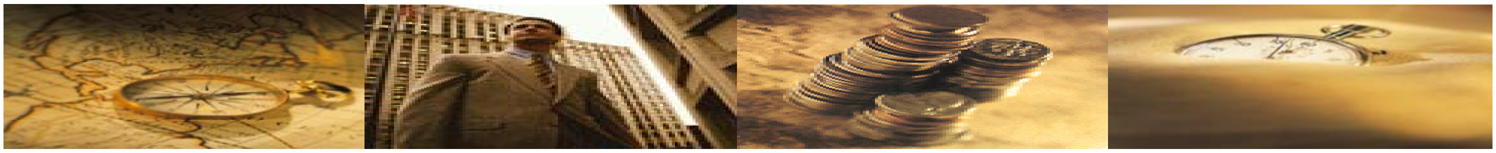

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FLAWED THINKING

Why do seemingly rational, intelligent people make poor financial decisions? Often the reason is an inaccurate perspective; the decisions may be logical, but the assumptions are faulty. If you believe you can fly, it's logical to jump off a 20-story building. The problem isn't with your logic, but your underlying assumptions on gravity and human capabilities.

Financial evaluations may seem to begin and end with numbers. But like everywhere else, ideas matter. Good financial assumptions can be expected to deliver good results. In contrast, the financial consequences of bad assumptions may range from inconsistent performance to catastrophic losses.

Here are three examples of flawed thinking in regard to financial matters, and some ways to keep inaccurate perspectives from creeping into your financial world: Y2K, A Nirvana Mindset, and WACronyms.

"It's tough to make predictions, especially about the future." - Yogi Berra

Y2K: 10 Years After

Ten years ago was January 2000. It was the beginning of a new year, a new decade, a new century, and a new millennium.

Hard to believe it was 10 years ago, isn't it? What do you remember about that momentous date in history? Do you remember…

- The price of gas? (National average was 1.51/gal.)
- Who was president?
  (Bill Clinton was wrapping up his second term)
- The predictions for the future?
  (Ah yes, the predictions…)

Apocalyptic, optimistic…& completely wrong

You do remember Y2K, don't you? The need to change the date format in computers from "1999" to "2000" was going to wreak havoc on society. The prospect of damage was so great, in the words of one computer programmer,

> "We must also prepare ourselves for the very real possibility that the outcome of this situation might well be the total extinction of the entire human race. It really could be worse than I am predicting and I really am being optimistic…"

But it wasn't just the Y2K problem that was a cause for concern…

> Richard W. Noone, author of "5/5/2000: Ice: The Ultimate Disaster" (Crown, 1997), claimed that May 5, 2000 was when Mercury, Venus, Mars, Jupiter and Saturn would be aligned with the Earth for the first time in 6,000 years. On that day, he predicted an ice buildup at the South Pole would upset Earth's axis and send "trillions of tons" of ice and debris "toppling into our oceans, flooding the planet and destroying all known forms of life."

Not every prediction for the new millennium was apocalyptic. Some people were incredibly optimistic.

> In 2000, Harry Dent, a financial analyst and author of several books on investing, predicted the Dow Jones Industrial Average would exceed 40,000 during the next decade. 40,000 would represent a huge increase since the DJIA was just below 11,500 on January 1, 2000.

Uh, just to review…The Y2K problem was a non-issue. And while global warming may cause climate change, there was not a natural disaster caused by ice *(and a book written by "Noone" might actually be "no one," even if it is available on Amazon)*. The DJIA index peaked at 14,164 on October 9, 2007 and then retreated, falling as low as 6,547 on March 9, 2009, a decline of 53% in 17 months. As of December 15, 2009, the DJIA recovered to stand at 10,501, but nobody thinks the Dow will reach 40,000 by December 31, 2009. Like a lot of other prognostications, both fearful and exciting, these guesses were way off target.

There were, however, some momentous and unexpected events during the decade, both apocalyptic and optimistic. There was a contested presidential election, the 9-11 terrorist attacks, the war in Iraq, and the mortgage and financial failures that led to the deepest recession since the Great Depression. After being shut out for 86 years, the Red Sox won the World Series twice in the past decade! Gold rose to more than $1,200/oz. and gasoline passed $4.00/gal. And what about Blackberries and iPhones and Wii Fit? Who could have imagined, right?

