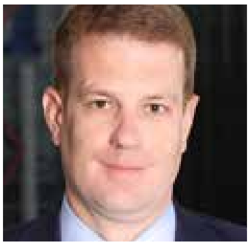
Morningstar Guide to Better Investing Outcomes

A manual for the individual investor

Introduction



The torrent of disturbing allegations from the royal commission into the finance industry has prompted many Australians to question whether their interests are being served by financial advisers. Faced with this new reality, we feel it's a crucial time to take a step back and examine the value of good financial advice and the ways in which self-directed investors can seize on that value without relying on a financial adviser.

Morningstar works with thousands of financial advisers globally and we feel that using our tools and research and applying our philosophy of prioritising end-investors can help advisers better serve their clients. Morningstar was founded because we felt it was unfair that people did not have access to the same information as financial professionals. We want to empower individual investors to take charge of their own financial outcomes—either by directly investing themselves or by having access to independent research that can be used to validate advice from their advisers.

I have been a self-directed investor from the time I began investing in my early 20s. While this may not be the path that is right for everyone, I have always enjoyed the intellectual challenge of investing and find it hard to believe that I can find an adviser that it is more interested in my financial goals than I am.

That being said, choosing a financial adviser has never been easier, and many investors welcome the chance to do so. However, just as we get the politicians we deserve, so it goes for financial advice. As a society, we are woefully uninformed, and more disturbingly we seem blissfully ignorant when it comes to financial matters, happy to hand responsibility for our financial future to perfect strangers, or act on BBQ hearsay.

We have created this guide with the self-directed investor in mind. And we hope it will be among the first steps you take on the path to achieving financial freedom—and deliver some intellectual nourishment and satisfaction along the way.

Before we get into more detailed and practical advice, we embark on a brief overview of the state of financial advice today, which we think will better equip you to use the advice that follows. Briefly, this guide will outline:

- The state of financial advice today
- Traditional methods versus goals-based investing
- We finish the guide with a brief discussion of behavioural coaching and explain how its principles can help you block out the noise and focus on value.

We trust you find this guide useful. Happy investing.

Mark LaMonica, CFA
Individual Investor Product Manager

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Financial advice in Australia

"Where are the customers' yachts?"

Fred Schwed

The financial advice process is a deeply personal experience. Low levels of financial literacy, high-stakes outcomes and our societal unease at talking about money leave many feeling profoundly vulnerable. And the financial advice industry does little to alleviate any of this discomfort. Jargon is used to add complexity when there should be none, which only serves to widen the perceived gulf between adviser and advised. The royal commission shone a light on countless troubling examples of financial advisers, industry executives, and scores of go-betweens, putting their interests ahead of others.

How did we get here?

The key to understanding any business or industry is to first examine how individuals and companies within that industry make money. In many industries this is a straightforward exercise. Take healthcare as an example. In healthcare there are pharmaceutical companies responsible for developing and manufacturing drugs and treatments. There are doctors responsible for determining the best drug to treat each individual patient. Finally, there is the chemist responsible for distributing the drug to the patient. Each party plays a crucial role in creating the product and ensuring the consumer is getting the best drug for their treatment. The financial advice industry is scarcely different. Product manufacturers create financial products—managed funds, ETFs, managed accounts, etc.—which advisers in turn recommend and distribute to the end investor.

