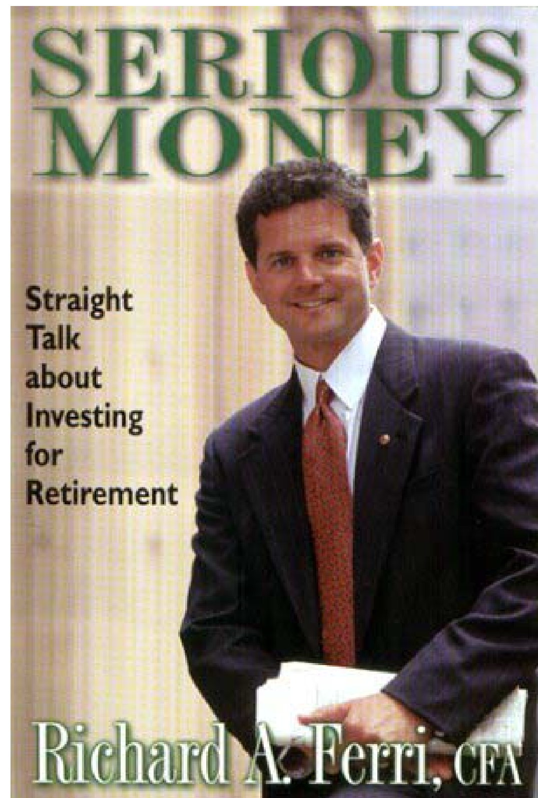

SERIOUS MONEY

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Serious Money: Straight Talk about Investing for Retirement

Introduction

We would all like to be successful investors, yet few people achieve a fair return on their investments given the risks they take. Misconceptions about the financial markets cause large reductions in returns. What are these common mistakes and how can people change their approach to eliminate them? Typical investment books promote strategies designed to beat the markets. Those ideas may sound good and look good on paper, but studies conclude that "beat the market" advice almost always fails, hampering retirement savings in the long-term.

Serious Money offers a better alternative. It promotes a philosophy that leads to superior wealth by "indexing" the markets' return. Indexing is an investment style designed to match the performance of the stock and bond markets, rather than trying to beat their performance. By using an indexing strategy, most investors will achieve higher returns on their investment portfolios, without added risk. One way to achieve the return of a market is to use a market matching "index fund." Several mutual fund companies offer index funds. They are also available on a variety of markets, including the U.S. stock market, foreign stock markets, Treasury bond market, corporate bond market, and others. Investors who embrace an indexing strategy will be much farther ahead in the long run than if they listen to popular investment advice that attempts to "beat the street."

There is a big difference between perception and reality on Wall Street. The carefully crafted perception from the investment industry is it is easy to beat the markets by following the recommendations of stockbrokers, analysts, magazines, books, newsletters, and other advice experts. Unfortunately, little evidence supports this belief. In fact, nearly every major academic study concludes the opposite. Beat the market strategies sold to the public en mass eventually backfire, causing below-market results overall. The allure of beating the market has created huge profits for those *selling* investment products and services; however, investors in those products have experienced a large gap between their return and the return of the markets.

This book includes dozens of references citing little known academic studies. Top colleges and universities publish a tremendous amount of information that is useful to individual investors. Several Nobel Prize winning economists contribute to this body of knowledge on a regular basis. Unfortunately,

much of the research remains trapped in academia. There are two reasons for this. First, the research is often complex and technical, making it difficult for the average reader to decipher. Second, much of the research refutes the marketing claims of large investment firms, and that means trouble for the firms. Unfortunately, professors on a limited budget have difficulty competing against the marketing power of Wall Street, so the message does not get out.

Serious Money explains an investment approach that leads to greater opportunities for a secure retirement. By understanding the financial services industry, and by learning what the real drivers are behind investment success, any investor can construct an efficient portfolio that meets their needs.

