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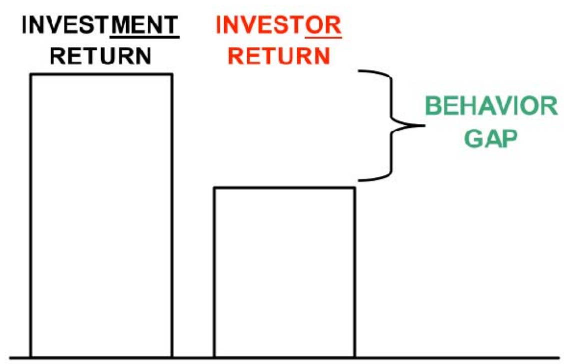
3 Solutions to Common Psychological Traps of Investing

By: Adam S. Drake, CFA

Sir Isaac Newton once said, "I can calculate the motion of heavenly bodies but not the madness of people." During the 20th century, behavioral economics emerged as an area of study that attempted to understand how social, cognitive and emotional factors affect economic decisions. The purpose of this article is to make readers aware of common traps investors fall into so that they can be better prepared to avoid them. The information herein is based on a presentation by Dimension Fund Advisors, and used with their permission.

Behavioral biases come into play in many routine decisions, but these biases can be detrimental when trying to make financial decisions. What are these biases, how do they affect decision making, and how can investors regain control?

First, let's revisit a basic fact: risk and return are related. Financial losses are processed in the same areas of the brain that respond to mortal danger. Investors who react emotionally to losses that have already occurred tend to avoid risk after the loss. Investors also tend to increase their risk exposure after profits have been made, assuming that success will continue. Although we know that more risk translates to more expected return, investors reduce risk when risk and expected return are their highest and increase risk when risk and expected return are their lowest. In short, investors tend to buy high and sell low. According to Dalbar, the average investor lost -41.63% in 2008 when the S&P 500 lost 37.72%. Why? Investors buy into strong performance and sell into weak performance. This tells us that investor behavior is more important than fund performance alone.



Inside This Issue:

3 Solutions, Continued

Here are several examples of common behavioral biases:

Overconfidence. Confidence is a good attribute in most areas of life, but overconfidence can be destructive to our wealth. Investor survey results consistently show that well over half of investors think that their portfolio's return will be higher than the markets. Of course, 50% of us must be above average and 50% must be below average. Overconfidence in what investors know, or what they think they know, seldom leads to outsized returns.

"Focus on what you can control, ignore what you can't."

Familiarity. This bias pertains to only holding investments which we are familiar with, such as stock in the company we work for or mutual funds invested in U.S. stocks. While it certainly is important to understand what you are invested in, ignoring the whole picture can mean missed opportunities. Remember, the market does not reward investors for familiarity or loyalty to an investment.

Regret avoidance. "Once bitten, twice shy." We tend to avoid repeating behavior that has caused past pain. You should avoid bad decisions, like not properly diversifying, but realize you can't avoid bad outcomes, like the market going down. The best way to avoid regret is to stick with a plan or hire an advisor that can keep you on track.

Extrapolation. This occurs when we base decisions on selected facts and ignore data that is contrary to our biased opinion. In other words, we often assume that a recent trend will continue into the future. The truth is that future returns are based on news that hasn't come out yet, and past returns are based on news that's already reported.

So, how can investors avoid these traps?

First, don't mix speculation with gambling. If you want excitement, go to Las Vegas. Buy and hold investing may seem dull, but investors should accept the ups and downs of the market knowing the odds favor the investor. The house, as in Vegas, has the advantage against the speculator.

Second, the only path to higher returns is to take higher risk. If anyone tells you otherwise, be skeptical. You can read the WSJ cover to cover before 7:00 AM, but you still don't know more than the market.

Finally, maintain a disciplined approach and partner with a good steward of your capital. Focus on what you can control: expenses, diversification, taxes, and discipline. Ignore what you can't control: picking winning stocks, picking winning managers, timing the market, and the financial press.

Ken Karr, CFP and Adam Drake, CFA are partners at Highland Investment Advisors, LLC, a registered investment advisor (RIA) providing investment management and financial planning since 2006. Based in Milwaukee, WI, the firm serves clients in eight states and manages investments for individuals, retirement plans, not-for-profits, and independent investment advisors. They can be reached at 414-755-2309 or info@highlandinvestmentadvisors.com

6 Things to Do Today to Prepare Your Business for Sale

By: Carol Roth

Too often, the shareholders of businesses wait until they are ready to sell their business to start planning for an exit. However, a lack of planning today may cause you to lose value when you ultimately are ready to go sip margaritas on the beach. Here are six best practices to follow before you want out.

1. Make sure your key employees are incentivized. Key managers who are not the sole shareholders of the business can create a huge conflict of interest during a sale and hold shareholders hostage during sale negotiations. Make sure to put in place incentives (like a sale bonus or stock options program) today to avoid eleventh-hour power plays.

"A lack of planning today may cause you to lose value when you ultimately are ready to go sip margaritas on the beach."

2. Establish key advisor relationships early. Strong service providers can add substantial value to a sale process- in fact, they should pay for themselves. Create relationships with an experienced accounting firm, lawyer and investment banker or business broker today. And this means advisors with relevant M&A experience, not your uncle Ira who happens to be the family lawyer. This will give your advisors insight and knowledge so that they can best advise you when you are ready to sell.

3. Get rid of "private company" expenses. Many private firms are run to minimize taxes for the shareholders. However, when you sell your business, the objective is the opposite: you want to show as much profit as possible. It is advisable to cut expenses that aren't mission critical to operating your business (like the yearly "company conferences" in St. Bart's, etc.) one to two years prior to selling a business. While you will lose the tax write off today, you should more than compensate for it when you sell the business.