No one sees the future, but everyone keeps looking.

The truth is we are constantly surprised by what comes next. In hindsight, we may be able to see how things took place, but rarely can we see clearly what's ahead. Most of the time, the historically significant changes are the ones that no one recognizes at the time. When the first transistors, computer chips, and fiber optics were developed, how could anyone have the insight to see them as the building blocks for cell phones, laptop computers, and the Internet?

Yet because we are intensely interested in the future, particularly as it relates to us, our inability to accurately predict it doesn't deter people from trying – or from making outrageous predictions. People still read horoscopes, still pay for a psychic hotline, and still subscribe to financial newsletters claiming "insider information" about the stock market. Whether it's a vision of impending disaster or great financial opportunity, there's an almost irresistible attraction to a message with a TEOTWAWKI element, i.e., the-end-of-the-world-as-we-know-it. Or as one marketing campaign put it "this changes everything."

Resisting the Prediction Impulse

There are two practical ways to blunt the impact of predictions on your financial life.

First, follow the money. Remember, there is often a profit motive attached to the prediction. If someone wants to charge you for an exclusive look at the future, it should give you pause. One Y2K doom-and-gloom futurist who has moved on to predicting other end-of-civilization scenarios has the nickname "Scary Gary," because he constantly promotes the next "big problem." Not surprisingly, he also has the next answer – for a price. If the prediction is coupled with an inducement to make a financial decision that enriches the predictor, be careful.

Second, sound principles for present circumstances usually trump unique predictions and strategies for the future. There are time-tested financial principles with a track record of success, and there are "special situations" that supposedly require a unique approach because "this is a once-in-a-lifetime" occurrence. No-money-down, no-documentation mortgages were made because both borrowers and lenders believed the predictions that housing values would always increase. When the prediction proved false, both parties were stuck. On the other hand, if everyone had insisted on sound financial principles (demonstrated by a substantial down payment), both borrowers and lenders might have been able to weather the storm of depressed housing prices.

- **HOW MANY OF YOUR FINANCIAL DECISIONS ARE BASED ON PREDICTIONS?**
- **DO THE PEOPLE WHO INFLUENCE YOU PROVIDE *PREDICTIONS* OR *PRINCIPLES*?**

REMEMBER: SOUND FINANCIAL PRINCIPLES DELIVER PROVEN RESULTS. PREDICTIONS MAY ENTERTAIN, BUT THEY DON'T ALWAYS WORK.

Why a "Nirvana" Mindset Delivers Grungy Results

What's the connection between an ancient Buddhist word, an economic concept introduced in the late 1960s, and a rock band from Seattle from the late 1980s?

First: the Buddhist word is *Nirvana,* a Sanskrit term which expresses a transcendent state of bliss, in which pain, suffering and external reality are extinguished.

Second: in 1969, Harold Demsetz, a professor of economics at UCLA, coined a new phrase, the *Nirvana Fallacy*.

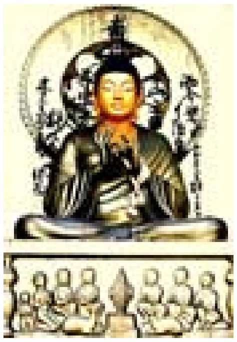
Finally: *Nirvana* was the name of a Seattle area rock band of the late eighties and early nineties that was known for its "grunge" style of music.

In 1969, Demsetz first used the phrase *nirvana fallacy* to identify problems in the way government leaders often formulated economic policies and responded to economic events. In a nutshell:

The problem, as Demsetz saw it, was that politicians and public policy makers often viewed their decisions as a choice "between an ideal norm and an existing 'imperfect' institutional arrangement. This *nirvana* approach differs considerably from a *comparative institution* approach in which the relevant choice is between alternative real institutional arrangements."

