

The ABCs of Behavioral Biases: S–Z

We're coming in for a landing on our alphabetic run-down of behavioral biases. Today, we'll present the final line-up: sunk cost fallacy and tracking error regret.

Sunk Cost Fallacy

What is it? Sunk cost fallacy makes it harder for us to lose something when we also face losing the time, energy or money we've already put into it. In *Why Smart People Make Big Money Mistakes*, Gary Belsky and Thomas Gilovich describe: "[Sunk cost fallacy] is the primary reason most people would choose to risk traveling in a dangerous snowstorm if they had paid for a ticket to an important game or concert, while passing on the trip if they had been given the ticket for free. "You're missing or attending the same event either way. But if a sunk cost is involved, it somehow makes it more difficult to let go, even if you would be better off without it.

When is it helpful? When a person, project or possession is truly worth it to you, sunk costs—the blood, sweat, tears and/or legal tender you've already poured into them—can help you take a deep breath and soldier on. Otherwise, let's face it. There might be those days when you'd be tempted to help your kids pack their "run away from home" bags yourself.

When is it harmful? Falling for financial sunk cost fallacy is so common, there's even a cliché for it: throwing good money after bad. There's little harm done if the toss is a small one, such as attending a prepaid event you'd rather have

skipped. But in investing, adopting a sunk cost mentality—"I can't unload this until I've at least broken even"—can cost you untold real dollars by blinding you from selling at a loss when it is otherwise the right thing to do. The most rational investment strategy acknowledges we cannot control what already has happened to our investments; we can only position ourselves for future expected returns, according to the best evidence available to us at the time.

Tracking Error Regret

What is it? If you've ever decided the grass is greener on the other side, you've experienced tracking error regret—that gnawing envy you feel when you compare yourself to external standards and you wish you were more like them.

When is it helpful? If you're comparing yourself to a meaningful benchmark, tracking error regret can be a positive force, spurring you to try harder. Say, for example, you're a professional athlete and you've been repeatedly losing to your peers. You may be prompted to embrace a new fitness regimen, rethink your equipment, or otherwise strive to improve your game.

When is it harmful? If you've structured your investment portfolio to reflect your goals and risk tolerances, it's important to remember that your near-term results may frequently march out of tune with "typical" returns . . . *by design*. It can be deeply damaging to your long-range plans if you compare your own performance to irrelevant, apples-to-oranges benchmarks such

as the general market, the latest popular trends, or your neighbor's seemingly greener financial grass. Stop playing the shoulda, woulda, coulda game, chasing past returns you wish you had received based on random outperformance others (whose financial goals differ from yours) may have enjoyed. You're better off tending to your own fertile possibilities, guided by personalized planning, evidence-based investing, and accurate benchmark comparisons.

We've now reached the end of our alphabetic overview of the behavioral biases that most frequently lead investors astray. In a final installment, we'll wrap with a concluding summary.

Until then, no regrets!

David Bromelkamp
President and CEO



The two greatest enemies of the equity fund investor are expenses and emotions.

—John C. Bogle, Founder, Vanguard

Headlines

- Dave Bromelkamp will be speaking at the Becketwood Cooperative on April 25. The topic will be Socially Responsible Investing (SRI).
- Eric Hutchens will be a speaker at the Markets Group 4th Annual Private Wealth Central States Forum on April 2, at the Hyatt Regency.
- We had a lovely time with clients, friends, and colleagues at the Allodium January 2019 Investment Forum. Dave, Anne, Eric and Kari spoke about **Managing Investment Risk in Volatile Markets**.
- Allodium was pleased to welcome ten new clients into the firm during the fourth quarter of 2018.
- Our office will be closed April 19, 2019, for a company holiday.
- Reminder: we are continuing to transition to the domain name of *allodium.com* for both our website and employee email addresses over the next year.

Note: To find out more about Allodium’s breaking news, please visit our website: www.allodium.com.

Upcoming Events

May 2, 2019:

Taking a trip this summer? Join us for Allodium’s Spring Wealth Management Workshop where we will discuss **Financial Planning Tips for Travelers**. Details coming soon.

WE APPRECIATE YOUR INTRODUCTIONS

To optimize our objectivity and avoid conflicts of interest, we are a fee-only registered investment advisor that is completely independent from banks, brokerage firms and other financial product providers. If you know someone who may be looking for this type of objective investment advice, please contact Dave Bromelkamp at 612-230-3702 or dbromelkamp@allodium.com to arrange a friendly, no-obligation introduction.

FINANCIAL PLANNING TIP:

Take Advantage of Tax-Deferred Accounts

As we enter into tax season, we are reminded of the impact that taxes have on our discretionary income. Whenever possible, investors should take advantage of tax-deferred accounts that defer tax on earnings to a future date. For investors with access to employer-provided retirement plans, contributing to a retirement plan is a simple way to build tax-deferred assets. Beginning in 2019 investors can now save an additional \$500 per year. The new contribution amounts are as follows:

RETIREMENT PLAN CONTRIBUTION LIMITS

PLAN TYPE	2018	2019	AGE 50+ CATCH UP CONTRIBUTION
401(k), 403(b) & most 457 plans	\$18,500	\$19,000	\$6,000
Combined Total to Traditional IRA & Roth IRS	\$5,500	\$6,000	\$1,000
SIMPLE IRAs	\$12,500	\$13,000	\$3,000
Combined Employee & Employer Maximum Contribution Limit	\$55,000	\$56,000	\$6,000

Traditional/Roth IRA contributions can be made up to the tax filing deadline of April 15th. Simple IRA matching contributions can be made until the tax-filing deadline (plus extensions) of the company return. Ask your CPA about eligibility. Taking advantage of the higher employer retirement plan contribution limits is just one of many ways to save on taxes.

Investment income also weighs on an investor’s tax return. Therefore, tax-efficient investing is an essential component of a sound financial plan. **Asset location** refers to where an asset is held—taxable brokerage accounts, tax-deferred accounts like 401(k) and 403(b) accounts, or tax-free accounts like Roth accounts and 529 plans. Investors must decide how to use “tax-preferenced” accounts to hold their investable assets to optimize tax efficiency. Picking the correct location for an asset can make a sizable difference in increasing your portfolio by reducing income tax liabilities. Choosing which types of tax-preferenced accounts are right for you depends on factors such as current and future income tax laws, your financial profile, personal income tax rate and the expected return features of the specific securities. Consider evaluating your investments in your various types of accounts to consider whether you are following a tax-efficient investment strategy and consult with your financial advisor or tax specialist.

Steward is published quarterly by Allodium Investment Consultants. Please contact Ilona Avraamides at 612-230-3711 or iavraamides@allodium.com if you have any comments about this publication or wish to be added to or removed from our mailing list.



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