



"Are we there yet?"



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Randall Dozer discusses "The Psychology of Investing" based upon the book by John R. Nofsinger, a seminal resource on the subject.

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A look at how things get built – both high-rise icons and professional service firms.

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Highland takes a "get it done" approach to meeting client needs. Special projects represent much of what we do. Take a look at some recent work.

# Our five year journey – and its not over yet

## Reflections from Bill Small and Rick Wyman on Highland's anniversary and what it means to clients

In the midst of a challenging business environment, Highland recently celebrated its 5-year anniversary.

As those who know us would probably guess, it was a decidedly low-key affair consisting of a few minutes of hallway banter and complaints about the weather.

The occasion did provide a chance to reflect on what an amazing journey it has been for our clients, our firm and our industry.

We are fortunate to work with a fantastic group of clients – engaged, passionate and thoughtful professionals – that largely weathered the financial storm of 2008 and 2009 well.

Once again the time-tested benefits of a formal, disciplined and emotionally contained investment process proved its worth.

A new generation of investors learned some powerful (and often painful) lessons.

Internally, we grew significantly with staff in Seattle, Portland and San Francisco.

Our independent co-fiduciary advisor approach has been welcomed in a time of increased industry scrutiny and regulatory burdens – along with expanded client awareness.

We applaud the continued trend towards full expense transparency but decades of



bad behavior doesn't go away overnight. We still have a long way to go.

Hardly a week goes by without examples of plan providers extracting fees far in excess of the value they provide. Their clients appear to be either too distracted or too complacent to do much about it. Directionally, things look good but the journey has just begun.

The landscape shifts, market dynamics change, and competitors come and go – but our mission remains the same:

**Improving retirement plans through conflict free investment advice**

**Here's to the next 5 years!**

## Behavioral Finance

## Insurance, Gambling &amp; the 401(k)

Randall L. Dozer, Senior Consultant,  
FSA, CFA

The past 40 years have seen great strides in investment theory including The Efficient Markets Hypothesis, The Capital Asset Pricing Model, Option Pricing Theory and Arbitrage Pricing Theory. These ground-breaking concepts have provided investors and investment consultants with numerous portfolio-building tools.

Curiously, all of these concepts and their resulting methods rely on **two questionable assumptions** that people:

- A – Make rational decisions;** and
- B – Are unbiased in their predictions about the future**

In a field dominated by professionally constructed investment portfolios, these rather troubling observations may be brushed aside, but anyone working with a 401(k) plan (or any other participant-directed plan) knows just how far from reality these assumptions actually are.

Employee investment decisions are often irrational. In addition, the basic structure of participant-directed plans render many traditional investment consulting approaches useless in all but the most limited of circumstances. Often the first response to this problem is to offer more investment education to employees. A more effective approach may be to better understand the psychology behind employee investment decisions.

Over the past two decades a field of study known as Behavioral Finance has sought to discover the how's and why's behind individual investment decisions. At first treated like the Rodney Dangerfield of financial theory, Behavioral Finance finally came into its own when two of its proponents, psychologist Daniel Kahneman and experimental economist Vernon Smith, were awarded the 2002 Nobel Prize in Economics.

This long-overdue vindication brought an obscure field into the mainstream and has exposed a wider audience to discoveries regarding human nature and financial uncertainty. These discoveries have become all the more relevant in a world dominated by participant-directed retirement plans.

One of these discoveries has helped answer an age-old question: **Why are people willing to pay so much for insurance?**

It has long been observed that people are willing to pay significantly more for insurance than the expected value of any loss (i.e., the amount of the loss multiplied by the probability of its occurrence). Until recently, it was thought that people were risk-averse.

In other words, the assumption was that people just don't like uncertainty. The concept of risk aversion was at odds with the popularity of certain risk seeking behaviors like gambling.

As it turns out, people are not risk-averse after all, instead, they are *loss-averse*. On the surface, this may seem like a subtle distinction, but it makes all the difference in responding to investment results and in making investment decisions. Behavioral Finance asserts that people have an aversion to loss, rather than risk. This is known as Prospect Theory.

