TRUST
INVESTMENT PERSPECTIVES

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When Instincts Are Wrong:
Overcoming Behavioral Biases

"We have met the enemy and he is us" - Walt Kelly

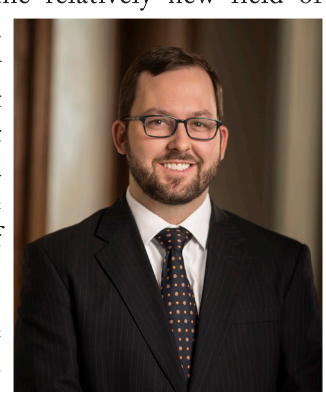
One of the fascinating aspects of managing wealth for individuals is getting to watch the wide range of human emotions play out in real time. Often, different clients react to the same event in diametrically opposed ways. Many clients will see the market drop on fears over the latest Trump tweet or North Korean nuclear test and have the impulse to sell in order to protect from further losses. A smaller number of clients will sense an opportunity to buy assets at lower prices.

Both reactions are understandable. However, one response is clearly more likely to lead to success over time. The "sell first and think later" response is driven by what Nobel Prize-winning psychologist Daniel Kahneman calls System 1 thinking – fast, intuitive and emotional. In his bestselling book *Thinking, Fast and Slow*, Kahneman shows how System 1 thinking is great for many human activities – everything from driving a car on an empty road to automatically knowing the answer to simple equations like 2 + 2.

System 2 thinking, on the other hand, is slow, deliberate and requires conscious effort. It's the type of thinking required for more complex equations, like 17 x 24, or making a left turn into dense traffic (both examples from Kahneman's book). Most importantly, it is less prone to error, making it the better system of thinking when it comes to most investing decisions.

The discoveries of researchers like Kahneman help explain why many predictions of traditional economic theory turn out to be incorrect in the real world. The problem lies with classical economists' assumption that people act in rational ways to maximize wealth. One needs look no further than the Dutch tulip bulb mania or the Beanie Baby craze of the 1990s (and perhaps the price of Bitcoin today) to find examples of human emotion overriding rational behavior.

The combination of traditional economic theory with human psychology led to the relatively new field of behavioral economics. Practitioners of this new science discovered that human irrationality isn't random - we are wired in a way that makes us susceptible to predictable patterns of irrational behavior.



Zac Reynolds
Senior Vice President

Behavioral economists have separated these behaviors

Continued on page 2

MARKET RECAP

Equity markets worldwide continued their upward trajectory in the third quarter, supported by strong earnings.

	Third Quarter	YTD	Past 12 Months
Dow Jones	5.6%	15.5%	25.5%
S&P 500	4.5%	14.2%	18.6%
EAFE (Int'l)	5.4%	20.0%	19.1%

Get to Know Us

A close look at one of our team members.

We are honored to work with dedicated professionals and great citizens. Assistant Vice President **Alex Kaiser**, a member of our OKC team since 2015, is one of them. He graduated from OSU and received his law degree from TU. We asked him a few questions.

Investment Perspectives: What do you like to do when you are not working?
Alex Kaiser: I love spending time with my wife, Jenn, and my daughter, Drew. When I'm not with my two favorite ladies, you will probably find me on the golf course.

IP: Describe what you do at Trust Company of Oklahoma.
AK: I am a trust officer, i.e. I am the client's quarterback. We provide clients with a wealth of services. It is my job to be the primary point of contact for clients and make sure that all of their needs and goals are being met.

IP: What is your favorite part of this job?
AK: The clients. It is a privilege to work with some of the most successful, kind, generous people in Oklahoma City.

IP: What impact do you wish to have on clients' futures?
AK: Whether it's helping them reach their retirement goals, leave a lasting charitable impact, amend their estate plan, or pay for the college education of their grandchildren, I want their lives to be better because of our dedicated work.

IP: What is something you are proud of?
AK: I am incredibly proud to serve on the Board of Directors of The Children's Center Rehabilitation Hospital in Oklahoma City. The services and care this hospital provides to children in need is truly incredible. I am humbled to be a part of the organization.

IP: What was the best financial advice ever given to you?
AK: Discipline trumps conviction. David Stanley, manager of the Oklahoma City office, told me this on my first day at TCO. In our industry, the markets give us very high highs and very low lows. It's easy to let the spikes and dips result in fear, greed and impulsive decision making. Those of us who can stay true to our financial goals and investment objectives will be better off in the long term.

