

The ABCs of Behavioral Biases: F-H

Let's continue our alphabetic tour of common behavioral biases that distract otherwise rational investors from making best choices about their wealth. Today, we'll tackle: fear, framing, greed and herd mentality.

Fear

What is it? You know what fear is, but it may be less obvious how it works. As Jason Zweig describes in "Your Money & Your Brain," if your brain perceives a threat, it spews chemicals like corticosterone that "flood your body with fear signals before you are consciously aware of being afraid." Some suggest this isn't really "fear," since you don't have time to think before you act. Call it what you will, this bias can heavily influence your next moves — for better or worse.

When is it helpful? Of course there are times you probably *should* be afraid, with no time for studious reflection about a life-saving act. If you are reading this today, it strongly suggests you and your ancestors have made good use of these sorts of survival instincts many times over.

When is it harmful? Zweig and others have described how our brain reacts to a plummeting market in the same way it responds to a physical threat like a rattlesnake. While you may be well-served to leap before you look at a snake, doing the same with your investments can bite you. Also, our financial fears are often misplaced. We tend to overcompensate for more memorable risks (like a flash crash), while ignoring more subtle ones that can be just as harmful or much easier to prevent (like inflation, eroding your spending power over time).

Framing

What is it? "Thinking, Fast and Slow," Nobel laureate Daniel Kahneman defines the effects of framing as follows: "Different ways of presenting the same information often evoke different emotions." For example, he explains how consumers tend to prefer cold cuts labeled "90% fat-free" over those labeled "10% fat."

By narrowly framing the information (fat-free = good, fat = bad; never mind the rest), we fail to consider all the facts as a whole.

When is it helpful? Have you ever faced an enormous project or goal that left you feeling overwhelmed? Framing helps us take on seemingly insurmountable challenges by focusing on one step at a time until, over time, the job is done. In this context, it can be a helpful assistant.

When is it harmful? To achieve your personal financial goals, you've got to do more than score isolated victories in the market; you've got to "win the war." As UCLA's Shlomo Benartzi describes in a *Wall Street Journal* piece, this demands strategic planning and unified portfolio management, with individual holdings considered within the greater context. Investors who instead succumb to narrow framing often end up falling off-course and incurring unnecessary costs by chasing or fleeing isolated investments.

Greed

What is it? Like fear, greed requires no formal introduction. In investing, the term usually refers to our tendency to (greedily) chase hot stocks, sectors or markets, hoping to score larger-than-life returns. In doing so, we ignore the oversized risks typically involved as well.

When is it helpful? In Oliver Stone's Oscar-winning "Wall Street," Gordon Gekko (based on the notorious real-life trader Ivan Boesky) makes a valid point . . . to a point: "[G]reed, for lack of a better word, is good. . . . Greed, in all of its forms; greed for life, for money, for love, knowledge has marked the upward surge of mankind." In other words, there are times when a little greed — call it ambition — can inspire greater achievements.

When is it harmful? In our cut-throat markets (where you're up against the Boesky's of the world), greed and fear become a two-sided coin that you flip at your own

peril. Heads or tails, both are accompanied by chemical responses to stimuli we're unaware of and have no control over. Overindulging in either extreme leads to unnecessary trading at inopportune times.

Herd Mentality

What is it? Mooove over, cows. You've got nothing on us humans, who instinctively recoil or rush headlong into excitement when we see others doing the same. "[T]he idea that people conform to the behavior of others is among the most accepted principles of psychology," say Gary Belsky and Thomas Gilovich in "Why Smart People Make Big Money Mistakes."

When is it helpful? If you've ever gone to a hot new restaurant, followed a fashion trend, or binged on a hit series, you've been influenced by herd mentality. "Mostly such conformity is a good thing, and it's one of the reasons that societies are able to function," say Belsky and Gilovich. It helps us create order out of chaos in traffic, legal and governmental systems alike.

