



July 2016 Newsletter

Newsletter

Investors Are Human, Too



In 1981, the Nobel Prize-winning economist Robert Shiller published a groundbreaking study that contradicted a prevailing theory that markets are always efficient. If they

were, stock prices would generally mirror the growth in earnings and dividends. Shiller's research showed that stock prices fluctuate more often than changes in companies' intrinsic valuations (such as dividend yield) would suggest.¹

Shiller concluded that asset prices sometimes move erratically in the short term simply because investor behavior can be influenced by emotions such as greed and fear. Many investors would agree that it's sometimes difficult to stay calm and act rationally, especially when unexpected events upset the financial markets.

Researchers in the field of behavioral finance have studied how cognitive biases in human thinking can affect investor behavior. Understanding the influence of human nature might help you overcome these common psychological traps.

Herd mentality

Individuals may be convinced by their peers to follow trends, even if it's not in their own best interests. Shiller proposed that human psychology is the reason that "bubbles" form in asset markets. Investor enthusiasm ("irrational exuberance") and a herd mentality can create excessive demand for "hot" investments. Investors often chase returns and drive up prices until they become very expensive relative to long-term values.

Past performance, however, does not guarantee future results, and bubbles eventually burst. Investors who follow the crowd can harm long-term portfolio returns by fleeing the stock market after it falls and/or waiting too long (until prices have already risen) to reinvest.

Availability bias

This mental shortcut leads people to base judgments on examples that immediately come to mind, rather than examining alternatives. It may cause you to misperceive the likelihood or frequency of events, in the same way that watching a movie about sharks can make it seem more dangerous to swim in the ocean.

Confirmation bias

People also have a tendency to search out and remember information that confirms, rather than challenges, their current beliefs. If you have a good feeling about a certain investment, you may be likely to ignore critical facts and focus on data that supports your opinion.

Overconfidence

Individuals often overestimate their skills, knowledge, and ability to predict probable outcomes. When it comes to investing, overconfidence may cause you to trade excessively and/or downplay potential risks.

Loss aversion

Research shows that investors tend to dislike losses much more than they enjoy gains, so it can actually be painful to deal with financial losses.² Consequently, you might avoid selling an investment that would realize a loss even though the sale may be an appropriate course of action. The intense fear of losing money may even be paralyzing.

It's important to slow down the process and try to consider all relevant factors and possible outcomes when making financial decisions. Having a long-term perspective and sticking with a thoughtfully crafted investing strategy may also help you avoid expensive, emotion-driven mistakes.

Note: All investments are subject to market fluctuation, risk, and loss of principal. When sold, investments may be worth more or less than their original cost.

¹ *The Economist*, "What's Wrong with Finance?" May 1, 2015

² *The Wall Street Journal*, "Why an Economist Plays Powerball," January 12, 2016

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Clients and Friends:

Set of new trekking poles: \$100
New backpack : \$280
Philmont trek cost: \$890
Spending two weeks with your son, away from phones and electronics: Priceless

I returned on July 6th from a "twice in a lifetime" 2 week backpacking trip with my son to the Philmont Scout Ranch in New Mexico. Other than the time with my son, the other highlight was seeing a mountain lion from about 150 feet. That is a sight that very few people ever get to see.

The first article in this newsletter reviews the psychology of investing, and discusses a variety of biases that some investors have.

The second article talks about preparing to retire in a volatile market (as we have had this year.)

The third article discusses four reasons that people spend too much (or more than they would like.) You may not fall into any of these categories, but you may have someone close to you who does.

Finally the two articles on the fourth page discuss US Savings Bonds.