IP: What inspires you to go to work every day?
AK: My co-workers. There is a culture and energy in the company that is second to none.

IP: What is your favorite book?
AK: *Into The Wild* by Jon Krakauer.

IP: What is your favorite place in the world?
AK: Currently, it's anywhere I am when my two-month-old daughter looks up at me and smiles.

IP: If you could have dinner with anyone, living or dead, who would it be?
AK: Warren Buffet, Pat Tillman and Abraham Lincoln.

into two main types – emotional biases and cognitive errors. Emotional biases spring from impulse or intuition, and can be difficult to correct – after all, we can't really help the way we feel. We can, however, recognize when certain feelings occur and do our best to avoid making decisions based on feelings alone. Cognitive errors are the result of subconscious mental "shortcuts" or blind spots in the human mind. These sorts of errors are more easily corrected than emotional ones, mainly through better information, education, and the use of System 2 thinking.

As identifying the problem is always the first step toward a solution, let's examine a few of the common errors people make when it comes to investing.

Emotional Biases

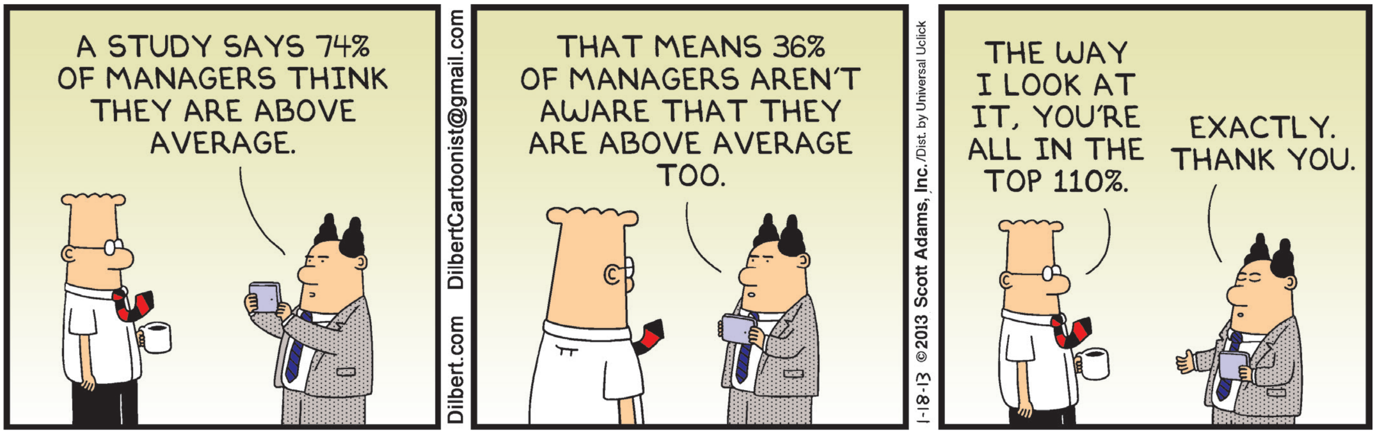
Loss-Aversion: Highly relevant to investing, loss-aversion bias was first identified by Kahneman and his partner Amos Tversky in 1979. They observed that people tend to strongly prefer avoiding losses as opposed to achieving gains. In simpler terms, most people feel about twice as much pain from losing money as they do pleasure from gaining an equivalent amount. We see this behavior often as some clients will scan their investments and quickly focus on individual securities trading at a loss. Often, there will only be a few securities in the red versus dozens of securities with gains. Still, System 1 thinking takes over and people will react emotionally even to the pain of unrealized losses.

By slowing down and engaging in System 2 thinking, most people will recognize that in a diversified portfolio, there will usually be some out-of-favor stocks. It's the total portfolio gain that counts – not any one security.

Overconfidence: Perhaps one of the most difficult biases to recognize in oneself, overconfidence is nonetheless potentially destructive to wealth. Studies show people generally do a poor job of estimating probabilities, yet still believe they do it well because they are smarter and more well-informed than they actually are. The same phenomenon causes 90% of drivers to consider themselves above average. Logically, of course, we know that a huge number of drivers are, in fact, *below average*.

Overconfidence often causes individuals to construct portfolios that are overly concentrated in one stock or sector. They may think they have an insight or edge and ignore the risk that is created

Continued on Page 3



by failing to diversify. Another common case: employees who invest the majority or all of their retirement savings in their employer's stock. They believe because they are inside the organization, they have greater control over how the company will perform. Sadly, former employees of companies like Enron and WorldCom found out how little control they actually had.

