Brown Brothers Harriman

# InvestorView

INSIGHTS AT THE INTERSECTION OF WEALTH, FAMILY, AND VALUES

OUR ECONOMIC FORECAST FOR 2023

*Winter 2023*

InvestorView

# CONTENTS

**01** A Letter to Our Readers

**02** Happy New Year? Our Economic Forecast for 2023

**10** A Letter to My Trustees: Using Values to Influence Discretionary Trust Distributions

**14** Managing Cognitive Bias



**Contributors**
Kathryn George
G. Scott Clemons
Suzanne Brenner
Adrienne Penta
Nicole Jackson Leslie
Ross Bruch

**Executive Editor**
G. Scott Clemons

**Editors**
Jennifer Gilbert
Kaitlin Barbour

**Designed By**
Creative Services

Dear clients and friends,

Happy New Year! We hope you are feeling as energized and excited for 2023 as we are.

In the feature article of this issue of *InvestorView*, BBH Chief Investment Strategist Scott Clemons covers our outlook for the markets and economy in 2023. He considers the state of play as we embark on the 23rd year of this century and discusses what we're watching as the year progresses.

Also in this issue, Adrienne Penta, executive director of the BBH Center for Women & Wealth, and Nicole Jackson Leslie, senior wealth planner, explore how a donor can guide a trustee, even after a trust has been created, to help ensure the trust is used to support and perpetuate a family's core values for generations to come.

Finally, BBH Senior Wealth Planner Ross Bruch looks at investment-related biases and offers solutions to help recognize and minimize their negative effects.

We hope you enjoy this issue. If you have any questions about the topics covered, please do not hesitate to reach out. We wish you a wonderful start to 2023.

Best regards,

**Kathryn George**
*Partner*

**G. Scott Clemons, CFA**
*Partner*
*@GSClemons*

**Suzanne Brenner**
*Partner*

BBH is pleased to announce the following Private Banking team members as General Partners of the firm, effective January 1, 2023:

Thomas Davis | Justin Reed

# OUR ECONOMIC FORECAST FOR 2023

**By G. Scott Clemons**
*Partner*
*Chief Investment Strategist*

This traditional January expression of good cheer and optimism is customarily followed by an enthusiastic and hopeful exclamation point, but given the challenges investors confronted last year, and the uncertainty with which we begin the new one, we thought it more appropriate and cautious to employ a question mark instead. At least for now.

We welcome the new year with three related questions:

- First, can the U.S. economy avoid a recession in 2023 and accomplish the rarest of economic outcomes, the fabled "soft landing" of which economists dream? Or will we experience a "squishy landing" that turns into an actual recession, albeit perhaps of a milder and shorter variety?
- Second, will there be enough continued improvement on inflation to allow the Federal Reserve to respond to a softer economy with easier monetary policy, and maybe even cut interest rates in the latter half of the year?
- Finally, how will financial markets respond to these economic and policy trends as they unfold?

In this article, we'll consider the state of play as we embark on the 23rd year of this century and consider what it might take to edit our question mark into a period, if not the usual exclamation point, as the year progresses.

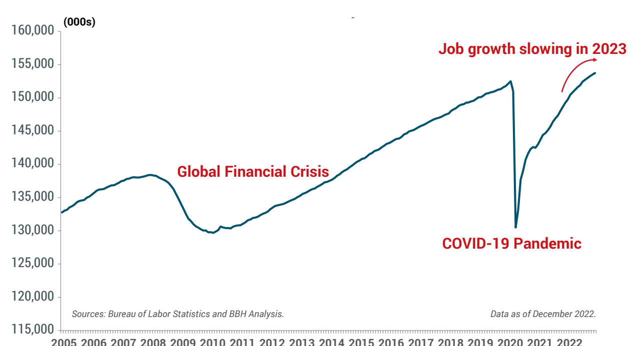
## SOFT OR SQUISHY?

No one rings a bell to signal the end of a pandemic. Yet behaviorally, at least, COVID-19 seems to be drawing to a close. People are flying, restaurants are full, theaters and churches are open, and workers are slowly returning to offices. But the economic ripple effects of the pandemic recession and the fiscal and monetary stimulus imposed in 2020 and 2021 continue to reverberate. The Trump and Biden administrations spent over $5 trillion to prevent the pandemic recession from becoming something worse. It worked. According to the National Bureau of Economic Research, economic activity collapsed in February 2020 but bottomed a mere two months later in April 2020, marking the shortest recession since economic record-keeping began in 1854.

For all of its messiness, the U.S. economy prior to the pandemic was a reasonably well-tuned system. The pandemic and subsequent policy response knocked it off balance, as shown by wide swings in inventory building, external demand, supply chain reliability, labor availability, and so forth. As we return to some semblance of normality, the future path and pace of economic growth will depend on the primary engine of economic activity: consumer spending. Herein lies the economic challenge for 2023, and herein lies our focus.

