



THE SECRET LIVES OF INVESTORS:

LESSONS FROM BEHAVIORAL FINANCE

INVESTOR WORKBOOK

STAYING ON TRACK: LESSONS FOR INVESTORS

Behavioral finance provides a useful framework to explain the motivations behind many common mistakes in investing. By recognizing our unconscious biases and the potential problems that they can cause, we stand a better chance to avoid decisions that compromise the realization of clearly established goals.

However, recognizing and understanding behaviors is not enough — we have to adopt our behaviors so that we can remain focused on the “big picture.”

A FEW LESSONS TO CONSIDER:

Lesson #1: Work with a trusted financial advisor.

A trusted financial advisor works with you to identify your goals, needs and aspirations to align your short- and long-term goals with your own risk tolerance. A financial advisor also offers much-needed perspective by helping to identify the consequences of impulsive and irrational decisions. Most importantly, your financial advisor, backed by the resources of his/her firm, helps you achieve your goals by providing valuable insight and guidance on economic issues, the markets, specific investments and strategies.

Lesson #2: Identify your goals, your time horizon and your tolerance for risk.

Distinguish between “real life” goals (funding an education, paying for retirement) and “performance” goals (e.g., achieving an average 5% annual return) and create a timeline showing when you may need to access funds you’ve invested. You should also carefully evaluate any changes and decisions, considering all of your goals — both near-term and long-term. In considering all of your goals, you should gain insight into what different types of investments are meant to accomplish as this will help you understand your own tolerance for risk.

Lesson #3: Don’t let emotions drive your decisions.

All too often, investors are irrational when making financial decisions. Basically, they let emotions drive their actions. These emotions can lead to irrational decision-making and impulsive decisions that often compromise the realization of stated goals. Before you react, make a list of your concerns, revisit your goals and review your strategy. If your goals and/or priorities have changed, or if you believe your strategy is no longer appropriate given the economic environment, contact your financial advisor.

Lesson #4: Focus on building wealth instead of reducing losses.

Investors are reluctant to sell a stock at a loss, since selling amounts to an admission that purchasing the stock was a bad decision in the first place. Stay focused on the big picture; that is, the goals you have established, and carefully evaluate any changes and decisions, considering all of your goals — short-term and long-term.

Lesson #5: Understand your perceptions.

Gain an understanding of how you process information when making decisions, including any biases and prejudices. Ask your financial advisor for comprehensive information on the investments and strategies he or she recommends so that you can make educated decisions. Also bring any reservations such as a reluctance to invest in a specific sector of the market to your financial advisor; he or she will be able to provide you with rationales for recommended investment strategies.

Lesson #6: Avoid “mental accounting.”

Avoid mental accounting by treating each dollar as a portion of your overall wealth, and not compartmentalizing your money. Your willingness to take risks should not be affected by artificial distinctions between “serious” needs (i.e., retirement, higher education), versus “play” needs (i.e., vacations, luxury items).

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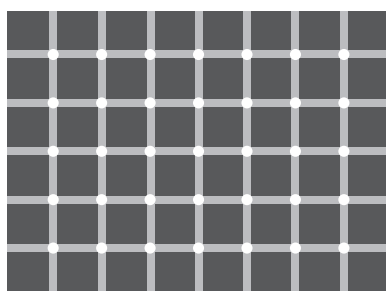
How would others describe you?

- IMPATIENT, HIGHLY COMPETITIVE, AGGRESSIVE AND INCAPABLE OF RELAXATION
- PATIENT, RELAXED AND EASYGOING
- EASILY BORED, NEED FOR EXCITEMENT AND SEEKING DARING EXPERIENCES

THRILL SEEKING

Researchers identify individuals who are easily bored, need excitement and seek out daring experiences as “T-types” — or thrill seekers. As investors, “T-types” are often drawn to the fast-moving action of day trading. While day trading provides the excitement they crave, these investors may neglect to make a rational long-term plan that addresses personal goals, risk tolerance and time horizon.

Consider this illustration: Do you see anything unusual?



WRITE DESCRIPTION:

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.....

.....

.....

PATTERN RECOGNITION

Optical illusions like these demonstrate how easily the human mind “sees” things that aren’t actually there when given only a simple diagram. Similarly, investors all too easily “see” trends and patterns that aren’t there based on short-term price movements or fragments of information about the markets or individual securities.

Which hypothetical investment is a better choice?

INVESTMENT A	INVESTMENT B
15.3% AVERAGE ANNUALIZED RETURN	11.9% AVERAGE ANNUALIZED RETURN
MANAGER TENURE 10 YEARS	MANAGER TENURE 10 YEARS

- INVESTMENT A
- INVESTMENT B

ANCHORING

With only the information given here, Investment A looks better. In actuality, Investment A is far riskier, as it has a standard deviation of 19%.⁴ However, there are always more facts to consider than simply an investment’s average return. The problem is that investors often “anchor” — or fixate — on a single bit of information like average return, downplaying other relevant data and ending up with a distorted view of an investment’s true potential.