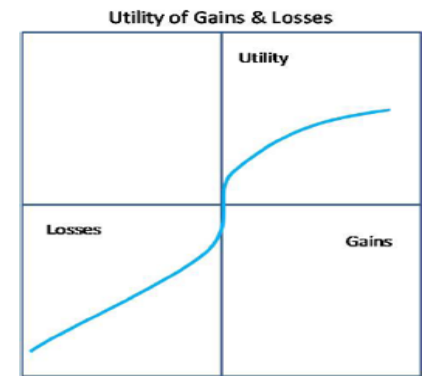
Prospect Theory tells us that people frame decisions in terms of gains and losses relative to an initial reference point. The reference point that separates a gain from a loss in a person's thinking can be quite fluid and is often irrational. Setting a reference point is called "anchoring."

Once an anchor is set, losses or gains are evaluated relative to that reference point. Figure 1 shows a function of how people value various levels of gain and loss relative to the anchor. In the figure, the anchor is the origin or zero point.

**Notice several things about this curve:**

**FIRST, the function is concave for gains.**

This means that although people feel good (i.e., have positive "utility") about a gain of \$500, they do not feel twice as good about a gain of \$1,000.



**SECOND, the function is convex for losses.** In other words, people feel bad about a loss, but twice the loss does not make them feel twice as bad.

**THIRD, the function is steeper for losses than for gains.** In other words, losses make people feel more pain than the pleasure felt through similar-sized gains.

This is the essence of loss-aversion. People hate losses and may go to great lengths, even irrational ones, to avoid them.

The psychological pain of loss can play out in several ways.

1. **Denial.** When employees refuse to sell an underperforming fund. Mentally, employees feel that they have not fully realized the loss until they actually dispose of the fund.
2. **Dissatisfaction.** Removal of a consistently losing fund from a plan may result in employee dissatisfaction. More so when employees are reluctant to abandon their losing funds.

Plan sponsors that replace a fund at anything less than a participant's "anchor point" may face an emotional response by employees.

As participants process feelings about the loss, they may need help to understand that such changes are appropriate in meeting their long-term objectives. Also, they should know that such actions are required if the plan trustees determine it to be an element of fiduciary oversight for the plan.

**How can retirement plan sponsors and individual investors address these issues?**

**NEXT TIME – Some live examples.**



## Vision + Passion + Commitment

When Edward Carlson created the vision of the Seattle Space Needle in 1960, it might have seemed like a pie in the sky idea...literally!

Designed by Graham and Victor Steinbrueck, it was built through the efforts of Graham, Bagley and Howard Wright, Ned Skinner and Norton Clapp – all legendary figures in Seattle's business history. Built in time for the Seattle Worlds Fair in 1962, construction took 8 months and was a wonder of its day. Today the Space Needle it is still owned by the Wright family under the name of Space Needle Corporation.

*Footnote: As a bank trust officer in 1989, Highland team member Ward Harris installed the Space Needle's 401(k) plan – which he still refers to as the "biggest plan in Seattle."*

## Resources

In building our firm, we are committed to the development and delivery of industry leading consulting and advisory solutions for clients – institutional employers and investors. Here are several of our recent enhancements and additions.

Investment consulting and advisory services require the judicious application of data and research through technology – supported by the skills and experience of the investment professional. At every step in business planning, Highland's staff searches out the best tools available to help meet client needs.

