Behavior Gap

A SNAPSHOT VIEW

Your investing behavior matters. It matters because making some of the classic behavioral mistakes has cost the average investor close to 7% per year —over half of his potential earnings.

If you purchased the average stock mutual fund in 1984, held on to it for 20 years, and didn't do a thing, you would have earned 10.7% per year. All you had to do to get that number was buy the average mutual fund and hold on to it!

For example, if you'd invested $10,000 in 1984 in an average fund, and did nothing—neither adding money nor taking it out—your account would've been worth $76,375 in 2004. However, the average investor actually experienced the following.

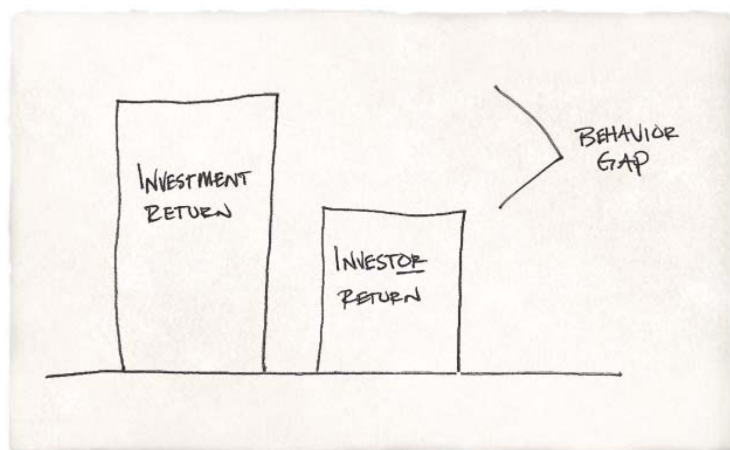
Remember the 10.7% return of the average investment? Well, compare that to this number: 3.7%. The

the average investor only earned 3.7%

average investor's real life return was 3.7% during that same 20-year period. That's not a typo—the average investor only earned 3.7%.

Now take a minute and think about this—that's a gap of 7% per year! This gap means that if the average investor started with a $10,000 investment in 1984, it would only be worth $20,681 after 20 years. That's money—over $55,000—just left laying on the table. How'd this happen?

I call this the Behavior Gap™, and it's time to close it.



In this snapshot I'll do three things:

1. Take you on a historical journey (that would be humorous if it wasn't so painful) to convince you the Behavior Gap™ does exist in the real world
2. Walk through a few of the big behavioral mistakes that we all make
3. Provide the one and only solution.

Before we get started, it's critical that we all understand one issue: INVESTMENT returns and INVESTOR returns are always different.

During the last few years, you may have noticed that your returns fell short of the returns you kept reading and hearing about in the media. If so, you're not alone. A fund's reported return is only part of the picture. The other half, well, it's not always pretty, and you rarely, if ever, hear it mentioned. Driven by investor behavior, the investor rate of return doesn't always match a portfolio's gains or losses.

Let me explain.

Your potential to earn the fund's published return rate is based on two criteria:

1. You bought AND held the fund for the entire time.
2. You didn't add or withdraw any money.

Sounds easy, right? The reality? Few people actually invest this way. Instead, investors chase past performance, buying funds too late (after they've already peaked) or selling funds too early (before they turn around).

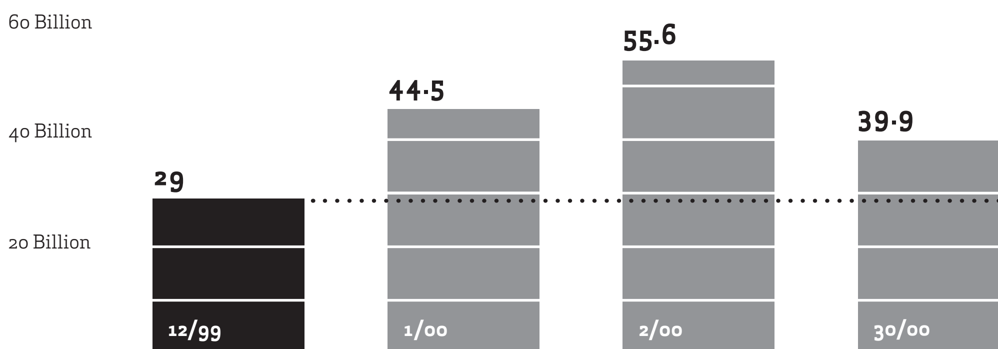
THE BEHAVIOR GAP ON A MASSIVE SCALE

Let's go on a journey back in time. As you travel with me, try to be honest about what you were seeing, thinking, and doing at the time.