4. Get your numbers into shape. Your financial statements are the key to determining the value of your company. However, many businesses have financials that are a hot mess, making them less credible. If you have > $5 million in revenue, get the last two years of your financial statements audited. Smaller companies should have their financials reviewed by a reputable accounting firm (again, not cousin Gladys the CPA). This can also point out weaknesses in your company's financial operations/controls, giving you time to correct any issues.

5. Run a tidy "house". Who doesn't let their housekeeping slide from time to time? Well in business, having your records in disarray can cost you value- the more administrative items that you have in shambles, the more penalties you will incur from the buyer. Make sure that all of your files are in order and review them frequently, noting special clauses like change of control provisions that could impact a sale.

6. Create a growth plan. While you may be ready to exit your business, show that your business still has opportunities ahead of it. Buyers don't want to buy a business that is ready to start a downward spiral or even just stay flat. Make sure you can credibly show three years of meaningful growth after the sale.

Carol Roth is an investment banker, business strategist and deal maker. She is a frequent radio, television and print media contributor. She can be reached at 847.215.4880 or croth@intercapmp.com.

Whew! They Didn't Pull the Plug on Grandma!

By: Al Young

Last December, President Obama and Congress acted. They did not let taxpayers face a situation where there was no federal estate tax in December, but there would be a federal estate tax on January 1st with an exclusion of only $1,000,000 and a tax rate of 55%. If that had happened, we might have been reading stories in the newspapers about families who pulled the plug on elderly relatives in December to avoid the estate tax. What a nightmare that would have been!

But our leaders did act, and in a surprising way. Rather than resurrecting the federal transfer taxes (estate tax, gift tax and generation skipping transfer tax) with the same exclusions and rates that existed in 2009, they increased the exclusions, cut the tax rates and made other taxpayer-friendly changes.

All of these changes are in effect through December 31, 2012. That means that our leaders must act again in only 2 years. But for now, significant planning opportunities are available.

Exclusions and Rates. The table below summarizes the exclusions and rates for years 2009 through 2012:

For married couples, revocable trust agreements typically use a formula clause to allocate assets of the first to die to a credit shelter trust (often called a Family Trust) in an amount equal to the federal estate tax exclusion. The balance of the assets, if any, is given to the surviving spouse or to a trust for the spouse. With an estate tax exclusion of $5,000,000, in many cases all assets of the first to die will be allocated to the credit shelter trust. That may be inconsistent with your wishes; you may want certain or all assets to pass directly to a spouse or to a trust for the spouse. The impact of the new higher exclusion on your particular situation should be reviewed with your attorney or other advisors at the earliest opportunity.

Portability. While the higher exclusions and lower tax rates have garnered most of the headlines, the new law contains a nugget that has not gotten much publicity: portability of the exclusion.

In years past, if the first spouse to die did not fully use his or her estate tax exclusion, that exclusion was lost. Under the new law, if the first to die does not fully use his or her exclusion, the surviving spouse can use the exclusion at his or her death. The transfer of the exclusion from one spouse to the other is referred to as portability.

Year	Estate Tax Exclusion	Gift Tax Exclusion	GST Tax Exclusion	Tax Rate
2009	$3.5 million	$1 million	$3.5 million	45%
2010	No Tax	$1 million	No Tax	35% (Gift Tax Only)
2011	$5 million	$5 million	$5 million	35%
2012	$5 million*	$5 million*	$5 million*	35%

* Indexed for Inflation

Pull the Plug, Continued

With portability of the exclusion, in many cases, estate planning documents can be made much simpler. Rather than automatically allocating $5,000,000 of assets to the credit shelter trust at the first death, all assets could be transferred to the surviving spouse. Then the surviving spouse would use an exclusion of $10,000,000 to shelter assets from the estate tax at his or her death. Of course, there may be situations where it still makes sense to fund the credit shelter trust at the first death. Examples include second marriages, planning for grandchildren, and estates greater than $10,000,000.

Portability is only available during 2011 and 2012. If it is to survive beyond 2012, our leaders must act to make it permanent. A good way to take advantage of portability now is to leave all assets to the surviving spouse, but give the surviving spouse the right to direct that certain or all assets be transferred to the credit shelter trust at the first death. This is known as a disclaimer. Plans that use this technique will remain viable even if portability is not extended beyond 2012.

Gift Tax Planning. As can be seen from the table above, prior to 2011, the gift tax exclusion was much less than the estate tax exclusion. In 2011 and 2012, the exclusions are the same. For those who used their $1,000,000 gift tax exclusion, an additional $4,000,000 exclusion is available. Now is a good time to make large gifts to family members, including grandchildren.

Generation Skipping Transfer Tax. For those with larger estates, the increase in the GST tax exclusion provides an opportunity to make additional transfers to grandchildren during both one's lifetime and at death. Importantly, the GST tax exclusion is not portable. If a married couple desires to leave more than $5,000,000 to grandchildren at death, funding a credit shelter trust or other trust at the first death should be done in order to use the $5,000,000 GST tax exclusion at the first death and allow the surviving spouse to leave up to another $5,000,000 to grandchildren at the second death.

If our leaders do not act to extend the new exclusions and tax rates beyond 2012, the pre-2001 exclusions ($1,000,000 for estate and gift taxes and approximately $1.35 million for the GST tax) and rates (55% for the estate tax, gift tax, and GST tax) will return. Now is a great time to consult with your attorney and other advisors to take advantage of today's opportunities.

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