MP McShane Partners

July 2021 Insights

Investment Overview

A Review of *Thinking, Fast and Slow*

This quarter's installment of McShane Partners' quarterly book club series expands upon several of the critical themes, arguments, and assertions central to the subject matter of last quarter's book, *The Psychology of Money* by Morgan Housel, while also providing a first-hand account of the disruptive emergence and gradual acceptance of *behavioral economics* as a *counterbalance* to *traditional economics* and *classical financial market theories*. *Thinking, Fast and Slow* by Professional Daniel Kahneman is a seminal treatise on behavioral economics, rooted in the groundbreaking research and analysis done by Professors Kahneman and Amos Tversky on *decision making*, for which they eventually won the Nobel Prize in Economic Sciences in 2002.

As the Investment Team has emphasized multiple times over the past several years, an individual's ability to *recognize*, *identify*, and *acknowledge* their own *behavioral biases* is critical to *mitigating negative influences* within an individual's *decision-making framework*, which is why we have repeatedly revisited the subject in our newsletters and other client communications.

Behavioral biases fall into two main categories: *cognitive errors* and *emotional biases*. Cognitive errors are caused by irrational, faulty, or inaccurate logical analysis and can be further classified into two subcategories: *belief perseverance biases* and *information-processing biases*. *Emotional biases* are considerably more complex than cognitive errors, as they are rooted in unconscious thoughts, feelings, and emotions. This inherent complexity makes emotional biases harder to identify, modify, and

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Wealth Advisory Overview

The Latest in Cyberattacks

The news has blown up in recent weeks with Cyberattack ransoms being paid by Colonial Pipeline and JBS (the world's largest meat company) and ransomware attacks on hospitals across the U.S. It is estimated that approximately 203 million U.S. ransomware attacks were perpetrated in 2020.

What is a ransomware attack? In a typical ransomware attack, groups target large organizations with deep resources, breaking into their networks and installing malicious software that locks every file on every computer with an encryption key, essentially an uncrackable password. The criminal group then extorts a ransom from the impacted firm in exchange for an encryption key or password. Some estimates have the largest group, Ryuk, having collected over $100 million in ransoms in 2020, with $350 million paid to all cyber-hijackers in that year alone. In the case of Colonial and JBS, the attack causes the industrial operations to cease, causing an inability to produce, ship goods, or operate machinery. As we saw in the case of Colonial, a lockdown of less than a week caused gas shortages across the East coast.

How do they get in? The top method, since 2019, has been to introduce malware into the organization. Malware is malicious software that can make changes to targeted networks, files, or gather information. Malware is introduced into an organization via an infected computer or device. The malware infection occurs when a

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Points of Interest

Investment Overview

A Review of *Thinking, Fast and Slow*

correct than cognitive errors because they often manifest themselves as instinctual reactions, responses, or impulses.

The following is a summary of the main parts and sections from *Thinking, Fast and Slow*, as well as a high-level review of several crucial concepts that the Investment Team believes may be particularly pertinent to individuals right now.

Two Systems: System 1 vs. System 2

As the title of the book implies, *Thinking, Fast and Slow* explores and analyzes how individuals make decisions by adopting the psychological premise that human beings utilize *two primary systems of thinking*: System 1 and System 2. While System 1 functions *automatically* and *instinctively* with relatively little deliberation or consideration, System 2 operates *more purposefully* in its engagement, activation, and requirement of *mental effort* (e.g., concentration). Kahneman provides the following description of the dynamic, hierarchical relationship between System 1 and System 2 in terms of their critical, complementary roles: "The automatic operations of System 1 generate surprisingly complex patterns of ideas, but only the slower System 2 can construct thoughts in an orderly series of steps." In other potentially oversimplified words, System 1 *thinks fast*, while System 2 *thinks slow*.

While most individuals prefer to identify with the *logical*, *analytical nature* of System 2, it is important to recognize that System 1 is significantly *more active* throughout the day performing *automatic*, *involuntary processing functions*, such as recognizing data, formulating thoughts and impressions, and completing rudimentary calculations. Kahneman describes System 2 as being inherently "lazy" because of the additional resources required by System 2 in the form of an individual's attention or concentration; as such, System 2 is only activated when System 1 is unable to provide an answer to a difficult question or is presented with an unfamiliar situation that "violates the model of the world that System 1 maintains" (*Source: Kahneman, 2011*).

