Do-It-Yourself

Lifetime Financial Planning

By Lawrence J. Russell

MBA - Stanford University

MA - Brandeis University

BS - MIT

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Chapter 1: Introduction and objectives

Section1.1: What is the objective of this book?

Manage your own personal finance and investment affairs

This book provides objective personal finance and investing information for the millions of people who are trying to manage their own financial affairs efficiently and optimally without the benefit of an advisor. My goal is to increase your knowledge and improve your ability to manage your financial affairs independently.

This book selects from among and updates many of the personal finance and investing articles that I have published on the Internet during the last ten+ years. This electronic book compiles these materials into a coherent collection, while it still gives you direct access to the original materials on the web.

By compiling my web published articles into an organized electronic book like this, I have corrected certain weaknesses of web publishing. Historically, physical books have presented coherent treatments of extensive and complex subjects, such as personal finance and investing. With the advent of the Internet, information fragmentation has become a significant problem for those seeking useful information on the web.

When individuals seek information via search engines, the good news is that they can immediately access an incredible wealth of information. If they are discerning and proactive in their use of advanced search engine keyword features, a web searcher may find the information needle that they seek within the Internet haystack.

However, there are downsides to keyword search approach to Internet research. Beyond the obvious problem of a deluge of low quality promotional material, even sophisticated use of search engines can be problematic. The Internet is like having an immense library with billions of doors – each of which enters onto a single page of information within millions of websites. Because websites tend to be difficult to structure and are cumulative in nature over time, a web searcher tends to flit from one web page to another. Keyword driven web searching can be highly frustrating and excessively time consuming. Searching the web can lack the coherence that comes with a good old book. This is one reason why I have put the effort into compiling this electronic book for your reading.

These are my main personal finance and investing websites, should you wish to access them:

http://www.theskilledinvestor.com/

https://www.theskilledinvestor.com/wp/

https://www.theskilledinvestor.com/VeriPlan/

http://www.financialplannerpasadena.com/

1.2: Who is the author?

Lawrence J. (Larry) Russell is the author of this book. Since 2001, I have been President and Managing Director of Lawrence Russell and Company, a personal financial planning services provider and registered investment adviser in Pasadena, California. I am also a former technology industry business executive with a background in corporate business management, technology start-ups, financial modeling, investment management, economics, statistics, taxation, and accounting.

To find my free books and publications see:

https://www.theskilledinvestor.com/VeriPlan/financial-planning/

Overview of my financial planning and investment management background:

My knowledge of financial planning and investments has been developed through:

* education at M.I.T. (BS-1975), Brandeis University (MA-1979), and Stanford University (MBA-1982) [Yup. I'm getting older every day.]

* twenty-five years of corporate and start-up management experience in the business and corporate development, marketing, financial planning, and investment functions

* studying the scientific finance research literature in depth to find evidence about which investment and financial planning strategies do and do not work

* design and development of VeriPlan, a lifetime financial planning software product

For more detailed biographical information, please refer to this appendix of this book:

Appendix: Author's background

For my resume, see my LinkedIn profile page:

https://www.linkedin.com/in/larryrussell

Chapter 2: Overview of financial planning

2.1: Straight answers are hard to find

Many people are confused and frustrated about how to do personal financial and investment planning. To rise above the confusion, you must have a durable and scientifically grounded understanding of what to do.

Few people have access to disinterested and reasonably priced advice and information. Financial advisors are expensive – whether or not you pay them directly – and no advisor can work without direct or indirect compensation. If you do not pay your advisor directly, then the industry will pay your advisor indirectly. When the industry pays your advisor, your best interests can fly out the window very quickly.

Most competent advisors prefer to focus their attention on the wealthy who can more easily afford their services. People of more modest means very often receive significantly inferior "free" services. All too often, they find that these free services quickly focus on the sale of expensive and sometimes inappropriate financial products.

An endless stream of books and articles flows from the financial media with contradictory recommendations. Various media chatter on and on daily about minutia regarding one company after another, yet they provide little useful synthesis for the average person.

On-line financial information rarely is very helpful. Free on-line tools for individuals tend to provide superficial one-size-fits-all solutions. Often, these tools are designed primarily to funnel you – the "retail" sales prospect – into a banking, credit, insurance, or investment purchasing process. You learn little and buy blindly.

When individuals attempt to make sensible decisions about purchasing financial products, the potential for confusion is astonishing. With securities investments, for example, uncertainties about future values and risk give rise to ongoing market price volatility and sometimes-extreme outcomes. Any consumer product characterized by such great uncertainty and by such wide value fluctuations necessarily must cause substantial buyer confusion.

In many respects, the US financial services industry is among the most competitive in the world. Yet, when it comes to delivering advantageous, cost-effective products for individuals, let the buyer be extremely aware. Confusion and misinformation allow inferior products to flourish along with those likely to be better. The vast spectrum of retail financial products and services ranges from excellent to abysmal. Unfortunately, the financial services industry makes the most money on the abysmal end of that spectrum.

In the rough and tumble world you face when you try to make reasonable financial decisions, you are much better off with a well-considered, long-term viewpoint. Stable and scientifically grounded knowledge can keep you focused and on track throughout your life. Furthermore, this knowledge allows you to ignore all the rubbish that comes with this territory.

2.2: Follow scientifically valid personal finance strategies

Without a scientific basis for personal financial decision-making, you have no way to distinguish a valid financial strategy from an industry-marketing sideshow or a trip to Las Vegas

Scientific financial strategies are financial practices that have been validated by objective financial research. You should demand that your financial strategies be scientifically valid. Far too many financial and investment strategies have no objective basis and are in fact contrary to what has been established in the financial research literature.

Regarding best practices in personal financial planning and investing, objective information about what tends to work and what tends not work is available. However to find this objective information, you must know where to look.

Academic specialists in finance and economics conduct most of the truly objective theoretical and statistical research on subjects that directly or indirectly affect the financial affairs and well-being of individuals. The scientific finance literature that they produce exists in bountiful quantities. Most of this objective and enlightening information is "hidden" in academic journals and working papers. With the Internet, however, much of this information is now "hidden in plain sight."

For justification regarding your investment and financial planning practices, you ought to be able to point to high quality research work performed by honest, objective, highly educated, skillful, well-respected, and thoughtful people regarding financial best practices. These people should have: a) developed theories, b) done their homework, c) run the numbers, d) published their findings, and e) had their publications stand up to peer-level criticism.

The financial and investment science of the past several decades has been built on an increasing wealth of historical securities market data and on extensive survey research data. These data sets have been sliced, diced, and analyzed statistically by thousands of researchers. When studies of different data sets or of the same data from different perspectives reach similar conclusions, it is reasonable to pay attention to the findings of these studies. It is also reasonable to call them scientific, while taking into account the associated uncertainties.

Without scientifically based financial information, there can be no valid or invalid financial guideposts. However, even with the abundant availability of scientifically based financial information, those who do not do their homework or have ulterior motives will continue to make vacuous financial assertions. In these circumstances, you need to choose whom you will listen to and what proof you will require, before you commit your money.

You should note that one of the severe problems with the analysis of historical data is that the financial services industry is also reading this academic research and conducting its own.

However, here is where some of the greatest danger arises for individuals. Remember that I said above that "honest, objective, highly-educated, skillful, well-respected, and thoughtful" researchers should conduct this financial research.

Unfortunately, the financial services industry also has access to the same data and over past decades, it has hired tens of thousands of highly skilled analysts, including many math, physics, and engineering PhDs, to sift through this information, as well. Among other things, these skilled analysts develop automated computer applications designed to gain an edge in the competition of the global, real-time, securities markets.

In addition, though a process dubbed "data mining" financial service firms also look back at the data to develop supposedly "innovative," but much more expensive and more risky financial products to sell to the retail market. All too often, these new products exploit the naiveté of individuals, such as extrapolating superior historical performance into the future. Objective financial research has repeatedly demonstrated that superior performance tends not to persist. Thus, financial research is a double edged-sword for individuals. Understood and used properly, it can help you to adopt better financial strategies. Used improperly and exploitatively, it can be used to lighten your wallet repeatedly over the years.

2.3: Principles of lifetime and retirement financial planning

In general, individuals benefit greatly, if they decide to follow financial and investment strategies that are:

* savings-oriented,
* thoroughly diversified,
* completely passive,
* risk-adjusted,
* cost-effective, and
* tax-efficient.

While it might seem very challenging to sustain financial practices with these characteristics over the long-term, in reality all these factors are interrelated. In fact, when you choose financial strategies with these characteristics, your financial life tends to become less complicated. When the complications of personal finance diminish, you can get on with living. You can plan to live and not live to plan.

By earning more and spending less, most people will have much more impact on their future financial well-being than they ever could by trying to be more clever investors. Investment cleverness tends to be counter-productive for individual investors. In contrast, another dollar saved is another dollar to invest.

Thoroughly diversified strategies eliminate unnecessary and uncompensated risk. In addition, fully diversified strategies usually are completely passive, and they tend to have lower investment risk. The more passive your strategies are, the better they are.

Motion without real purpose in finance wastes both your money and your precious time. Motion in finance is futile, because asset price setting is generally very efficient, and the costs of making changes are high and push you backward. Market timing does not work. With investing, the watchwords are buy-and-hold-and-hold-and-stay-put-until-you-actually-need-the-money.

Optimal investing is all about risk-adjusted asset returns at the portfolio level. Securities markets tend to pay a premium for risk taking, but only for market level risk taking. Securities markets tend not to compensate for the risks associated with holding some subset of selected securities. Stock picking does not work and individuals need to understand this. There is no risk free money in investing, but there are many ways to take more unnecessary risk without commensurate rewards.

Your financial and investment practices need to be cost-effective. Cost reduction is the single most important factor that will improve investment returns for most people. In addition, when you cut down your investment costs, you also cut out the incentive for someone to sell something to you. When you stop listening to financial sales people and start looking proactively and only for low cost, passively managed, risk-adjusted, and fully diversified investments, you will simplify your choices. You will still have plenty of low-cost, broadly diversified investment options. Furthermore, the scientific evidence indicates that these choices will be the most favorable to your interests.

Greater tax efficiency tends to be a simple by-product of following the other decision rules listed above. More risky, poorly diversified, active strategies tend to incur higher taxes. Nevertheless, you always need to understand the tax implications of the financial actions you take.

2.4: The perspective of this book

This book focuses on the best interests of individuals and families. Fiduciary care of people's financial interests requires knowledge, experience, and the absence of financial conflicts of interest that distort the quality of information and advice given to people.

Global securities markets have a dog-eat-dog ethos with winners and losers. Highly competitive and ruthless securities markets are necessary for efficient price setting and capital allocation. I applaud when full-time financial professionals engage in competition among themselves with knowledge, resources, and skill.

However, when similar strategies are applied to individuals who lack knowledge, education, and resources, then this is an unfair fight. When the inadequacies, ignorance, biases, and misperceptions of individuals are exploited systematically, this is deplorable. Unfortunately, this approach is standard operating procedure for many parts of the financial services industry that could be viewed as global financial parasites.

When financial industry marketing and promotions imply that there is a partnership or advisory role, but actions taken indicate that this is not the case, then this is moral bankruptcy. When the financial industry is so strong that it distorts fairness in governmental regulation, then many deplorable behaviors are not criminal, largely because laws, regulations, and enforcement are too weak.

I believe that enlightened individuals should never naively expect fairness, when they deal with much of the financial services industry. Despite the financial industry's recent self-induced credit crisis, self-immolation, and taxpayer bailout, there is no reason to believe that this industry will ever change voluntarily. The game is just too profitable for the financial services industry and its excessively compensated employees to expect things ever to change fundamentally.

The mass of American financial consumers are trusting, docile sheep regarding their personal financial affairs. The amount they are willing to waste on overpriced financial services is astonishing. Far too many US consumers pay far too much and get woefully little value in return from the financial services industry. The industry repeatedly scrapes the consumer excess off the table and stuffs it into its salaries, bonuses, and corporate earnings reports. The only salvation for most individuals is that eventually some of them will wake up and decide to stop paying tribute to this beast.

Chapter 3: Lifetime financial planning -- 10 steps in the right direction

Step 1 - Take personal responsibility

Step 2 - Sustain a sufficiently high pre-retirement savings rate

Step 3 - Always own a fully diversified portfolio

Step 4 - Take personally appropriate investment risks

Step 5 - Manage investment risk and return through asset allocation

Step 6 - Select investment securities using valid criteria

Step 7 - Slash your investment costs and taxes

Step 8 - Budget your insurance expenses

Step 9 - Use time-efficient financial management practices

Step 10 - Self-manage with occasional professional consulting

Overview

Individuals and families need a rational financial planning process genuinely dedicated to their best interests. You need truly objective knowledge and you need to be in control -- whether or not you have a financial advisor. With a well-designed personal financial plan, you can optimize your financial affairs over your lifetime. In addition, you can greatly reduce the waste of your money and your time.

1 - Take personal responsibility

Because you must live with the results, you need to take full responsibility for your own financial planning and investment success or failure. Delegating financial planning and investment decisions to advisers, largely on faith can be very dangerous. Naive hope without adequate personal financial knowledge, attention, and control is very risky to your welfare. The only sensible solution is to increase your personal knowledge and skill in financial planning and investment management.