Regret-Aversion: This is the tendency to avoid making decisions that they fear could lead to regret in the future. Oftentimes this will lead to people being "frozen" after sharp moves up or down in the market. If the market has fallen significantly, the fear instinct kicks in and people are afraid they will invest only to see the market move down further. Conversely, if the market has had a strong run (as is the case today), fear of investing right at the top can keep investors out of the market and on the sidelines.

A good strategy for overcoming regret-aversion is creating a plan and sticking to it. For example, those who have their 401(k) contributions automatically withheld from each paycheck are much less likely to alter their investments after sharp moves in the market versus those who are manually making contributions.

Cognitive Errors

Hindsight: This is the bias behind the phrase "Hindsight is 20/20." Meaning, of course, that it is easy to see the right course of action with the benefit of hindsight. This is a dangerous bias, though, because it leads people to believe that what did happen was inevitable, or the only possible outcome. In reality, what did happen was one of many possible outcomes.

Think about this as a game of chance. If someone flips a coin and lands on heads five times in a row, we know that is an unusual result – something that should only happen about 3% of the time. We also recognize that an outcome of three heads and two tails was just as possible (and indeed more likely). We don't assume that the flipper of the coin is highly skilled at flipping heads – only that chance or luck led to an unusual result. Predicting the future, whether it is the path of a hurricane or the performance of a stock, is an inexact science. A forecaster can incorporate all the information available and still be wrong. Or make a wild forecast and be right due to luck. It requires a large sample size of predictions to discern between luck and skill.

Confirmation bias: Some people tend to seek out information that confirms their preconceived notions and to ignore or undervalue information that contradicts their beliefs. Examples abound, inside and outside the investing world. Think of your diehard Republican friend who only watches Fox News or your liberal relative who gets all her news from MSNBC. Neither person is likely to have their beliefs challenged. At TCO, one tactic we use to combat confirmation bias is to ask portfolio managers to lay out a bear case as well as a bull case when considering a particular investment. By fully examining both sides of the argument, we are less likely to fall victim to this bias.

Costly Errors

Identifying mistakes is the easy part. Recognizing them and consciously changing a behavior to be more rational is more challenging. Making the effort to engage in more System 2 thinking should certainly pay off, though, as studies from Vanguard and Morningstar estimate that behavioral investing errors cost investors around ±2% per year in lower returns versus the overall market. Those lower returns can be attributed to poor timing decisions – namely buying high and selling low, often due to behavioral errors. Working with a professional money manager means having someone who can recognize and mitigate these emotional biases and cognitive errors.

Of course, if you made it through this article, you are clearly well above average and immune to any of the biases that affect lesser humans. Congratulations!

The Class of 2030

Gearing Up for College Without Going Broke

I recently dropped my youngest child off at his first day of kindergarten. As we were walking into the classroom, I overheard another parent reference these children as the Class of 2030. It caused me to think about those very kids, most of whom were tripping over their untied shoe laces, who will be arriving on college campuses in just 13 years. Scary. But not as scary as the college tuition.

According to some projections, the estimated cost for my five-year-old to attend a four-year public university is around $175,000 and this is assuming he receives in-state tuition. A private college is expected to be closer to $475,000. *Gulp*! No wonder college tuition and student loans are the top financial concern of young people today. Even for high net worth Americans, this price tag is getting harder to swallow. And in the end, the experts behind the projections agree that the best gift you can give your child (or grandchild) is an education.

Saving for College & Paring Down Estates

An efficient method of saving for college is through a 529 savings plan. Created in 1996, this tax-advantaged investment vehicle has become a popular tool for helping save for college. It offers a variety of benefits, including some that go further than the goal of college tuition. It could even play a part in your family's estate plan.

A 529 plan can be set up for anyone intending to take part in post-secondary education (including university, community college or trade school). The account is owned and controlled by an individual (usually a parent or grandparent) and has a named beneficiary. There are several important tax benefits associated with most 529 plans.

First, assets within the account grow tax free, including appreciation and income. Second, as long as the funds are used for qualified education expenses (such as tuition, fees, room, board, and books), the withdrawals are free from federal, and usually state, income tax. Lastly, for state-sponsored 529 plans, contributions into these plans often receive a state tax deduction for the owner.

