

## INSIGHT & OUTLOOK

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### Investors Behaving Badly

Over two hundred years ago Benjamin Franklin wrote, "I conceive that the great part of the miseries of mankind are brought on them by false estimates they have made of the value of things." That astute observation is just as valid today, particularly when applied to investments. A relatively new field of study, behavioral finance, has insights into why investors are prone to making "false estimates."

Investors face a challenging task. They must make their decisions in an environment of uncertainty. They must constantly make judgments about the probabilities of a range of outcomes, assign values to those outcomes, and combine those judgments and values to form a course of action. Unfortunately, they are susceptible to errors every step of the way. We will examine a few of them below.

#### *Judgment Biases*

- Overconfidence

When surveyed, 80% of registered drivers rate themselves as "above average" drivers. Simple statistics tells us that many of those drivers overestimate their skill. Research shows that most people have an exaggerated belief in their abilities whether it be driving, handicapping horses, or assessing the outlook for the financial markets. Overconfidence can lead investors to underestimate the risk (and consequences) of outcomes they confidently believe are unlikely. Therefore they unknowingly take on more risk than they think.

***ADVICE TO INVESTORS: CONSIDER THE VIEWPOINTS OF THOSE WHO DIS-AGREE WITH YOU. CHALLENGE YOUR ASSUMPTIONS.***

- Self-Attribution Bias

Overconfidence is often coupled with a form of self-deception which interferes with investors' ability to learn from mistakes. Typically, investors with this bias attribute good outcomes to their skill and insight while blaming poor outcomes on "bad luck", poor advice, or some other external cause.

***ADVICE TO INVESTORS: BE BRUTALLY HONEST IN ASSESSING WHAT WENT WRONG WITH AN INVESTMENT. TRY TO LEARN FROM IT.***

- Hindsight Bias

Research indicates that most people cannot accurately remember what they thought at the time regarding the probability of a future event. After it has occurred their recollection is "Sure, I saw that coming, it was obvious". Just look at how many financial pundits claim they called the dot-com bubble in 2000.

Hindsight errors are dangerous to investors' financial health for two reasons. One, they reinforce overconfidence by encouraging the illusion that financial events are more predictable than they actually are. Two, they

#### Inside this Issue:

FLP Update - Page 3  
Q & A - Page 4  
Reduced Fees! - Page 4

"GIVE NO DECISION TILL BOTH SIDES THOU'ST HEARD."

PHOCYLIDES

## Investors Behaving Badly (continued)

change what were justifiable decisions at the time into egregious errors in the minds of investors if those decisions do not work out as anticipated. For example, after a stock has risen, to those with hindsight bias its rise appears to have been inevitable. They think, “So why didn’t my advisor buy it before it went up?”

**ADVICE TO INVESTORS: REMEMBER THAT HINDSIGHT IS ALWAYS 20-20. INVESTING, LIKE BRIDGE, IS A GAME OF PROBABILITIES—DON’T TREAT IT LIKE A CHESS MATCH.**

### *Information Processing Errors*

Next, we move to errors investors make in assigning values to possible outcomes and in forming preferences about which action to take.

- Mis-weighting Probabilities

Research shows that most people systematically overweight low probability events and underweight high probability ones. This explains why people like long shots compared to other outcomes with equal expected values. For example, most people prefer a 1% chance of winning \$1000 to an outright gift of \$10. A rational decision maker would be indifferent because their expected values (probability of occurrence times the payoff) are identical i.e.  $1\% \times \$1000 = \$10$ ,  $100\% \times \$10 = \$10$ . State lotteries depend on this common processing error for their success. Of course the payoffs are larger but the probabilities are far, far lower.

This tendency to mis-weight probabilities also shows itself in a variety of investment guises. Investors tend to pay too much for out-of-the-money options, they tend to cling to shattered stocks in the hope they will come back, and they tend to pay too much for hot growth stocks.

**ADVICE TO INVESTORS: BE WARY OF THE TENDENCY TO MIS-WEIGHT PROBABILITIES AND ATTEMPT TO BE COLDLY ANALYTICAL IN ASSIGNING YOUR WEIGHTS.**

“WHERE FACTS  
ARE FEW,  
EXPERTS ARE  
MANY.”

DONALD R. GANNON

- Loss Aversion

Repeated studies have shown that, on average, investors weigh losses about 2.5 times more heavily than gains. In layman’s terms, the pain of a loss far outweighs the pleasure of a gain. This aversion to loss is perfectly understandable. Unfortunately it leads some investors into making suboptimal decisions. The worst is refusing to sell at a loss. Some investors are very reluctant to admit they made a mistake (self-attribution bias) so they cling to the hope that the investment will rally. They rationalize, “It’s not a loss unless I sell”. So they don’t. As a result their portfolio begins to fill up with underperforming “cats and dogs”.

Loss aversion can also paralyze some investors from investing in assets that offer good long term payoff probabilities because they can’t tolerate those investments’ short term volatility. Common stocks come readily to mind.