By 1999, playing the stock market had become America's favorite pastime. Now, it's the year 2000. The stock market has gained 86% during the last three years. Remember the concept of chasing past performance? Well, it's about to happen again. Prior to January 2000, the record for net inflows (money going in, minus money going out) into stock mutual funds was $29 billion. Now here we are in January 2000, right after a 86% run up, and look at these numbers.

In January , net inflows shot up to $44.5 billion. In February, the shortest month of the year, inflows hit $55.6 billion. That's almost $2 billion a day! March was nothing to sneeze at either with an investment of another $39.9 billion.

Fund Net Inflows | Jan. 2000 - Mar. 2000



Think about that. In three months, $140 billion dollars entered the market—AFTER it already had gained 86%. At a time when investors should have shown some caution, they allowed themselves to get swept along with the crowd. They allowed external factors to influence their investing behavior.

Investors paid for their irrational exuberance. March 24, 2000, marked the peak for this particular cycle. By October 10, 2002, the market had lost 50% of its value.

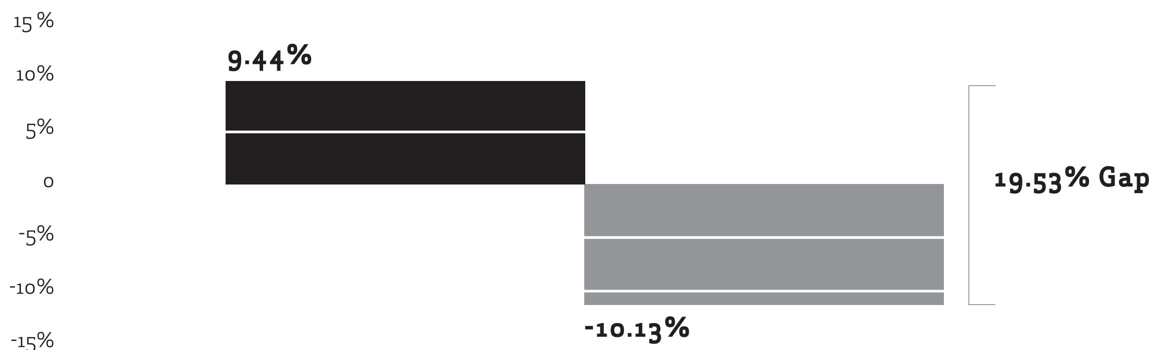
So now fast forward to 2002. After buying into the excitement of early 2000, inves-

tors clearly had enough by October. With the stock market down over 50%, people continued to sell. October marked the fifth month in a row that investors pulled more money out of stock mutual funds than they invested. That had never happened before. I repeat, never. At the market low, instead of buying equities at the best "sale" prices in five years, investors moved their money into bond funds, making the classic mistake of having bought high and sold low. Bond funds experienced a record inflow of $140 billion in 2002. At the time, bond funds were—wait for it—at a 46-year HIGH. See a pattern?

A BEHAVIOR GAP EXAMPLE

In March 2007, the Janus Enterprise Fund published its 10-year rate of return, a healthy 9.44%. Now remember, the investment rate of return assumes you invested a set amount of money in the beginning and left it alone—no adding or subtracting. What about the average investor return? That number was different. The average Janus Fund investor saw a return rate of -10.13%. That's not a typo. -10.13%. That's a gap of 19.56%!