When is it harmful? Whenever a piece of the market is on a hot run or in a cold plunge, herd mentality intensifies our greedy or fearful chain reaction to the random event that generated the excitement to begin with. Once the dust settles, those who have reacted to the near-term noise are usually the ones who end up overpaying for the "privilege" of chasing or fleeing temporary trends instead of staying the course toward their long-term goals. As Warren Buffett has famously said, "Investors should remember that excitement and expenses are their enemies. And if they insist on trying to time their participation in equities, they should try to be fearful when others are greedy and greedy only when others are fearful."

Well said, Mr. Buffett! We've got more behavioral biases to cover in upcoming installments, so stay tuned.

David Bromelkamp
President and CEO

Headlines

- We enjoyed an informative evening with clients learning about tax reform at our 2018 Spring Wealth Management Workshop at Olsen Thielen. Scott Hoyles and Joseph Mayer were the guest speakers.
- Allodium was pleased to welcome two new clients in the first quarter of 2018.
- Our office will be closed July 4th and September 3rd for company holidays.
- Just a reminder that you can now reach Allodium at www.allodium.com. We will be transitioning gradually over the next year, so you can still find us at www.aicria.com. Employee email addresses will also be transitioning to the new domain of @allodium.com over the course of the year.

Note: To find out more about Allodium's breaking news, please visit our website: www.allodium.com.

Upcoming Events

September 12, 2018:

Dave Bromelkamp will be a moderator at the Markets Group 5th Annual Great Plains Institutional Forum at the Hyatt Regency in Minneapolis. He will moderate the panel on "Environmental, Social, and Corporate Governance (ESG) Integration."

September 13, 2018:

Dave Bromelkamp will be a speaker at the Markets Group 3rd Annual Private Wealth Great Plains Forum at the Hyatt Regency in Minneapolis. His topic will be "The Future of Wealth Management."

September 27, 2018:

Watch for Allodium's 2018 Fall Wealth Management Workshop titled "Passion to Impact: Generous and Powerful Charitable Giving." More details coming soon.

For more information about this event, please contact Ilona Avraamides at (612) 230-3711 or iavraamides@allodium.com.

FINANCIAL PLANNING TIP:

New Tax Laws — Plan Ahead for 2018

As the details of the new tax reform is becoming more understood, now is a great time to start planning for the 2018 tax year. You have probably completed last year's tax return or you have prepared an estimate. With that information, you should be able to begin making projections using the new tax laws.

For those of you who are employed, we advise that you reexamine your tax withholding from your paycheck. The IRS recently released an updated withholding calculator that reflects the changes under the new tax law. It is recommended that taxpayers double-check withholdings, especially if you are in a two-income family, claim the child tax credit, itemize, or have complex returns. You can find the new withholding calculator here: <https://apps.irs.gov/app/withholdingcalculator>.

Plan Ahead

While planning ahead for the new tax year, you'll also want to talk with your tax professional and financial advisor about how the new tax law impacts your financial planning and investments. There are several opportunities to consider such as:

- Contributing directly to charity from an IRA (if you are 70½ or older)
- Donating appreciated securities to a donor advised fund or directly to charity
- Increasing your retirement plan contributions to align with the new limits
- Roth conversions and back-door Roth IRA contributions
- Reviewing how you pay your investment management fees

Please let us know if you would like a review of your financial situation in light of the new tax laws.

WE APPRECIATE YOUR INTRODUCTIONS

To optimize our objectivity and avoid conflicts of interest, we are a fee-only registered investment advisor that is completely independent from banks, brokerage firms and other financial product providers. If you know someone who may be looking for this type of objective investment advice, please contact Dave Bromelkamp at 612-230-3702 or dbromelkamp@allodium.com to arrange a friendly, no-obligation introduction.

"The Stock Market is designed to transfer money from the Active to the Patient."

~Warren Buffett, CEO & Investor

Steward is published quarterly by Allodium Investment Consultants. Please contact Ilona Avraamides at 612-230-3711 or iavraamides@allodium.com if you have any comments about this publication or wish to be added to or removed from our mailing list.

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