2 - Sustain a sufficiently high pre-retirement savings rate

Most people simply do not save enough of their current income to fund adequately their future needs. The single most significant financial lever that individuals control directly is their lifetime effort to obtain sufficient income. The second is their management of personal expenditures. The difference is their current savings rate. Without a significant inheritance or the successful capture of a leprechaun, the only path to wealth is a high and sustained savings rate during one's working years.

3 - Always own a fully diversified portfolio

A fully diversified portfolio is a key contributor to improved investment risk management and a more certain path to wealth. Diversification has become an axiom of personal investing, because variability associated with the specific risks of businesses and other investment entities can be reduced or eliminated through a diversified portfolio -- without reducing total expected returns. Diversification genuinely is an investment "free lunch."

4 - Take personally appropriate investment risks

Investors with different levels of risk tolerance are more satisfied with investment strategies that are better aligned with their risk preferences. Differences in risk tolerances mean that more risk-averse investors are personally more satisfied with a lower risk portfolio despite its lower expected returns. The must consume less and save at higher rates, but their path to success is more certain.

Less risk-averse investors are more satisfied with portfolios characterized by higher risk and higher expected returns. In relative terms, they can consume more and save at a lower rate. However, the success or failure of their financial plan is subject to greater variability, since they have a greater dependence on more risky investment assets, which may or may not deliver the returns that they expect.

5 - Manage investment risk and return through asset allocation

Your risk and return preferences relative to the average investor who hold the average portfolio will influence your choice of a portfolio asset allocation. Appropriately setting your personal asset allocation in line with your personal risk tolerance is a critical decision for every investor. Because the average risk-averse investor holds the average portfolio asset allocation, this becomes the starting point in determining how a specific individual's portfolio might diverge from that average allocation. Periodic rebalancing over time maintains your intended expose to investment risk and return.

6 - Select investment securities using rational criteria

Given the extremely large number and variety of available securities, investors need a rational basis to select among them. Without rational selection criteria and a good understanding of which factors are more or less likely to increase risk-adjusted returns, investors will make poor decisions based on false assumptions. Your portfolio investment strategy should focus on broad-based, market oriented financial investments that can be acquired economically and held inexpensively in your portfolio for an extended period. Of course, investment costs and tax implications heavily influence how you structure and manage your investments.

7 - Slash your investment costs and taxes

Even with optimal investment strategies, there is still substantial room to improve upon net investment performance through continued and vigilant focus on controlling investment costs and managing taxes. The investment fees extracted by the financial securities industry from the average retail investor are grossly excessive. Total costs imposed on unwitting investors have increased substantially during the past several decades, as the industry feeds on your assets without adding value.

At the same time, industry deregulation, market innovation, and increased competition have provided many new and useful mechanisms for individual investors to manage their assets in a far more cost-efficient and tax-efficient manner. You must be proactive in seeking low cost investments, because most financial services industry representatives have zero interest in leading you to low cost alternatives. Nevertheless, it is easy to find investments that cut your investment costs and taxes.

8 - Budget your insurance expenses

The world is fraught with numerous potential risks – financial and otherwise. Insurance can be purchased for a wide variety of situations, but the issue is always value and affordability. Many people could spend all their investable capital on insurance premiums and have nothing left to invest and build a financial cushion for the future. While value, affordability, risk exposure, and risk tolerance should affect insurance purchase decisions, insurance is often sold and purchased emotionally. The issue for the insurance consumer is where to set a rational rather than emotional balance between insured risks and the cumulative investment opportunity cost on the premiums paid.

9 - Use time-efficient financial management practices

Time in life is the most precious and perishable asset that any person has. Your time should be spent enjoyably and efficiently. Scientific investment strategies that rely on relatively efficient financial markets allow people to minimize personal time spent financial planning and investment management. Fully diversified, completely passive, extremely low cost, buy-and-hold, set-and-largely-forget investment management strategies deliver superior risk and return with less time and hassle. Such strategies are far more time-efficient and cost-efficient than the financial hamster wheels that the industry has set up for retail investors.

10 - Self-manage with occasional professional consulting

Most proactive and knowledge seeking individuals can manage their own personal finances. They simply do not need a continuous relationship with a financial advisor charging high fees. For occasional assistance, pick an advisor who can deliver competent, objective advice, but who does not sell financial products. If you agree with the advice, buy recommended financial products directly via the most inexpensive channel possible. When financial advice and financial product sales activities are combined, it is highly dubious that you will get the best advice in your best interest. It is much more likely that the advisor will feed his or her family first with your money.

Step 1 - Take personal responsibility

You need financial management skills, because you must live with the results of your decisions

Because you must live with the results, you need to take full responsibility for your own financial planning and investment success or failure. Delegating financial planning and investment decisions to advisers, largely on faith can be very dangerous. Naive hope without adequate personal financial knowledge, attention, and control is very risky to your welfare. The only sensible solution is to increase your personal knowledge and skill in financial planning and investment management.

People face formidable challenges to lifetime financial success and their ability to retire with financial security. Throughout your life, you must decide for yourself whether any particular personal financial planning or investment management concept is fact or fiction. One thing can be guaranteed -- there will be no shortage of ideas proposed to you by others about what you should do with your money.

The best financial rules persist and should not vary with market cycles or financial crisis

The best individual investment and financial planning rules persist and do not vary due to market cycles or financial crisis. The financial crisis demonstrated clearly that there really are no "smart money" managers -- at least none that you can hire to work in your interests after all of their costs is considered. The financial crisis demonstrated clearly that there really are no "smart money" managers. In particular, there is none to work for your best interests after considering all of their costs.

Furthermore, when the financial tide went out, so much fraud and malfeasance was uncovered that only the most gullible of people still believe that wide swaths of the financial services industry actual operate in their best interests.

If you delegate decisions to an advisor, you still must live with the consequences

Individuals or "retail clients" are a huge industry profit center. The profits are immense, the fees are ever-present, and the bite out of your wallet is huge over the course of your lifetime. You need to get educated, and you need to be skeptical. While the industry has very polished song and dance routines in a vast rainbow of flavors, most of what you are told to do is not what is best for you. The vast majority of the supposed "financial innovation" that you encounter is designed largely to lighten your wallet. These numerous industry pickpocket processes are subtle, but steady, and most investors never understand the lifetime opportunity cost of paying "just a few percent" for services without commensurate value.

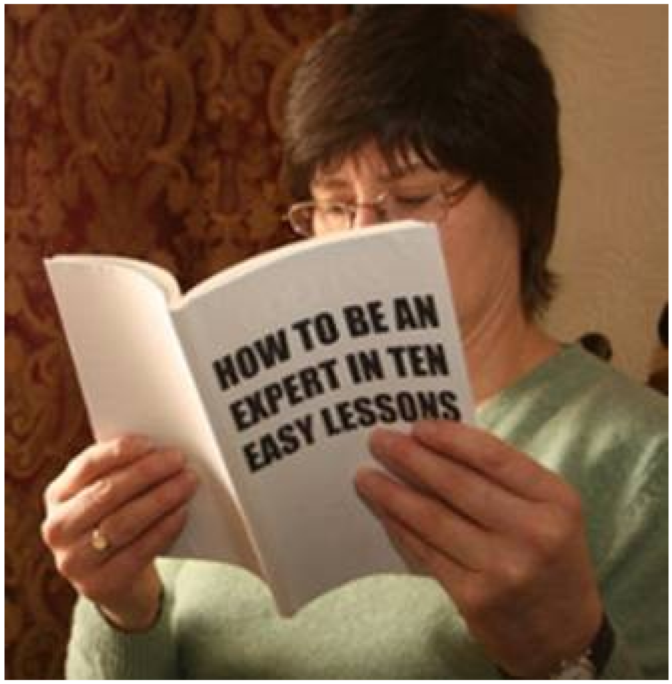
Only a minority of the investment, mutual fund, ETF, insurance, annuity, education, retirement, and other specialized financial products that you encounter have any long-term validity demonstrated in the objective financial research literature. Unfortunately, your best interests will come after the best interests of the financial services industry. It is a simple as that.

You must make intelligent and informed decisions about whether the financial planning strategies and tactics recommended to you in the financial media and by financial advisers are valid for you and your family. The vast majority of financial ideas proposed to you during your lifetime will be suboptimal, self-interested (not yours), simply wrong, and/or just plain rubbish.

Many people have highly inadequate financial knowledge and skills

Some of the saddest financial stories concern naive older people who are robbed of their lifetime savings by some smooth-talking, slime bag financial scam artist. These fraud victims have no way to recover the lost lifetime assets. Before the fact, they needed to know better to avoid being duped. However, they lacked the knowledge, skills, and judgment to know better, when it really counted for them to know how to protect themselves.

Is it reasonable to expect that you would have such expertise? You may be an expert in your profession or trade, and you may earn substantially more than you need to meet your current expenses. The dilemma is whether and how you will also learn to manage, grow, and protect your financial assets, as you focus on earning income and saving from your real-life career. Nevertheless, when you develop your financial expertise, you will increase the chances that your assets will grow sufficiently to fund your family's future financial needs.



Personal finance requires knowledge different from professional and career skills

Many people do need help from financial planners and investment counselors. Frustrated with complexity of personal finance and investing, they want to find someone they can "trust." They base their advisor selection decisions on the "trust" recommendations of friends and colleagues. Then, they want to hand over the keys and let someone else drive.

Unfortunately, the entire financial services industry uses a "we are worthy of your trust" marketing message. Much of the trust that individuals have is misplaced and ill founded. It is difficult to find another service industry where so much is paid for so little genuine value in return.

Advice from the financial services industry is often shallow, sub-optimal, and/or inappropriate

https://www.theskilledinvestor.com/financial/financial-advisors-investment-counselors.html

Personal financial planning and asset class investment advice from the financial services industry is often shallow, sub-optimal, and/or inappropriate. While advice might seem plausible, many financial industry recommendations are simply not good for you. The financial services industry writes its marketing material to sound reasonable to individuals. Some recommendations are reasonable, but many are not.

The vast majority of personnel in the financial services industry are taught how to sell the most profitable financial products. Relatively few genuinely understand finance and investments from the perspective of what is really best for their clients. Even fewer have an incentive to act in the best interests of their clients. The interests of the industry and its customers very often are in conflict. In an unfair fight, the financial services industry will win, as it delivers excessively expensive and overly risky financial products to its overly trusting clientele.

Naive trust, faith and hope are not a reliable path to financial success, when you are dealing with the financial services industry. There are simply too many potholes, conflicts of interest, and hands in your wallet. The only practical solution is for you to increase your personal investment knowledge and skills.

Step 2 - Sustain a sufficiently high pre-retirement savings rate

Your savings rate is the single most important financial lever that you control.

Sustaining adequate lifetime savings is a difficult challenge. Most people simply do not save enough of their current income to fund adequately their future needs.

The single most significant financial lever that individuals control directly is their lifetime effort to obtain sufficient income. The second is their management of personal expenditures. The difference is their current savings rate. Without a significant inheritance or the successful capture of a leprechaun, the only path to wealth is a high and sustained savings rate during one's working years.

Economists call the potential of each person to earn money, pay expenses, and still set aside financial savings their "human capital." For most people, their personal human capital is all they have financially, until they convert some of their human capital into longer lasting investment assets.

Over their lives, individuals must rely increasingly upon assets to replace earned income. Without inheritance or winning the lottery, you can invest only if you save. When saving to fund an investment program, you must live within both your current and future economic means.

Sustaining adequate lifetime savings is a difficult challenge. Prior to retirement, you must produce earned income to cover current expenses. On top of that, you must produce excess income and control your expenditures to allow for adequate personal savings rates. Your personal savings rate will largely determine whether you will build up enough assets for the unknown and uncertain future that lies decades in front of you.

In retirement, your cash flow management challenge shifts from saving for retirement on to retirement expenditure management. Your retirement investment assets and investment income must be adequate for your retirement expenses, yet you cannot know how long your retirement savings will last.

Greater savings result from awareness and control of personal consumption

Expense control allows for personal savings, personal investing, and eventually deferred consumption of investment returns and the investment principal, if necessary. Those who are better at managing their savings plan tend to be much more conscious of their expenditures. They tend to be more aware of the level of their current personal expenses relative to their current earned income. In short, they are better at personal financial planning and family cash flow management.

Personal savings rates increase with conscious planning and better expenditure decision-making. Better expenditure control results from a conscious decision made at the time of each purchase. Across your lifetime, the quality of your personal financial decision-making at the point of purchase will determine much of your overall financial success. Each purchase potentially involves a "need versus desire" decision. Some people do this better than others do. Some plan ahead and understand their limitations. Many simply do not.

Most people do not have a high enough personal savings rate for future financial needs

Your cumulative lifetime labor earnings are variable and uncertain. Your human capital is perishable. Personal income volatility has increased significantly at all income levels in recent decades and people must exercise increased discipline to restrain spending in a fluctuating income environment.

The passage of time steadily diminishes your total personal earning potential. Furthermore, illness and injury can randomly slash the value of your potential human capital, while disrupting your life and permanently altering your best-laid financial finance and savings plans.