Happy reading, and please let me know if you have any questions.
Eric

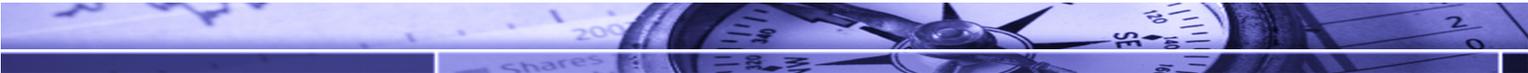
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Be Prepared to Retire in a Volatile Market

Four Reasons Why People Spend Too Much

I have matured U.S. savings bonds. Are they still earning interest and, if not, can I roll them over to another savings bond?



Market losses on the front end of your retirement could have an outsized effect on the income you might receive from your portfolio.

Be Prepared to Retire in a Volatile Market

In an ideal world, your retirement would be timed perfectly. You would be ready to leave the workforce, your debt would be paid off, and your nest egg would be large enough to provide a comfortable retirement--with some left over to leave a legacy for your heirs.

Unfortunately, this is not a perfect world, and events can take you by surprise. In a survey conducted by the Employee Benefit Research Institute, only 44% of current retirees said they retired when they had planned; 46% retired earlier, many for reasons beyond their control.¹ But even if you retire on schedule and have other pieces of the retirement puzzle in place, you cannot predict the stock market. What if you retire during a market downturn?

Sequencing risk

The risk of experiencing poor investment performance at the wrong time is called sequencing risk or sequence of returns risk. All investments are subject to market fluctuation, risk, and loss of principal--and you can expect the market to rise and fall throughout your retirement. However, market losses on the front end of your retirement could have an outsized effect on the income you might receive from your portfolio.

If the market drops sharply before your planned retirement date, you may have to decide between retiring with a smaller portfolio or working longer to rebuild your assets. If a big drop comes early in retirement, you may have to sell investments during the downswing, depleting assets more quickly than if you had waited and reducing your portfolio's potential to benefit when the market turns upward.

Dividing your portfolio

One strategy that may help address sequencing risk is to allocate your portfolio into three different buckets that reflect the needs, risk level, and growth potential of three retirement phases.

Short-term (first 2 to 3 years): Assets such as cash and cash alternatives that you could draw on regardless of market conditions.

Mid-term (3 to 10 years in the future): Mostly fixed-income securities that may have moderate growth potential with low or moderate volatility. You might also have some equities in this bucket.

Long-term (more than 10 years in the future): Primarily growth-oriented investments such as stocks that might be more volatile but have higher growth potential over the long term.

Throughout your retirement, you can periodically move assets from the long-term

bucket to the other two buckets so you continue to have short-term and mid-term funds available. This enables you to take a more strategic approach in choosing appropriate times to buy or sell assets. Although you will always need assets in the short-term bucket, you can monitor performance in your mid-term and long-term buckets and shift assets based on changing circumstances and longer-term market cycles.

If this strategy appeals to you, consider restructuring your portfolio before you retire so you can choose appropriate times to adjust your investments.

Determining withdrawals

The three-part allocation strategy may help mitigate the effects of a down market by spreading risk over a longer period of time, but it does not help determine how much to withdraw from your savings each year. The amount you withdraw will directly affect how long your savings might last under any market conditions, but it is especially critical in volatile markets.

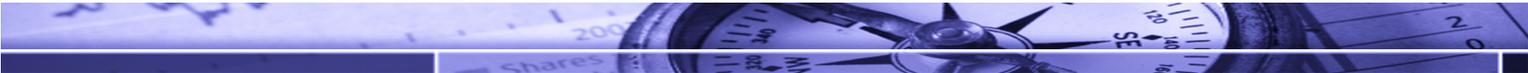
One common rule of thumb is the so-called 4% rule. According to this strategy, you initially withdraw 4% of your portfolio, increasing the amount annually to account for inflation. Some experts consider this approach to be too aggressive--you might withdraw less depending on your personal situation and market performance, or more if you receive large market gains.

Another strategy, sometimes called the endowment method, automatically adjusts for market performance. Like the 4% rule, the endowment method begins with an initial withdrawal of a fixed percentage, typically 3% to 5%. In subsequent years, the same fixed percentage is applied to the remaining assets, so the actual withdrawal amount may go up or down depending on previous withdrawals and market performance.

