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Financial Briefs

MARCH 2023

The Practical Implications of Investment Theory

Many investment principles used to develop investment portfolios derive from one investment theory — the capital asset pricing model. What exactly is this theory and how does it apply to your investments?

The capital asset pricing model was developed over 50 years ago by Harry Markowitz, who won a Nobel Prize for his work. His theory centers on the concept that adding an asset to a portfolio that is not highly correlated with other assets in the portfolio can reduce the portfolio's variation risk. Before his theory, it was common practice to look for undervalued assets to add to a portfolio. His approach evaluated how a particular asset would impact the portfolio's risk and return. Whether it makes sense to add that investment to the portfolio depends as much on how the asset's return will vary with returns of other portfolio assets as it does on its own return prospects.

This theory provides the underlying rationale for asset allocation. The key is that the returns of different assets do not behave in the same manner during different economic times, so adding different assets can reduce the volatility in that portfolio. While the return of a diversified portfolio may be lower than that of investing solely in the best performing asset, this is typically viewed as an acceptable tradeoff for the reduced risk. Many people have also realized it is difficult to identify the best performing asset in any given year, so a diversified portfolio pro-

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7 Psychological Traps

Sometimes, when it comes to investing, volatile markets aren't your worst enemy; it's actually yourself. That's because money and logic don't always go hand in hand. Unfortunately, our brains often play tricks on us, causing even the sav-viest of investors to make decisions that don't really make a lot of sense, from panic selling to ignoring opportunities.

The problem of psychological investing traps is so pervasive, in fact, that there's a whole field dedicated to studying it called behavioral finance. Researchers in this discipline look at the way psychology affects how we make financial decisions, and some of what they've discovered is pretty interesting. Knowing about these traps can help you avoid them and make you a better investor.

Here are seven psychological traps to keep in mind.

Sunk Costs Bias — The sunk costs bias has to do with the all-too-common tendency to stick with something, whether a bad boyfriend or a bad investment, long after it's clear it's not worth it anymore. Still, because you've invested a certain amount of time or money, you're reluctant to give it up. In investing, you might end up hanging on to a stock long after you should in the vain hope you'll eventually come out ahead. But in these cases, it's better to cut your losses rather than hang on to a loser.

Familiarity Bias — Most of us are biased toward that which is familiar to us. We eat at restaurants we've been to before and follow the same roads to work because we know what to expect. With investing, familiarity bias involves favoring investments that are familiar to you. You might prefer to invest in the company you work for or big-name businesses that are in the news. That could cause you to overlook important opportunities you don't know much about.

Anchoring — Anchoring is the process of getting attached to a particular reference point — such as the

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Practical Implications

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vides more consistent returns.

Some investment implications that have been drawn from this theory include:

- A properly diversified portfolio will combine assets that do not have highly correlated returns. Thus, when one asset is declining, other portfolio assets may be increasing, or may not be decreasing as much.
- Rather than focusing on each investment's risk, investors should consider their portfolio's overall risk.
- Including a small percentage of a volatile investment may not increase a portfolio's overall risk, provided that investment's returns do not vary closely with the returns of the other assets in the portfolio.
- When small portions of stocks are added to an all bond portfolio, risk initially decreases, even though stocks are more volatile than bonds. Therefore, an all bond portfolio is not the lowest risk portfolio.
- Investors should consider how varying percentages of different asset classes will affect their portfolio's risk and return before deciding on an asset allocation.

Managing Your Portfolio

Consider this investment process to incorporate this theory:

- **Determine your risk/return preferences.** You should assess the potential downsides as well as upsides for various investments to get a feel for how much risk you can tolerate.
- **Decide on an asset allocation mix.** Your asset allocation strategy represents your personal decisions about how much of your portfolio should be allocated to various investment categories. After considering your risk tolerance, time horizon for investing, and return needs, you can form a target asset allocation mix. Within broad investment categories, make allocation decisions for each category. Not only will each individual's allocation strategy differ, but your strategy will vary over time.
- **Select individual investments.** Investigate a wide range of options, but make sure you understand the basics of each, examining the types of risk they are subject to as well as their historical rates of return. Your selections should fit in with your overall asset allocation.
- **Rebalance periodically.** Over time, your asset allocation will stray from your desired allocation, due to varying rates of return on your investments. Determine how much variation you are willing to tolerate, perhaps 5% or 10% from your desired allocation. If portions of your portfolio have strayed more than that, you should take steps to get your allocation in line. However, first determine if there are ways to do so without incurring tax liabilities. Selling assets from taxable accounts may result in taxable transactions. Instead, you may want to make new investments in some of your underweighted assets, redirect periodic income to other asset classes, or take withdrawals from overweighted assets.

Please call to discuss your investment portfolio.