Contributions are considered completed gifts even though the owner retains control over the account. You may also create 529 accounts for as many individuals as you like, giving up to $14,000 annually per account (or if you are married, $28,000) without triggering gift taxes.

If students don't go to post-secondary education or don't need the money, beneficiaries can be re-assigned within the family. In addition, a 529 plan can be passed down from generation to generation without federal income taxes ever being paid as long as future heirs use the funds for qualified higher education expenses. Depending on the amount transferred, gift taxes may be a consideration. Funds can always be withdrawn from the 529 plan for non-educational needs, but the earnings portion will generally be taxed at the recipient's rate and subject to a 10% penalty. Additionally, state tax deductions received from previously made contributions may be subject to recapture.

Setting Up A 529 Plan

If you decide a 529 plan is worth consideration, do your due diligence when selecting a plan. Plan features differ from state to state. At TCO, an experienced team can assist you with your gifting plans for your child or grandchild's college education. Consult our professionals before making any decisions that could impact your tax liability. Now back to the Class of 2030: their future is bright; but we better start learning how to tie those shoes.

Whittney Stauffer
Vice President

Managing Your Finances While Grieving the Death of a Spouse

Lesa Creveling
Senior Vice President

Mourning is painful and stressful. In the midst of dealing with the loss of a loved one, moving on with life and taking care of legal issues, a surviving spouse is overwhelmed with emotions and new financial responsibilities.

The transition is typically harder for those who relied financially or logistically on their now deceased spouse. The widow or widower might not know how to balance a checkbook or manage the retirement account because the decedent always handled "the money stuff." We, at TCO, often see the death of a spouse become a financial shock for some individuals. Those who had a plan – and a team of experienced professionals – encounter fewer challenges during the grieving period.

Here are six tips based on our experience helping clients navigate the legal and financial turmoil that follows the loss of a life partner. Call our professionals if you have further needs. We can guide you through this difficult and entangled path.

Prepare for the paperwork

Request at least 12 certified copies of the death certificate. They are difficult to obtain later. Generally, you will need an original for each asset/account to be transferred. There will be lots of forms to fill out.

Determine your income stream

Determine your sources of income and how much you will receive monthly, then develop a new budget. Consult your investment professionals to assist in determining your needs, income stream and how these might need to be altered.

Create a checklist

Consult your professional advisors (attorney, CPA, trust officer) to assist you in putting together a checklist and priorities. Notify the Social Security Administration of the death in order for you to obtain survivor benefits.

Avoid major life decisions the first year

You will be taken by the emotional toll and it's possible that you might react in the heat of the moment. Avoid hasty decisions such as selling the house too quickly. Wait until you feel more settled.

Estate closure & insurance claim

Collect life insurance, rollover IRAs, file termination paperwork for any joint tenancy assets, create sub-trusts if required by a trust document, probate assets if needed.

Update your estate plan

Update your beneficiary designations, will and trust documents, as the death of your spouse might require changes in your estate plan.

SPOTLIGHT

The **Oklahoma Council on Economic Education** (OCEE) is dedicated to reaching every student in Oklahoma with personal finance and economic education. Founded in 1954, the nonprofit seeks to provide K-12 Oklahoma teachers with practical educational resources and professional development opportunities to help them incorporate the principles of economics and personal finance in their classrooms.

The need for financial education in Oklahoma schools cannot be overstated. Research shows that the income of nearly one in three young adults in Oklahoma goes toward debt repayment. In fact, more individuals are filing for bankruptcy than graduating college in this state. It may not be a surprise to learn that Oklahomans are ranked third in the nation at spending more than we make.

OCEE's proven methods lead to an increase in credit scores and a decrease in credit delinquency. Moreover, at a time when education budget cuts have never been more severe and the burden on our schools has never been greater, OCEE is a source of support for K-12 teachers and students.

By working with partners across Oklahoma to provide teacher and student programs, OCEE reached 576 teachers and impacted the lives of over 31,000 students in 2016.

OCEE constantly seeks new partners and volunteers to help expand its programs to reach the remainder of the 700,000 students and 46,000 Oklahoma teachers. In November, OCEE will be hosting their largest annual event for third to fifth grade students and teachers in three Oklahoma cities: Tulsa, Oklahoma City and Ardmore. This event will be an opportunity for these educators and their students to see OCEE's impact on their lives. To learn more about OCEE and how you can help, visit **econisok.org**

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