Part I: The Performance Gap (Chapters 1 - 6)

The book begins with an explanation of the retirement problem facing America, and why every working adult needs to learn about effective investment strategies. Income from Social Security and employer pensions is diminishing. This means each person will need to rely more on his or her own investment savvy to ensure his or her financial security in retirement. The problem is so critical, that some Generation X workers believe they are more likely to be abducted by a UFO than to collect Social Security benefits.

The remainder of the book is divided into three distinct parts. Part I describes the hard facts about the public's lack of investment success in the financial markets, and explains some reasons for the shortfall. Most people are not fully aware of how their investments are performing or how they compare to the appropriate market benchmark. Surveys show wide dispersion between perceived investment returns and actual portfolio results. One example was the scandal surrounding the famous Beardstown Ladies (*Beardstown Ladies' Common-Sense Investment Guide*, New York: Simon & Schuster, 1995). This noted investment club of respected older women published several best-selling books on investing before someone discovered that their great success in the stock market was a sham. The club had grossly miscalculated their return over the years.

How large is the performance gap between investor returns and market returns? The average individual investor achieves about half the return of the markets they invest in. Surprisingly, a number of studies document this phenomenon, some going back to the early 1900s. Recently, a major research project of mutual fund investors conducted by an independent company confirmed the earlier findings. Having personally analyzed the returns of hundreds of individual portfolios, I find performance is definitely lacking. Individual investors are not achieving performance anywhere close to the markets they

invest in.

Why does the performance gap exist? Three chapters in Part I summarize three major reasons for the gap. First, the cost of investing is considerably high for the public. Whether they realize it or not, investors spend on average 2% per year for portfolio management. Brokerage commissions, mutual fund sales loads, management fees, and other charges have a large and direct impact on investment results. Second, market-timing errors reduce performance. As investors try to guess the future direction of the markets, they attempt to buy low and sell high. This may sound very appealing in theory, but there is no academic evidence to support the idea that market timing strategies work. Third, people want to be winners, and they want to own winning investments, so they tend to chase the hottest stocks and mutual funds that have recently beaten the market. Unfortunately, as investors switch from one investing fad to another, they tend to buy high and sell low, which significantly reduces their long-term results. Studies show that chasing-the-hot-dot is the single greatest barrier to investment success.

Part II: Investment Experts and other Barriers to Success (Chapters 7 - 10)

Why do people consistently make investment mistakes such as market timing? One answer lies in an analysis of the investment industry. Part II takes a hard look at the antics of Wall Street and the sellers of investment advice. The industry does an adequate job of educating the public about basic investment concepts and retirement needs, but it does a poor job of executing those concepts. Having spent ten years as a stockbroker at two national firms, I am very familiar with the misleading sales tactics used on Wall Street, and the potential of the products sold. Do not confuse the goals of your financial advisor with your own. While many honest and ethical people work in the field, as a whole the industry exists to make money from you, not for you.

The public is often confused by the role of financial planners, stockbrokers, and other advisors who render investment advice. Most of these people sell investment products and services and are paid a commission or fee for doing so. The title of "Vice President" and other fancy names are earned by reaching a sales quota, not as a result of experience or client satisfaction. There are very few requirements needed to become a financial advisor and virtually no academic background is necessary. As a result, many advisors have very limited understanding of the economics, the stock and bond markets, and the investment products they recommend. Although many people believe their advisor is an investment expert, this is typically far from the truth. Most recommendations are based on the desire to sell a product, not investment acumen.