Kahneman provides the following example of how individuals are primed to provide intuitive responses to problems or questions without actively engaging System 2:

> *Here is a simple puzzle. Do not try to solve it but listen to your intuition:*
>
> *A bat and ball cost $1.10.*
>
> *The bat costs one dollar more than the ball.*
>
> *How much does the ball cost?*
>
> *A number came to your mind. The number, of course, is 10: 10¢. The distinctive mark of this easy puzzle is that it evokes an answer that is intuitive, appealing, and wrong. […] More than 50% of students at Harvard, MIT, and Princeton gave the intuitive - incorrect - answer. At less selective universities, the rate of demonstrable failure to check was in excess of 80%. [Correct Answer = 5¢]*

The presence of two systems within the decision-making framework helps to explain why individuals interpret or analyze the same data in completely different ways, as one individual's *behavioral bias* may be rooted in System 1, while another individual's *cognitive error* may be rooted in System 2.

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Monthly Index Review
USD Total Return

Data as of June 30th 2021	June 2021	2021 YTD	2020	2019
S&P 500® Index	**+2.33%**	**+15.25%**	+18.40%	**+31.49%**
Dow Jones Industrial Average	+0.02%	+13.79%	+9.72%	+25.34%
NASDAQ Composite	**+5.55%**	+12.92%	**+44.92%**	**+36.69%**
Russell 2000	+1.94%	**+17.54%**	**+19.96%**	+25.52%
MSCI Emerging Markets	+1.37%	+7.58%	+18.69%	+18.88%
MSCI EAFE	**-1.41%**	+9.17%	+8.28%	+22.66%
Bloomberg Barclays U.S. Aggregate Bond Index	+0.70%	**-1.60%**	+7.51%	+8.72%

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A Review of *Thinking, Fast and Slow*

Heuristics & Biases

Heuristics are *simplified, less-complicated* processes or procedures that individuals rely on to provide satisfactory - albeit, imperfect - answers to difficult questions. Heuristics can be thought of as bypasses fabricated by System 2 and installed in System 1 to reduce the need to engage or activate System 2 when confronted with complicated problems or difficult decisions, thereby avoiding the strain of allocating resources (e.g., focus, attention, etc.) to System 2. One particularly relevant example is the *availability heuristic*, which happens when individuals rely on *readily available results* or *the recallability of recent instances* to determine the *expected frequency of an event* (*Source: Kahneman, 2011*). The availability heuristic is the source of *availability bias*, which is an *information-processing bias* that exaggerates or overestimates the probability of outcomes that are *more retrievable*, *readily categorizable*, and *highly resonant*.

Kahneman provides a fascinating theoretical extension of the potential power of the availability heuristic that has become increasingly relevant and recognizable over the past several years:

> *[Sunstein and Timur Kuran] invented a name for the mechanism through which biases flow into policy: <u>the availability cascade</u>. They comment that in the social context, "all heuristics are equal, but availability is more equal than others." They have in mind an expanded notion of the heuristic, in which availability provides a heuristic for judgments other than frequency. In particular, the importance of an idea is often judged by the fluency (and emotional charge) with which that idea comes to mind. An availability cascade is a self-sustaining chain of events, which may start from media reports of a relatively minor event and lead up to public panic and large-scale government action.*

"This is the essence of intuitive heuristics: when faced with a difficult question, we often answer an easier one instead, usually without noticing the substitution."

- Daniel Kahneman

Another example of heuristics manifesting as behavioral biases is *representativeness*: *representativeness bias* is a *belief perseverance bias* that involves using "best fit" approximations to assimilate new information into preexisting classifications or categories, while ignoring or excluding potentially important details or unique characteristics. *Base-rate neglect* is an instance of representative bias wherein individuals ignore or fail to appropriately incorporate the probability of a category, class, or population being considered when predicting the likelihood of potential outcomes. This can result in investors relying on *skewed perceptions of risk-return* based on readily available data sets for inappropriate classifications or categories (e.g., growth, value, etc.) when evaluating potential investments.