In the financial services industry, there are several ways product manufacturers can distribute their products to consumers. One way is through financial advisers. Since it is the financial adviser that is providing advice to the end consumer on how to invest, getting the adviser to push your product is a natural way to get customers to buy it. This used to be quite easy. The investment product manufacturer would simply pay the financial adviser a commission as reward for recommending his or her products. In fact, commissions worked so well that 73% of the time, according to a 2010 study by consumer advocacy group Choice, an adviser recommended products from his or her direct or indirect employer. A problem remained, however. While this model worked well for the product manufacturers and the advisers it didn't work too well for the end investor. The product manufacturers were happy to pay commissions because they earned a percentage of the amount invested every year through an asset-based fee. They also knew that as the investment products gained value the amount collected in fees would increase. To prevent advisers moving clients into different products, grandfathered commissions were used. This ensured the adviser continued to get paid years after their clients bought the product. The priority should have been to provide the investor with the best product. Instead, however, it simply incentivised the adviser to sell products that paid the highest commission. This fee model was a huge incentive for a vertically integrated financial manufacturing and advice industry. In other words, if you were a financial product manufacturer it made sense to also have a group of advisers that would distribute your product. These companies were able to earn fees for providing advice, on one hand; and on the other, earn fees for managing the investment that the advice recommended (at least for the 73% of time that the adviser recommended a product from their employer). The 2009 Ripoll Report, which emerged in the wake of the inquiry into financial products and services in Australia, found that 85% of financial advisers were associated with a product manufacturer. The grey areas surrounding the provision of financial advice in Australia forced the government to act. In July 2013,the Future of Financial Advice (FoFA) reforms imposed a ban on trailing and up-front commissions and similar payments. FoFA forced advisers to prove they were putting the interests of their clients first.

What has changed and what hasn't post FoFA?
Banning commissions eliminated one of the foundations of the profitability of vertically integrated product manufacturing and distribution companies. What FoFA did not do, however, was expressly eliminate vertical integration. While there were structural changes to the industry the vertically integrated model remained very much intact. The Productivity Commission reports:

- Of the estimated $4.6 billion in revenue in the financial planning sector, 48% was earned by the big four banks and AMP
- 44% of advisers operate under an Australian Financial Services Licence "AFSL" licence controlled by the 10 largest financial institutions
- The big four banks, AMP and IOOF have more than 35% of advisers operating under a licence that they control, with the big four banks making up 30% of total advisers

Is vertical integration a problem that is hurting consumers of financial advice? It certainly doesn't have to be. Vertical integration can in fact lower the cost of providing services. This is ultimately a good thing if those savings are passed on to consumers. It is not such a good thing if it results in customers being charged fees every step along the chain from product manufacture to distribution.

It is worth examining how vertical integration in the Australian financial services industry has operated since commissions were banned to see if the benefits are in fact being passed on to consumers. On the surface, the banning of commissions should have eliminated the inherent conflict of interest whereby an adviser worked for a product manufacturer and was paid to sell their product. In practice this is less clear.

Most advisers that operate under a licence controlled by a product manufacturer are required to put clients into products that figure on an approved product list. There is no regulation that stipulates the use of approved products lists. Nor are the approved products lists generally available to the public. The industry argues such lists are a necessary risk management tool since they allow the advice licence holder to have some oversight over which investments are selected out of the thousands of financial products available to consumers. The Australian Securities and Investments Commission (ASIC) examined approved product lists in a report titled Report 562: Financial advice: Vertically integrated institutions and conflicts of interest, published in January 2018. The report found that on average, 21% of approved product lists consisted of in-house manufactured products while the remaining 79% comprised external products. While the approved product lists were overwhelmingly made up of externally manufactured products the picture changes when you consider which products received investments from advice clients. The actual provision of personal advice from the adviser resulted in 68% of total client funds being put into in-house products. The same ASIC report found that 65% of reviewed customers files "did not demonstrate that the customer would be in a better position following the advice" and only 25% of customer files reviewed complied with the best interest duties included in the FoFA regulations. Certainly a troubling picture.

What does good financial advice look like?

> Investing is simple, but not easy.
> Warren Buffett

If putting clients into unsuitable investment products constitutes poor financial advice, it stands to reason that the inverse must be true: steering clients into the best investment products is good financial advice. In absolute terms, this is certainly true. The ability to earn returns that far exceed the market indices is why Warren Buffett is closing in on US$90 billion, whereas you, all presumptions aside, are probably not. Obviously it's a little unfair to compare your financial adviser to one of the world's greatest investors. Even moderately exceeding market returns would be a great outcome. But in practice this is very difficult to do over the long term.