The mass media has taken Wall Street by storm. Hundreds of magazines, TV shows, radio talk shows, and Internet sites spout out fountains of investment advice on a regular basis. Is any of this information worth following? The perception is that the advice helps people invest effectively for retirement and other long-term goals. Clearly, the investment world does not change that rapidly. As a result, there should be no need to recommend different investments on a daily basis, as most in the media do. It would be more beneficial to investors if the media stayed consistent with a few wise mutual fund choices. However, the media is not in the advice business, they are in the advertising business. Their goal is to sell advertising space to financial companies such as mutual funds, brokerage firms, insurance companies, and others distributors of financial products and services. Therefore, the information that pours out of the media concentrates on short-term strategies, which does the public more harm than good. This information may please advertising clients who benefit from turnover, but it does not help individual investors who are trying to save and invest for the long run. In many ways, your success as an investor is based on your ability to ignore the quasi-advertising in the mass media, and concentrate on the important concepts highlighted in Part III this book.

With more than 400 mutual-fund companies and over 10,000 mutual funds on the market, investing in mutual funds has become a national phenomenon. However, the mutual fund industry has many ghosts in the closet. Few people know much about the funds they invest in or about the mutual fund industry in general. The last chapter in Part II explains some interesting and disturbing facts about the mutual fund business. In the never-ending battle for investor attention, many companies use questionable sales practices and promote short-term investment strategies. This lowers investor performance and increases your frustration.

Part III: Closing the Performance Gap (Chapters 11 - 16)

Part III of this book offers a unique solution for achieving a fair return on your retirement savings. It begins with a brief historical review of the stock and bond markets, which includes an estimate of the returns expected in the future. The performance of the markets over the next 20 years is likely to be more challenging than the last 20 years.

Investing in the stock market is best accomplished through indexing. This method of investing involves the purchase of index mutual funds that are designed to produce the return of a market index, such as the Dow Jones Industrial Average. Several low cost index funds are now available through a number of mutual fund companies. Ultimately, an investor should build a globally diversified portfolio of low cost

stock and bond index funds, and maintain that mix for a very long time. Indexing the global markets keeps investment costs low and eliminates the need to chase popular strategies.

The bond market offers investors a variety of low cost options. In addition to low cost bond index funds, people can purchase individual bonds. Part III includes simple strategies explaining each method. Purchasing individual tax-free municipal bonds offers a great advantage for high net worth investors. In complex markets, such as high yield bonds or mortgages, investors should rely on low cost mutual funds.

We all have different ideas of what "retirement" means. For some people it means no work at all, for others it means cutting back from a full-time occupation. Nevertheless, every retiree should know approximately how much money they need at retirement and develop a savings plan to meet that goal. The annual income from this nest egg should be large enough to fill in the gap left by diminishing pensions and Social Security.

One step in the financial plan is to decide how much to invest in stocks and bonds. This is called asset allocation. Your asset allocation decision should be based in part on the mathematical assumptions of the retirement goal, plus your attitude toward risk. There is an interesting chapter that covers these concepts. What makes a plan work is the discipline to maintain a consistent allocation over a long period of time and during all market conditions. If people take too much risk in their portfolio, they are likely to abandon the investment plan during adverse market conditions, which will lead to lower long-term results.

Tax planning is an essential ingredient in any investment plan and is covered as a separate chapter. Investors should use tax advantaged retirement accounts and purchase tax efficient investments whenever possible. The less you pay Uncle Sam, the more you have working on your behalf.

The last chapter includes a review of the main points in *Serious Money*, and provides a case study of how one couple invested their portfolio using these ideas. Earning a fair return is not difficult. The methods presented in this book are logical, easy to understand, and lead to greater wealth. Warren Buffet once said, "You don't need to be a rocket scientist. Investing is not a game where the guy with the 160 IQ beats the guy with 130 IQ."

Appendixes:

Serious Money ends with three appendixes. Appendix #1 provides the formulas needed to calculate an

investment return. Every investor should keep track of their returns on a regular basis and compare the returns to an appropriate market benchmark. Appendix #2 is for individual stock investors. It explains why stock investing is only a hobby and should be treated as such. It also explores the relationship between brokerage firms and investment banking clients. Appendix #3 provides background information about the oversold use of canned asset allocation models. Advisors who sell products using simplistic risk tolerance questionnaires to figure an asset allocation cause more harm than good.