A modified endowment method applies a ceiling and/or a floor to the change in your withdrawal amount. You still base your withdrawals on a fixed percentage of the remaining assets, but you limit any increase or decrease from the prior year's withdrawal amount. This could help prevent you from withdrawing too much after a good market year, while maintaining a relatively steady income after a down market year.

Note: Asset allocation is a method used to help manage investment risk; it does not guarantee a profit or protect against investment loss.

¹ Employee Benefit Research Institute, "2016 Retirement Confidence Survey"



Four Reasons Why People Spend Too Much



You may be more likely to overspend on a particular purchase compared to other possible expenditures. According to research conducted by the Consumer Reports National Research Center, adults in the United States reported that they would spend money on the following throughout the year:

- 54%--electronics
- 33%--appliances
- 27%--a car
- 23%--home remodeling

Source: Consumer Reports, November 2014

You understand the basic financial concepts of budgeting, saving, and monitoring your money. But this doesn't necessarily mean that you're in control of your spending. The following reasons might help explain why you sometimes break your budget.

1. Failing to think about the future

It can be difficult to adequately predict future expenses, but thinking about the future is a key component of financial responsibility. If you have a tendency to focus on the "here and now" without taking the future into account, then you might find that this leads you to overspend.

Maybe you feel that you're acting responsibly simply because you've started an emergency savings account. You might feel that it will help you cover future expenses, but in reality it may create a false sense of security that leads you to spend more than you can afford at a given moment in time.

Remember that the purpose of your emergency savings account is to be a safety net in times of financial crisis. If you're constantly tapping it for unnecessary purchases, you aren't using it correctly.

Change this behavior by keeping the big picture in perspective. Create room in your budget that allows you to spend discretionary money and use your emergency savings only for true emergencies. By having a carefully thought-out plan in place, you'll be less likely to overspend without realizing it.

2. Rewarding yourself

Are you a savvy shopper who rarely splurges, or do you spend too frequently because you want to reward yourself? If you fall in the latter category, your sense of willpower may be to blame. People who see willpower as a limited resource often trick themselves into thinking that they deserve a reward when they are able to demonstrate a degree of willpower. As a result, they may develop the unhealthy habit of overspending on random, unnecessary purchases in order to fulfill the desire for a reward.

This doesn't mean that you're never allowed to reward yourself--you just might need to think of other ways that won't lead to spending too much money. Develop healthier habits by rewarding yourself in ways that don't cost money, such as spending time outdoors, reading, or meditating. Both your body and your wallet will thank you.

If you do decide to splurge on a reward from time to time, do yourself a favor and plan your purchase. Figure out how much it will cost ahead of time so you can save accordingly instead of tapping your savings. Make sure that your reward, whether it's small or big, has a purpose and is meaningful to you. Try scaling back. For example, instead of dining out every weekend, limit this expense to once or twice a month. Chances are that you'll enjoy going out more than you did before, and you'll feel good about the money you save from dining out less frequently.

3. Mixing mood with money

Your emotional state can be an integral part of your ability to make sensible financial decisions. When you're unhappy, you might not be thinking clearly, and saving is probably not your first priority. Boredom or stress also makes it easy to overspend because shopping serves as a fast and easy distraction from your feelings. This narrow focus on short-term happiness might be a reason why you're spending more than normal.

Waiting to spend when you're happy and thinking more positively could help shift your focus back to your long-term financial goals. Avoid temptations and stay clear of stores if you feel that you'll spend needlessly after having an emotionally challenging day. Staying on track financially (and emotionally) will benefit you in the long run.

4. Getting caught up in home equity habits

Do you tend to spend more money when the value of your assets--particularly your property--increases? You might think that appreciating assets add to your spending power, thus making you feel both wealthier and more financially secure. You may be tempted to tap into your home equity, but make sure you're using it wisely.