10-Year Rate of Return



The Janus investor rate of return is an extreme example of bad behavior. Your gap experience may not be that big. However, regardless of size, the same types of behavior create the gap between the investment and the investor rate of return. To begin closing the gap, you need to understand what behavior creates it.

COMMON BEHAVIOR MISTAKES

We know it doesn't make sense to buy high and sell low. We've known that since we were kids. But we all do it, and we do it over, and over, and over. It's time to change the way you invest, and it has very little to do with finding the perfect investment—it's all about changing your behavior.

1. Confusing Speculating with Investing

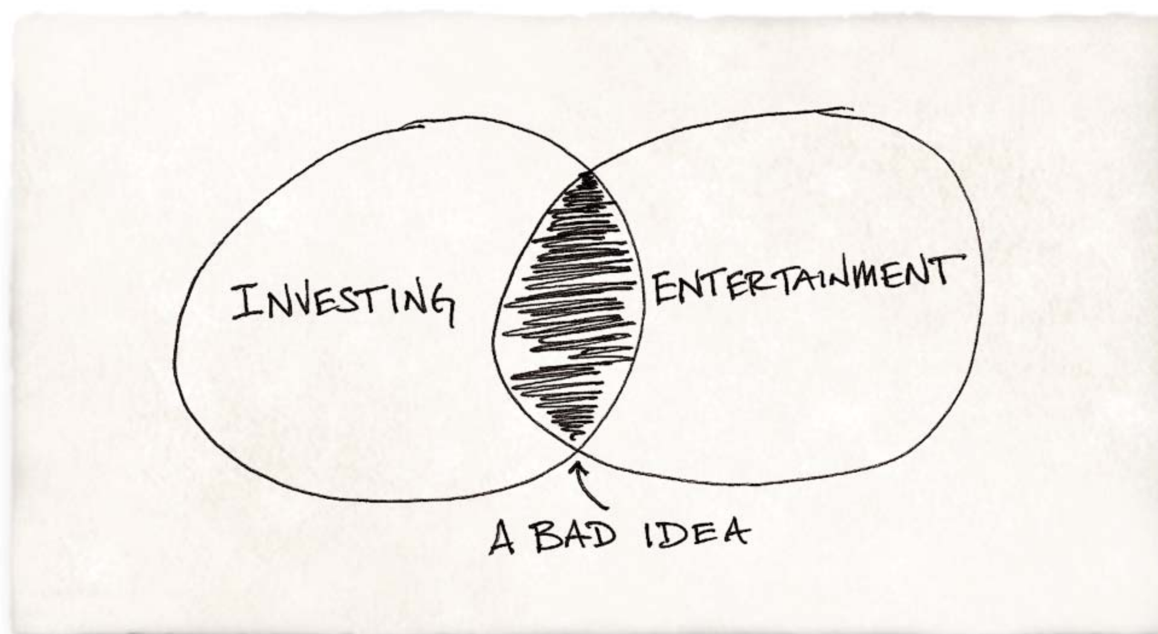
Good behavior closely mirrors the patience shown in planting an oak tree. Over time, the tree will grow and spread its roots deep, only reaching its full size after many years. The oak tree wouldn't reach its potential if you replanted it in a new spot every year, hoping to get better growth. This speculative behavior focuses on short-

term results and shows no patience for day-to-day fluctuations, costing you in the long run. On the other hand, behavior that focuses on investing in long-term goals will pay off handsomely in the future.

2. Confusing Investing with Entertainment

Investors have a bad habit of treating the stock market like a Monopoly® game.

You'll do yourself, and your investments a favor if you go to the movies instead. When you try to make investing entertaining, you start making decisions that aren't based on what's best for the long term but rather on what perks up your day. We aren't dealing with play money. This is the real thing, and you've worked too long and too hard to throw it away. Trust me. Go to the movies.



3. Confusing Intelligence with Ability

You're smart. You're successful. Otherwise you wouldn't have money to invest. So shouldn't you handle your own investments? Investment success isn't about skill. It's about behavior. Consider this example.

Investment success
isn't about skill.
It's about behavior.