We foresee multiple headwinds to consumer spending in 2023, starting with the labor market. The good news is that the labor market has recovered all of the ground lost in 2020, adding, on average, close to 400,000 jobs per month in 2022. The bad news is that this pace of growth is unsustainable. As the recovery phase comes to an end, future expansion will rely on organic growth, and our labor market simply doesn't grow by hundreds of thousands of jobs per month. For the decade preceding the pandemic, monthly job growth averaged 183,000, which would mark a sharp deceleration from the current pace. To be clear, we do not expect job growth to evaporate, just slow down. The effect here is largely psychological: Even if job growth remains absolutely healthy, the *relative* slowdown in 2023 could weigh on consumer sentiment, and therefore spending.

**Total U.S. Employees on Non Farm Payrolls**



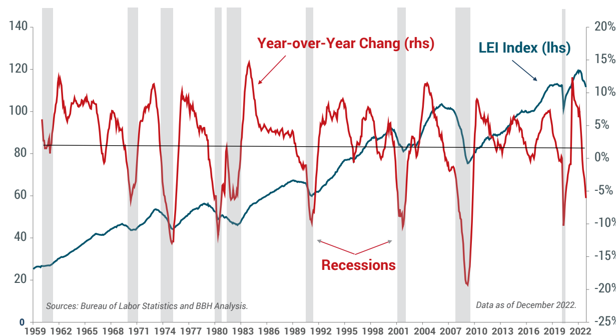

The story is similar with housing. New housing starts fell by 40% during the pandemic, restricting supply at precisely the point where the demand for housing soared as buyers, flush with stimulus money, sought to take advantage of low mortgage rates and move into larger (or more suburban) homes. The average price of a house in the United States rose 53% from February 2020 through June 2022. These dynamics are now reversing. The supply

of new houses has recovered, stimulus checks are a distant memory, and mortgage rates now hover around 7%. Not surprisingly, housing prices have softened, falling 10% from last summer's peak. As with the labor market, the effect here may be mostly psychological. Even if a homeowner is not seeking to sell her home or refinance, the narrative of a weakening housing market makes her feel poorer, and, importantly, act poorer.

To be fair, there are plenty of things beyond labor and housing weighing on consumer sentiment. Take your pick: lingering high inflation, political dysfunctionality, a looming and likely debt ceiling crisis, continued Russian aggression in Ukraine, natural catastrophes, et cetera. It's a target-rich environment for people looking for reasons to be nervous.

All of these moving parts can be succinctly captured in the aptly named Index of Leading Economic Indicators (LEI). As the title implies, this "meta index" comprises a variety of underlying indicators, including credit conditions, interest rate spreads, manufacturing sentiment, building permits, average work week, and initial claims for unemployment, all compiled to arrive at a real-time indicator of economic conditions. As the nearby graph illustrates, historically when the year-over-year change in the index dropped sharply, a recession almost always followed. We're there now. The absolute index peaked in February 2022, turned negative as of June 2022, and now stands 7.4% lower than a year ago.

**Index of Leading Economic Indicators (LEI)**

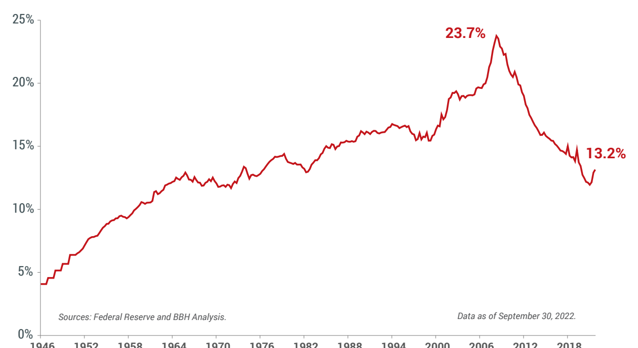



The overwhelming evidence of an economic slowdown makes a recession forecast the majority view among most economists and forecasters. The far more interesting line of analysis is what shape a recession might take. Here, there is good news. Unlike previous cycles, there are no obvious financial bubbles that need bursting, and those smaller ones that have burst (crypto, anyone?) don't seem to pose the systemic threat that housing and mortgage debt did in the last big recession. Furthermore, largely because of a decade and more of deleveraging, American households are in far better financial shape now than they were headed into the 2008 recession. Indeed, overwhelming household debt was precisely what made the Great Recession so great. This time is different.

Where it is true that household debt has risen to record highs, this observation on its own is incomplete. Just as an investor would never assess the financial strength of a company only by looking at outstanding debt, so, too, with households. The important measure is debt relative to something, usually assets or income. On these measures, American households are in decent shape, which should provide a cushion or shock absorber to an economic downturn in 2023.

All household debt – mortgages, home equity, credit card, and auto and student loans – relative to income stood a little over 100% as of September 2022, compared with a peak of 134% in 2008. Although this ratio rose a bit during the pandemic and recession, the current level is roughly where it was 20 years ago. Debt to assets is even more encouraging. At 13.2%, the ratio of household debt to assets is back to levels last seen in the early 1980s.