⁴ Standard deviation measures the risk or volatility of an investment’s return over a particular time period; the greater the number, the greater the risk.

Traditional economic theory tells us that investors are rational decision-makers — carefully weighing all available information to make choices that result in the best possible outcome. But the reality is that even “sensible” investors often make irrational decisions, influenced by emotions, misperceptions and errors of logic.

Where would you rather make a purchase? A store that offered...

6 DIFFERENT CHOICES OF JAM

24 DIFFERENT CHOICES OF JAM

CHOICE OVERLOAD

Having too many choices can actually get in the way of making a purchase — or an investment. In one study¹, the people given a choice of six jams were more likely to buy than those given a choice of 24 jams. Another study² found that the more investment choices employees were given, the fewer participated in their 401(k) plan.

How would you rate your automobile driving skills?

ABOVE AVERAGE

BELOW AVERAGE

OVERCONFIDENCE

Most respondents will answer “above average.” In fact, in a study, 93% of people rated themselves above average. Clearly overconfidence prevails or is widespread — since only 50% of any group can be statistically “above average.” This tendency to overestimate one’s abilities also applies to investors — far more think of themselves as “experts” than could ever actually be true³.

Investor 1 purchased security A at \$10. Investor 2 purchased the same security at \$20. Security A’s price rose to \$30 before settling at \$15. Which investor is less likely to sell security A?

INVESTOR 1

INVESTOR 2

LOSS AVERSION

Though both investors experienced a paper “loss” when the price declined from \$30 to \$15, only investor 2 experienced a real loss — and all other things being equal, is less likely to sell, based on the principle of loss aversion — the tendency for people to avoid accepting the reality of losing money. The problem: if there’s little chance of the investment coming back, investors may be better off taking the loss and redeploying the money in a more productive investment.

¹ “When Choice is Demotivating: Can One Desire be Too Much of a Good Thing?,” by S.S. Iyengar and M. Lepper. *Journal of Personality and Social Psychology*, pp. 79, 995-1006, 2000.

² “How Much Choice is Too Much?: Contributions to 401(k) Retirement Plans,” by S.S. Iyengar, W. Jiang and G. Huberman. *Pension Research Council of The Wharton School of The University of Pennsylvania*, 2003.

³ “Are we all less risky and more skillful than our fellow drivers?” *Acta Psychologica*, Volume 47, Issue 2, February 1981, pp. 143-148.

Which offer sounds more attractive to you: paying \$3 a day or \$1,095 a year?

\$3 A DAY

\$1,095 A YEAR

FRAMING

In the long run, both offers cost the same; \$3 a day adds up to a total of \$1,095 a year. However, breaking a large amount into a series of smaller payments makes a cost more attractive to many buyers. Clearly, the way a situation is described, or “framed” in words and numbers, can influence how people perceive it. Investors are well advised to step back and make sure they are comparing “apples to apples” when evaluating their choices.

Which would you prefer?

12% ANNUALIZED RETURN WITH 8% INFLATION

5% ANNUALIZED RETURN WITH 1% INFLATION

FRAMING

This is another example of framing. Both options yield a 4% net return after inflation; however, the one with a 12% nominal return “feels” more appealing to many people. The trouble with framing is that it can subtly affect perceptions even when investors are aware that it is happening. If you suspect that framing is coloring your opinion of an investment, it’s often useful to discuss it with someone else — especially a trusted advisor.

As an investor you have two options — Pay down a car loan that charges 7% a year in interest or invest in a 10-year Certificate of Deposit (CD) at 7% Annual Percentage Yield?

PAY DOWN A CAR LOAN THAT CHARGES 7% A YEAR IN INTEREST

INVEST IN A 10-YEAR CERTIFICATE OF DEPOSIT (CD) AT 7% ANNUAL PERCENTAGE YIELD

MENTAL ACCOUNTING

All other things being equal, paying down a 7% car loan is exactly the same as keeping and earning 7% on the CD. However, many investors think of liabilities and assets in two entirely separate mental “buckets,” even though they are both part of the same financial reality. This tendency to create artificial distinctions between financial decisions is known as “mental accounting”; the downside may be that this may unnecessarily limit their decision making as a result.

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All discussion of behavioral finance and market psychology reflects general principles and does not represent a recommendation for specific action.

All investments involve risk, including loss of principal amount invested. There is no guarantee that investment objectives will be achieved. Investors should carefully consider their objective, risk tolerance and time horizon before investing.

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* Ranked ninth-largest money manager in the world, according to *Pensions & Investments*, May 26, 2008, based on 12/31/07 worldwide assets under management.

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