The Bureau of Economic Analysis of the U.S. Department of Commerce has tracked the national personal savings rate since 1952, as part of its "National Income and Product Accounts" and "Flow of Funds" reporting. From the 1950s through the 1980s the national savings rates fluctuated around the 9% to 10% range. In the early 1980s, these rates began to decline. In 2006 and 2007, they even turned slightly negative! After the 2008 credit crunch and great recession this situation improved gradually. The savings rate approached 10% before the pandemic. After the pandemic recovery is has retreated again to around 5%.

A negative national personal savings rate means that for every dollar someone saves, another American goes more than a dollar into additional debt. Because a sustained long-term savings rate of 10% to 20% is usually required to save adequately for secure and comfortable retirement, the lack of significant American net savings in recent decades is very disturbing. Note that only when you start saving early in your working career, would a consistent lifetime savings rate of 10% be adequate to build wealth and retirement security. The longer you wait to start to save, the higher your savings percentage must be.

Only after the dreadful global credit crunch of 2007 to 2009 had devastated credit availability and forced both lenders and borrowers to change dramatically their easy borrowing and lending practices did this declining savings rate trend reverse. In 2009, the US savings rate began heading toward the high single digit percentages as people spent less, saved more, and paid down their debts more quickly. Whether the national savings rate will approach or exceed 10% and stay there is a significant question. This savings rate will have a great impact on the long-term financial security of many millions of US families.

Therefore, the first thing you must get right in your lifetime financial planning is your financial savings program. To ensure that your personal savings rate is high enough to build up an adequate asset base, you must understand, track, and project your cash flows. You cannot know the adequacy of your savings rate and your progress toward your investment goals without measuring your current progress and projecting your future cash flows.

Any comprehensive cash flow projection must also include planned future cash requirements for living expenses and special requirements, such as a down payment on a house, college expenses, retirement, charitable giving, and estate bequests. Projected personal financial requirements provide the baseline expenditure plan over which you can overlay various income and investment return scenarios to test the adequacy of your current savings and investment plans.

Step 3 - Always own a fully diversified portfolio

Diversify your investments completely and globally – now and always

A fully diversified portfolio is a key contributor to improved investment risk management and a more certain path to wealth. Diversification has become an axiom of personal investing. With a diversified portfolio, the variability associated with the specific risks of businesses and other investment entities can be reduced or eliminated – without reducing total expected returns. Diversification genuinely is an investment "free lunch."

https://www.theskilledinvestor.com/financial/asset-diversification.html

When you hear that you should diversify your investments, this means that you should diversify your investments completely and globally - now and always. The investment research literature repeatedly demonstrates that a fully diversified, low cost investment strategy is superior. Get diversified. Stay diversified. Be globally and fully diversified all of your life. Stay in the markets through thick and thin, while investing with an asset allocation that is appropriate for your greater or lesser tolerance for investment risk.

The best investment strategy is to seek complete market diversification at the lowest investment cost using passively managed and globally diversified index mutual funds. You can reduce the volatility of your personal portfolio significantly and track the return of the market with relatively small investment costs. Other strategies tend of be sub-optimal, involving greater portfolio volatility and risk -- and accompanied by higher costs in term of expenses, taxes, time commitment, and stomach acid.

Nothing that has happened in the credit crisis changes the value of broad market diversification. Some uninformed post-crisis commentary has questioned the wisdom of diversification, which only indicates a failure to understand what diversification can and cannot do for you.

Diversification mitigates volatility over time

Diversification across a portfolio can and does mitigate volatility over time. However, when systemic factors across asset classes are in motion in the securities markets, then there is nowhere to hide, as occurred with the credit crisis. As over-leveraged investors across a wide variety of asset classes scrambled for liquidity, selling pressure increased broadly, buying demand collapsed, and asset values crashed generally, albeit, not uniformly. Those who were very broadly diversified felt less pain, but they still felt pain.

However, if you really like the potential for a lot more pain, then go ahead and do not diversify. Eventually, that pain is much more likely to come to an ill-diversified investor's portfolio compared to the portfolio held by a broadly diversified investor.

Of course, ill-diversified investors chasing tactical and active strategies are always hoping for outsized returns for the added risk. Sadly, only a minority of active investors trading in and out of the market will get lucky. Largely, luck is at play here. For most investors, in fact, it is actually the lack of luck. The percent of the lucky minority achieving excess returns tends to diminish with time -- as excessive fees and taxes cumulatively eat away at illusory excess returns -- proving the foolishness of active strategies.

For risk-adjusted investing, diversification is not an option

Diversification is not an option, if your goal is optimized, risk-adjusted personal investing. Diversification is not an optional part of family investment strategy, if that family wants to sleep well at night. When you are less than fully diversified, every day that you wait exposes you to investment risks that the securities markets do not compensate through better returns. When you are less than fully diversified, your investment portfolio risks are higher than they need to be without any reasonable expectation of getting additional returns.

When you a) chose an active management strategy versus a passive one, b) try to time the markets versus staying put, c) buy individual securities versus funds, d) favor certain economic sectors versus full domestic and international diversification, etc., then you are much more likely to lose than to win. This is simply because the road you are taking is unnecessarily rough and unnecessarily winding, and this gives you less certainty that you will reach your goals. You might overshoot in performance if you are lucky, but you are far more likely to under-perform, because of the various higher expenses, higher costs, and higher taxes that cumulatively drag down active strategies. The longer your time horizon the greater the chances that you will fall behind a passive, lowest cost, market index investment strategy.

A passive strategy targets a market return and can still be a bumpy ride -- especially if you are not fully diversified globally and you have not adopted an asset allocation that is appropriate to your tolerance for investment risk. Nevertheless, the attendant risks are lower and potential variations are much narrower than active strategies.

Furthermore, passive strategies that drive down investment costs and expenses to the bare minimum are not continually burdened by repeatedly having to pay tribute the financial services industry with a much larger and undeserved share of your returns. It is hard enough to finish a marathon without carrying water for the financial securities industry at the same time.

To diversify globally, use the broadest, cheapest passive index mutual funds and ETFs

A fully diversified portfolio is an absolute investment necessity. A very high degree of diversification can be achieved through investing in a variety of low cost passively managed index mutual funds or exchange-traded funds. Such investments are also among the lowest cost investment vehicles available to individual investors in the financial markets. Given that this alternative is easily and cheaply available, the relevant question is never whether a portfolio should be fully diversified.

Through investments in broad-based index mutual funds and exchange-traded funds, diversification is relatively easy and inexpensive to achieve. Attempting to become broadly diversified through the self-assembly of a portfolio of a large number of individual securities is far more difficult and much more costly.

Portfolio self-assembly is much more likely to result in higher risk with returns that lag the market. Buying individual stocks and bonds instead of diversified funds provides you with no advantage whatsoever. The industry likes it, because individual securities trading generates fees and keeps going the charade of potentially beating the market.

However, when you buy individual stocks and bonds, you are less than fully diversified, and you are exposed to more risk. In addition, you get to waste your money and time for nothing. Pay more and get less. What kind of value added is that? You are better off ignoring this kind of investment counseling and financial advice.

Step 4 - Take personally appropriate investment risks

Investors with different levels of risk tolerance are more satisfied with investment strategies that are better aligned with their risk preferences. Differences in risk tolerances mean that more risk-averse investors are personally more satisfied with a lower risk portfolio despite its lower expected returns. The must consume less and save at higher rates, but their path to success is more certain.

Only some can live with the greater risks associated with the potential for higher returns

Everyone would love both low investment risk and high investment returns in the same portfolio, but such portfolios are just pipe dreams. Investing is all about intelligent and sensible exposure to investment risks. Investing means that the investor is willing to incur risk in exchange for the possibility of a higher future payoff. Unless there is a chance that you will lose some or all of your capital investment, you simply are not investing.

Rational investors expect increased returns for taking on investment risks. Investors have rational expectations for positive risk-adjusted payoffs. Current securities market prices reflect the current risk consensus and carry a discount compared to expected future values.

On average, stock and bond investments have paid investment risk premiums historically. These premiums have fluctuated and have been thoroughly unpredictable until after the fact. Investors who have consistently stayed in the market have earned higher returns over time. While the desire to avoid investment risk is understandable, investment studies have demonstrated that efforts to time the market by jumping in and out have not been successful.

https://www.theskilledinvestor.com/financial/investment-returns.html

Investors need investment strategies aligned with their personal psychology and risk tolerance

Investors with different levels of risk tolerance are more satisfied by the expectations associated with investment strategies that are better aligned with their risk preferences. Differences in risk tolerances mean that more risk-averse investors are personally more satisfied with a lower risk portfolio despite its lower expected returns. They must save at a higher sustained rate and consume less along the way, but their financial strategy is more certain.

Less risk-averse investors are more satisfied with portfolios characterized by higher risk and higher expected returns. In relative terms, they can consume more and save at a lower rate, because they are expecting and depending upon higher asset growth. However, the success or failure of their financial plan is subject to greater variability, since they have a greater dependence on more risky investment assets, which may or may not deliver the returns that they expect.

Because investing is inherently risky, individuals should understand their probable response to risk factors that actually do materialize. Risk tolerance is an issue of personal psychology and will determine whether an investor will adhere to and sustain an investment strategy, during difficult economic times. When markets are performing poorly and fears are high, an inappropriate alignment between an individual investor's portfolio risk or volatility and his or her risk tolerance can be very costly.

In such circumstances, some less knowledgeable and unprepared investors may take inappropriate actions that can be explained by their personal psychology at the time. However, these mistaken actions can be inappropriate for the financial market situation and highly detrimental to their long-term financial goals and welfare. Some investors may panic and sell when they did not have to, only to see the market recover, while they subsequently remain on the sidelines with a dramatically diminished financial asset portfolio. Portfolios with different risk and return characteristics are simply better for certain investors depending upon their tolerance for risky investments.

Step 5 - Manage investment risk and return through asset allocation

Asset allocation reduces risk by investing across asset classes with differing risk and return characteristics

Your risk and return preferences relative to the average investor who hold the average portfolio will influence your choice of a portfolio asset allocation. Appropriately setting your personal asset allocation in line with your personal risk tolerance is a critical decision for every investor. Because the average risk-averse investor holds the average portfolio asset allocation, this becomes the starting point in determining how a specific individual's portfolio might diverge from that average allocation. Periodic rebalancing over time maintains your intended expose to investment risk and return.

Investing and asset allocation is all about risk-adjusted investment returns related to your overall investment asset portfolio. Because the risk and return characteristics of various asset classes are not completely correlated, changes in their market prices tend to offset each other to some degree. Therefore, you normally can assemble an investment portfolio with lower overall investment risk, when compared to the risk of each of the individual asset classes that make up your portfolio. In effect, the various asset classes provide additional diversification benefits that go beyond the benefits of investment risk reduction that can be achieved through full diversification within each individual asset class.

https://www.theskilledinvestor.com/financial/asset-allocation.html

What is an investment asset class?

Whether you invest through broadly diversified index mutual funds or diversified exchange-traded funds (ETFs), the largest and most established financial asset classes are stocks, bonds, and cash. Stocks, bonds, and cash are sometimes referred to as financial assets, and most financial assets are priced and are traded on real-time securities markets publicly.

Real estate property is an additional asset class, which creates some complications related to portfolio diversification. The great majority of individual investors with some financial assets also tend to be real estate property owners. For many, their real estate assets - usually their personal residence - can grow in value over their lives to become a very substantial and even majority part of their personal investment asset portfolios. Since this real estate equity is in a home, which also provides shelter, then these real estate assets really function as a financial asset reserve of last resort after equity, bond, and cash financial assets are exhausted.

Beyond stocks, bonds, cash, and personal real estate holdings, there are numerous other perhaps real, but very often fanciful or false asset classes that are promoted to individual investors by the financial industry. A few of the alternative asset classes and associated investment products that are pitched to individual investors include various commodities, gold, foreign exchange, hedge funds in 57 varieties, infrastructure, managed futures, private equity, limited partnerships, and on and on.

Once you stray beyond public market stocks, bonds, cash, and real estate, the proliferation of additional asset classes and investment vehicles seems virtually unlimited. Unfortunately, many of these alternative asset classes and investment products are fraught with problems for less sophisticated (and even for more sophisticated) individual investors. Promoters suggest that the grass is greener with these alternative asset classes, but many seem more like swamps upon closer inspection. In general, false or misleading performance claims, excessive sales fees, excessive costs, excessive risks, and excessive taxes characterize this alternative investment swamp.

If you are not highly sophisticated in financial analysis (and even if you are), you can do fine and probably a lot better, if you stay away from these alternative asset classes entirely. Individual investors can do quite well across their lives by sticking solely to the cash, bond, stock and real estate asset classes for their entire investment portfolios.

Your personal investment risk tolerance should determine your investment asset allocation

Investing always involves risk. All investors -- small or large -- skilled or unskilled -- irrational or rational -- sophisticated or unsophisticated -- must navigate the same uncertain securities market and economic waters to get to their financial goals. An investor's ability to tolerate risk will dictate whether they can stay in the markets in the bad times, as well as the good times.

By analogy, those who cannot tolerate rough waters should sail in a bigger, safer, and slower boat (more cash and bonds and less stocks). Those who can better stomach the storm can sail in smaller, faster boats (more stocks and less cash and bonds) and perhaps go faster while exposing themselves to greater risk. On average historically, greater risk has yielded greater rewards, but investors need to be aware of their personal limitations and choose the appropriate investment boat, given their risk tolerance and fortitude.