**U.S. Household Debt to Assets Ratio**

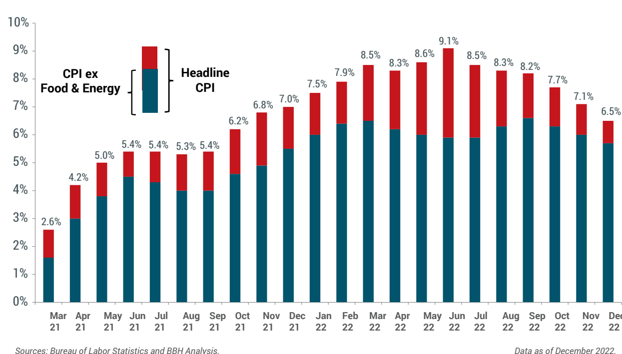


This data is admittedly lagged, but we use it here not to gauge the *timing* of a recession, but the likely *severity*. Healthy household balance sheets don't mean that the economy will avoid recession, but it does imply that there is enough cushion on household balance sheets to make a recession shorter and milder than the historic norm.

## INFLATION AND THE FED

This is the point in the economic cycle when the Federal Reserve usually begins to saddle up and ride to the rescue by easing monetary policy. Recall, however, that the Fed has a Congressional mandate to foster "maximum employment, stable prices, and moderate long-term interest rates." These goals can be mutually exclusive from time to time, although for most of the past few decades the absence of inflation has allowed the Fed to focus primarily on economic support. The sharp recovery from the pandemic, fueled by trillions of stimulus spending, led to higher inflation than the U.S. has experienced in many decades. Disrupted supply chains exacerbated price pressures, leading to a perfect storm of rising demand and constrained supply.

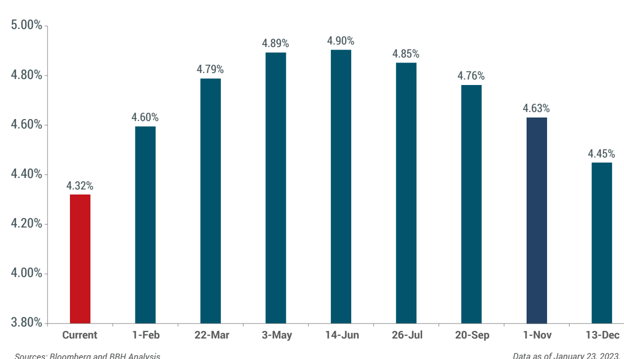
**Inflation**




These pressures have begun to ease. It now seems likely that consumer inflation, as measured by the Consumer Price Index (CPI), peaked in June 2022 at 9.1% and has declined for six consecutive months to end the year at 6.5%. This marks the lowest annual inflation rate since October 2021. As the nearby graph illustrates, most of the relief has come through a softening in food and energy prices, reflecting declines in the raw materials that drive this part of the inflation basket. We believe that this trend will continue into 2023, providing even more relief at the grocery store and the gas pump.

It is, however, probably premature for the Fed to declare victory just yet. First, note that the core measure of inflation – prices excluding food and energy – hasn't declined meaningfully over the past year. Lower food and energy prices are great, but if the year-over-year change in this category falls to zero, we're still left with core inflation of about 6%. Second, recalling the Fed's mandate to facilitate "maximum employment," with the unemployment rate at a 50-year low of 3.5%, there has arguably been no impairment – yet – in the labor market due to higher interest rates. We watch with growing interest headlines reporting layoffs mostly in the technology and financial sectors. As and when this anecdotal evidence begins to translate into unemployment data, we expect the Fed will broaden its attention beyond inflation, stop raising rates by midyear, and perhaps even ease monetary policy in the second half.

**Feds Fund Futures Market Indications**

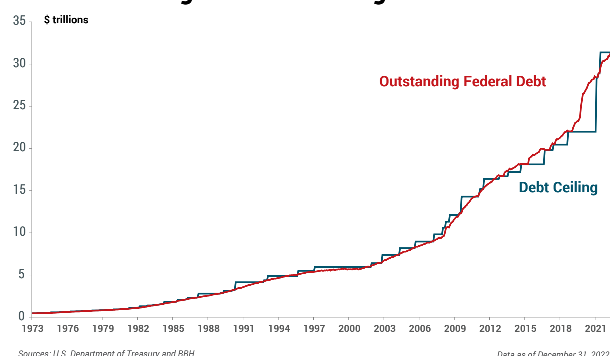



The futures market for the fed funds rate indicates precisely this. Markets expect the Fed to raise interest rates at the February 1 meeting, followed by another hike in March or May. This would bring rates to around 5% by early spring. From there the futures market anticipates a relatively quiet summer, followed by an increasing likelihood of interest rate cuts in the latter half of the year. This is, of course, neither a guarantee nor a perfect crystal ball, but this interest rate path is entirely consistent with a mild recession taking hold at some point around the middle of 2023.

## WHAT COULD GO WRONG?

All else being equal, this is a benign scenario for financial assets, at least later in the year. Bond prices would benefit from an end to rising interest rates, while bond investors would continue to earn higher coupon rates than they have seen in quite some time. Similarly, the derating in equity valuations would likely ease on the prospect of flat or even lower interest rates. The problem, of course, is that all else is never equal.