Overconfidence

Kahneman dedicates several chapters to describing the *overconfidence* bias and related *behavioral biases* that often stem from an individuals' *conscious* or *subconscious illusions*. Two of the more pernicious and pervasive behavioral biases related to overconfidence are *hindsight bias* and *illusion of control bias*, both of which are *belief perseverance biases*. *Hindsight bias* describes the propensity to perceive past events and prior outcomes as having been <u>*more*</u> *predictable* than other potential outcomes that did <u>*not*</u> materialize, while *illusion of control bias* refers to the tendency of individuals to *incorrectly* assume or believe they have the ability to control expected outcomes. One particularly compelling excerpt from this section on **Overconfidence** comes from a sub-chapter titled "The Illusions of Pundits":

> *Everything makes sense in hindsight, a fact that financial pundits exploit every evening as they offer convincing accounts of the day's events. [...] The illusion that we understand the past fosters overconfidence in our ability to predict the future.*

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Choices

Kahneman provides a detailed review of *prospect theory* in Chapter 26: the economic theory for which Kahneman and Tversky were awarded the Nobel Prize in Economic Sciences in 2002. In 1979, Kahneman and Tversky published "Prospect Theory: An Analysis of Decision under Risk" and presented numerous challenges to the real-world applicability and practicality of *expected utility theory*. Specifically, prospect theory identified critical inconsistencies that contradicted the *rational investor assumption* at the core of expected utility theory, suggesting instead that individuals are heavily influenced by the context of risk when making a decision. For example, investors tend to exhibit *risk aversion* when there is a *moderate to high probability of a gain* or a *low probability of a loss*, while conversely exhibiting *risk-seeking behavior* when there is a *low probability of a gain* or a *high probability of a loss*. Prospect theory essentially explains why individuals may purchase lottery tickets and insurance, while at the same time investing their investment assets conservatively.

Kahneman and Tversky illustrated how, when faced with financial decisions, individuals' responses to losses were *stronger, more poignant* than their responses to corresponding gains: *loss aversion* is a central tenet of prospect theory and behavioral economics, as explains why so many individuals make sub-optimal financial decisions.

Two Selves

To conclude *Thinking, Fast and Slow*, Kahneman explores how human beings are often forced to make decisions based on the competing interests of our two selves: *the experiencing self* and *the remembering self*. *The experiencing self* is *emotionally*, *psychologically present* in the moment itself, while *the remembering self* relies on our memories of past experiences. The failure to make rational, perfectly informed decisions that serve our best interests over the long-term is often the result of favoring or indulging *the experiencing self* in the moment, whether to avoid pain or seek pleasure in the short-term.

While short-term experiences dictate and influence our perception of *well-being*, individuals should remain cognizant of potential flaws in their logic and/or decision-making processes in order to *avoid overweighting short-term pleasure* at the expense of achieving their long-term goals - further down the road, *the experiencing self* will thank you!

Stock & Strategy Spotlight

Name	Ticker	June 2021	2021 YTD
JOHCM International Small Cap Equity Fund	JOSMX	-0.57%	+6.93%

Description & Investment Thesis

Earlier this month, the Investment Team received notification from representatives of J O Hambro Capital Management ("JOHCM") of a decision made by its Board of Trustees to close the JOHCM International Small Cap Equity Fund ("the Fund") and convert all underlying holdings to cash or cash-equivalent securities ahead of the proposed liquidation of the Fund, which is scheduled to take place on July 16th 2021.

Upon receiving this information, the Investment Team removed the Fund from all affected security-level models within our trading and portfolio management systems, as well as all firm-wide buy lists. Given the taxable nature of this liquidation and the corresponding implications for client investment portfolios, the Investment Team has been systematically reviewing portfolio-level positioning and proposing, processing, and executing sales of existing positions in the Fund, where prudent. At this time, the Investment Team is focused on maximizing after-tax net total returns in the Fund by taking into consideration asset location and the corresponding treatment of unrealized gains/(losses).

While the Investment Team does not have an immediate replacement for the Fund, we are actively researching and analyzing potential investments that would be value-additive and complementary to our existing positioning in high-quality mutual funds, exchange-traded funds ("ETFs"), and individual stocks across our International Equity portfolios.

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link or file is opened or executed. The most common tactics involve using software to get around security holes, or tricking users into downloading malware by pretending to be a source they trust. (This is known as a phishing scam.) Social engineering and spoofing are other ways in which individuals are manipulated into providing access and information to perpetrators.