The commitment to achieving a perfect solution sometimes ignores the realities of life. As an example of nirvana thinking, Sheldon Richmond, writing in the July/August 2009 issue of *The Freeman,* quotes comments made this summer by a certain unnamed United States Senator on how the government might be able to prevent another financial crisis:

NIRVANA



BUDDHIST NIRVANA

ECONOMY
NIRVANA
FALLACY

NIRVANA
ROCK
BAND

"(We) need a tough, strong regulator, unified – no holes in the system – … who sees the problem ahead of time, so they have complete transparency, they know exactly what's going on…"

Richmond then asks a question: *"How will the regulators know exactly what's going on?"* Further, is it reasonable to expect the regulators will see the problem ahead of time? (Richmond notes that "Fortune-telling is not a widely distributed skill.") And how can we be sure the regulators are smart enough to know what to do in the event of another crisis? While it might sound like an ideal solution, the senator's proposal to appoint one or more all-knowing regulators isn't possible in the real world. No one has access to all the information, and even if they did, no one is smart enough to know how to perfectly apply it. This is an ideal that cannot be attained.

Another problem of Nirvana thinking is that it has a tendency to look backward and assume that what worked best in the past determines what should be the ideal for the future. As a result, Richmond says regulators end up "enforcing formal (possibly outdated and irrelevant) rules, looking for a repeat of the last problem, while missing the next one entirely."

Nirvana thinking is not only unrealistic, but relying on it can lead to unpleasant consequences. Investors large and small have been burned because they believed that "approved" financial products and institutions were safe. But AAA ratings couldn't guarantee that some companies wouldn't go broke. And FINRA licensing didn't stop some financial companies from running Ponzi scams.

The Nirvana Fallacy isn't exclusive to government regulators and public policy. The same Nirvana delusions plague economic analysts who believe they can attain a transcendent state of financial bliss by identifying "risk-free" strategies and formulas to guarantee investment profits. The reality is risky financial products cannot be made risk-free. This "ideal" is not a practical reality.

Insurance decisions can also be affected by the Nirvana Fallacy. Usually, buying insurance means allocating money against something unwanted and unlikely – an auto accident, an illness, a disability, etc. If none of those things happen, it's easy to look backward and say "those premiums were a waste. That money could have been put to a better use than to buy insurance."

As cars get safer, medicine cures more disease and safety measures diminish accidents, it's possible to imagine an ideal world where no one is a bad driver, no one gets sick and accidents don't occur. If that world existed, insurance wouldn't be needed, right?

Because today's reality and the future ideal are far enough apart, most people don't go without insurance. Instead, they just try to minimize the outlay by relying on statistics – which can be another version of the Nirvana Fallacy.

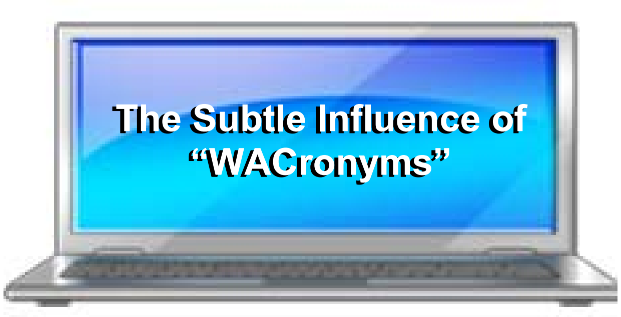
For example: Since statistics indicate the chances of a slim, healthy, non-smoking, safe-driving individual dying before age 60 are very low, it's seems like the ideal scenario would be to allocate the smallest amount possible to the least amount of life insurance for the shortest time period – because ideally, this person isn't going to die before life expectancy. The "savings" from spending as little as possible on life insurance could be invested to build an accumulation for the future. Eventually, the size of your savings will eliminate the necessity of "wasting" any more money on life insurance premiums. This application of Nirvana thinking is also known as "buy-term-invest-the-difference." It is a financial strategy based on the expectation that ideal circumstances will play out – not only regarding whether one lives or dies, but also regarding the performance of the invested savings *and* that one's future financial circumstances will be precisely as imagined 20 or 30 years earlier – i.e., there will be continuing good health, continuing employment, etc.