Like a horror movie zombie that refuses to die once and for all, the debt ceiling is back on center stage this year. As readers are well aware, the debt ceiling limits the amount of cumulative money the U.S. can borrow by issuing bonds. Ironically, the debt ceiling was first created in 1917 to make it *easier* for Congress to spend money in response to World War I. Rather than authorize borrowing to accompany each and every spending bill, Congress instead decided to create a cap to cover all necessary and foreseeable expenses. The unintended consequence, of course, is that Congress needs to raise the cap from time to time in order to pay for money already committed, making it the perfect political football in a divided government.




As the nearby graph illustrates, the debt ceiling has done very little to constrain the growth of federal debt. Indeed, graphically this looks more like a debt ladder than a debt ceiling. The limit on federal debt was last raised in December 2021 to the current level of $31.4 trillion (or $31,381,462,788,891.17 for those of you keeping very close track). On January 13, Treasury Secretary Janet Yellen announced that outstanding U.S. debt had reached this ceiling and that the Treasury Department had begun to delay certain payments, mostly consisting of delaying pension payments into civil service and postal retirement funds. These "emergency measures" have been well honed in previous debt ceiling crises and should buy time until June or so before the U.S. runs a real risk of defaulting on a repayment of Treasury debt.

The debt ceiling has historically served as political kabuki theater, as politicians wring maximum political benefit from brinksmanship before arriving at an 11th-hour agreement to raise or suspend the ceiling and avoid the unthinkable implication of default. There is an old adage in financial markets that whereas the most predictable risk is the least dangerous, the least predictable risk is the most dangerous. It is precisely the seeming predictability of the debt ceiling debate and the expectation of a benign outcome that makes the current environment so dangerous. At the risk of offering a political observation, there is a vocal minority of members of the 118th Congress that do not seem to grasp the implications of a default, even if technical and brief. Treasuries are the lifeblood of the global financial system and play a role as counterparty assets and assurances throughout the world. The dollar enjoys the "exorbitant privilege" of being the global reserve currency, which creates more demand for Treasuries than the U.S. economy alone generates. This allows the U.S. to enjoy lower interest rates than would otherwise be the case, and it would be the height of economic foolishness to sacrifice this privilege on the altar of political posturing.

How might this play out? One of the more outré suggestions in certain economic circles would take advantage of a loophole in the law that allows the U.S. Treasury to mint gold and silver coins only in specific denominations (such as $50 or $100) but places no such restrictions on the minting of platinum coins. The Treasury, therefore, could theoretically mint a single $1 trillion platinum coin and deliver it to the Fed in exchange for $1 trillion of cash, which the Fed, as the central bank, can legally print. This is, of course, ridiculous, although the whole concept of refusing to finance spending bills that Congress already committed is similarly ridiculous, so perhaps this is an idea whose time has come. Originally a fringe idea floated in social media circles, more and more mainstream economists are warming up to this idea.

In a much more traditional vein, the debt ceiling problem could be solved, or at least postponed, through the issuance of premium bonds. Here, too, there is a bit of a loophole, in that only the face value of government debt counts toward the debt ceiling. As an example, consider a $100 face value bond issued today with a 4% coupon and a one-year maturity. The face value of $100 adds to outstanding debt, while a buyer of this bond adds roughly

It is precisely the seeming predictability of the debt ceiling debate and the expectation of a benign outcome that makes the current environment so dangerous.

Rather than predicting the future state of play, the timing of that state, and how prices might react, we rely on fundamental research and rigorous valuation analysis.

$100 to the U.S. Treasury upon purchase. But what if this same bond were issued with a coupon of 104%? The price would be much higher, given the premium yield, but the face value of $100 is unchanged. This would result in a $100 addition to the national debt, but around $200 of cash income to the Treasury. Add a bunch of zeros to this simple example, and voila, no debt ceiling crisis.

Outside of financial approaches, constitutional scholars have variously argued that the debt ceiling itself violates the 14th Amendment to the Constitution, which states (among other things), that "The validity of the public debt of the United States authorized by law … shall not be questioned." This amendment was ratified in 1868 in the wake of the Civil War out of fear that previously Confederate states might renege on Union-issued debt. Might the Democratic caucus choose to make a constitutional issue of the debt ceiling? Does the presence of a debt ceiling speak to what debt is "authorized by law," or not authorized by law? Does the Biden administration want to pick a fight that would head swiftly to the Supreme Court? We don't know. What we do know is that the debt ceiling fight could easily weigh on economic and investment sentiment as we approach the real deadline sometime this summer, and as politicians seek the least bad solution to a problem that they themselves created.

Long-term investors should make a distinction between those developments that could pose a sentimental or psychological risk, and therefore impair asset prices for some time, and those developments that pose a fundamental risk, which might impair values. The latter is more serious. For now, we place the debt ceiling debacle into the category of sentimental risk while acknowledging that the game of debt ceiling chicken could result in a car crash if neither side blinks.

## WHAT TO DO?

There are countless approaches in the wide world of investment management, but they are all ultimately variations on one of two strategies. By far the most popular investment strategy is price anticipation. Turn on the television or pick up any financial newsletter, and someone is usually recommending that investors buy something to benefit from an expected rise in prices or sell something to avoid an expected decline. An analyst might insist that you buy a stock before an earnings release that he expects to surprise on the upside, or sell a bond before the Fed meets and raises interest rates again.