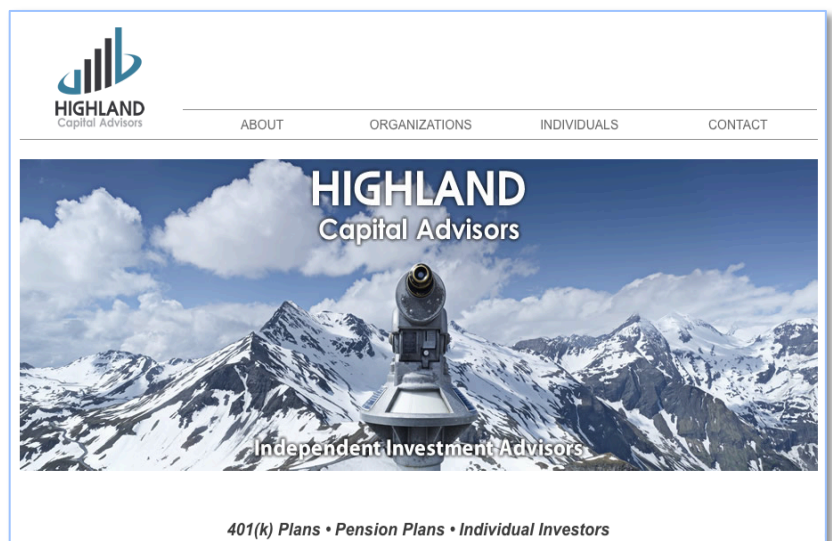
Earlier this year, Highland made a long-term commitment to our clients through access to a new institutional quality, industrial strength platform as used by other major consulting firms and financial institutions. Through it, Highland has access to extremely sophisticated data and technology, along with investment research and analytical opinions from a range of industry sources. We have now migrated our major client reporting deliverables to this sophisticated and scalable platform. Client benefits accrue in the form of lower costs, faster turn-around and greater flexibility.

After five years, our corporate image needed an update. The result is a new logo developed through a global, on-line competition among young design professionals. It has been well received as a symbol of our profession and Highland's services.

Taken together, the result can be seen at right and on the Internet at Highland's renewed website – still a work in progress – but one that presents Highland's message to our professional referral sources and prospective clients.

We will add more features and functionality based upon client and partner input, including account access, scheduling and on-line employee education, guidance and advice.

Your opinion is important to our planning and design decisions. Please visit [www.hcportfolios.com](http://www.hcportfolios.com) and let us know what you think.





## What we do

At Highland, our services cover a wide range of business needs.

Unlike many brokerage or insurance affiliated “advisors” Highland has robust on-board professional expertise to address the challenges and opportunities in the management of investment-based benefits plans.

Over a third of our annual revenues come from project-based consulting engagements such as vendor searches and employee benefit communications.

We help clients understand what they have and how to make it better – measured by risk, return (including costs) and employee satisfaction.

**Highland Capital Advisors** is an investment advisory firm registered with the United States Securities and Exchange Commission.

We are committed to the success of institutional employers and investors, and to the employees and communities they serve. We provide plan-level consulting and participant-level advisory services to corporate, not-for-profit, government and union retirement plans.

For more information about Highland and its services, please call.

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### Client solution:

## Recordkeeping vendor search project for a multi-employer labor retirement plan

A large union plan in Washington state asked Highland’s Rick Wyman to help find a solution for the service needs of 1,100 skilled construction workers.

A trusted administrator had served the money purchase pension plan for many years, but new regulations required a move to more specialized service technologies.

Rick offered to conduct a study and search for a recordkeeping service provider to replace the incumbent.

Supported by Ward Harris, the project team conducted an analysis of the plan’s needs, priorities and preferences.

Because of specialized assets held by the plan, Highland worked with the client, its other professionals and a wide range of potential vendors to configure the ideal service package to meet all of the union members’ needs.

Over a two-month project span, a dozen initial candidates were considered. Four selected finalists made one-hour presentations to the Trustees of this \$40 million plan.

At the end of a daylong session, the Trustees made an informed decision that met all their objectives.

During the implementation phase, Highland and the successful candidate are working with the client to ensure a smooth transition. The plan moved from balance-forward recordkeeping to a daily-valuation service model with enhanced member services and support.

The results? Modern, efficient and effective services delivered without product bias or influence.

Members will also benefit from actively negotiated service costs that are competitive, fair and fully disclosed at the plan and participant levels.