcting your **bias blind spot**, or the tendency not to compensate for one's own cognitive biases. We'll help you approach investing with a more humble and patient attitude, avoiding "get rich quick" schemes and insignificant noise in the market. We partner with you as someone you can trust to answer any questions you may have regarding financial situations. Most importantly, we help you admit and learn from mistakes, learning the right lessons without panic or obsession. While we don't have a leather couch, you are welcome to talk through the psychology of investing with us at any time.. As always, contact us with any questions as we welcome the opportunity to spend time with you to review any issues you may have.



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