The challenge with the price anticipation approach is threefold. First, an investor has to know the future. If we have learned nothing else over the past few years, surely we have learned that the future is forever an unknowable place. To make matters worse, when we think of uncertainty, we naturally think of examples like the roll of a die. In reality, the future is far messier than a six-sided die. It is more like a die with infinite sides and an unimaginable (ex ante) range of outcomes. Who had global pandemic on their bingo card at the end of 2019? A land war in Eastern Europe? History continues to surprise, both at the macro and micro level.

Second, even if your outlook is infallible, your timing has to be perfect as well. An old maxim holds that being too early is indistinguishable from being wrong. Recall Fed Governor Alan Greenspan's famous observation in 1996 that the stock market was plagued with "irrational exuberance." Fundamentally he was right, but investors who sold on the basis of that assessment missed a bull market that doubled over the subsequent three years.

Even then, it's not enough to know what the future holds and when. A price anticipation strategy thirdly requires that an investor know what a particular forecast means for asset prices. Consider the pandemic: If in January 2020 you had known with precision the timing and gravity of the COVID-19 pandemic, would you have concluded that equity prices would rise close to 120% from the lows, even while the pandemic continued to spread? It's easy in hindsight, but impossible in the moment.

Another, and far rarer, investment approach offers a way out of this tripartite challenge. Instead of pursuing a strategy of price appreciation, our investment teams at Brown Brothers Harriman, as well as those external managers with whom we partner, focus their efforts on value recognition. The difference may seem subtle, but the approach is profoundly different. Whereas we certainly focus on the various moving parts in the global economy and financial markets as a way to identify and assess risk and opportunity at the asset class level, we commit capital on a security-by-security basis into assets that have a greater than average degree of control over their own destiny and that we can acquire at a discount to the fundamental value of the asset. Rather than predicting the future state of play, the timing of that state, and how prices might react, we rely on fundamental research and rigorous valuation analysis. In a price anticipation strategy, price is the dominant variable and the focus of attention. In the value recognition strategy, price is secondary to value. The difference between price and value creates the investment opportunity.

We believe that this is the right way to preserve and grow capital in any market environment and is particularly important in a market still disrupted by the economic shocks of the past few years. It doesn't work every time, as we have seen lately. Over shorter timeframes, investor sentiment swings wildly from unbridled optimism and enthusiasm (2021) to outright despair and loathing (2022), and prices can deviate wildly from value. Over time, however, we are confident that fundamental value wins out.

Happy New Year. Here's to a healthy, happy, and prosperous 2023. ■

# A Letter to My Trustees:

## Using Values to Influence Discretionary Trust Distributions

**By Adrienne Penta**
*Managing Director*

**Nicole Jackson Leslie**
*Vice President*
*Senior Wealth Planner*

Tax-driven estate planning is too often divorced from the purposes of intergenerational wealth. While lifetime gifting to irrevocable trusts offers many benefits, including reducing gift and estate taxes and increasing creditor protection, the long-term purposes of the assets being gifted ought to be considered at the same time. How the donor (that is, the creator of the trust) wants the trust assets distributed – when, how much, and for what purpose – is a complicated set of questions that requires significant reflection.

Most modern-day irrevocable trusts provide a purely discretionary distribution standard, meaning that the trustee has the discretion to distribute any amount at any time to any beneficiary so long as the trustee deems such distribution to be advisable after considering their fiduciary duties. This standard is preferred by many estate planners and professional advisors because it provides significant flexibility, allowing the trustee to react appropriately to future unforeseen circumstances while maintaining the creditor protection so many donors desire.

Discretionary trusts, however, allow donors to postpone thinking about the purposes of the trust. Once the trust is drafted, signed, and funded, donors are often ready to take a break from estate planning, rather than doing the hard work of reflecting on their values and how they might envision the future use of the trust assets.

Here is the good news: If you set up a discretionary trust and would like to share your intentions for the trust and its beneficiaries, it's not too late! In this article, we explore how you can guide a trustee, even after the trust has been created, to help ensure the administration of your trust is rooted in purpose.

## Articulate Your Values

There are numerous tax and financial benefits to putting assets in an irrevocable trust, but being able to articulate the values that motivated you to create the trust in the first place is just as important. Conveying the purpose – the why – behind a trust helps future generations understand the planning and thinking of those who came before them and will help them make informed decisions when dealing with the trust as a beneficiary.

As BBH Senior Advisor Ellen Perry writes in "A Wealth of Possibilities: Navigating Family, Money, and Legacy": "Strong, healthy families generally have well-defined, clearly articulated, life-affirming values. In such families, values are discussed openly, lived enthusiastically, constitute the organizing principle of family life, and define the nature and quality of many family relationships."