4 Reasons for Goal-Focused Investing

The fact is, investing isn't just about making your money work for you. It's about making your money work for you for a particular purpose. In other words, you need a goal. Here are four specific reasons why a goal-focused approach to investing is important.

Because It Puts You in Control

When you first start investing, it's easy to get overwhelmed. You may feel like you have little control over what happens to your money. No matter how careful you are, you could lose what you invest. But if you take a goal-focused approach to investing, you're not just watching the value of your portfolio rise and fall based on the whims of the market. You are making specific decisions that you designed to help you reach specific goals.

Because It Will Be Easier to Save

Saving money just to save money is no fun for most people. Having concrete goals can turn saving from an abstract concept into a concrete step towards a certain aim. Studies have shown that the better you are at setting goals, the more you're likely to save.

Because You'll Be Less Focused on How Others Are Doing

A little competition is healthy, but when it comes to investing, it can get risky. If your father-in-law is bragging about the great return he got on his investments, it can be tempting to drop your plan and copy his moves. But if you're investing toward a goal with a clear plan, you'll be able to congratulate your relative on his success while staying focused on your needs.

Because It Will Help You Weather the Ups and Downs of the Market

The market goes up and the market goes down. Just like a roller coaster, these peaks and dips can make your stomach do flip flops, especially when your life savings is on the line. But having a goal-focused approach can help you cope with those ups and downs. If you know you won't need your money for another 30 years, you can handle some volatility today. But if you're going to need your money in the next couple of years, you can select less volatile investments so the day-to-day movements of the market won't stress you out.

If you need help setting your own investing goals, please call.

7 Psychological Traps

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price you paid for a stock — and using that to guide future decisions. Or you might fixate on a stock's previous high, even though that price was an anomaly. Anchoring is why you think you got a great deal when buying a car for $50,000 if the initial price was $60,000, even though the car's really worth more like $40,000.

Whether you're buying stocks or cars, anchoring involves using a single piece of information to determine what a stock or other investment should be worth while also discounting more relevant information, such as a company's fundamentals or broader economic trends. Unfortunately, avoiding anchoring is difficult, but considering all available information before choosing an investment can help.

Focusing Too Much on the Recent Past — Recency bias is the tendency to make decisions or judgments based on information that's relatively new or recent. For example, during times when the market is up, people may ignore or discount the possibility of a market decline. Or, if a certain category of stocks has done poorly recently, people may conclude that those stocks *always* have negative returns, even if the dip is an anomaly. As with other psychological traps, you can avoid this one by doing your best to consider the entire universe of information at your fingertips, not just what happened yesterday.

Following the Herd — While following trends might be fine for fashionistas, it's not always a smart investing move. Yet herd investing is an all-too-easy trap to fall into. If everyone is telling you that now is the time to get into a certain hot investment, you may feel you need to act fast so you don't miss out. But just because something is popular doesn't make it a good investment. Blindly following the herd without first consulting your own financial goals and plan doesn't make you a smart investor.

Overconfidence — Most of us like to think we're smarter than the average person. Yet if you hit it big with a certain investment, you may attribute that success to your skill rather than what it really is — luck. This can cause you to repeat the same behavior again.

Panic — Investing isn't for the faint of heart. When the market takes a sudden dip, it's easy to panic, which can lead you to make bad decisions, such as selling at a big loss, rather than riding out the natural hills and valleys of investing. Making these emotionally-driven choices costs you a lot of money. When making investing decisions, make sure they're based on evidence, not your initial gut reaction to the day's events.

Please call if you'd like to discuss this in more detail.

Reevaluating Your Portfolio

Periodically, you should thoroughly review your portfolio to ensure it is still helping you work toward your investment goals. Follow these steps during that review:

Review your current portfolio mix. List the current value of all your investments. Determine what percentage of your portfolio is held in stocks, bonds, cash, and other investments, but don't stop there. Take a closer look at where the stock portion of your portfolio is invested.

Analyze each investment. Determine whether it still makes sense to own each investment. Review why you purchased each investment and whether those reasons are still valid. Instead of worrying about what you paid for the investment, decide whether you would buy it today at its current price.

Determine if changes are needed to your current allocation. If we've learned anything over the past few years, it's that your portfolio should not be highly concentrated in one area or sector. Instead, look to broadly diversify your portfolio. Some points to consider include:

- **Decide how much to allocate to stocks and bonds.** Your stock and bond mix is a major factor in determining your expected portfolio return and how much your portfolio will fluctuate with market movements. However, be careful not to let recent events cause you to allocate too much to bonds just to avoid stock market fluctuations. Make this decision based on your financial goals, risk tolerance, and time horizon for investing.
- **Reassess your stock allocation.** The stock market moves in cycles, with different sectors outperforming other sectors at different times. Since no one can predict when one sector will outperform, it is typically best to broadly diversify your stocks over all areas.