If the average investor sails in the average investment boat, then the more risk averse investor should choose a larger, slower boat, while the more risk tolerant investor should choose the smaller faster boat. Risk tolerant investors tend to be frustrated by the lower performance of slow boats, while risk averse investors in small fast boats may experience fears and losses (however temporary) that they simply cannot tolerate.

Virtually all investors are risk averse to some degree. Therefore, securities markets are expected to pay a positive, albeit uncertain, future return or risk premium. Otherwise, no investor with greater or lesser risk aversion would be willing to put their capital at risk versus storing their money in a more certain asset with lower risk. The few who crave risk have casinos, day trading, ForEx, commodities, or some other “zero-sum-plus-costs" games, where they can give their money away to the "house" slowly or quickly. Unfortunately, few will enjoy themselves during this foolish process.

Setting your personal investment asset allocation is a critical decision for every individual investor

Because the average risk-averse investor holds the average portfolio asset allocation, this becomes a reference point in determining how a specific individual's portfolio asset allocation might diverge from that of the average investor's asset allocation. The aggregate values and relative proportions of the financial markets will define this average asset allocation. Then, the relevant questions to ask are "How does my personal risk tolerance compare to the average investor and how should my personal asset allocation differ from that of the average investor?"

In addition to this book, I have also written a comprehensive financial planning software product called VeriPlan. With it you can test various asset allocation strategies and to understand the lifetime implications of those strategies.

Step 6 - Select investment securities using valid criteria

Without scientifically verified strategies, investors make inferior decisions

Given the extremely large number and variety of available securities, investors need a rational basis to select among them. Without rational selection criteria and a good understanding of which factors are more or less likely to increase risk-adjusted returns, investors will make poor decisions based on false assumptions. Your portfolio investment strategy should focus on broad-based, market oriented financial investments that can be acquired economically and held inexpensively in your portfolio for an extended period. Of course, investment costs and tax implications heavily influence how you structure and manage your investments.

Without scientifically verified strategies, investors make inferior decisions. If you cannot find scientific evidence to verify a personal investment management strategy, then just do not do it. To cut to the chase about what tends to work best with investment strategy and retirement planning, I have concluded that all forms of active management that cannot be cost justified should be driven out of personal investment strategies.

The best investment strategy for lifetime personal finance and retirement planning

Individual investors need to choose a comfortable, very low cost, low tax, risk-adjusted market investment strategy and let it run over time. Maintenance should be minimal and low cost, and the urge to chase "beat the market" mirages should be heavily restrained. Investors' strategies should focus on broad-based, market-oriented investment funds securities (mutual funds and ETFs) that can be acquired economically and held inexpensively for an extended period.

Buy the cheapest, most broad based investment mutual funds and exchange traded funds (ETFs). Buy and hold them. Keep holding them, unless you really need the money for some other purpose. This is what assets are for. You keep them until you need them. Otherwise, get on with your real life.

Key concepts related to the best investment strategy for your personal investment portfolio

The current price of a security represents the market's consensus about its potential future value, given the various advantages and disadvantages that all investors see in holding or selling that security. As such, the current security price is a weighted average value forecast of events that might or might not occur. Market prices are the best available assessment of forward-looking, risk-adjusted fair market value.

https://www.theskilledinvestor.com/financial/investment-securities-valuation.html

Through securities market prices, a wide array of investors with differing predictions and varying concerns essentially "vote" on the expected or likely future value of a security through its current price. Investors' evaluations of the value of securities may vary widely. What one person might see as a great bargain, another might consider grossly overpriced. Without this divergence of opinion over current securities values relative to potential future values, there would be no trading of securities. Given the immense volume of securities trading that occurs daily across the world's securities exchanges, it is clear that there is no shortage of significant differences of opinion about current market values.

Securities prices represent the current valuation consensus on a risk-adjusted basis. Risk refers to the expected size and likelihood of future up or down price variations or volatility. As such, not only do prices reflect expected returns, they also reflect the panoply of concerns, optimism, risks, and euphoria about how a wide range of factors might affect the price in the future.

Given this highly speculative, future-oriented, and risk-adjusted valuation process, there are bound to be very significant price fluctuations as time goes on. This variability is the natural side effect of the market's communal, self-interested valuation process, and this variability is neither good nor bad. It seemly means that speculation about future investment value has been, is, and will always be subject to risk and uncertainty.

Future securities market values are fundamentally unknowable

The problem with trying to predict future securities market values is that the future is fundamentally unknowable, until it arrives. While history can be instructive about what might be more or less likely in the future, history tends not to be predictive. Securities prices exhibit only a very tiny level of predictability within a very large range of random fluctuations. The blending of expectations about future returns and risks into current securities prices means that the situation is subject to a wide range of either insightful to specious predictions. Unfortunately, you can only guess which predictions are insightful or specious, until after the fact.

The volatility of prices across time provides an opportunity for just about anyone to develop a supposedly predictive theory on how the markets actually work and to offer selected data to support their arguments. The only reliable way to sort through what is true or false is to rely upon the investment research studies of highly disciplined academics who carefully test these theories using market price data that is unbiased.

https://www.theskilledinvestor.com/financial/investment-luck.html

Individual investors should ignore concerns about securities market values

Individual investors are usually better off, when they ignore concerns about whether the securities markets fairly value investment securities. If there is a reasonably large and liquid market where investors interact through "arm's length" transactions, then individual investors should simply accept current market prices and avoid the usually futile temptation to second-guess current values and to try to beat the market. While some securities prices will eventually be shown to have been either too high or too low relative to their subsequent prices, the reasons almost always have nothing to do with market pricing mistakes by the securities markets.

Current securities market prices do a pretty good job of reflecting information that is already know. Statistical studies demonstrate that errors tend to cancel each other leaving little opportunity of investors - especially amateur individual investors - to identify, trade, and profit on these current pricing errors. In effect, especially among individual investors, those who appear to have done better than the market were largely just lucky and those who did more poorly were simply unlucky.

Instead, prices tend to change over time due to unpredictable future events which occur and cause the securities markets to revalue securities. New information continually changes forward-looking expectations about expected future investment values. Since this new information becomes known only if and when it happens, there is no way to have reliably predicted it. Speculation about a range of possible future events will influence current prices, but only time will tell what actually will happen.

Professional investment fund manager costs and taxes substantially exceed any performance added-value that they might contribute

Some full-time professional investment managers and professional securities analysts might be able to discern when a security is more likely to be under-valued or over-valued. Before their added costs and taxes are considered, on average active professional mutual fund managers have been shown to deliver performance that is only modestly better than passive index benchmarks. However, across all professional investors there is no evidence that they can consistently beat the markets, after their added costs and higher taxes are taken into consideration.

The costs of trying to beat the market simply overwhelm any professional value-added. Through increased investment fees, costs, and taxes, the average professional investment fund manager charges several times the average value that might be added. The effort to identify and hire only "superior investment managers" is highly uncertain, usually futile, and subject to a great deal of error and dumb luck. In reality, except for cost reduction, there are no reliable metrics to predict superior investment fund performance and to identify superior money managers before the fact.

So, where are all the perennially superior traditional money managers who can be hired economically to manage your money and that of thousands of others for a superior return? They are not to be found. Individual investors spend an excessive amount of time and money looking for investment mutual fund managers who will almost all turn out not to be the next Warren Buffett in the long run.

Choosing the lowest cost investments will always mean adopting a passive index benchmark investment strategy. The logical decision of individual investors is to avoid all activism and not to pay more for a poor chance of winning versus a much larger chance of losing. Instead of trying to beat the market or trying to find a mutual fund manager who will beat the market net of his substantial added costs, individual investors should instead focus their efforts on:

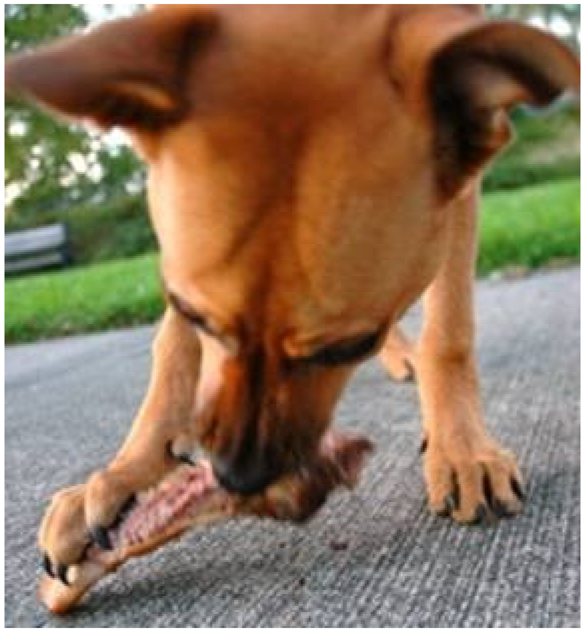
* earning more income and saving more to fund their investment program understanding their relative investment risk tolerance and choosing an investment
* asset allocation that is appropriate for their personal risk profile
* using rational selection methods to acquire a low cost, low tax, broadly diversified, passive market-based portfolio
* applying time and energy to investment activities that tend to increase personal financial welfare, while eliminating time spent on activities that undermine it.

Invest passively in very low cost, very broadly diversified index funds across the world. Save more to build your assets. Save your time and do something else that you actually enjoy, instead of wasting your time and money playing amateur individual investor.

https://www.theskilledinvestor.com/financial/selecting-investment-funds.html

Step 7 - Slash your investment costs and taxes

You can significantly improve your net risk-adjusted investment returns by lowering your investment fees and taxes. Cut your investment expenses and taxes to the bone



Follow the example of Rose the puppy,

and tear your investment expenses and taxes down to the bone

Even with optimal investment strategies, there is still substantial room to improve upon net investment performance through continued and vigilant focus on controlling investment costs and managing taxes. The investment fees extracted by the financial securities industry from the average retail investor are grossly excessive. Total costs imposed on unwitting investors have increased substantially during the past several decades, as the industry feeds on your assets without adding value.

At the same time, industry deregulation, market innovation, and increased competition have provided many new and useful mechanisms for individual investors to manage their assets in a far more cost-efficient and tax-efficient manner. You must be proactive in seeking low cost investments, because most financial services industry representatives have zero interest in leading you to low cost alternatives. Nevertheless, it is easy to find investments that cut your investment costs and taxes.

https://www.theskilledinvestor.com/financial/cost-control.html

Cutting your investment costs to the bone has been, is, and always will be the single most reliable method for individual investors to increase their long-term net investment returns. The financial crisis did nothing to knock investment cost cutting out of this number one effectiveness position for individual investors. Investment cost cutting is always the first and best lever to use to improve long-term net portfolio returns. The dot com securities market implosion and the credit crunch crisis and near depression have given investors two more opportunities to become aware of the corrosiveness of excessive investment costs.

No other investment indicator is as reliable as lower costs in producing better net investment performance. Unless you slap them away, numerous financial industry hands will stay in your investment wallet and keep taking "a little bit" here and "a little bit" there in terms of:

* sales loads to pay brokers and advisors who induce you to buy investments with higher costs;
* ongoing 12b-1 sales fees that pick your pocket year after year;
* higher fund management fees to pay for active management activities that inevitably fall short of passive benchmarks -- especially as the time period increases;
* higher portfolio churning and turnover which leads to higher hidden costs;
* high percent-of-assets advisory fees that compound costs, because advisors try to beat-the-market to justify their fees -- inevitably falling short over time on average; and
* a myriad of other one-time and recurring industry fees that bleed away value related to your taxable retirement asset accounts.

Millions of individual investors have started paying serious attention to investment costs. This has been demonstrated by massive investment asset shifts from higher cost to lower cost investment vehicles in recent years. When securities market values stagnate, people inevitably begin to look more at reducing their costs to improve their net returns.

Yet, the truth is that they should always have been looking for the lowest cost investments -- and they always should in the future. There is no credible evidence that professional investors can pick winners that do well enough to overcome their higher costs. Over and over again, the investment research literature has demonstrated the opposite: The less you pay in investment expenses, the more you tend to keep!

If you have not already done so, it is time for you to wake up about investment costs. Net investment performance short-term and long-term is a zero sum game across all investors. Long-term the global securities markets tend to reflect the value of the global economic development and growth that underlies the markets. Over the long run, securities markets act as an allocation mechanism to distribute this underlying economic value to debt holders and to enterprise shareholders.

Along the way, if you keep giving away some of your ownership share to the financial industry through higher investment costs, then your assets will just end up somebody else's pocket. While the financial industry attempts valiantly to minimize and obscure the effects of their unjustified investment costs, the corrosiveness of excessive costs is always there, damaging your family's long-term welfare. If you own assets, then you are a profit center for the industry. Get real. There is no "partnership" between the industry and individual investors.

Each and every year, the average individual investor spends about 2% to 3% of their total investment portfolio assets on excessive investment management fees, unnecessarily high securities trading costs, unjustifiably high investment custody fees, and completely avoidable usually short-term capital gains investment taxes. Where do you think a lot of those multi-billion dollar Wall Street broker bonus payments are coming from? Directly or indirectly from your taxable financial assets and retirement financial assets is the answer. In aggregate, brokers don't add value. Some clients seem to win on occasion, but most just keep losing, while the brokerage house always takes its cut of the action.