Another tactic that has recently been on the rise is a supply-chain attack. In a recent example hackers infiltrated the information-technology company SolarWinds, then used that access to break into the systems of the firm's clients, which included servers operated by NATO, the European Parliament, the government of the United Kingdom, and several branches of the federal government, including the Treasury and Commerce Departments.

Banks and financial organizations are 300 percent more likely than other organizations to be targeted by a cyberattack. They also spend more than any other organization on cyber security, with spending on cyber security amounting to almost 11% of the total budget for financial institutions last year. These are huge numbers and are likely to continue to increase. While most banks employ a dizzying array of anti-hack measures, they identify the largest threat to be access gained through vendor connections and customers.

A contributing factor in the frequency and magnitude of attacks is the rise of cryptocurrency, making it much easier for criminals to collect. "Cryptocurrency provided the perfect answer to allowing hackers to prey on their victims and extort unlimited and anonymous cash payments while completely minimizing their exposure of being caught by law enforcement," programmer Stephen Diehl wrote in a Twitter thread following the Colonial Pipeline hack. As Dahl explained, before the crypto boom, cyber criminals had to resort to huge numbers of pre-paid gift cards in amounts as small as $1,500 for ransom payments. In-person payments and wires transfer were often impossible due to the threat of law enforcement raiding the hand-off or banks reporting and/or preventing transfers to a criminal operation. The anonymized nature of Bitcoin transfers allows a clean international method in which "there's no upper bound on the extortion amount." The real value of the Colonial Pipeline ransom was not $4.4 million, but 75 Bitcoin.

What Can You Do to Protect Yourself and Your Data?

Most experts agree that individual Americans don't need to worry, at least not immediately, that their personal information was rifled through or stolen in the recent attacks into U.S. computer systems that officials suspect was the work of Russian hackers. It's unclear what the hackers could do in the future. Cyberattacks are an important reminder that all systems, including those we use daily, are vulnerable.

Craig Danuloff, CEO of The Privacy Co., has offered five tips on how to make your information less vulnerable to hackers.

1. **Do not re-use passwords on any important accounts.** "That way if the password list from Company A is stolen, hackers cannot use that list to get into your account at Company B," he said. I'll add another frequently cited suggestion that we all hate to implement, but really is very important, use **strong** passwords (letters, numbers, special characters, that do not form a word) and change them periodically! Password123! Is NOT a strong password! Here is an interesting article about the most common passwords in 2021 and how frequently they can be guessed based on your demographics!
2. **Use two-factor authentication wherever possible, especially on important accounts.** In testimony before Congress, Colonial Pipeline CEO Joseph Blount admitted that the company wasn't using multifactor authentication to log-in — the simple step requiring users to plug in their password on a computer and confirm their identity on their phone or other device.
3. **Choose platforms that use end-to-end encryption for your data.** "Files or photos sitting in cloud storage can be stolen," he said. In true end-to-end encryption, encryption occurs at the device level. That is, messages and files are encrypted before it leaves the phone or computer and isn't decrypted until it reaches its destination. As a result, hackers cannot access data on the server because they do not have the private keys to decrypt the data. The security behind end-to-end encryption is enabled by the creation of a public-private key pair. This process, also known as asymmetric cryptography, employs separate cryptographic keys for securing and decrypting the message.

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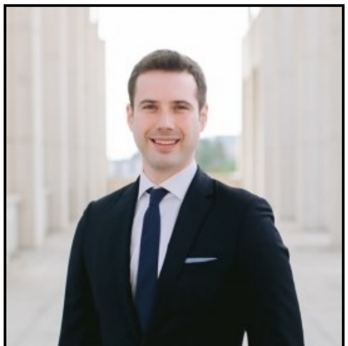
Public keys are widely disseminated and are used to lock or encrypt a message. Private keys are only known by the owner and are used to unlock or decrypt the message.

4. **Don't give up your data to every site that asks for it.** "Data that isn't there can't be stolen," Danuloff said. All kinds of services ask for your address, phone number, even your Social Security number. "The vast majority of them don't need it," he said. So give them "alternative facts." Use burner email accounts.
5. **Use a personal monitoring service** that informs you when your data has been stolen in a hack or when there are signs of identity theft. These are useful tools, he said, "to stay ahead of potentially costly or complicated problems." Many banks and credit cards now offer this service for free or for a nominal charge.

