401(k) TODAY

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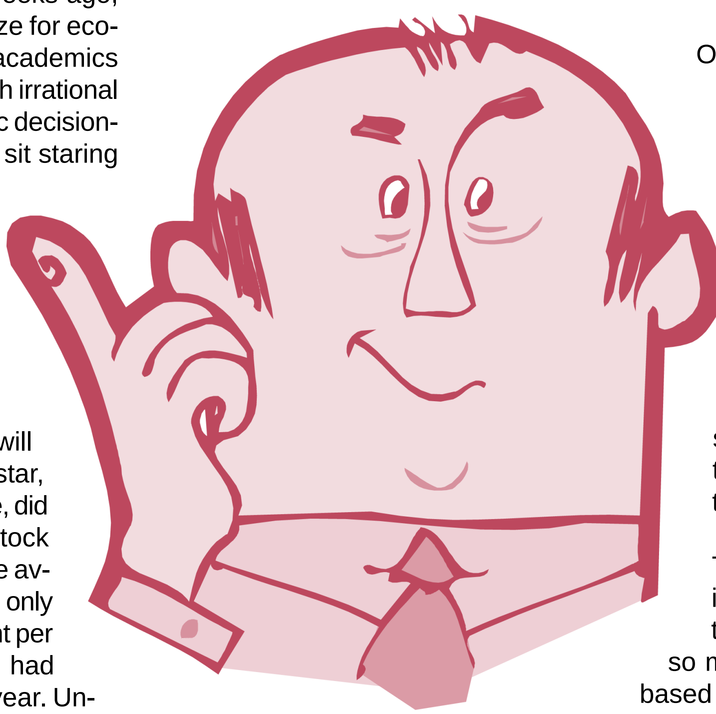
Asking Yourself The Right Question

by Stephen J. Butler

John Nash, the character in the movie "A Brilliant Mind," was a Nobel Prize winner in 1994 for his experiments in game theory: the process of making mathematically rational decisions based on calculations of probability. A few weeks ago, by comparison, the Nobel Prize for economics was awarded to two academics who studied the extent to which irrational behavior ruled much economic decision-making. Meanwhile, here we sit staring at our retirement plan statements showing how much money we have lost. We feel like we ought to do something, anything, but can we be sure that our next move will be rational and profitable?

The odds are great that we will do the wrong thing. Morningstar, the mutual fund ranking service, did a study at the height of the stock market frenzy showing that the average mutual fund investor had only earned an average of 3 percent per year, while the average fund had been gaining 16 percent per year. Understanding what caused this abysmal result is what propelled professors Daniel Kahneman and Vernon Smith into the Nobel winners' circle.

We basically don't like to lose, so we become paralyzed. We would rather sit on a bad investment than take the risk of switching to a new one and losing more money as a result of our decisive action. It bothers us more to lose as a result of action than as a result of inaction. So, we avoid the possibility of taking a step that runs the risk of making us feel stupid. Sitting tight offers the peaceful fog of denial and leads to something called "the status quo bias."



How we ask ourselves the question can impact what we decide to do. The stories about Kahneman's and Smith's work all cite the following simple experiment: Students were told that they could save 200 out of 600 people from a disease. Or, they could select a second option where there was a one-third chance that everyone would live and a two-thirds chance that everyone would die. Seventy-two percent of the students took option one. Then the same question was presented differently by describing option one where 400 people would die versus option two where there would be a one-third chance that no one would die and two-thirds that everyone would die. Presented this way, seventy-eight percent of the students elected option two. How the question was asked determined the outcome of the poll even though the arithmetic was the same in both cases.

Of course, these were just Princeton students, but they reflect the basic truism of society in general. People will shun risks when gains, like lives saved, are at the forefront of the brain. They will take risk, on the other hand, when they are focused on avoiding a certain loss, even if the loss could be magnified further by taking the riskier course of action. Risk, remember, is a measure of future uncertainty, so option two offers more uncertainty as to the future outcome.

The relatively new field of behavioral economics represents the attempt to understand why we make so many financial decisions that are based on factors other than cold, hard economic probability. When it comes to investment decisions, we need to decide how to ask the question. Is the glass half empty or half full? If we view our retirement account as being half full, we will want to lock in what we have today by moving out of stocks and into a money market fund. This is the equivalent of saving at least some lives (above) with 100 percent certainty.

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Making The Case For Being Frugal

by Stephen J. Butler

I was recently offering some financial advice to a retired woman with more than $1 million in assets when she asked me if I thought it would be OK for her to buy a new couch.