These wasted investment costs mean that the average individual investor typically gives away between 1/4 and 1/3 of his or her annual investment returns to the securities and financial services industry every year. In aggregate across all individual investors, these investors will get nothing in return.

Well, that is not entirely true. In exchange for paying more to engage in high tax and high cost active investment management strategies, participating investors will be taken on a much wilder investment roller coaster. Unpredictably, active investors may experience more dramatic ups and downs. On average, in addition, they will suffer inferior investment performance due excessive investment costs and unnecessary capital gains tax payments.

The cumulative long-term impact on personal investment portfolios is simply staggering. Across all investors, these excessive costs are a complete waste. In fact, excessive investment expenses are simply an incredible wealth transfer to the securities and financial services industry. The associated and unnecessary capital gains taxes are just a wealth transfer from individuals to the government.

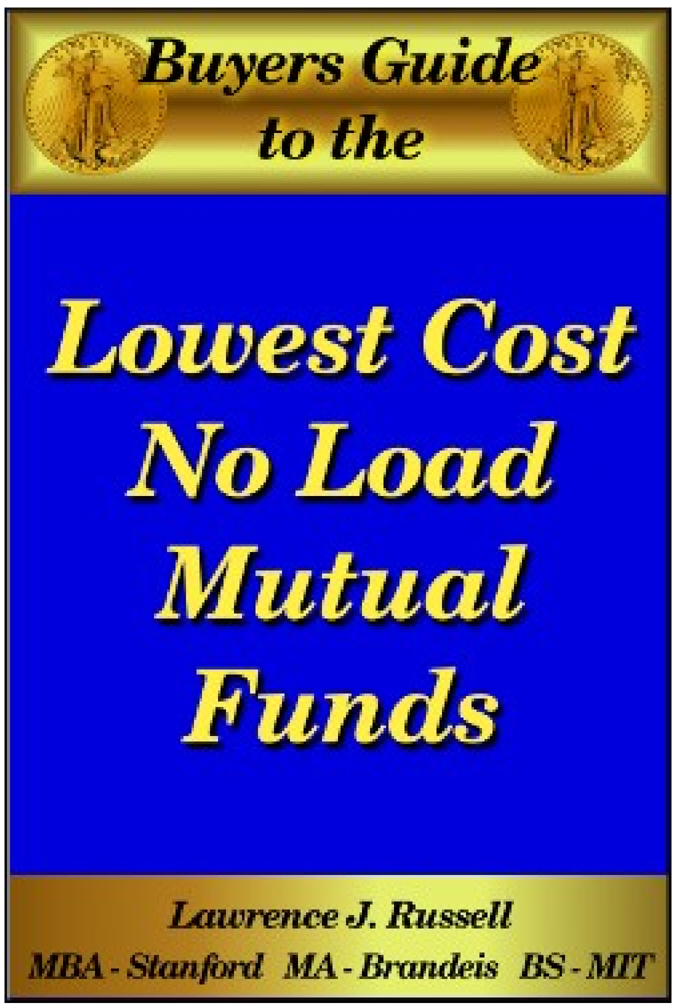
It is difficult to identify another industry that charges so much and promises so much to their customers, and yet ends up delivering so little in terms of genuine added-value to their customers. Until individual investors wake up to the fact that they are paying far more than is necessary for so little in return, they are far more likely to have dramatically diminished lifetime investment portfolio assets.

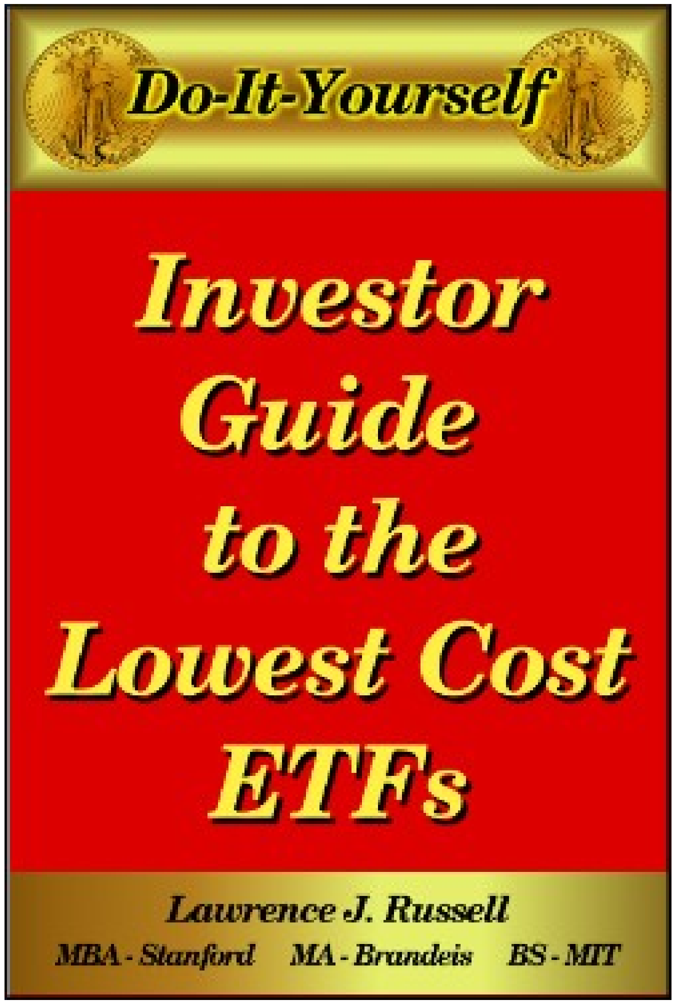
I have researched and written two objective books

that can help you cut your investment expenses and increase your wealth

They are both FREE to download at this web address:

https://www.theskilledinvestor.com/VeriPlan/financial-planning/





Step 8 - Budget your insurance expenses

Set an insurance budget as part of your planning for non-investment risks

The world is fraught with numerous potential risks – financial and otherwise. Insurance can be purchased for a wide variety of situations, but the issue is always value and affordability. Many people could spend all their investable capital on insurance premiums and have nothing left to invest and build a financial cushion for the future.

While value, affordability, risk exposure, and risk tolerance should affect insurance purchase decisions, insurance is often sold and purchased emotionally. The issue for the insurance consumer is where to set a rational rather than emotional balance between insured risks and the cumulative investment opportunity cost on the premiums paid.

The reality is that individuals and their families must intelligently and rationally budget for those insurance coverages that might ameliorate most effectively the risks that could do most damage their lifetime financial prospects. There simply are too many risks and too many types of insurance that cost too much. Given the required premiums for the broad range of insurance coverages, a majority or even a large minority of the US population simply cannot afford adequate coverage for most of these insurance risks. Furthermore, they cannot find jobs that help to provide adequate coverage in some of these risk areas.

At the outset, let me be very clear about the role of insurance in personal financial planning. Certain types of cost effective and carefully selected insurance coverages from reliable insurance companies are vital and very important to protect your family's long term financial interests. Determining which insurance coverages would be most beneficial to you requires 1) knowledge of your needs, 2) an appreciation for uncertainty, 3) an understanding of the best product alternatives, and 4) complete objectivity in the decision process. Unfortunately, putting all four of these factors together when buying insurance is a very tall order.

Given the unpredictability of life and the attendant risks, fears, and emotions, a primary point of this article is to urge you to shift your personal insurance decision making process toward as much rationality as is possible. When you find yourself in an insurance sales process, where subtle or overt appeals to your emotions have begun to predominate, stop and step outside the sales process for a breath of fresh air. Your emotions may be willing to pay any price for safety, but your rational mind should be asking about the tradeoffs. Do your homework before the ink is drying on the insurance contract.

Insured risk avoidance always involves financial and investment tradeoffs

Tradeoffs between personal financial and investing strategies and insurance risk management are inevitable. Living is risky and unpredictable. For the price of their premiums, insurance companies promise to eliminate or reduce many of these risks for you. When you have coverage in force, you experience an insured event, and your insurance company steps up to meet its obligations, the real virtues of insurance are obvious. At other times, you must operate in a very broad realm of uncertainty about: a) what might happen to you and your family, b) whether the insurance that you happened to purchase will actually cover the risks that actually materialize, and c) whether your insurance company will deliver on its promises.

To remind you of the extent of the various risks to which you might be exposed, these are many of the insurance coverages that you could buy, depending upon your needs:

* auto insurance
* business insurance for the self-employed
* dental insurance
* disability insurance and workman's compensation insurance
* earthquake insurance
* fire insurance
* flood insurance
* flight insurance
* general liability insurance
* home owners insurance / condo insurance / renters insurance

* legal insurance
* long-term care insurance
* medical insurance / group health insurance / individual health insurance
* mortgage insurance / title insurance
* property insurance / boat insurance
* term life insurance / universal life insurance / whole life insurance
* unemployment insurance
* vision insurance

Insurance is never free and you should never expect it to be "profitable" to you. Unless an insurance company is poorly managed and makes excessive benefits commitments, you can never make a "profit" from an insurance company on the premiums you pay. From a strict financial standpoint, you should always expect to get less money out of insurance than you pay in insurance premiums.

In general, you are paying to participate in a risk sharing pool. That is all insurance really is. If, somehow, you find an insurance contract that seems to provide excessive benefits relative to its costs, then you better be toward the front of the claimant line, because the insurance fund will be exhausted before those at the back of the line get served. A better approach would be not to enter into any insurance contract that seems too good to be true.

Insurance is even more expensive, because it not just a redistribution of paid in premiums and the pooled financial assets of policy holders. Insurance premiums include very substantial sales and marketing costs, administrative expenses, and insurance company profit requirements. For some forms of insurance, less than 50 cents of each dollar taken in gets paid out in benefits. Insurance is like a lottery. Insurance premiums and lottery tickets are both prices of participation. Yet, with insurance there inevitably is less joy in the payout, because something rather nasty needs to happen to become a "winner" with insurance.

Affordability tradeoffs between insurance and investments

Insurance affordability inevitably dictates that most people will bear some insurable risks without insurance coverage. Individuals may be more or less comfortable with this situation. Having a good understanding of one’s risk exposure and risk tolerance is one place to begin.

Given that people are exposed to many, if not most, of the risks that could potentially be reduced by the insurance coverages listed above, where do you set the balance? A good start is to have a better understanding of the potential impact of certain risks, through financial planning and cash flow modeling across your lifetime. To judge the value of insurance, you need to have a better understanding of the inevitable reduction of consumption, savings, and investments that accompanies higher insurance premium payments.

Focus insurance coverage on catastrophic risk exposures

Catastrophic personal events can drain assets and destroy the best of investment plans. In general, individuals can significantly lower insurance premium costs by focusing on buying catastrophic risk coverage and using self-insurance for more minor risks. For the insurance that you must have, shop around and choose high deductibles to reduce premium payments. Carefully evaluate the scope of insurance coverage to assure that the policy has good quality catastrophic coverage. Then, invest the premium savings achieved through higher deductibles, rather than spending those savings. Over time, these premium savings and investment returns on them will build up your self-insurance asset pool.

Property, liability, life, disability, and other types of insurance may be rational purchases, because of risk pooling with other risk adverse people. However, these types of insurance are not investments in and of themselves. Instead, they limit the financial impact of potential, but relatively unlikely, negative future events. The question comes down to finding good quality insurance at a competitive price and determining the tradeoff between money spent on premiums versus money retained and invested.

Optimal investment planning focuses on enhancing expected risk-adjusted portfolio performance. An optimal investment plan assumes that the necessary labor-based net income will be earned over time to build up your investment assets. By adopting optimal investment practices, individuals increase the chances of financial success that can be attributed to investment returns. However, other risks are inherent in life planning, and there are no guarantees. Personal financial and investment plans may fall short of goals due to a long list of non-investment risks. These risks include inadequate savings, personal tragedy, and family misfortunes.

Combined insurance and investment products confuse financial decisions

In recent years, insurance firms have expanded their products and services from offering only pure insurance to selling hybrid products that combine insurance and investment characteristics. Long ago, the insurance industry garnered tax treatments that can make their products more seem more appealing to persons with particular tax situations. The mixing of these tax advantages into hybrid insurance and investment products makes the rational evaluation of hybrid insurance and investment products even more challenging.

Unfortunately, many hybrid insurance/investment products are characterized by inferior returns, very high costs, significant insured risk limitations, and other problems. Ultimately, the issue that the potential buyer must sort through is whether the purchase of a separate insurance-only product and a separate investment-only product would yield better insurance risk reduction and superior risk-adjusted investment performance. Very often, buying separate low cost insurance and separate low cost investments is a much better alternative.

For example, insurance-based annuity income guarantees are not investments. Investment risk cannot be insured or avoided. Without the risk of loss of capital, you simply cannot be investing. If you think that you can pay someone else to take away your investment risk through some insurance guarantee and still have the chance of earning an investment risk premium, you are simply mistaken. No insurance company will take on your investment risk, unless they can do so profitably for the capital that they must put at risk.

Insurance-based annuity income guarantees are not investments

Many investors rationally seek retirement income guarantees through annuities insurance products. When they purchase such insurance with their labor income and/or investment assets, they change the complexion of their portfolios. When they shift investment risk bearing to an insurance company providing a guarantee, they cease to be investors for that portion of their assets.