Instead of thinking of your home as a piggy bank, remember it's where you live. Be smart with your home equity loan or line of credit--don't borrow more than what is absolutely necessary. For example, you may need to borrow to pay for emergency home repairs or health expenses, but you want to avoid borrowing to pay for gratuitous luxuries that could put you and your family's financial security at risk. After all, the lender could foreclose if you fail to repay the debt, and there may be closing costs and other charges associated with the loan.

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I have matured U.S. savings bonds. Are they still earning interest and, if not, can I roll them over to another savings bond?

Once U.S. savings bonds have reached maturity, they stop earning interest. Prior to 2004, you could convert your Series E or EE savings bonds for Series HH bonds. This would have allowed you to continue earning tax-deferred interest. However, after August 31, 2004, the government discontinued the exchange of any form of savings bonds for HH bonds, so that option is no longer available.

Since matured savings bonds no longer earn interest, there is no financial benefit to holding on to them. If you have paper bonds, you can cash them in at most financial institutions, such as banks or credit unions. However, it's a good idea to call a specific institution before going there to be sure it will redeem your bonds. As an alternative, you can mail them to the Treasury Retail Securities Site, PO Box 214, Minneapolis, MN 55480, where they will be redeemed. If you have electronic bonds, log on to treasurydirect.gov and follow the directions there. The proceeds from your redeemed bonds can be deposited directly into your checking or savings account for a relatively

quick turnover. Another important reason to redeem your matured savings bonds may be because savings bond interest earnings, which can be deferred, are subject to federal income tax when the bond matures or is otherwise redeemed, whichever occurs first. So if you haven't previously reported savings bond interest earnings, you must do so when the bond matures, even if you don't redeem the bonds.

Using the money for higher education may keep you from paying federal income tax on your savings bond interest. The savings bond education tax exclusion permits qualified taxpayers to exclude from their gross income all or part of the interest paid upon the redemption of eligible Series EE and I bonds issued after 1989 when the bond owner pays qualified higher-education expenses at an eligible institution. However, there are very specific requirements that must be met in order to qualify, so consult with your tax professional.



How many types of government savings bonds are there, and what's the difference between them?

While the U.S. government has issued 13 types of savings bonds, there are currently only two series available for

purchase through the U.S. Treasury Department: Series EE bonds and Series I bonds. U.S. savings bonds are nonmarketable securities, which means you can't resell them unless you're authorized as an issuing or redeeming agent by the U.S. Treasury Department. Savings bonds are guaranteed by the federal government as to the timely payment of principal and interest.

You can buy Series EE bonds and I bonds in any amount from \$25 up to \$10,000, which is the maximum amount you can purchase for each bond type per calendar year. In other words, you may buy a total of \$10,000 annually in both EE and I bonds, for an annual total of \$20,000 for the two types combined.

Series EE bonds earn a fixed rate of interest as long as you hold them, up to 30 years. You'll know the interest rate the bond will earn when you buy it. The U.S. Treasury announces the rate each May 1 (for new EE bonds issued between May 1 and October 31) and November

1 (for new EE bonds issued between November 1 and April 30).

Series I bonds are similar to EE bonds, but I bonds offer some protection against inflation by paying interest based on a combination of a fixed rate and a rate tied to the semi-annual inflation rate. The fixed rate component doesn't change, whereas the rate tied to inflation is recalculated and can change every six months. The total interest (fixed and inflation adjusted) compounds semi-annually.

In any case, the interest on EE or I savings bonds isn't paid to you until you cash in the bonds. You can cash in EE bonds or I bonds any time after one year, but if you cash them out before five years, you lose the last three months of interest.

The interest earned on both EE and I bonds is generally exempt from state income tax but subject to federal income tax. Interest income may be excluded from federal income tax when bonds are used to finance higher-education expenses, although restrictions may apply.