There are several tools that can be useful in thinking about values, such as the Motivational Values™ cards created by 21/64, a nonprofit consulting practice specializing in next generation and multigenerational engagement in philanthropy and family enterprise. This tool can be a useful first step in helping donors articulate and prioritize their core values that influenced the creation of the trust and should guide trustees as they make distribution decisions. For example, if entrepreneurship is a core value, an appropriate use of the trust assets might be providing a loan or seed capital to help a beneficiary launch or grow a business. If self-reliance is a core value, then perhaps the trust should not provide for distributions that would replace income for a beneficiary who is otherwise able to support themselves.

**Conveying the purpose – the why – behind a trust helps future generations understand the planning and thinking of those who came before them and will help them make informed decisions when dealing with the trust as a beneficiary.**

Core values are big ideas – they are not a prescription for how beneficiaries should live their lives. For example, one family might value family relationships and connection between siblings and their children. This is a core value that the trust could support by using assets to pay for an annual family retreat or hiring a family historian. Another family may choose education as a core value and recommend that the trustee prioritize distributions for that purpose, whether that is paying for tuition or enabling a beneficiary to move to a new place and immerse themselves in that culture for some period of time.

The ways in which these values are experienced will differ among family members and generations and will change over time. Each generation will (and should) find its own way to embrace and shape the family's values. Focusing on high-level core values instead of less consequential preferences will go a long way in helping the trustee evaluate distribution requests now and after the donor's death. (Keep in mind that some trusts may continue in perpetuity so long as assets remain, so think long term!) It will also help beneficiaries understand the purpose of the trust and how it fits into their lives, including their relationships with their spouses, partners, and children.

## Keep Your Trustee's Perspective in Mind

When thinking about the trust's purpose, it is important to consider the role of the trustee. An "independent" trustee is required for many irrevocable trusts. This may be a family member, professional advisor, or corporate trustee. This person or entity will be subject to fiduciary duties and faces a variety of considerations when presented with a distribution request.

First, the trustee must confirm whether the requested distribution is permissible according to the terms of the trust instrument. This article has focused on discretionary trusts, but there are many different types of trusts. While many trusts are discretionary, some require the trustee to follow a standard, such as limiting distributions for expenses relating to health, education, maintenance, and support (the HEMS standard), or direct that distributions are only permitted for specific purposes, such as education, or when a beneficiary reaches a particular age or milestone.

If a distribution request is within the permissible boundaries of the trust instrument, the trustee may need to determine whether the trust in question is the best source of funds to satisfy the request. Some trust instruments require or suggest that a trustee take into account a beneficiary's other resources when evaluating requests. This often involves tax considerations and may result in the trustee advising that another source of funds be exhausted before turning to the trust in question.

The trustee will also need to consider the interests of the other beneficiaries (if any) and those who will benefit from the trust after the current beneficiary or beneficiaries pass away, referred to as "remainder beneficiaries." Depending on the trust's terms, the trustee may have a duty to preserve the trust assets as much as possible for the next generation and beyond. This may restrict their ability to make discretionary distributions to current beneficiaries.

Finally, assuming all tax and logistical conditions have been satisfied, the trustee will evaluate whether making a distribution is in the beneficiary's best interests. One benefit of holding assets in trust is creditor protection; so long as assets remain in an irrevocable trust, they are usually well protected from creditors, including a divorcing spouse. The trustee will want to confirm there is no exposure to creditors who may reach the trust assets once they are distributed to the beneficiary.

The trustee may also evaluate the beneficiary's own financial situation and ability to manage large sums of money on their own. If the trustee has concerns about the beneficiary's ability to handle a distribution, they may apply trust funds directly for the beneficiary's benefit. For example, the trustee may be able to use trust assets to pay bills on behalf of a beneficiary or purchase an asset for the beneficiary to use, such as a house. If the distribution request is for something that will be an ongoing expense, such as starting a business or buying a home, the trustee will want to make sure the beneficiary has a plan for supporting those ongoing costs.

## Put Pen to Paper

Once you've defined your family's core values and understand the distribution standard of the trust, you can prepare a letter of wishes to the trustee. This letter, while nonbinding, can provide invaluable guidance to a trustee of a discretionary trust. It can be drafted after the trust is created and may be modified in the future as your family or its circumstances change.

Donors often delay (or forgo) writing a letter of wishes because it is hard work and challenging to begin. Frequently, clients will ask for sample letters so that they may have a starting place. While a template can be helpful, it is important to start with your own values when preparing the letter. Put yourself in the shoes of a beneficiary or trustee of a discretionary trust who is wondering what the trust is for: What types of distribution requests are acceptable? Are there particular distributions that should be off limits or would make you regret funding the trust?

When the trust is created, the beneficiaries might be too young to need or care about the trust funds. However, young beneficiaries grow up to have financial needs (or desires) and make requests of the trustees. Many donors begin to reflect seriously upon their intent and the purposes of the trust when distributions or requests for distributions begin. This may cause panic but can be used as a catalyst to think deeply about the purpose of the trust and put those intentions in writing. If a side letter exists but now seems stale or incomplete in light of a beneficiary's request, an evaluation of that request can allow donors to take a new perspective and refresh the letter without having to revise the trust, which is not always an option.