For example, fixed or immediate annuities are not an investment. Instead, you transfer your assets to an insurance company and you pool your longevity risk across all annuity participants. Your expected total return is likely to be inferior to holding onto your assets and continuing to be exposed to the investment risks. However, unless you have far more financial assets than you are likely ever to need, you cannot self-insure against longevity risk.

Longevity risk is when you live far longer than expected and you exhaust your financial assets somewhere along the way. The value of an annuity is realized, when you live a long life, and of course, the insurance company also stays around to meet its commitments with an adequate asset pool. When your lifespan is shorter, you just happen to be the part of the annuity participant pool that provides valuable financial assets to fund the remaining lives of the other participants. From six feet under, presumably, you will not be concerned about your altruism toward these other longer lived annuity participants.

Finally, there is one insurance risk that individuals must retain and cannot shift, when they trade their financial assets and investment risk to an insurance company for an annuity. This risk concerns whether the asset pool of the guaranteeing insurance company will be adequate to fulfill its future annuity obligations. The sad, yet still ongoing saga of the 1991 collapse of Executive Life Insurance Company is a reminder of nontransferable risk when dealing with insurance companies.

Do your homework about the insurance company from which you intend to buy an annuity or any other insurance product. Looking into the resources and ratings of insurance companies can reduce the risk of non-fulfillment. Do not expect that a commissioned insurance agent or insurance broker will do this assessment, as carefully as you should. Insurance agents and insurance brokers get paid at the front end of the insurance contract purchase, whereas you will want to get paid all the way through to the back end of that contract!

Step 9 - Use time-efficient financial management practices

Passive investment strategies improve your expected risk-adjusted returns, while saving your time

Time in life is the most precious and perishable asset that any person has. Your time should be spent enjoyably and efficiently. Scientific investment strategies that rely on relatively efficient financial markets allow people to minimize personal time spent financial planning and investment management. Fully diversified, completely passive, extremely low cost, buy-and-hold, set-and-largely-forget investment management strategies deliver superior risk-adjusted returns with less time and hassle. Such strategies are far more time-efficient and cost-efficient than the financial hamster wheels that the industry has set up for retail investors.

Financial planning and investment management processes should be time efficient

When pursuing optimal financial planning and investing strategies and controlling your costs and capital gains taxes, you also need to establish a time-efficient system to monitor, adjust, and adhere to your financial plan. You need to control and limit the time that you spend on your financial planning, and you need to focus your planning efforts on the most effective activities.

Perhaps the most overlooked aspect of personal investment management is the incredible waste of time. Do-it-yourself individual investors buying individual securities rather than investment funds demonstrably under-perform passive index fund benchmarks -- especially as the time period increases. Many people waste a large part of their lives implementing investment strategies that have absolutely no reasonable expectation of doing them any good. Alternatively, they pay active professional fund managers excessive fees to do the same dance with poor results, as well.

Scientifically valid investment strategies are more time efficient, because they are consistently passive in nature

With investing, less is more. On average over time, people are exposed to less risk and get better net investment results after investing costs and taxes are considered, when they invest in a globally diversified, passive index fund portfolio that they (or their advisers) do not keep changing. Less is more when you buy and hold and hold and hold a portfolio with an asset allocation that is appropriate for your investment risk tolerance. The financial research literature repeatedly demonstrates this.

The only reasons why the active management "debate" never seems to be settled is that those who make money off of other people's money keep telling people to do something rather than to do nothing. Doing something always costs more, but there is so much volatility in securities prices that there will always appear to be short-term winners.

While short-term winners will appear to be better and exhibit investment skill, in fact these apparently superior results are far more likely to be just short-term dumb luck. Time sorts apparent skill from real skill. Unfortunately, for the proponents of skill versus luck, the data does not favor skill over luck. The longer the time period studied, the fewer supposedly superior managers there are. Many investors reach the correct conclusion that the emperor has no clothes.

The foregoing does not explicitly measure the time-efficiency of individual investor investing activities. With professional investors, you can evaluate investment performance over time relative to incremental costs and taxes. When this is done in careful investment research studies, investment professionals tend not to look so professional or so valuable after all. However, individual investors tend to be more atrocious investment managers, when they try to do it themselves.

Index mutual fund and ETF investments require far less personal attention

Scientifically valid financial management and investing strategies often are more time efficient, largely because they are consistently passive rather than active in nature. It is questionable whether the vast majority of individual investors should own directly any common stocks or individual bonds rather than investment funds.

Most individuals are very poor portfolio managers. Instead, they could achieve better returns with lower risk by owning only index mutual funds and/or exchange-traded funds (ETFs). The superiority of broadly diversified index mutual fund and ETF based investing for individual investors is broadly established in the financial research literature.

Do-it-yourself individual investors make all sorts of investment errors. The result is usually either no benefit or negative results for the effort expended. No sane person would work for an employer who paid them a zero dollar or negative hourly wage, but millions of amateur investors do this to themselves. They keep fooling themselves, because few of them will ever bother to compare their results carefully against a low-cost, fully passive, and totally hands off index fund investment strategy. People waste huge amounts of time and get negative results that they never realize.

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When you figure out that active investment strategies just enrich the financial services industry at your expense, you will abandon them

If you buy and sell individual stocks and bonds, do yourself a favor and fire yourself as an investment manager of your own portfolio. Adopt a low-cost, globally diversified, direct purchase, index investment fund strategy and then leave it alone. Instead, spend your time doing something else that you really do enjoy doing. By not wasting your time inevitably under performing a passive index fund portfolio, you will instead actually be paying yourself to pursue another activity that you really do enjoy.

A side benefit of choosing passive, low cost index mutual fund and ETF fund-based investments is to be more time efficient. Index mutual funds and exchange-traded funds require far less personal attention. Managing a well-diversified, passive index-based portfolio of individual securities is a task that professional portfolio money managers can manage much more economically. The most cost effective multi-billion dollar index investment funds can be managed very efficiently by a small number of skilled professional traders.

If you choose optimal investment strategies and properly automate your financial tracking and periodic investing to the degree possible, then spending more time on personal finance becomes a matter of choice and not a necessity. Unless financial planning and investing is an enjoyable hobby, which it is to some, there is a significant personal cost to spending time on personal finances. It is important to calculate one’s "effective hourly wage" for the time spent on investment management and to ensure that this hourly wage remains high. Otherwise, fire yourself and hire some low cost index funds instead.

Step 10 - Self-manage with occasional professional consulting

If you need financial advice, pay for it directly. “Free financial advice” is often the most expensive advice you can get.

Most proactive and knowledge seeking individuals can manage their own personal finances. They simply do not need a continuous relationship with a financial advisor charging high fees. For occasional assistance, pick an advisor who can deliver competent, objective advice, but who does not sell financial products. If you agree with the advice, buy recommended financial products directly via the most inexpensive channel possible. When financial advice and financial product sales activities are combined, it is highly dubious that you will get the best advice in your best interest. It is much more likely that the advisor will feed his or her family first with your money.

The only reliable way to ensure financial advisor objectivity is to pay directly for their services

Pick financial advisers and investment advisers solely to obtain objective and high quality financial advice. Specific financial counsel and investment counsel is potentially of high quality, only if it is carefully customized to your particular needs and only if it is given by an adviser who is absolutely independent, knowledgeable, and competent. The only reliable way to ensure the potential objectivity of any financial planning advisor or investment counselor is to pay directly for the adviser's services, after investigating the adviser's background, competence, and work ethic.

There are no shortcuts. "Free" advice is never free. In fact, free advice is usually far more expensive than the advice that you receive from an advisor whom you pay directly. When you choose to obtain "free" advice, in lieu of paying fixed hourly services or a fixed fee for a planning project, the long term costs to you can be horrendously high. However, these huge costs are largely hidden and that is why this industry game of "free" financial advice keeps going on.

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Free “advice” from industry-paid advisors leads to inferior investments

Advice that is contingent on any expectation that you will purchase products through your financial counselor is subject to major conflicts of interest. Financial advisers, who are not paid directly by you, must instead derive their compensation from commissions and other fees paid by the financial services industry. "Free" recommendations lead you to buy financial products that were not the best for your needs and that are not the best products available.

Many people pay investment front end sales loads for advice that seems free. Industry representatives willingly tell you that their advice is both free and good. You just end up paying a financial sales rep to sell to you and in the process perhaps to confuse or mislead you about the facts. The industry argument is that the advice is free and that you only have to pay, if you do follow the good advice that is given so freely.

Sales charges and good financial advice are a contradiction in terms. For example, industry-paid financial advisors do not get paid to push better investment index mutual funds with the lowest costs and the best future prospects. Much better advice can be found, when you look of it. If you buy and hold very low cost, low turnover, and broadly diversified passive index mutual funds, you are more likely to get better net long term total returns after taxes, fees, and other costs are taken into consideration.

For example, when you pay a front end sales load, your initial invested assets are lower by the amount of the front end sales charge. In addition, only actively managed mutual funds will be recommended and actively managed funds tend to carry more expensive management expense ratios and higher hidden investment portfolio trading costs. Furthermore, an additional 12b-1 sales fee will get tacked on every year. With a 12b-1 fee, the same investment counselor who gave you the initial "free" advice will get paid over time to stick around and sell you more of the same.

Financial sales loads, excessive asset fees, high cost active investment strategies, and a myriad of other suboptimal financial industry strategies and products typically bleed 1/4 to 1/3 of the typical individual investor's portfolio annually. This waste compounds year after year after year, until individuals and their families get smart and realize that "free" is not really free and that "just of percent or two" will have a huge cumulative negative impact on their financial welfare.

Financial advisor conflicts-of-interest are very dangerous to your personal finances

Many industry-paid advisers are ethical and helpful. However, the reputations of ethical advisers are tainted by others who are just salespeople who masquerade as advisers. Furthermore, even industry paid advisors face a career-long struggle to be independent of financial industry influences. They must spend their careers balancing the best interests of their clients against the interests of the financial companies that employ them. They must weight continuously the best interests of their clients against their own personal financial interests, paychecks, and bonuses.

When they are paid by the financial services industry and not by their clients, think about the continuing dilemma that even an ethical person faces. Training programs for industry compensated financial advisors and investment advisors focus on selling, selling, and more selling. These people are classified as "producers" by the industry, because that is what they do. They produce revenue and profits for their companies. These revenues and profits come from you.

When an advisor is not independent, you never know whether you are getting good advice or the latest sales pitch

When a financial advisor is not independent of the financial services industry, you can never be certain whether you are getting the best advice or just falling for the latest financial sales pitch. Once an ethical and newly minted financial counselor emerges from a financial industry training program and starts a financial sales career, the pressure to produce is constant. His compensation program will provide incentives to take more and more from his clients and will pressure him to pull in more and more assets to manage. His company will constantly pressure him to perform and produce more revenue.

Now, think about the not-so-ethical financial advisor who is paid by the industry and thinks first about his or her paycheck and bonus, before taking care of your personal financial interests. You do not stand a chance.

US financial services industry regulation is minimal at best. When a loose regulatory environment is combined with not-so-ethical financial advisors and investment counselors, almost anything goes. Most financial consumers are confused and outgunned. If industry sales reps can push expensive, high compensation products into the "retail" financial consumer channel, they will. There is little to stop them from emptying the wallets of naive retail financial consumers and individual investors.

You have to seek out and find proactively financial advisors who are truly independent. If you become more knowledgeable about how the personal finance advisory industry works, you can better assess the quality of the financial and investment advice that you receive. Eventually, you will realize that the only financial advisor you want is one whom you pay directly and who receives no compensation from the industry in any form.

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Chapter 4: Lifetime and retirement investment management

4.1: The best investment strategy for individuals

4.2: Fifteen value-added individual investor activities

4.3: Passive index investment strategies are simply superior

While you may hear comments, such as "this time is different," with investing it never is different. Certainly, the particular facts of the situation are different, but the underlying issues of risk and uncertainty in the face of a truly unknowable future are always there. How humans respond will ebb and flow, but there is never a way to wash out the risk and uncertainty.

The only metrics we will ever have are metrics from the past – whether one minute, one year, or decades ago – and those metrics are NEVER predictive. They simply cannot be predictive because information about the future is simply not available. If you consciously ignore the charlatans who twist the past into an implied prediction of the future, and you seek out knowledge from researchers who have genuinely tried to be objective in their investigations, you find that investment knowledge tends to be timeless and the general themes and reliable strategies tend to repeat. Studies from prior decades remain useful and the themes repeat just with new data.

You must stay in the markets to earn investment risk premiums when they unpredictably occur. If you think you can get in and out of the game, you are also fooling yourself. Timing does not work over the long run. If you think you can get in and out of the investment markets and do better than the market over time, you simply have not read the research literature. Where are all the stay-at-home day-trader billionaires? There are none at home staring at computer screens and making $8 trades. The only "day-trader billionaires" are on Wall Street playing with other people's money and taking the fees and a piece of any random gains over time.

4.1: The best investment strategy for individuals

The best investment strategy is a more simple investment strategy

The complexity of personal investment management is driven by the nature of investing in securities that have uncertain and unknowable future values. Nobody — amateur or professional — has a working crystal ball that can predict future asset values. Anyone can have a more or less well-informed outlook and operate with an evolving set of theories as to what might happen.