The bad news is that Cyber crime will continue to increase as lucrative schemes are paying off for the criminals. The good news is that you can take steps to protect yourself, and the cyber criminals are in the crosshairs of public and private resources around the world. McShane Partners is committed to keeping your data safe and frequently reviews and enhances our security protocols. If you have questions or concerns, please contact your McShane Partners advisor to help you ensure the safety of your assets.

NextGen: The CERTIFIED FINANCIAL PLANNER™ or CFP® Designation



Ryan Vaudrin, CFP®
Wealth Advisor

One of the most important designations in the financial planning field is the CERTIFIED FINANCIAL PLANNER™ designation or CFP®. What exactly is the CFP® designation? The CERTIFIED FINANCIAL PLANNER™ or CFP® is a designation that tests advisors' knowledge of comprehensive financial planning, while holding them to a higher ethical standard within the planning profession. Obtaining the designation is a challenging process consisting of four components: education, examination, experience, and continuing education.

The first step to obtaining the CFP® designation involves completing the education requirement. This includes coursework in General Principles of Financial Planning, Ethics, Education Planning, Tax Planning, Risk Management, Investments, Retirement, and Estate planning. After all modules have been completed, an individual's knowledge must be demonstrated by creating and presenting a comprehensive financial plan in a final capstone course.

The second step to obtaining the CFP® designation involves passing the certification exam. The CERTIFIED FINANCIAL PLANNER™ exam is a one-day exam offered three times per year. It consists of 170 multiple choice questions, which may include comprehensive case studies. The exam is designed to test the eight principles from the education component. Passing the exam certifies that advisors have demonstrated proficient comprehension of the material.

The third step to obtaining the CFP® designation involves completing the relevant work experience requirement. This can be achieved by documenting 6,000 hours (approximately three years) of work experience using the financial planning process or 4,000 hours (about 2 years) working under the direct supervision of a CFP® professional.

The final step in obtaining the CFP® designation involves completing the ethics requirement. Advisors must uphold high ethical standards to act as a fiduciary by putting clients first in providing financial advice. Advisors will complete a background check, along with an agreement stating any past disclosures against them. CFP® designation holders must complete 30 hours of relevant continuing education, including an ethics component, over each two-year period.

The CERTIFIED FINANCIAL PLANNER™ or CFP® is the gold standard that advisors strive for to distinguish themselves within the industry. It is important to realize that not all advisors who call themselves financial advisors or financial planners hold this designation. At McShane Partners, our planning team has several designations including the CFP® to provide our clients with the most solid and diverse advice possible.

Senior Planning: The American Rescue Plan Act of 2021

Lorri Tomlin, FPQP™
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The American Rescue Plan Act of 2021, better known as Biden's Covid-19 stimulus bill, represents more than just stimulus checks. The plan also includes changes to the Affordable Care Act (Obamacare) that increases federal support for health insurance. Some of those changes include providing subsidies to employers to help cover the costs for COBRA and modifications to the income limits that are used to determine Premium Assistance Tax Credits for those purchasing health insurance from compliant state plans. These modifications represent the biggest changes to the ACA since it passed in 2010. While the changes are temporary, applicable for 2021 and 2022 only, they are intended to help cover the cost of health insurance for people who lost their jobs during the pandemic.

The COBRA subsidies provided to employers helps terminated employees maintain insurance coverage. Normally, when a worker loses a job and therefore their employer sponsored health insurance, they can maintain their policies through COBRA for several months. However, they are required to pay the premiums themselves up to 102% of the premium amount. The American Rescue Plan provides COBRA coverage for involuntarily terminated workers for **free** from April through September 2021. The COBRA premiums are paid for by the former employer and then reimbursed in the form of a refundable payroll tax credit.

The modifications to the Premium Assistance Tax Credit income limits help to further reduce the cost of health insurance for many individuals. The ACA, to help offset the cost of buying health plans, provides tax credits to those who have income levels below 400% of the federal poverty level. These income levels are also used to determine the premium costs for qualified plans. People who earned over 400% of the federal poverty level were previously not eligible for these tax credits. The American Rescue Plan eliminates those income caps. Now, those with income above 400% of the federal poverty level can be subsidized for health insurance costs that exceed 8.5% of their Adjusted Gross Income. In addition to the elimination of the income cap, the Plan also reduces the amount of income a person is required to spend on a state-run health insurance policy for all other incomes below 400% of the federal poverty level.