While it is impossible to contemplate every distribution request that your trustee may face in the future, you can help prepare them for difficult decisions by providing guidance on how you would evaluate certain situations. For example, consider:

**Do you want to ensure harmony among siblings, and is equal treatment necessary to do so?**

**If a beneficiary lives in an expensive part of the world, should the trustee take that into consideration to make larger distributions than you might otherwise consider prudent?**

**Should a beneficiary's access to other resources (earned or inherited) be factored in when considering distribution requests?**

**How do you feel about one-time distributions vs. expected or repeated distributions that beneficiaries may come to rely on?**

Most donors are clear that they do not want their trustees to facilitate a frivolous lifestyle but do want to provide for education, medical expenses, and emergencies. However, most distribution requests fall in the murky middle. While you do not want to bind the hands of your trustees to manage future circumstances as they have discretion to do, painting a picture of how you hope the trust assets are used will be valuable to them and to the beneficiaries down the road.

**Once you've defined your family's core values and understand the distribution standard of the trust, you can prepare a letter of wishes to the trustee.**

## Conclusion

For all these reasons, it is important to be intentional when working with your estate planning team to create a trust and draft a side letter of wishes. Choosing the right trustee (and having a proper succession plan) who will carry out your wishes and help ensure the trust is used to support and perpetuate your core family values for generations to come is also critical. Reach out to a member of your Brown Brothers Harriman team if you are interested in learning more about our values-based planning tools or would like to get started on creating or modifying a side letter of wishes. ■

Wealth and Well-Being

# Managing Cognitive Bias

**By Ross Bruch**
*Senior Vice President, Senior Wealth Planner*

## The Endowment Effect

In 1990, behavioral economists Daniel Kahneman, Jack Knetsch, and Richard Thaler published the results of a now-famous experiment commonly known among behavioral scientists as "the mug study."[1] The researchers divided Cornell University student volunteers into two equal groups. The first group received a coffee mug from the university bookstore; the other group received nothing. The experimenters then created a market between the groups to allow students with mugs to sell them to the students without mugs. Traditional economic theory predicts that under such circumstances, the parties should be able to find a price at which about half the mugs will exchange hands. However, in the experiment, very few mugs were sold due to a large gap in valuations; on average, students that were given the mug demanded more than twice the price that the students without the mug were willing to pay. Why did two similar groups of people differ so widely in their pricing? Based on the results of this study, which has been repeated and verified through additional experiments numerous times over the past three decades, the researchers determined that people place a higher value on things they own compared with things they don't, whether it be a mug, a car, or an investment. The researchers labeled this phenomenon the "endowment effect."

The endowment effect is a type of cognitive bias, or an error in thinking that occurs when people incorrectly process and interpret information in the world around them. In other words, it is what happens when one's brain creates a new "subjective reality," ignoring or minimizing its focus on objective input and, at times, leading people to make illogical choices. This phenomenon is particularly relevant to investment decisions because it has the capability of interfering with one's ability to correctly evaluate market risk. It can also lead individuals to be overly attached to their investments. For example, a person who inherits shares of stock from a deceased relative may exhibit the endowment effect by refusing to sell those shares, even if they do not fit within the beneficiary's investment goals or portfolio diversification.

The endowment effect is one of many types of cognitive biases that can irrationally influence investment decisions. Here, we highlight additional types of investment-related biases and offer three possible solutions to help recognize and minimize their negative effects.

## Prospect Theory

Imagine a gameshow contestant who has just won a $10,000 prize; he is then offered a chance to double his winnings by correctly calling the outcome of a coinflip, but he also risks losing it all if he guesses incorrectly. Should he opt for this double-or-nothing opportunity? From a strictly economic viewpoint, these two options are equal. On average, people that flip the coin will receive $10,000, since half the group will win $20,000, and the other half will walk away empty-handed. Yet when faced with this type of decision, most people take the guaranteed payment. In fact, people will often "play it safe" even if the economic odds slightly favor taking a risk – for example, if the top prize in the gameshow situation is raised to $21,000, most people will still choose a $10,000 prize. The leading theory behind why people typically prefer the safer option – known as prospect theory – states that the mental pain of a loss outweighs the joy of an equally valued gain.[2] In the case of the coinflip, guessing incorrectly feels like losing $10,000, even though contestants walk away no worse off than they were before entering the contest. And while doubling one's payout following a correct guess feels good, the economic benefit one receives in this situation doesn't match the possible psychological detriment of receiving nothing.

"

**The endowment effect is a type of cognitive bias, or an error in thinking that occurs when people incorrectly process and interpret information in the world around them.**

## Other Cognitive Biases

While the endowment effect and prospect theory are among the most well-known cognitive biases, they are far from the only ones that can affect financial decisions and risk assessments. Other notable cognitive biases include the following:

- **Overconfidence bias** occurs when one overestimates one's abilities and knowledge, thereby causing him or her to misjudge the likelihood of a successful outcome.
- **Confirmation bias** happens when one seeks out information that supports one's existing beliefs and ignores information that contradicts those beliefs, thereby causing a "blind spot" in his or her analysis.
- **Sunk-cost bias** is the tendency to continue investing time, money, or other resources into a situation because of the resources that have already been invested, even if the situation is not likely to be successful.
- **Availability bias** occurs when one bases judgments on information that is easily available, rather than on all of the relevant information.
- **Anchoring bias** is the tendency to rely too heavily on the first piece of information that is provided and to use that as a reference point for all subsequent judgments.