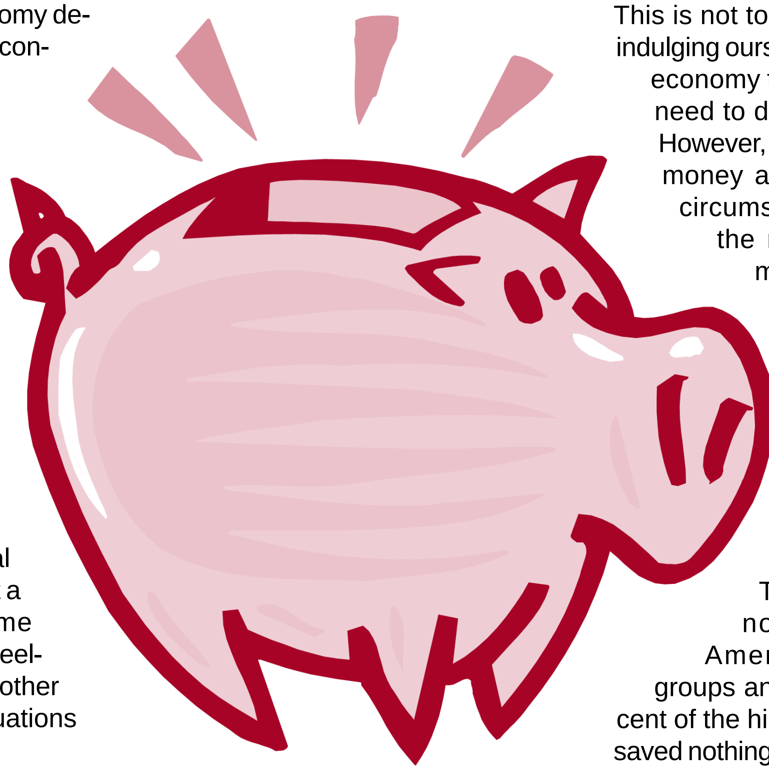
"Of course," I said, "but be sure to invest in one of those clear plastic slip covers to protect it." We all understand that people need new couches periodically, but many other consumer goods can be postponed indefinitely.

It can pay to revisit how we're spending money these days, because it is a great time to be investing whatever we can manage to save. While the economy depends on a continuing engine of consumer spending, we don't all have to be cogs in that machine. There are those of us who don't buy lottery tickets or spend $4 of after-tax money on frappachinos at Starbucks. Those of us in this group are generally capable of some cost-benefit analysis, and we gain some enjoyment from knowing that we are receiving good value whenever we spend money.

Studies show that people who are unhappy with their financial situations generally feel that just a 10 percent increase in income would satisfy the shortfall in that feeling of entitlement. Most of us, in other words, don't let our financial situations get totally out of control.

Reading about the excesses of America's Most Wanted CEOs left me wondering why on earth someone would want to live in a 15,000-square-foot home with a $6,000 shower curtain. Who can imagine rattling around in what must feel like a hotel? When the income scale is huge by anyone's standards, the needs just expand proportionately. This explains why Mercedes is introducing a $350,000 automobile. It's to meet the needs of, as their marketing people put it, those people who wear $30,000 watches.

Beyond being entertained, there is something constructive to be gained from reading about excessive spending. What if the press suddenly made our spending habits and purchases public information? Do we see any excesses that would be an embarrassment? Where in our spending patterns can we detect any waste? How much do we spend that we hope our spouses don't notice?



I made a big mistake years ago when I bought a bright red Italian motorcycle as a "surprise." My wife took one look at it and called it "obscene." I wound up selling the motorcycle and buying a living room rug as "punishment," and I learned my lesson once and for all.

Habitual spending is the most insidious, because when we get in the habit of something, it loses some of its "value-added enjoyment factor" as it becomes part of a routine. When some expenditures become routine, they stop being special when compared with buying something new and different with the same money. It drives me nuts to see working people spending $2 a day of after-tax money on coffee ($400 a year) when that could be the equivalent of another $600 or more in pre-tax contributions to their 401(k) plans.

There are a number of good books on how to be frugal. One of the best is "The Tightwad Gazette" written by Amy Dacyczyn from Maine, a state that imposes the highest tax rate and thereby breeds frugality. Amazon.com has lists of similar books, and these books are important for the motivation they engender as much as for their specific ideas.

This is not to say that we need to stop indulging ourselves. None of us want the economy to completely tank. We all need to do our part as consumers. However, to the extent that we spend money at all, this is a time to be circumspect. We should review the mental checklist of what makes us feel good about ourselves before we spend the next dime. Furthermore, a little patience may also yield progressively better bargains on just about everything in the months to come.

The National Bureau of Economic Research divided Americans into 10 income groups and discovered that 10 percent of the highest income bracket had saved nothing. Twenty percent of each of the other groups had saved nothing. This amounts to a lot of people with no savings who have made a lot of money. A 40-year lifetime of earnings for the average family making $50,000 adds up to $2 million. How hard is it to save and invest some of that? And what better time than now?