The chart and example below help to illustrate these changes, showing the percentage of income required to pay for coverage before and after the American Rescue Plan.

Amount Taxpayers Must Spend on Policies Purchased Through State-Run Health Insurance Exchanges To Qualify for Premium Assistance Tax Credits

	Special Enhanced Rates for 2021 and 2022		'Regular' Rates	
Household Income As A Percent of Poverty Line	Initial Premium Percentage	Final Premium Percentage	Initial Premium Percentage	Final Premium Percentage
Up to 133%	0.00%	0.00%	2.00%	2.00%
133% to 150%	0.00%	0.00%	3.00%	4.00%
150% to 200%	0.00%	2.00%	4.00%	6.30%
200% to 250%	2.00%	4.00%	6.30%	8.05%
250% to 300%	4.00%	6.00%	8.05%	9.50%
300% to 400%	6.00%	8.50%	9.50%	9.50%
400% and higher	8.50%	8.50%	N/A	N/A

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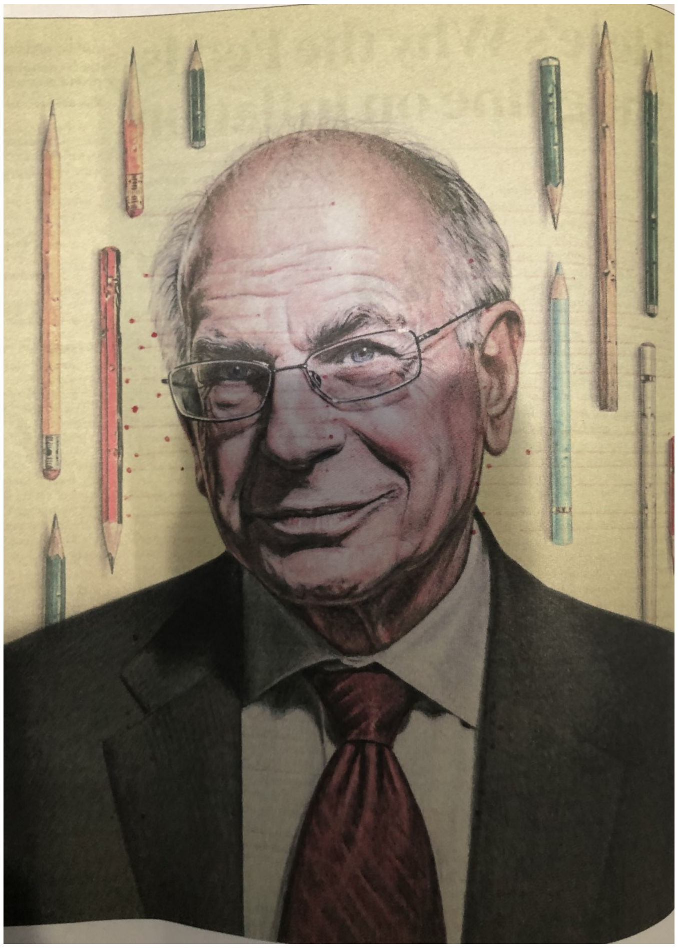
The 2021 federal poverty level for a household with 1 person is $12,880. Therefore, an individual who makes $32,200 is at 250% of the poverty level and would have paid 8.05% of their income ($2,592.10) on insurance premiums before the American Rescue Plan. For 2020 and 2021, the same individual will be required to pay 4% of their income ($1,288) on insurance premiums and the Premium Assistance Tax Credits pick up the rest. Please feel free to contact us if you any questions regarding these changes.

Around McShane Partners

Quarterly Book Club



Daniel Kahneman is the author of our Quarterly Book Club feature *Thinking, Fast and Slow*. Kahneman is a Nobel Prize—winning psychologist who addresses the science of decision making. See this month's Investment Overview for an in depth review of the book. If you are interested in a copy, please email Abby Williams at awilliams@mcshanepartners.com. Stay tuned for updates regarding future Quarterly Book Club features.

New Partner Party

The McShane Partners team gathered last month to celebrate our newest partners: Lorri Tomlin and Becky Hoover.

Happy Hour

McShane Partners recently held a joint happy hour with Rosenwood, Rose & Litwak. We currently rent office space from the law firm as we await completion of our new building.

McShane Partners

Wealth management is our only business; therefore, our attention is undivided, and our intentions are transparent.

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