“ ”

**Cognitive biases aren't always counterproductive. In many instances, they provide mental shortcuts so people can evaluate new information more quickly and easily to make both major and minor decisions.**

## Managing Cognitive Biases

Cognitive biases aren't always counterproductive. In many instances, they provide rules of thumb or information processing shortcuts so people can evaluate new data more quickly and easily to make both major and minor decisions. However, when we misunderstand our instincts or they cause us to misinterpret information, they become harmful and can lead to poor risk analysis and decision-making. To a large degree, such biases are impossible, and frequently undesirable, to eradicate entirely. Yet it is important to find ways to manage these biases and mitigate their potential damage to one's long-term planning and investing goals. Here are three evidence-based methods to help limit the negative impact of cognitive biases:

- **Metacognition:** Although it may sound overly simplistic, merely recognizing the existence of cognitive biases and examining whether they may influence decisions can be a helpful step in reducing their potential negative effect. A recent literature review on critical thinking and cognitive bias found that metacognition – having an awareness and understanding of one's own thought process – was helpful in reducing the impact of such biases.[3] However, to do so, one must first understand the potential types of biases that can influence decisions. While this article has identified several of the most prevalent forms of biases in financial decisions, it is far from an exhaustive list. Additional exploration in the psychology of bias is highly encouraged.

- **Improve financial education and literacy:** New research suggests that financial literacy and education play an important role in reducing cognitive bias and thus empowering and enabling individuals to make smarter decisions about money and wealth.[4] While this approach is especially applicable to new or inexperienced investors, experienced investors may also benefit from recognizing its importance when considering investments in financial sectors they are less familiar with.

- **Consider the alternative:** It is very difficult for decision-makers to separate themselves from a specific situation when they are emotionally tied to the outcome. Instead, research has demonstrated that an effective tool in limiting cognitive biases is to have decision-makers "consider the opposite" or "consider an alternative."[5] Using this strategy, decision-makers are asked to generate reasons for an opposing position or explain an alternative outcome – essentially trying to argue with their own beliefs. Doing so directs their attention to reasons for the alternative positions rather than simply generating supporting reasons for the initially held position.

All three of these mitigation tools force decision-makers to slow down, think through their decision process, and consider a more well-rounded, well-informed approach. While these solutions may be inefficient for making insignificant or minor choices, employing them to minimize cognitive bias can be helpful in improving decisions that have long-term consequences. ■

[1] *Kahneman, Daniel, Jack L. Knetsch, and Richard H. Thaler. "Experimental Tests of the Endowment Effect and the Coase Theorem." Journal of Political Economy.*

[2] *Tversky, Amos, and Daniel Kahneman. "Advances in Prospect Theory: Cumulative Representation of Uncertainty." Journal of Risk and Uncertainty 5, no. 4 (1992): 297–323.*

[3] *Maynes, Jeffrey. "Critical Thinking and Cognitive Bias." Informal Logic 35, no. 2 (2015): 183–203.*

[4] *Khan, Dahiman. "Cognitive Driven Biases, Investment Decision Making: The Moderating Role of Financial Literacy." January 5, 2020.*

[5] *Hirt, Edward R., and Keith D. Markman. "Multiple Explanation: A Consider-an-Alternative Strategy for Debiasing Judgments." Journal of Personality and Social .*

140 Broadway
New York, New York 10005-1101

NEW YORK BEIJING BOSTON CHARLOTTE CHICAGO DUBLIN GRAND CAYMAN HONG KONG HOUSTON JERSEY CITY
KRAKÓW LONDON LUXEMBOURG NASHVILLE PHILADELPHIA TOKYO WILMINGTON ZÜRICH **WWW.BBH.COM**


Opinions, forecasts, and discussions about investment strategies represent the author's views as of the date of this commentary and are subject to change without notice. References to specific securities, asset classes, and financial markets are for illustrative purposes only and are not intended to be and should not be interpreted as recommendations. Brown Brothers Harriman & Co. ("BBH") may be used as a generic term to reference the company as a whole and/or its various subsidiaries generally. This material and any products or services may be issued or provided in multiple jurisdictions by duly authorized and regulated subsidiaries. This material is for general information and reference purposes only and does not constitute legal, tax or investment advice and is not intended as an offer to sell, or a solicitation to buy securities, services or investment products. Any reference to tax matters is not intended to be used, and may not be used, for purposes of avoiding penalties under the U.S. Internal Revenue Code, or other applicable tax regimes, or for promotion, marketing or recommendation to third parties. All information has been obtained from sources believed to be reliable, but accuracy is not guaranteed, and reliance should not be placed on the information presented. This material may not be reproduced, copied or transmitted, or any of the content disclosed to third parties, without the permission of BBH. All trademarks and service marks included are the property of BBH or their respective owners. © Brown Brothers Harriman & Co. 2023. All rights reserved.



PB-05975-2022-12-19 Expires 12/31/2024