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Don't Let Bad News Deter You

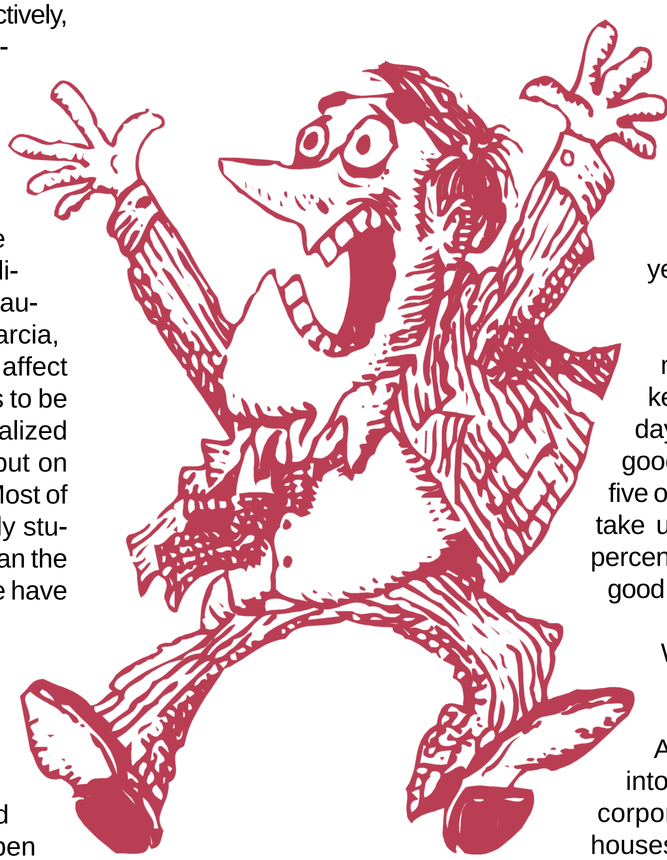
by Stephen J. Butler

Bunker Hunt of Texas lost several billion dollars when, with his brother, he tried to corner the silver market back in the 1970s. At the time, he told reporters, "A billion dollars isn't what it used to be." Some of us have seen a lot of money evaporate from our retirement plans over the past two years, but we need to remember that these losses haven't exactly been our hard-earned dollars. Collectively, we have lost more than 4 trillion dollars, but thanks to the roaring '90s, a trillion dollars isn't what it used to be. We have trumped Bunker.

Some of us are upset, if not mad, and this is a big mistake. In the movie "Godfather III" after the helicopter gun ships shoot up the restaurant, Al Pacino reminds Andy Garcia, "Never hate your enemies. It can affect your judgment." We have reasons to be annoyed, starting with institutionalized corporate greed and corruption, but on the whole, things are not so bad. Most of us, unless we did something really stupid, have far more money today than the after-tax cost of all contributions we have made over the years.

To improve our general outlook and feel really good, we need to first disabuse ourselves of several destructive thought patterns. First, we need to get a grip. We should have expected to have this happen sooner or later. We should also forget about the one person in 50 who just happened to cash out of the market at the end of 1999. We all know at least one of these people, as this proportionately small group tends to be good about sharing. I happen to know some people who also bailed out of the market after the 37 percent rise in 1995. They saw that year as the blowout year and walked away from the 22 percent, 33 percent, 28 percent and 21 percent successive gains over the following four years.

The numbers never lie, so it pays to look at a typical case for someone who has the most to be concerned about. This would be someone with perhaps $100,000 in retirement plans as of 1991 who has deposited $10,000 per year every year since 1990. Everything in the following analysis is linear, so if your numbers amount to half or double these amounts, you can adjust accordingly.



Based on the returns of an S&P 500 index fund, the $100,000 at the end beginning of 1992 has now accumulated to approximately $270,000. Its high point was about $420,000 at the end of 1999. The $10,000-per-year contribution has accumulated to about $175,000. Its 1999 high point was $235,000. Today's combined total is almost $450,000, and this is after the greatest market collapse since 1929. Assuming that some of the initial $100,000 consisted of compound earnings, the cost in after-tax take-home pay for all the contributions required over the years was about $140,000 (about two-thirds of the actual contribution amounts thanks to effective "subsidies" in tax savings from state and federal governments.) This is how much we sacrificed in consumer spending to achieve our $450,000 nest egg.

Unfortunately, many view the glass as half empty instead of half full. Some of these are younger people who have all the time in world to wait around for the next roaring decade. In the meantime, they can be loading up on mutual fund shares at the lowest prices we have seen in years. It is reassuring to note that some of the greatest single-year market gains occurred during the middle of the Great Depression. Later, after the 1973 decline, the market had recovered by 1976. Markets could go lower than they are today, but with prices this low, a lot of good things can happen over the next five or 10 years. When they do, they will take us by surprise. Last Tuesday's 5 percent gain in market values is a very good example.