As the future unfolds, positive and negative economic, technological, competitive, political, and other developments determine the evolution of securities values. And, even as new information becomes known in the future, the value of a particular securities will be always be an amalgamation of currently known information and a forward-looking market consensus about the murky future.

In general, it is this very uncertainty that provides investors with opportunities (however unpredictable) to earn over time more or less than a market return on their invested assets. Investing involves varying degrees of risk and participants in real time securities markets buy securities at what they perceive to be a discount against their expectations for higher future values. They sell when they think current market prices exceed the future opportunity.

Thus, the uncertainty about the future drives much of the inherent complexity of investing. Everybody wants a magic system to beat the market and to do better than the other guy, but when you take the time to think about it, you realize that the future cannot be known until it arrives and that there can be no magic bullets, reliable systems, or sure bets with investing.

Nevertheless, the inherent complexity of investing is exacerbated greatly by the proliferation of investment products and services aggressively promoted by a securities and financial services industry that purports to serve your best interests. However, this proliferation of complex investment products most often seems only to serve the financial self-interests of the securities industry itself. Averaged across all retail investors, the high fees of the financial service industry dramatically reduce rather than help to increase retail investors' net assets.

Personal investing can be simplified greatly by focusing only on valid strategies that have support in the investment research literature. This personal investment planning summary is intended to help you to understand that you can manage your investments using strategies that have a demonstrated basis in the research literature.

When one pursues strategies that are designed to focus solely on the fiduciary interests of individual investors, the vast majority of investment products promoted by the industry can simply and easily be eliminated from consideration. They cost far more than they are worth. Aggressive investment cost control is not a magic bullet to beat the market, but it is a very effective way to avoid being the rube who gets fleeced by the fast talking slick suit.

Once you have committed to a durable long-term investment strategy, you can manage by yourself relatively easily the details of investment implementation. You do not need to pay high costs for something you can do yourself.

Use an easy-to-manage, do-it-yourself lifetime investment strategy based upon valid principles

To improve your long-term investment returns, move fully toward the completely passive, globally diversified, and extremely low cost end of the investment securities products spectrum. Invest only in a variety of passive, very broadly diversified, and low cost investment funds.

Understand better your investment risk tolerance relative to the larger population of investors and decide how much you are willing to be exposed to investment risk. Your investment risk tolerance leads to your asset allocation strategy, which sets the balance of overall expected investment risk and return in your personal portfolio.

Get invested and stay invested in the global securities markets according to your asset allocation — through thick and thin. Never attempt to second-guess the markets or to time the markets by moving assets around hoping to beat the markets. When you hold securities with an asset allocation that is commensurate with your tolerance for risk, you can ride out market panics without panicking, so you will also be in the markets when they rise toward new highs. The academic research shows clearly that nobody really knows how to time the markets and jumping in/out when you are confident/scared usually leads to inferior results.

Buy and hold and hold and hold some more

Buy and hold and hold and hold. When you own broadly diversified, passive index investment funds, professional investment portfolio managers will make all the needed adjustments within these funds for you over time.

Maintain your asset allocation within the percentage policy variance that you have pre-determined. Do so in as low cost a manner as is reasonably possible. Use asset purchases during your accumulation periods and asset sales during your divestment periods to maintain your target asset allocation. This reduces the need to make changes and incur costs solely to maintain your asset allocation percentages.

Only buy investment mutual funds from mutual fund companies that deal directly with the public. Only buy exchange-traded funds (ETFs) through discount brokers. Only a small fraction of either mutual funds or ETFs are low cost, broadly diversified, passive funds with low turnover. Buy them and ignore the rest with middling or higher fees. In addition, if you do not have a clear understanding of ETF trading, buy only mutual funds. After the May 6, 2010 stock market flash crash, it should be clear that naive traders fooling with ETF market orders and stop loss orders that automatically convert to market orders unwittingly could do real damage to their portfolios

Never pay any broker or any other commissioned financial advisor another dime during your lifetime to tell you what funds you should buy. They do not know what will happen to future asset values, because they have no information to make such judgments. Instead, their high advisory costs will be extracted from your assets up front and along the way. Purchasing investment funds through an advisor is far more likely to reduce rather than increase your wealth. Investment cost are not "just a few percent." For the average investor, average investment costs consume about one-third of average annual investment returns — year after year after year after year. The cumulative losses with even average investment costs are huge and simply horrendous across the lifetime of the average investor.

Improve your overall net investment portfolio returns by consciously managing the asset "tax location" of your investment assets, which can reduce the investment taxes that you pay. Federal capital gains investment tax rates vary by holding period and different types of assets have returns that are treated differently under the federal tax code. Take advantage of the opportunities that you have to arrange your assets for minimal taxation.

Focus the time that you spend on financial affairs during your lifetime on increasing your income and/or managing your consumption to increase your savings rate. In addition to reducing your investment costs, saving more is the single most effective way to accumulate assets for retirement and other personal finance goals.

Enjoy your life and resist the compulsion to act as an amateur investment portfolio manager. By ceasing their amateur investment management activities, most people can free up substantial amounts of time to spend on far more pleasurable activities. Don’t you have other things you would rather do than spend your life playing futile investment games?

Most people waste a great deal of time on activities that are more likely to reduce rather than increase their investment portfolios

Very low cost, professional index fund managers can manage your money far more efficiently in terms of much lower costs, far greater diversification, better returns, lower taxes, and significantly less time than you can ever realistically hope to do as a personal investment portfolio manager. Do yourself a favor and decide to fire yourself as a personal investment manager in favor of a handful of index fund managers running very broadly diversified, low cost funds.

Despite these factors, some people just cannot resist the personal investment management game. If you simply cannot resist the temptation to play personal investment portfolio manager, then understand clearly that this is likely to be one of the most costly hobbies that you could have. If you are anything like the average investor (and you probably are), then your self-managed personal investment portfolio is highly likely to cost you money through inferior returns, higher costs, and inadequate diversification. Moreover, this hobby is extremely likely to waste a significant amount of your valuable time over your lifespan.

However, if you must play investment manager, then never play with the rent money, the baby's milk money, or the money that you are relying upon for your retirement, your kids' education, or other important obligations. Since investment portfolio self-management is not likely to be a value-added activity, never allocate more than 10% of your overall investment assets to this hobby. Invest the remaining 90+% in accordance with the investment methods summarized above.

In addition, learn how to track carefully and accurately your investment performance relative to appropriate passive benchmarks, so that you do not fool yourself into thinking you have more skill than you actually do. Everybody is an investment genius in a rising market, if they do not track performance relative to appropriate passive market benchmarks. Academic research clearly demonstrates that individuals most often achieve significantly sub-optimal investment results relative to passive benchmarks, while simultaneously they carry higher and unnecessarily risks due to non-diversified self-managed portfolios.

You investments should work for you rather than you working for them. Avoid all the financial industry games designed to make money off of your assets and to keep you moving assets around chasing performance gains that have already passed you by. Instead, simplify your investment program, and use your financial assets to enrich and protect your life and the lives of those you love.

4.2: Fifteen value-added individual investor activities

Determine first whether your strategies target optimal risk-adjusted investment returns

This value estimation is separate from any hourly opportunity cost related to spending time on your investments versus an alternative use of your valuable time. When you combine an estimate of your value-added or value-diminishing investment contribution with the opportunity cost of your time commitment, you derive an estimate of your total investment wage or opportunity cost. For more on this topic, see: Calculating your investment wage and the opportunity cost of your time.

Even if an individual investor feels a substantial amount of confusion about investing, he or she usually holds on to the hope that spending more time will increase investment returns. This is only true if the strategies implemented actually add investment value rather than diminish portfolio value. Value generating strategies can positively offset the opportunity cost of the time you spend. If not, more time spent on poor strategies will just increase your shortfall.

15 activities that are more likely to increase returns, lower costs, reduce taxes, and/or reduce risk

These 15 guidelines summarize personal financial planning and investment management practices that are more likely to benefit you and your family in the end.

1) Spend much more of your time on managing your career and controlling your living expenses. These are the two most powerful levers that any individual controls related to the success of an investment program. The most successful investment programs always involve continuing additions from savings.

2) Become fully diversified (yes, FULLY diversified and ALWAYS diversified) by owning the very broader market possible in your portfolio See: Why is diversification valuable to individual investors?

3) Drive out all forms of investment activity designed to beat the market. Target a market return and be very happy if you get close to it. Most individual investors fall well short of earning a market return, because they chase past performance that does not repeat, and they pay much higher investment costs as they chase the mirage of superior investment performance. See: Can you really beat the securities markets?

4) Learn about and adopt optimal risk-adjusted investment strategies. Understand the risks that financial markets tend to reward and those risks that you can take without any likely reward. See: Investment securities markets do not pay you for the risks of holding individual common stocks and bonds

5) Use rational investment selection criteria that have been validated by the scientific investment literature. Use only these criteria to pick your investments See: Rational selection of bond mutual funds and equity mutual funds — overview

6) Look for efficient, long-term investment vehicles, buy them, and hold them, and then hold them some more. Save your time and money. Stop all this short-term flopping around, because it is counter-productive.

7) Track your investment progress periodically, but do not chase performance. Superior past performance is overwhelmingly due to luck rather than skill, and in practice, it is impossible to detect before the fact the tiny minority of professional managers with true skill from among the vast majority who will just be lucky and not so lucky. See: The illusion of superior professional investment manager performance

8) Understand the incredibly high price to you of excessive investment costs and buy the lowest cost investments through the lowest cost channel consistent with your strategy See: Reduce investment expenses and control investment taxation

9) Be conscious, rational, and pro-active about taxes related to your investments. Taxes should never be ignored, but at the same time, they should NEVER be the dominant consideration in any investment decision.

10) Understand your tolerance for risk in comparison to other investors and make sure that your portfolio asset allocation properly reflects your relative risk tolerance.

Avoid being overly conservative or overly aggressive relative to your risk comfort zone. Errors either way are potentially very costly. See: Assess your personal investment return and risk tolerance preferences

11) Stop twiddling with things, and adhere to your passive strategy. Let it run. Go do something else that is more rewarding financially and/or more emotionally and spiritually fulfilling. Do not listen to people who tell you to twiddle, especially if they are industry professionals who will make money from you, when they do the twiddling for you. See: Does it matter how financial planners and investment advisors are paid?
12) Develop an understanding of the things that investors tend to do wrong, and monitor yourself so that you do not do the same things.
13) Find advisers who will truly put your interests first and who will give you full attention and comprehensive and reasoned advice. Advisers should more than pay for themselves, but many times they are actually a net cost to you. Managing your advisers is the ONLY place in investing where you really should be active rather than passive. See: Fee-only compensation aligns the interests of clients and their financial advisors
14) Shop around for advisors and be a critical, cost-conscious consumer. If you do not do some independent checking and critical thinking and just follow a friend's advice about whom to use as an adviser, then you may simply be just as wrong as your friend is. Just because you like and advisor's personality and feel that you can trust an advisor, this does not mean that you are getting enough value to justify his or her cost. Advisers are expensive. Pay attention to their "value to cost" ratio. See: Choose objective and competent investment advisers
15) Understand insurable risks and economical ways to reduce them. Being focused only on investment risk can leave you unnecessarily exposed in other risk areas that could wreck your financial plans. See: Insure against financial risks economically

This list of value-added investment factors is not exhaustive. It also does not attempt to list the myriad of things that investors should not do.

In summary, if you have a reasonable sense that you truly understand investing and have kept accurate performance records to verify your prowess versus the appropriate market benchmarks, then you may actually be adding value by spending time on investing. If not or if your practices are contrary to the strategies listed above, then the more time you spend with your investments, the more likely you are to come up short — very short.

Your primary and most reliable lever to improve you risk adjusted investment performance is to slash your investment expenses to the bone.

4.3: Passive index investment strategies are simply superior

Passive investment strategies lower risk and narrow the range of outcomes

Passive, index-oriented investment strategies tend to be superior, because they narrow the range of outcomes, and thus, they reduce the total investment risk associated with your portfolio. The superiority of "passive" over "active" investment strategies was established decades ago. Two things are wrong with active strategies:

1) They increase your risk without increasing your expected gross return, and
2) They cost more and thus lower your expected net return.

The only way the active strategies could be superior is if you could reliably pick superior active managers who will deliver risk-adjusted results net of additional costs and taxes that are better than a passive strategy. Gosh, wouldn't that be great?! Unfortunately, superior investment manager identification before the fact is just another industry chimera.

Those who perpetuate this spurious "debate" usually make money from active investment fees and other costs, either directly or indirectly. Just ignore them. They will never really go away or stop talking, but you do not have to listen to them or believe them.

Most often, those who argue for passive investing do so by arguing that on average the lower implementation costs of passive investment strategies will increase net investment returns. The most succinct presentation of this lower-cost-higher-returns argument is Professor William F. Sharpe's elegant two-page paper, "The Arithmetic of Active Management," published in 1991 in The Financial Analysts' Journal (Vol. 47, No. 1, January/February 1991. pp. 7-9). Dr. Sharpe is a Stanford University Professor Emeritus and co-recipient of the Nobel Prize in Economic Sciences (1990).