Traditionally the financial services industry prefers to ignore the impact of financial planning decisions and instead focus on two measures of how a portfolio performs, alpha and beta. Beta represents the risk that an individual takes based on their asset allocation. The higher the allocation to equities, the higher the beta of the portfolio will be. Historically this has led to higher long-term returns but also increased volatility as equity returns can fluctuate greatly over certain periods of time (the 2008 GFC, for instance). Alpha, on the other hand, represents the excess returns that result from actively managing a portfolio and selecting higher performing investments—in other words, the benefit of picking stocks that outperform the market indices.

If an adviser is paid solely to manage a portfolio of assets, and does nothing else, i.e., offers no additional advice on anything other than the investment of your assets, then the concepts of alpha and beta should be relatively good measures of the value of advice. However, advisers typically face numerous constraints that limit the amount of time they have to select investments. More regulations, more compliance, pressure to win new customers and serve existing ones, not to mention an approved product list that limits the universe of investment options. To that end, consider the following analysis by Capgemini, which reveals how US financial advisers allocate their time:

Servicing existing clients:	40%
Administrative tasks:	24%
Prospecting for new clients:	17%
Investment research / portfolio management:	10%
Compliance:	5%
Training:	4%

Little wonder that then many advice practices resort to outsourcing the investment selection side of the business to a third party. This accounts for the growth of managed accounts—a mechanism that allows the outsourcing of the investment decision-making to a professional money manager. The adviser works with the client to select an investment objective that corresponds with a pre-established strategy from a professional investment manager. The purchase of the individual securities is then done by another third party based on the strategy and the securities are held in the client's name. There are two crucial points for individual investors to note here. First, the growth of managed accounts is an acknowledgement by a growing number of advisers that the value of financial advice lies not in selecting investments. The second consideration for individual investors who use an adviser to implement a managed account is fees: what are the total fees from this arrangement and who gets them? Or is there a cheaper way to get the same investment portfolio? In many cases, the same investment strategy can be accessed in a cheaper investment vehicle.

If an adviser adds little value to investment selection, then where does the value of financial advice really lie? A 2013 Morningstar study published in the Journal of Retirement examined this very question. The good news is that we found that making good financial planning decisions can lead to more than 15% more utility-adjusted wealth (utility-adjusted means that we are adjusting for the investor's risk-aversion). This increase in wealth came from two sources:

1. Using a goal-based total wealth approach to financial planning
2. Behavioural coaching

What is the traditional approach to financial planning?

The delivery of good financial advice has undergone somewhat of a revolution. Traditional financial planning usually involves assessing a client's risk tolerance based on a questionnaire that evaluates your behaviour according to various market scenarios. This self-assessed willingness to take on risk would then translate into an asset allocation target, which is in turn applied to your whole portfolio. In other words, if you indicated a high willingness to take on risk, the adviser would recommend that you invest in riskier investments.

At Morningstar we see three main problems in using a self-assessed risk tolerance as the foundation for financial advice:

1. First, it assumes that individuals can accurately assess their own risk tolerance. It turns out that as humans we are very poor at assessing how we will respond to certain scenarios. The reason for this is that our perception of risk fluctuates according to our emotions. Our tolerance for risk tends to rise when the market is going up (greed and fear of missing out take over) and a low risk tolerance when the market is going down (fear). This natural tendency to buy high and sell low is not a formula for successful investing.
2. Second, the traditional financial planning approach ignores the fundamental reason that people invest. Investing is a means to an end and that end is not achieving some market return. We invest with a life goal in mind more than a mere investment objective. It may seem like semantics to distinguish between the goal of having $1m in your superannuation

account by retirement and the lifestyle that a $1m super balance will provide. However, it makes a huge difference when we start thinking about risk. The traditional financial planning process focuses on the willingness to accept risk. The willingness to take on risk should, however, always be weighed against your specific goals. By considering your available resources and goals you get a more specific idea of the amount of risk you can and should take.

3. Third, basing investment decisions on a single measure assumes you will have a portfolio geared towards a single goal. That single goal has traditionally been retirement. If your self-assessment indicates a high tolerance for risk and you are relatively young, the adviser will take all your investable assets and put them into an aggressive portfolio. That may be appropriate for retirement, but most life goals—be it buying a house or changing careers to pursue a passion—precede retirement.