Make comparisons between real alternatives, not just an ideal

If you understand the issues underlying the Nirvana Fallacy, you should be able to see how it can negatively impact your financial decisions, because you run the risk of pursuing ideals that can't be realized, or you forgo acting on practical (if less-than-perfect) options.

The best way to reach a long-term objective is to consistently improve the real choices you have right now. Ironically, it is the free market process of gradual adjustment and refinement over time that usually gets us closer to our ideals.

In contrast, making elaborate plans to impose a "new reality" on our circumstances often results in wasted energy, and neglects workable strategies already in place. To turn a phrase and close the connections that began this article, the Nirvana Fallacy often delivers grungy outcomes, not at all what you would expect from a transcendent state of bliss.



The Subtle Influence of "WACronyms"

Every subculture has its own special lingo, including acronyms. Baseball fans know the importance of RBI, OPS and ERA. Car nuts understand RPMs and HP. The military is full of acronyms, including dangerous things like IEDs and RPGs. And governments are big users of acronyms, too, from agencies (FBI, CIA) to legislation (ERISA, TARP). The President of The United States even has his own acronym – POTUS.

With its vast array of products, the lingo of the financial world is tailor-made for acronyms. In fact, the list of financial acronyms stretches from ARMs to ZEBRAs (adjustable rate mortgages to zero-based risk swaps), with every letter in-between represented. In theory, financial acronyms give people a shorthand method for comprehending or communicating larger ideas; if you know the specifics contained in IRAs and 401(k)s, discussing the comparative features can be much more efficient.

But according to Jason Zweig, author of "The Little Book of Safe Money" (Wiley, 2010), financial acronyms can have a dark side, because the shorthand convenience of acronyms can be used to manipulate financial consumers. Zweig calls "these products of financial engineering 'WACronyms,' (short for "Wall Street acronyms") because they tend to sound innocent when, in fact, many of them are full of wacky complications and incomprehensible risks."

Psychologists have found that the human mind responds to acronyms because they provide what is known as "fluency," making information more recognizable and easy to digest. And in general, our tendency is to prefer familiar or easily processed ideas over unusual or complex ones.

Numerous psychological studies have shown that a name or title can exert great influence over our perceptions. In particular, Zweig says, "the easier something is to perceive, remember or pronounce, the safer it will make us feel—regardless of its actual risk or benefit." It's for this reason that a drug officially known as …

> 1-[[3-(6,7-dihydro-1-methyl-7-oxo-3-propyl-1Hpyrazolo[4,3-d]pyrimidin-5-yl)-4-ethoxyphenyl]sulfonyl]-4-methylpiperazine citrate

…is given the name "Viagra." Not only is it easier to pronounce the first time we hear or see it, but with its "hints of life and vigor and waterfalls," the product makes a distinct connection to things with which we are already familiar.

Thus, acronyms can become a form of marketing. It is Zweig's contention that "investment bankers put a great deal of energy and effort into coming up with product names that can somehow be reduced to a catchy WACronym—because Wall Street knows that a fluent name automatically makes investors more comfortable with risks they do not understand."

As an example, Zweig cites the WACronym CMO:

> **"Collateralized mortgage obligations" is an intimidating 11-syllable mouthful that sounds like something a debt-collection agency might try extracting from you while an ex-wrestler … dislocates your thumbs. A "CMO," on the other hand, sounds short, cool, snappy and familiar, like a fast-food restaurant, a sports statistic, a videogame, a type of sneaker, a new-model car. You would never guess that by late 2008, some CMOs were worth only a tiny fraction of the original prices at which Wall Street foisted them onto "sophisticated investors."**

In any sub-culture, knowing the lingo (including the acronyms) marks you as an insider. There is a certain "cool factor" in knowing the phrases, using the jargon. No doubt some investors, even very intelligent ones, have been swayed by catchy WACronyms. But this information doesn't mean all WACronyms are bad deals for consumers. And it also doesn't mean that most people should stick to simple financial products, because some complex financial products can have a legitimate place in even the most conservative investor's portfolio. It just means you should be aware of the psychological factors and marketing strategies at work below the surface.