While we're at it, we're taking this opportunity to conduct a thorough housecleaning of corporate America. We've fired a broadside into the ranks of some of the largest corporations and investment-banking houses. I love these "perp walks" with people like Andrew Fastow in handcuffs having to carefully duck his head as he gets into the back of a squad car. This sends a shot across the bow of corporate America and offers a reminder of who the true owners are. The power of a democracy is truly awesome and wonderful to watch. A policeman once reminded me that most crimes are solved because criminals are basically, as he put it, "stuck on stupid." When the curtain closes on this chapter of business history, a lot of frozen assets will have been returned to us stockholders.

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Asking... *(from page 1)*

If we view the glass as half empty, then we will be more inclined to accept the risks that will fill it up again. Unlike the students' experiment, our investments do not have a finite test with a beginning and an end. We have the luxury of knowing with some certainty that, given enough time, the glass will be full once again. The current bear market, when compared against historical standard deviation measurements, represents an event that has had less than a 5 percent chance of happening. The probability of it dropping substantially lower is perhaps one or two out of 100.

At this point, long-term investors with portfolios whose contributions were largely made before the big run-up of the 1990s are now about even with long-term stock market returns of about 10 percent per year. Those whose accounts are newer have a greater percentage of assets that were contributed throughout the '90s, when market values were much higher. If this is the case with you, your losses are greater because you bought most of your mutual fund shares at higher prices.

In the first case, the glass is half full right now, and you can consider locking in gains by moving toward fixed-income investments. In this way, you will be responding to the human tendency toward "loss aversion." Studies in behavioral economics show that the pain of a loss has far greater weight than the exhilaration from an equivalent gain. If you are inclined to want to do this, it is important to know why you feel this way. You can always overrule your feelings, and you might be better off staying the course.

In the second case, you might as well view the situation as a glass half full and recognize that today's rock-bottom values offer the reverse of yesterday's high values that led to such dismal results. We will take more risk to avoid a sure loss than we would to lock in a sure gain. If we start thinking about how much we want to avoid any future losses, we will take some risks. Therefore, if we keep depositing money regularly, we are steadily reducing the average price we have paid for all of our shares combined. The result will be a glass that fills that much sooner.

A most readable book on the subject of how the mind makes financial decisions is "Why Smart People Make Big Money Mistakes -- And How to Correct Them," by Gary Belsky and Thomas Gilovich. Those of us with mutual funds or credit cards owe it to ourselves to understand how money can mess with our heads. To the extent that financial advisers create value, it is because they offer a sounding board for filtering our behavioral economic urges. This contribution is difficult to measure, and our temptation is to just look at simple cause and effect results of investment advice. The paradox is that specific investment advice, like what stocks and mutual funds to buy, may have little to do with long-term financial success. In the end, advisers who double as therapists may contribute the most to our financial success. ■

Bad News... *(from page 3)*

Meanwhile, with regard to possible war in Iraq, the uncertainty has already been reflected in today's stock prices. The financial term for this price reflection is "discounted." Today's stock prices have already "discounted" the risk of war in the Mideast, so we can set that issue aside as we consider our investment strategy.

And so, for those who of us who are upset by the cloud over our financial affairs, there is a sunny side of the street. In fact, when there are no clouds in the sky, the market is usually overpriced. Relax. Recent events have simply overshadowed what remains as our major financial accomplishment over the years. ■

Being Frugal... *(from page 2)*

Kevin Spacey in the movie "American Beauty" says while waving at the interior of his home, "This isn't life; this is just stuff."

Speaking of interiors, when we once returned from a vacation a new house-sitter asked with a disapproving tone, "Do you know that your dogs sleep on the furniture?" For her benefit, we pretended to be shocked, absolutely shocked, at that information. However, there is more to enjoying life than filling it with consumer goods and struggling to keep them in new condition. Our dogs do sleep on the furniture, but given our state of mind, there's nothing we can do about it. And ... those clear plastic slip covers are out of the question. ■

Cool Stuff

by Lindsy Golden

Indexes
Prime Rate – 4.25%

Fixed Mortgage
30 Year – 5.67%
15 Year – 5.11%

Home Equity Loan
6.93%

New Car, 48 Month Loan
6.23%

Internet Sites

www.smartmoney.com
A great one-stop shop for up to the minute stock quotes, smart financial articles, and information on personal finance.

www.savingforcollege.com
Learn all about 529 plans. Any questions about the plans can be answered here.

www.investinginbonds.com
Discover how bonds work, how to invest in bonds, how interest rates and bonds work together, plus much more.

Dow Jones Six Month Forecast
December 2002 – 9,635
January 2003 – 8,253
February 2003 – 8,679
March 2003 – 7,014
April 2003 – 7,499

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