What is a goal-based total-wealth approach to financial planning?

At Morningstar we believe in putting the investor—rather than the investment—first. We think today's investors are concerned with more than beating the market. Our approach looks beyond investments and retirement and instead prioritises all your major financial goals.

Consider these two examples:

1. **Working with an adviser** The first scenario is for individual investors who want to use an adviser. Morningstar works with thousands of advisers around the world to help them provide better financial outcomes for their clients. There are many ways of providing goals-based and total wealth-focused advice, but the elements we have outlined should seem familiar if your adviser is following a similar philosophy.

2. **Independent investor** The second scenario is for independent individual investors who do not want to use an adviser but still want the benefits from a systemic approach to financial planning. This would also apply to individual investors who want to do their own work to test and validate their adviser's recommendations.

A focus on goal attainment

Working with an adviser

The focus should be on long-term goal completion rather than on the performance of the investments that make up a portfolio.

The tone should be set from the first meeting with the adviser where the discussion should be about you, your family and your goals.

Additional meetings and communications from your adviser should follow the same script. Updates should focus on progress against milestones to achieving your goals and not on the performance of investments.

Remember that the actual investments in your portfolio are a means to an end and nothing more. Beware if the adviser rushes to complete a regulatorily mandated risk tolerance questionnaire so he or she can start talking about all the great investments you can buy. Your hopes and dreams matter more than the answers to hypothetical scenarios in the questionnaire.

Independent investor

There is no need for an adviser to be involved in the process of defining your goals. That said, it is important to acknowledge that many people struggle with defining goals because it requires thinking about the future in a very specific and concrete way. To derive the benefits that come from goals-based investing it is critical that you, or you and your family, set aside some time to have this conversation.

Make sure that your goals are concrete—think when, what and how much each goal will cost (remember this is a future cost and must account for inflation).

Morningstar provides our Premium members with the *Morningstar Portfolio Construction Guide*, to assist independent investors with the goal definition and tracking process.

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A total wealth approach

Working with an adviser

Context is a crucial component to financial planning. To establish the appropriate context the adviser must understand more about you than just the contents of your portfolio.

Before any conversation about investments, the focus should be on your career and prospects, your age, where you live, your family circumstances and any specific personal circumstances. This will allow the adviser to understand your total resources and limitations which will provide a clearer perspective on what it's going to take to accomplish your goals.

You should be wary if the first question your adviser asks you is how much money you are looking to invest.

Independent investor

Again, this is a case where the adviser is not necessary for the conversation. Many people struggle with the level of self-reflection necessary to get value out of this exercise. The key is to look at aspects of your life and honestly reflect on any potential ramifications on reaching your goals. Everyone is unique but below are some of the possible things you should consider:

- **Your career**: What factors could influence your salary and employment that are outside of your control? Is your job in a highly cyclical industry where a downturn could result in salary reductions and layoffs? What are the prospects for future increases in your income? What is the longevity of your career? What are your core skills and are they at risk for automation?

- **Family**: Are there potential dependents that you may have to support—adult children, aging parents, etc.?

- **Where you live**: We often hear about inflation on a national level but there are many local and personal factors that may impact your expenses—real estate prices, the impact of rising interest rates, etc.

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Risk

Working with an adviser

The way your adviser defines risk is a crucial indicator of their overall philosophy of delivering financial advice.

We believe the common practice of focusing on risk preference doesn't paint a complete picture. Your adviser should do more than simply ask you how you feel about taking risk (which is commonly done through a risk tolerance questionnaire).

Conversations with your adviser should focus on risk aversion—the amount of risk you should take given your available resources and the goals you want to accomplish. This is a far more complete picture of risk than just focusing on than the amount of risk you want to take.

The amount of required risk and your goals are fundamentally linked. The reason you invest in the first place is to meet your goals. The act of investing is a trade-off between risk and return. Taking on less risk with your investments may increase your risk of not reaching your goal.