When you ask people if they are better-than-average drivers, almost everyone will tell you "yes"—despite what their driving records say. The same is true for investing. Most people are overconfident in their ability to invest successfully. It stems from the tendency of human beings to think we're smarter or more able than we are.

Now that you know the gap exists, and why it exists, the question remains, "How do you close it?"

THE FAMILY CFO

Investing requires objectivity, and few of us have it, especially when it comes to our money. We all struggle to not make emotional decisions about our investments. It's not easy and asking for help doesn't mean you're stupid. The solution sounds quaint, but you need someone who cares as much about your money as you do, but has the emotional distance to make the smart decisions. You need more than a stockbroker. You need a Wealth Management Team, and the cornerstone of that team is your Family Chief Financial Officer (CFO).

A Wealth Management Team consists of all the financial advisors in your life, from your attorney to your CPA. Using a holistic approach, the Family CFO compiles your team's expertise and implements action based on their advice and his experience, focusing on your long-term wealth management plan. A traditional stockbroker or industry salesperson can be driven by commissions based on selling you products and services you don't really need. A Family CFO doesn't face the same conflict of interest. It's not about making a short-term sell. In fact, the best Family CFOs are paid a predetermined rate and receive compensation from only one source: you. There's no hidden strings, no lurking fees. You control your financial relationship.

For the Family CFO, it's about the relationship and understanding what you need from your investments. Maybe it's more free time with your family or ensuring your retirement; whatever your goals a Family CFO will help make that happen. You remain your family's CEO, making the big decisions. Your Family CFO helps you make sure you're making the right ones.

Know this about the Family CFO—it's an emotional investment on both your parts. A good Family CFO will know what makes you tick, and in the beginning, that can be a little uncomfortable. However, your efforts will be rewarded, and you'll reach a point where you can release yourself from the burden of second-guessing every investment decision.

Family CFOs close the Behavior Gap. They care about you, your family, and your future success. They can also be incredibly difficult to find. The traditional financial industry hasn't done a good job of training for this role. That's why you need to ask the right

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questions. Think you've found the likely candidate? Ask him how the market did that day. If he knows all the details, he's not the guy for you. Your Family CFO needs to be focused on the long term. You'll know you've found your Family CFO if you ask the previous question and she says, "I have no idea." Sounds crazy, but I promise it works.

CLOSING THE GAP

I believe that changing investing behavior can change the world. We're talking about the difference between you having financial freedom versus constantly watching the ticker tape run across the bottom of CNBC. This snapshot only touches on the surface of the Behavior Gap™ and the Family CFO.

If you've been muttering under your breath while you read it, "I knew that" or "Wait a minute..." then you might be interested in following the conversation at behaviorgap.com. You'll find more information about what drives typical investment behavior and how to make the Family CFO relationship work for you. It is possible to close the gap. For more information, you can also email me: carl@behaviorgap.com.

ABOUT THE BEHAVIOR GAP

For years, a guy named Carl noticed something interesting: The real-life return of the AVERAGE INVESTOR was dramatically lower than the return of the AVERAGE MUTUAL FUND. In theory, this gap shouldn't exist, but investors were leaving money on the table and didn't seem to understand how it happened.

Carl named this phenomenon the Behavior Gap™. For over 15 years, Carl's relentless curiosity has driven him to explore why

the Behavior Gap exists and to share what he knows about it. Carl's main purpose for creating the Behavior Gap is to help people close the gap by learning and practicing the best investor behavior. Carl shares his findings via behaviorgap.com and at public speaking engagements.

ABOUT CARL RICHARDS

So who is Carl? After more than ten years working in the brokerage industry, Carl went out on his own to serve as the Family Chief Financial Officer (CFO) for a select group of families. In addition to his role as Family CFO, Carl also serves in a research capacity for multiple financial firms with offices in Arizona, Nevada, North Carolina, Georgia, and Utah.

Carl received a Bachelor of Science degree in Finance from the University of Utah, and he's credentialed as a Certified Financial Planner™. Married with four children, Carl enjoys spending time outside with his family. If you want to learn more about the Behavior Gap™, feel free to email him at carl@behaviorgap.com.

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