Zweig's recommended response to WACronyms is simple: "Ask what the WACronym stands for. If you can neither pronounce nor understand the terms the abbreviation stands for, don't invest in it." Hey, that's common sense: You shouldn't buy something you don't understand, whether it comes with or without a WACronym.

2010: The Year of the Roth IRA Conversion

If the early announcements are any indication, 2010 could be the Year of the Roth IRA conversion. How do we know this? Well…

An August 27, 2009 article from *Morningstar* (news.morningstar.com) calls the chance to convert to a Roth IRA "the planning opportunity of the decade."

In an article for the *Detroit Free Press,* on November 19, 2009, Susan Tompor reported "the Roth IRA conversion is definitely building buzz."

On November 24, 2009 *Forbes.com* led with "Get ready to be bombarded with information about Roth IRA conversions."

Admittedly, three sources by themselves do not make a trend, but they are representative of the general media buzz. What's the big deal? Here's the story:

Congratulations
all the best in the years
Retire

Roth IRA retirement plans have the following features:

- Eligibility to make deposits to a Roth IRA is dependent on your income level.
- Deposits receive no tax deduction.
- Once you have held the Roth IRA for at least five years, and are at least age 59 ½, withdrawals are tax-free.
- There are no required minimum distributions from a Roth IRA at any age.
- Roth IRA assets can be left to children or other heirs.

A change in tax law, effective 2010, broadens the ability of owners of Traditional IRA accounts to convert them to Roth accounts. This is what the fuss is all about.

Beginning in 2010, the income limits on Roth IRAs will be eliminated, so investors of all income levels will be able to convert their Traditional IRA assets to Roth IRA assets. This is significant, because prior to this change, only those with a modified adjusted gross income (MAGI) of $100,000 or less could execute a conversion.

Reasons to consider a conversion to a Roth IRA

You may pay less in taxes. If you convert your Traditional IRA balance to a Roth IRA, you'll pay taxes on the amount being converted. But because of recent market volatility, your account balance may be lower than it was when the market was stronger. In effect, you may pay less in taxes.

If you convert in 2010, you have the option to spread the tax burden over two years. When you convert to a Roth IRA, you will have to pay taxes on any deductible contributions and investment earnings. But, if you make the conversion in 2010, you can pay the taxes in 2010 or you can spread the taxes over the subsequent two year, 2011 and 2012.

There are no required minimum distributions. Unlike Traditional IRAs, Roth IRAs do not require that you take minimum distributions when you reach age 70½. That means your account can continue to grow tax-free until you – or your heirs – are ready to withdraw the money.

Reasons to not convert to a Roth IRA

Money. The Roth conversion isn't a freebie. In order to convert to a Roth IRA, you must pay income taxes on the Traditional IRA as if you had cashed out. If you pay the tax from funds in the IRA account, it will decrease the transfer amount and diminish the tax-free growth that might occur over time. Further, if you use funds from the IRA and are younger than 59 ½, the amount used to pay the tax may be subject to an early withdrawal penalty. "A Roth conversion is expensive. There's a big up-front cost to doing this," Tim Steffen told Tompor. Steffen is a financial and estate planning manager for Robert W. Baird & Co. in Milwaukee.

You think you'll be in a lower tax bracket in retirement. If your financial situation is such that you anticipate future income will be much lower than it is today, paying the tax now may not make sense.

You have a short time until you intend to withdraw the funds. Money transferred to a Roth IRA must remain in the account for five years, or it will lose its tax-free withdrawal status.

"It goes back to: What's your tax bracket? Do you have the funds outside the IRA to pay the tax? And what's your time frame for needing those assets?" said Jill Garvey, vice president and regional manager for the wealth planning group at Comerica Bank.