Independent investor

For independent investors the question of risk is not something that needs to be viewed in isolation. When investing your own money there is no compliance department or regulator to ensure an adviser has considered the risk tolerance. There is also no need to shoe horn people with very different circumstances into the same portfolio based on a common risk tolerance.

When focusing on goals the real risk to be assessed is the risk that you do not meet your goal. Only you can assess what that means. For instance, not meeting your retirement goal means that you may have to work for a few more years or cut back on your lifestyle in retirement. The good news is that being actively engaged in your portfolio and assessing performance using progress against goals allows you to make course corrections along the way.

A good way to determine how you are tracking against your goals is to look at the required rate of return necessary to reach the goal. If the required rate of return to meet your goal is unrealistic based on historical market returns you may need to reassess. Conversely, if the required rate of return is low you may be able to achieve your goal with a more conservative portfolio.

Morningstar provides our Premium members with the *Morningstar Portfolio Construction Guide*, to assist independent investors with the goal definition and tracking process.

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Portfolio construction

Working with an adviser

Selecting invests should be the last step of your initial work with your adviser. As previously stated, the actual investments should only be selected once your adviser understands your circumstances and your goals have been clearly defined.

To understand how your adviser selects investments you can ask them how portfolio choices align to client profiles. It is operationally easier for an adviser to just have a single asset allocation target for each risk level. It is also unlikely that this approach will serve you well. Different goals have different risks and that should all be incorporated into the portfolio selection process.

Independent investor

Constructing a portfolio and picking investments is not an area where advisers typically add much value. That of course doesn't make it an easy process for independent investors. Portfolio construction is a two-step process. First, an investor must determine the asset allocation of the portfolio, or what types of assets should go into the portfolio. Then individual investments are selected within each of those asset classes.

The first step is to select an asset allocation target for each goal. To assist with this process Morningstar has multiple guides and tools, including five different defensive/growth asset class combinations related to five different levels of risk. These can be found in the following areas:

1. *Morningstar Portfolio Construction Guide*

2. Use our Wealth Forecasting Engine to review forecasted returns for each of the five portfolios.

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Portfolio construction (cont'd)

Working with an adviser

As we described in the overview section of this guide, much of the public and regulatory scrutiny of advisers has been based on selecting investments that serve their interests rather than yours. A good adviser should be open to discussing why a particular investment was selected. One way to get reassurance is to validate the recommendation against an independent opinion. All advisers have access to independent research, with 60% of them having access to Morningstar research. Ask your adviser for a second opinion.

The asset allocation and investments in your portfolio should change as you make progress towards your goals—they should not remain static simply because your risk tolerance has.

Goals-based portfolios often have a "glide path" that details how they should change over time. Remember that you have multiple goals with multiple time horizons and the investments dedicated to funding each of these goals can be very different (short-term vs. long-term).

Independent investor

The second step is to select the underlying investments. Morningstar provides independent research on more than 650 securities in Australia and New Zealand. Our research can be accessed via Morningstar Premium and we have several tools that can be used to identify our top rated investments. These can be found in the following areas:

1. The Morningstar Stock Screener is a tool that can be used to search for stocks by sector, market cap, and key criteria including performance figures and valuation ratios. For Premium members, you can also include criteria such as our analyst recommendations, economic moat, stewardship rating, fair value uncertainty or three analyst pre-defined searches.

2. The Morningstar Fund Screener is a tool that can be used to find investment trusts, superannuation funds, pensions and annuities by fund manager, category, assets, minimum investment and returns criteria. For Premium members we also include the Morningstar Rating as search criteria.

3. Morningstar's ETF Model Portfolios are a series of diversified, model portfolios that are designed for varying investor risk and return profiles. Asset allocations have been devised using Morningstar's strategic asset allocation framework and long-term capital market assumptions. ETF selection relies on Morningstar's qualitative and quantitative ETF research.