Move your allocation closer to your desired allocation. When making changes, first consider the tax ramifications of the transactions. If you can make changes without incurring tax liabilities, you may want to make the changes immediately. But if substantial tax liabilities will be incurred, look for other ways to get your portfolio closer to your desired allocation. For instance, any new investments should be made in areas that are underweighted in your portfolio. Or you may be able to reallocate in your tax-deferred accounts, where you typically won't incur tax liabilities. However, if you can't get your allocation in line within a year using these approaches, you might want to sell some of the poor performers and reinvest the proceeds.

If you'd like help reevaluating your portfolio, please call.

Business Data

Indicator	Month-end Dec-22	Jan-23	Feb-23	Dec-22	Feb-22
Prime rate	7.50	7.50	7.75	7.50	3.25
3-month T-bill yield	4.35	4.60	4.75	4.35	0.36
10-year T-note yield	3.88	3.52	3.92	3.88	1.83
20-year T-bond yield	4.14	3.78	4.10	4.14	2.25
Dow Jones Corp.	5.54	5.09	5.65	5.54	3.31
GDP (adj. annual rate)#	-0.60	+3.20	+2.70	+2.70	+6.90

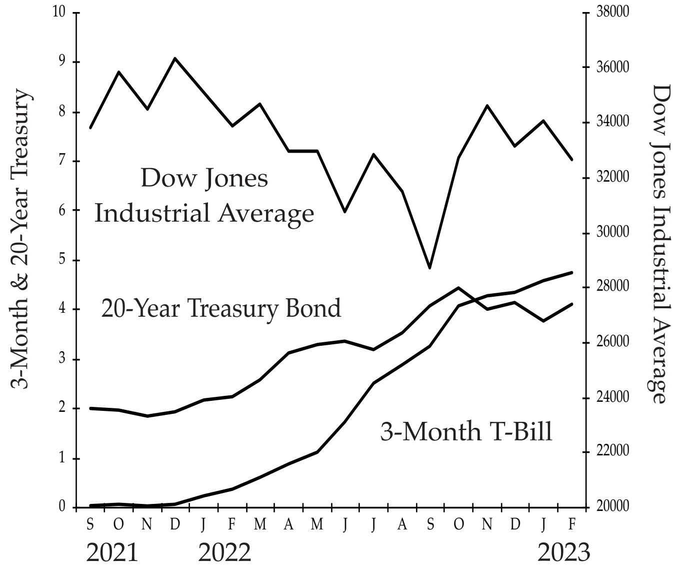
Indicator	Month-end Dec-22	Jan-23	Feb-23	% Change YTD	12-Mon.
Dow Jones Industrials	33147.25	34086.04	32656.70	-1.5%	-3.6%
S&P 500	3839.50	4076.60	3970.15	3.4%	-9.2%
Nasdaq Composite	10466.48	11584.55	11455.54	9.7%	-16.7%
Gold	1812.35	1923.90	1824.60	0.7%	-4.5%
Unemployment rate@	3.60	3.50	3.40	-8.1%	-15.0%
Consumer price index@	297.71	296.80	299.17	0.5%	6.4%

— 2nd, 3rd, 4th quarter @ — Nov, Dec, Jan Sources: *Barron's, Wall Street Journal*

Past performance is not a guarantee of future results.

18-Month Summary of Dow Jones Industrial Average, 3-Month T-Bill & 20-Year Treasury Bond Yield

September 2021 to February 2023



News and Announcements

The Benefits of Low Correlated Assets

Correlation is a statistical measure of how one asset class performs in relation to another asset class. Correlations can range for +1 to –1. A correlation of +1 means the two assets move very closely together in the same direction. Combining assets with a high positive correlation will not provide much risk reduction. A correlation of –1 indicates the assets move in opposite directions, a rare event in the investment world. A correlation close to 0 means no relationship exists in the price movements of the two assets.

Combining assets with consistently high correlations to each other does little to reduce risk. The greatest combination benefit to a portfolio seems to be achieved by combining assets with consistently low correlations, which results in consistently reduced risk.

When selecting investments for your portfolio, don't just look at their risk and return characteristics. Also consider the diversification aspects for your overall portfolio. While correlations change over time, general observations include:

- Stocks tend to have a low positive correlation with corporate and government bonds.
- Short-term bonds tend to have a low correlation with long-term bonds.
- Stock markets around the world are all positively correlated to some degree. In general, European stock markets are more closely correlated to each other and the U.S. than to markets in Japan or Asia. Correlations between developed countries tend to be higher than correlations between developing and emerging countries.
- Real estate tends to have a low correlation with stocks and bonds.

If you'd like to discuss correlation in more detail, including how it may impact your portfolio, please call.

FR2022-1111-0027