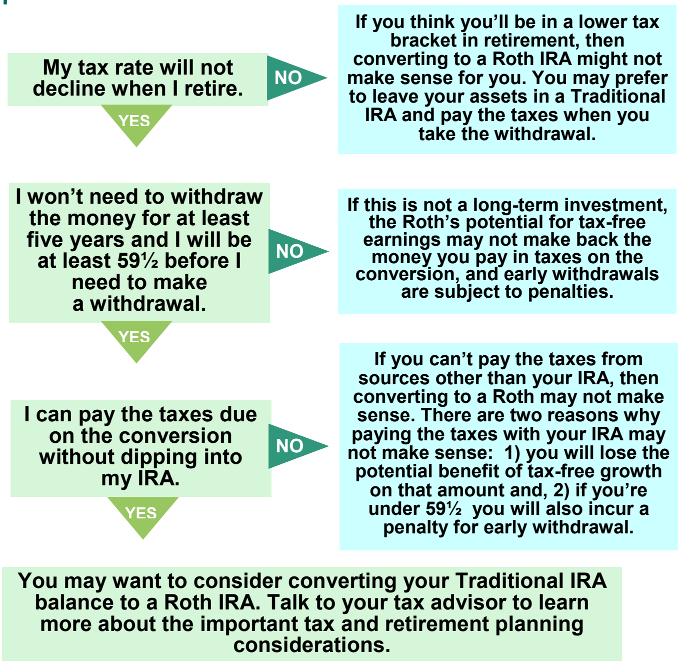
Another twist: *(see next page)*

What might happen to tax rates in the future? In the *Detroit Free Press* article, Garvey points out that the current federal income tax rates expire at the end of 2010. If Congress takes no action to renew these rates, the highest tax rate would jump to 39.6%, up from 35%. And with the deficit ballooning, it's not unthinkable that Congress might authorize even higher marginal tax rates.

The conversion decision is "a little more art than science," according to John Carl, president and founder of the Retirement Learning Center in Brainerd, Minnesota. "How much [in] taxes are you willing to fund now for a lifetime of tax-free income?"

IRA Help is Everywhere. To assist you in your decision, many financial companies are offering Roth Conversion Calculators on their web sites. But this is a transaction that probably can't be decided by answering a few questions or entering some numbers in an on-line calculator. A consultation with your tax advisor is a must, as well as the financial professionals who will be handling the conversion paperwork.

Is a conversion to a Roth IRA right for you? Here are some points to consider:



My tax rate will not decline when I retire.

NO: If you think you'll be in a lower tax bracket in retirement, then converting to a Roth IRA might not make sense for you. You may prefer to leave your assets in a Traditional IRA and pay the taxes when you take the withdrawal.

YES

I won't need to withdraw the money for at least five years and I will be at least 59½ before I need to make a withdrawal.

NO: If this is not a long-term investment, the Roth's potential for tax-free earnings may not make back the money you pay in taxes on the conversion, and early withdrawals are subject to penalties.

YES

I can pay the taxes due on the conversion without dipping into my IRA.

NO: If you can't pay the taxes from sources other than your IRA, then converting to a Roth may not make sense. There are two reasons why paying the taxes with your IRA may not make sense: 1) you will lose the potential benefit of tax-free growth on that amount and, 2) if you're under 59½ you will also incur a penalty for early withdrawal.

YES

You may want to consider converting your Traditional IRA balance to a Roth IRA. Talk to your tax advisor to learn more about the important tax and retirement planning considerations.

5-MINUTE FINANCIAL THOUGHT: Which is easier: Managing your debt, or managing your assets?

Most of the factors regarding your debt are under your control. The terms and conditions of borrowing are typically well-defined, and with minimal effort, you can determine a payment strategy that matches your circumstances. Over time, a reduction in your indebtedness should free up more money for saving and investing.

By comparison, you may frequently find you have limited control over some of the factors affecting the performance of your invested assets. The broader market will determine the value of your equity holdings, whether in paper assets like stocks, or real assets such as rental property. And interest rates and dividend distributions are usually someone else's decision, not yours.

With so many of the variables associated with asset management beyond your control, it's worth asking the question:

Would you be better off devoting most of your energies to re-structuring debt to free up more money for saving, then using conservative, safe low-yield financial vehicles instead of trying to squeeze higher returns from riskier options?

Think of it this way: $100 earning 4% annually results in a larger amount than $75 earning 10%. If you can find the extra $25 through debt management, why take the risks associated with trying to earn 10% on a smaller amount?

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