4. Morningstar's monthly Global Equity Best Ideas is a compilation of stock ideas sourced from Morningstar's global equity research team. Coverage includes companies based in Australia & New Zealand, Asia, the Americas and Europe, which are currently trading at significant discounts to our assessed fair values.

Behavioural coaching

> The investor's chief problem—and even his worst enemy—is likely to be himself.
>
> **Ben Graham**

Another area in which advisers can add value is behavioural coaching. Simply put, it's through behavioural coaching that an adviser can stop you from making bad decisions. Before we introduce techniques independent investors can use to prevent poor decisions, let's examine why such decisions are made.

When the markets start dropping, do you begin to panic? Do you feel envious when you hear that other people's investments are beating yours? Investing is clearly more than a mathematical analysis of risk and return. It's a struggle with ourselves: to block out irrelevant information, to have the strength to stick to a plan and to resist the urge to follow the herd (except, of course, when it knows better than we do). Facing this internal struggle, investors are often told to avoid the emotional roller coaster and magically remove emotions and temptation from the picture. Easier said than done.

Consider these two options. Which one should you choose?

a. Buy low, sell high (i.e. make a profit);
b. Buy high, sell low (i.e. put your money in a big pile and burn it)

Got your answer to that one? Great, now let's try another one. Imagine a story splashed all over the news about a hot company with a revolutionary new product, think, the next Apple or Tesla. Should investors:

a. Check out the company and potentially invest;
b. Ignore the news and invest as before.

We may assume "a" is the correct response. But we're likely to be conflicted. At the same time, we sense it's a trick, and that "b" is probably the right answer. But "a" feels natural because words such as "all over," "hot," and "revolutionary" ring positive, and they tell us that many other people like the company. We're naturally drawn to things others like and find valuable. Behavioural scientists call that "social proof".

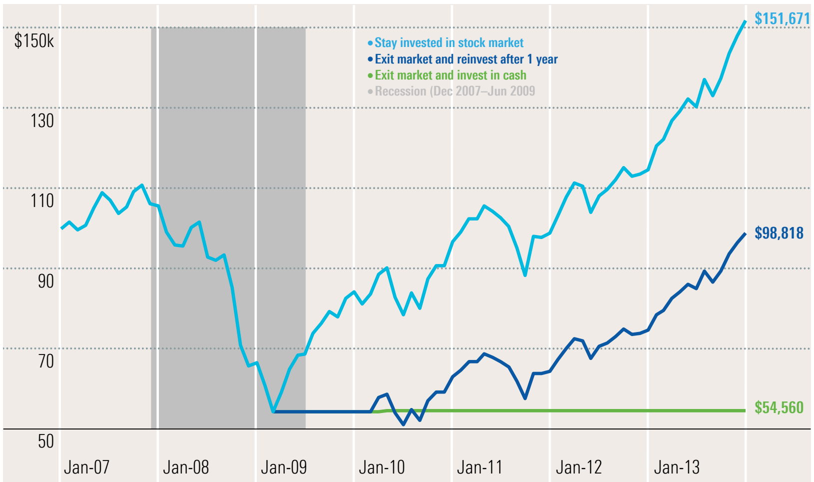
Unfortunately, investing isn't natural. If other people like an investment, the price goes up. If the price goes up, all things being equal, you're buying high—which is like putting money in a big pile and burning it. Yes, there are many nuances here, like the fact that other people might drive the price up even more after you buy it (a phenomenon known as the "greater fool" theory). But putting aside the nuances and our innate temptation to try to outsmart everyone, that's one small part of the crazy logic of investing.

So, investing is a bit crazy. Why should that matter? It matters because if we do what feels natural, if we don't understand the crazy world of investing, we can lose our money. This doesn't mean that we might "miss out" on a hypothetical future gain. It could be much more serious than that—it may mean failing to reach our goals.