**ADVICE TO INVESTORS: SELL YOUR LOSERS AND LET YOUR WINNERS RUN. REMEMBER NO ONE BATS 1.000 SELECTING INVESTMENTS SO SOME LOSERS ARE INEVITABLE. FOCUS ON THE LONG RUN.**

### *The Foundation for Sound Decisions*

An important caveat exists in overcoming obstacles to sound decision-making. Investors should always remember that facts are the foundation - get the facts wrong and even the most analytical and objective decision process will produce the wrong answer and unsatisfactory results. As the great investor/speculator Bernard Baruch put it, “Every man has a right to his opinion, but no man has a right to be wrong in his facts”.

Here at Patton Albertson & Miller we strive to be right about our facts. We hope we can do an equally good job minimizing the investor pitfalls outlined above.

*Bill Miller*

## Family Limited Partnership Update

Last quarter's *Insight & Outlook* discussed Family Limited Partnerships ("FLP") and specifically how to minimize the risk of a bad audit by the IRS. Since that publication, taxpayers have received a bit of good news from the United States Fifth Circuit Court of Appeals which, on May 20, 2004, returned a positive decision for taxpayers who use the FLP strategy. In this case, *D. Kimbell, Sr., Exr., 2004-1 USTC ¶60,486*, the IRS made a section 2036(a) argument. This argument, in layman's terms, tries to paint family limited partnerships as estate tax avoidance schemes without economic substance. At the heart of the argument is whether the transferor (the contributor of assets to the partnership) retains too much control for the transfer to be considered a "bona fide sale." The following facts were significant in the Kimbell case and, most professionals would agree, played an important role in the favorable finding:

1. The decedent (transferor) retained enough assets outside the FLP for her support.
2. There were no personal use assets contributed to, or mingled with, the FLP.
3. Assets contributed to the FLP, or at least a portion of them, required active management.
4. There was a purpose for creating the FLP beyond what could be accomplished by a trust.
5. The creation and funding of the FLP was done properly and in accordance with the applicable state law.

**"ONLY THE LITTLE  
PEOPLE PAY  
TAXES."**

LEONA HELMSLEY  
HOTEL OWNER &  
PRISON INMATE  
1989

So what does this all mean for those who have already created, or may be considering the creation, of a FLP? Clearly, the Kimbell case was a defeat for the IRS but, as positive as the outcome was, there are also some cautions to be heeded. The moral of the Kimbell case would seem to be that the use of Family Limited Partnerships is alive and well provided the taxpayer "plays by the rules." In summary those rules are:

- Form and fund the FLP properly. An attorney experienced in the creation of FLP's can help in this regard.
- Run it like a business. Holding regular partnership meetings and paying the general partner a fee for his or her work are two examples.
- Keep good records. Minutes, meeting agenda's and a check register free from personal transactions are a good starting point.
- Have a purpose beyond saving estate tax. Educating the next generation on the business of managing the family wealth would be an example but there are others.
- Do not contribute personal use assets to the partnership. No homes, vacation homes, etc. If you have contributed a personal use asset then make sure you pay a market rate of rent to the partnership for its use.
- Have all assets in the partnership appraised. Use someone experienced with FLP valuations and discounting. Make sure the assumptions used are reasonable.
- Make distributions from the partnership in proportion to ownership. If you own 1% of the partnership you can't receive 50% of each distribution.

Of course, we would add one more at the risk of sounding self serving: employ experienced professionals to help make sure you "play by the rules." Patton Albertson & Miller specializes in Family Limited Partnership administration. We would be happy to talk with you about your situation whether you already have a partnership or might be considering the formation of a partnership.



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## Questions & Answers

- Q. In today's investment climate picking stocks successfully seems almost impossible. Should I consider putting my money into "index funds" and just forget about trying to select stocks?
- A. We don't think so. Indexing was certainly a successful strategy during the 1980's and 1990's as the bull market ran basically uninterrupted for 18 years. The old saying "a rising tide floats all boats" was certainly descriptive of how index funds performed during that great bull market. However, if you look back over the past 80 years the New York Stock Exchange has had three great bull markets: 1920-1929; 1949-1965; and 1981-1999. Each of these bull markets were followed by prolonged periods in which the market went sideways; that is, several mini bull runs followed by a pullback that put the market back to exactly where it began. For example, if index funds had been in existence in 1966 you would have held that fund for 16 years (until 1982) with a zero return! We think we are in a similar type of market today where the general momentum is "sideways." This means that individual stock selections are much more important than in the 1990's and indexing will likely be an underperforming strategy.

## Fees are Going Down ! ↓

We are pleased to announce that Fidelity Investments has lowered its minimum trading commission on trades of less than 1,000 shares from \$24.95 to \$17.95, a 28% reduction! The good news does not stop there, however.

The per share cost of 3¢ on trades of 1,000 shares or greater is being lowered to 1.5¢. For those clients with an account of \$1,000,000 or more the cost is now \$8 per trade up to 3,000 shares and 1¢ per share on trades greater than 3,000 shares! Of course, all of this savings is passed right through to our clients. From inception Patton Albertson & Miller has been, and will continue to operate as, a "fee only" advisory firm. That means we receive compensation only from our clients. We don't accept commissions, soft dollar compensation, referral fees, 12b(1) trailer fees or any other form of compensation that would conflict with our clients' interests. When our trading commissions go down we pass every nickel of that savings back to our clients.

*Now when is the last time your financial services provider wrote to tell you your fees were going down?*