Investing is fascinating, and it's often exciting and fun. But we can't ignore the dark underside. Investments

The importance of staying invested

Ending wealth values after a market decline



Source: *Simple but Not Easy: Morningstar's Guide to Helping Investors Overcome Behavioral Obstacles*

are always risky, and there's always the chance of losing out. But, a key factor that make investments risky is our own behaviour as investors. Studies show that investors who actively traded stocks in the market made mistakes again and again—and had returns that were one third lower than that of average return.1 Even investors who have invested in mutual funds have similar challenges—losing up to 3.11% of returns on average (some are better, some are worse).

As Ben Graham said in *The Intelligent Investor*: "The investor's chief problem—and even his worst enemy—is likely to be himself." So, what actually happens?

What we do wrong

While there are many ways in which investors can run into trouble, three problems are very common:

- **Problem #1**: Chasing returns. If you've ever talked with mates about the stock market, you've probably felt the urge to invest in a new hot stock or sector. The problem is this: so has everyone else.

- **Problem #2**: Exiting the market during downturns. When the markets get jumpy, people ask themselves, "Is the market going to fall more, and should I get out?" Unfortunately, it's impossible to tell whether a drop in the markets will continue, or whether it will rapidly turn around. In the extreme, Morningstar research shows that if investors pulled out of the market and missed the 10 best upswing days from 1992–2012, they'd have lost 45% of their returns.

- **Problem #3**: Picking inappropriate investments. Investors are inundated with information about investments. It can be overwhelming, so we often go with what feels right. Unfortunately, for complex issues like asset allocation, diversification, and portfolio selection, the details matter, because they help drive long-term growth and determine whether we reach our goals.

What we can do about it

Many of us are hardwired to make mistakes in the market. Common errors (or "biases") include being overconfident in our ability to pick stocks, focusing unduly on recent returns, and underestimating the power of compound interest. The research on these biases is extensive and spans decades of work. Here's a quick summary of the key lessons from this research, which you can use as a starting point to think about the way you invest.

If there's one overriding lesson in the research, it's this: we're hardwired for these biases, and the most common advice in the investment community—telling investors to just be smart and resist them—is woefully insufficient. Instead, we should look for clever ways to avoid or short-circuit such biases.

Overconfidence Bias

WHAT IS IT: Being overly optimistic about one's likelihood of success. For example, investors often falsely believe they can select investments better than others and can outperform the market.

HOW TO TACKLE IT: Educating yourself about the prevalence of overconfidence appears to be effective. That means remembering that all investors tend to be overconfident.

Confirmation Bias

WHAT IS IT: Subtly seeking out and paying more attention to information that supports one's viewpoint. For example, confirmation bias would be believing that a company or sector will do well in the future, and then "finding" information that agrees.

HOW TO TACKLE IT: List reasons that others might give against their viewpoint (i.e. to scrutinise an opposing viewpoint). Another technique is "prospective hindsight," whereby you imagine a future in which you learn that you were wrong and think about why that happened.

Recency Bias (Related: Representativeness Bias)

WHAT IS IT: Focusing unduly on recent events and using them to judge the future. For example, believing that an investment's recent stellar performance means it will do well in the future.

HOW TO TACKLE IT: Study powerful examples of when buying after stellar performance led to disaster, like the run-up to the 2008 Global Financial Crisis. Statistics alone, however, aren't enough; the more vivid and easy to remember the example, the better (this is a reason experience makes you a better investor). You can also focus on an alternative way to interpret past performance with easy-to-remember rules. For example, "when prices go up, the opportunity to profit usually goes down," or "the danger of losing money usually goes up as prices rise."

Disposition Effect

WHAT IS IT: Holding on to investments that have lost relative value for too long in order to avoid the regret of a bad decision or selling stocks too early that gain in price. This is related to loss aversion: our overweighting and fear of losses relative to gains.

HOW TO TACKLE IT: Set guidelines for when to sell before you are caught up in the emotions of regret and fear.

Present Bias

WHAT IS IT: Failing to take future needs seriously enough and focusing on the present instead.
For example, not putting aside enough for one's investments to have a comfortable retirement.

HOW TO TACKLE IT: List each of your likely expenses in retirement because the amount you'll need is surprising, and it makes the future more real. Another technique is to pre-commit to saving more when you receive your next raise or bonus.

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