Professor Sharpe convincingly argues that in any period the performance of the average actively managed fund mathematically must trail the performance of the average passively managed fund by the average difference in fund management costs. This article is available on Professor Sharpe's website. (Find Professor Sharpe's website)

While the relative costs of active and passive strategies are very important, the higher risk and higher uncertainties of active strategies are just as important. Unpredictably, active strategies can lead either to significantly higher or to significantly lower returns. The key issue is that active strategy outcomes are more unpredictable even before any higher costs are considered. Active strategies introduce a very large and completely unnecessary element of added lifetime personal financial planning risk. To the contrary, passive strategies narrow the range of your outcomes. Because passive strategies target a market return, the expected variance around the market return tends to be much narrower than the variance around more active strategies.

Studies of actively managed equity growth mutual funds illustrate this point. See "How many mutual funds are needed for a well-diversified portfolio? - a commentary" which discusses a study by Professor Edward O'Neal that showed a 12 to 1 ratio for the best performing equity growth mutual fund compared to the worst performing equity growth mutual fund over a 19-year period from 1976 to 1994. If you make the wrong choices in fund selection, then this wider variability of returns can subject you to far greater risks when compared to a passive market index strategy. You cannot get rid of overall market risk, but you do not have to take on additional active risks that could doom your lifetime financial plan to failure.

Of course, you might figure that you will be lucky and only choose higher performing mutual funds and ETFs for your investment portfolio. Guess again. Millions of naive investors chase performance, get in late, pay higher costs, and fall full farther and farther behind a market return. See: "Do mutual fund Morningstar Ratings changes influence individual investors?" and "Does it pay to trade when the Morningstar Rating of a mutual fund changes?"

Also, see "Can a limited number of stocks provide complete portfolio diversification?" which discusses a study by William J. Bernstein, who demonstrated that most randomly chosen stock portfolios will under-perform the market return. The primary reason is that stocks with stellar long-term performance records are relatively few in number and are not obvious choices before the fact. Therefore, more portfolios will not contain them and thus will under-perform the market average.

Those who perpetuate this un-ending and self-serving active versus passive pseudo-debate in front of individual investors are predominantly the same professionals who make money from the individuals whom they can draw into their active investment strategies. The scientific finance literature provides miniscule support for active strategies and instead provides a very large body of evidence favoring passive strategies. While academics constantly test whether certain strategies are likely to "beat the market," the academic consensus is that active strategies are inferior to passive strategies. Considering that reliable methods to select supposedly superior managers beforehand are lacking and that proper comparisons of strategy returns should always be net of all investment costs, taxes, and implementation time commitments, the case for active strategies evaporates completely.

Active strategies arrive in a multitude of polished guises. However, they usually are easy to spot, simply because they promise higher returns and they cost a lot more to implement. Directly or through intimation, promoters will always promise to be better, but there will be no performance warranty. While performance variations for active strategies are much wider and some may deliver superior results, the average active strategy will tend to trail the market return to the extent of its higher costs. The under-performance of some active strategies will be ghastly. If your personal financial plan relies on active strategies and it comes up short, you will find that the warrantee on any direct or implied promise of better performance expired the day, hour, minute, and second that you bought your investment.

Concerning the selection of better investments, the primary variable that tends to predict better investment performance is lower costs. On average, the lower the cost of an investment, then the better the net performance will be. The more professional investment management fees you pay directly or indirectly, the lower your net return. If you want to understand scientifically based mutual fund and ETF selection criteria, see: "Scientific mutual fund and ETF screening criteria — a summary."

Generally, passive and therefore lower-cost strategies allow you to ride the market's return with the lowest fare ticket. More often than not, you are likely to have a fatter wallet when you reach your destination. On an after-risk, after-cost, after-tax, and after-your-valuable-time basis, passive strategies have proven superior. On occasion, some roads in life are both better and easier. Passive index investing is one of these roads. Think about how you invest and evaluate whether there is a better way.

My *The Skilled Investor* website provides numerous articles on active and passive investment strategies.

Find my Luck versus Skill articles on *The Skilled Investor* website

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Chapter 5: Most wealth comes from sustained savings

5.1: Living expense tracking methods

5.2: Analyze your required lifetime savings rate

5.3: Earned income drives personal finances

Sustained savings allow you to build wealth through investing

For most families, how much you earn, spend, and save are by far the most dominant determinants of your long-term financial well-being. Self-control in your consumption decision-making is far more important than clever investing. Expenditure control works, while clever investing is usually counter-productive.

You always should consume currently at rates that are sustainable across your lifecycle. During their lives, the vast majority of people must convert their human capital into investment assets through their savings, before their ability to earn slips away with increasing age or disability.

Short of receiving a substantial inheritance, marrying "very well", or having unusually good luck in the lottery, all you have to rely upon in life is your personal human capital or your ability to earn and save. There are no other shortcuts. You probably already know whether inheritance or marriage would relieve you of the burden of working and saving. As a wealth planning strategy, lotteries are a highly improbable. Regrettably, lotteries and casinos tend to attract the less educated and those who have very poor math skills.

Focus your financial planning on income, expenditure management, and savings

You should focus the great majority of your financial planning efforts on earnings, expenditure management, and savings. To understand your family's ongoing financial situation, you should measure all your income and all your expenses at least annually and, preferably, monthly.

Valuable investments that many people will never have can slip through their fingers at the checkout stand every day. Simply put, most people should save much more than they do. A person's ability to distinguish between needs and wants and to evaluate and control his current expenditures are the primary determinants of his financial success in life.

If relative wealth is measured solely as assets currently owned, then financial and investment planning would be relatively simple. VeriPlan, however, takes a broader view. While higher income obviously helps, the consumption differences between one person/family of similar income and another will determine who builds more assets over time.

A person with millions of dollars who spends at high, but unsustainable rates arguably is dollar wealthy now. Will he be so in the future, and should we really consider him to be wealthy now, if he is headed toward ruin? Another person who has lesser dollar wealth now, but who achieves higher satisfaction from more modest expenditures that are sustainable across a lifetime, in fact, may be more "wealthy" now, because his financial trajectory is sustainable.

By looking at wealth as a lifecycle pattern of sustainable expenditures within one's resources, then people who are truly wealthy cannot be determined solely by their current assets. While personal wealth should measure current financial and other salable assets, it should also measure the ability to sustain expenditure rates, build assets, and avoid future financial crisis.

Your intention to meet all expenses and debts across your lifecycle should influence your current financial behaviors and your current financial plan. You should consume and save across your lifecycle in a balanced and conservative manner. Since the future offers neither guarantees nor any predictability, you must further restrict current consumption to build substantial assets that can provide buffers for times of future difficulty, to fund your retirement, and to provide for an estate, if desired.

5.1: Living expense tracking methods

You fly blindly, if you do not track how much you spend

Many people do not track their living expenses and do not understand the magnitude of their consumption. Failure to monitor your consumption expenditures means that they are flying blindly regarding their future finances. If you do not understand how much you spend and how much you are saving and investing, you simply do not have a financial plan. This situation dramatically increases your family's long-term financial risk.

Except for those few of you who have incomes and assets that far exceed your needs and desires to consume, awareness of expenses has increased for almost everyone else. Any sensible person, enduring this financial crisis and recovery, has thought about controlling expenses relative to their perhaps uncertain future income. Consumption control is the single most powerful tool that everyone has to influence whether their money will last.

Yet, simply controlling consumption is not enough. You also need to keep track of what you spend so that you know whether you are living within your means. Expense tracking can be a nuisance, and the more bothersome it is, the less likely you are to do a reasonably complete job of it. Thus, this article discusses a variety of expense tracking methods, so that you might pick one that would best fit your needs.

Three primary methods of tracking ordinary living expenses

In general, there are at least three primary methods of tracking ordinary living expenses on either an annual, quarterly, or monthly basis. These methods are more or less time consuming, and each provides differing levels of information about your consumption. Furthermore, these methods can have ancillary efficiency benefits to your ongoing family financial management process.

Consolidated account cash flow expenditure tracking

To track expenditures via cash flow analysis requires that you funnel all your expenditures through one or just a very few checking, credit, and debit accounts so that you have more consolidated records of your family's financial transactions. The greater the number of accounts, then the more time consuming it is to remove inter-account transfers. Then, on either a monthly, quarterly, or annual basis, you simply measure the net cash flows and compare beginning and ending balances. The result is the net cash flow for the period.

For example, in its most simple form you would have one checking account and one or two credit/debit accounts, through which you paid all of your ordinary living expenses during a year. You could automatically deposit your net paychecks into this checking account, after your gross pay had been reduced for income tax and other tax withholdings, regular investments, etc. This consolidated account would be dedicated to paying only your ordinary living expenses, through 1) checks, 2) monthly payoffs credit card bills (in full, of course), and 3) cash for spending money.

Using this method, all you would need to do is take the beginning cash balance, add paycheck deposits, and subtract the ending balance to arrive at the ordinary living expenditures for the period. Of course, for whatever period you chose (monthly, quarterly) there would be a few bill payment timing issues. However, these timing issues, would tend to average out over the periods.

To make this ordinary expense cash flow measurement method work, you would need to pay other mortgage/debt payments and investments from a different account. Presumably, your ordinary expenses would be much less than your net earned income. As the cash balance in your ordinary expense checking account rose, you would periodically transfer cash to an interest bearing money market account periodically. Then, this interest bearing account would pay your mortgage, your debts, and enable you to make further make more investments – either automatically at regular intervals or on an ad hoc basis.

This cash flow method has the advantage of simplicity and requires only that you pay attention to which accounts you use for which types of payments. However, this method only provides an aggregate measure of ordinary living expenses and does not allow you to understand in greater detail where you are spending your money.

Note further that it is really not necessary to have a separate account to make mortgage, tax, and investment payments. If you use a single account, you would just need to adjust for any such "non-ordinary living expense" payments, when you do your cash flow analysis. Nevertheless, using separate checking for ordinary living expense payments and a separate money market or other bank account for all other payments does have certain virtues.

While checking accounts do not pay interest, keeping a small cash buffer in a checking account can help to avoid periodic account fees and buffer your from overdraft charges. Periodically, as your cash builds up, you can transfer funds to an interest bearing money market account out of which you can pay mortgage bills and real estate taxes and make investments.

Receipt collection and addition

Alternatively, you could keep all receipts and total them on a monthly, quarterly, or annual basis. This method is more work than the account based cash flow analysis method discussed above. Receipt tracking requires that you be conscientious about collecting and totaling ALL of your receipts. This includes tracking the checks that you have written from your checkbook.

This receipts tracking method also would require you to track cash expenditures. You might simply make notes for cash expenditures (above some trivial minimum) and treat these as receipts. Otherwise, you could just use a very simplified cash flow measurement for your cash payments, such as adding up monthly ATM cash withdrawals.

While this manual receipt collection and totaling method requires more time and more conscientiousness about keeping receipts, it also can have more benefits. You can sort receipts into standard expense categories and keep a total of these categories.

Simple spreadsheets would allow you to track both expenditures within categories and total expenditures over time. Categorization of expenditures is helpful, when understanding fluctuations over time, and deciding where to reduce expenditures, if you sought to do so because your savings rate was below your expectations and plan.

Use of an automated personal computer-based or on-line expense tracking program

This third alternative can be more time consuming, but it can provide even more expense tracking and payment automation benefits. Overall, the use of a fully automated expense monitoring and bill payment system can be more efficient than a manual system.

There are a number of PC based automated personal expense tracking systems available. The leading one is Intuit's Quicken, but there also are Mint.com (which was acquired in 2009 by Intuit), Mvelopes, and others. It is largely a matter of personal preference.

For people who are very comfortable with computer based and Internet applications, these automated programs provide a wide variety of benefits. Regarding Quicken, for example, ordinary living expense tracking is almost a side benefit of using it to manage your short-term cash flows and accounts. In addition to logging all your transactions, you can use its ability automatically to connect to your online financial accounts and to integrate your checking, savings, credit, and investment accounts for a unified view on your PC. This is true of many other programs, as well including some more sophisticated automated bill paying systems offered by banks and credit unions.

Learning these applications can take various amounts time, and time is required for ongoing maintenance. Nevertheless, the automated integration of all your accounts, and the ability to make electronic bill payments and other financial transactions, can easily compensate for the learning and ongoing time commitment. Remember that the manual alternative is usually less appealing if a person has more than just a few bills to pay. One can spend a large amount of time and postage by manually and repeatedly paying recurring bills by mail.

Furthermore, bill payments through the mails might not be delivered properly. In addition, due to human error mailed payments sometimes are not processed properly by the financial institution that receives them. These error situations are irritating and time consuming to correct. Electronic payments can be more efficient and more timely and can have a lower error rate.

5.2: Analyze your required lifetime savings rate

Understand the current savings rate that is sufficient to meet your lifetime personal savings needs

If wealth were to be measured solely as assets currently owned, then financial and investment planning would be relatively simple. However, a much broader view is necessary. While higher income and more current assets obviously help, consumption differences between one person or family and another determine who builds sufficient assets over time and who is heading toward financial ruin.

A person with millions of dollars in current assets who spends at very high and unsustainable rates arguably is dollar wealthy now. However, will he still be wealthy in the future, and should we really consider him wealthy now, if he is headed toward financial ruin due to excessive consumption? Another person who has lesser dollar wealth now, but who spends at more modest rates that are sustainable across a lifetime, in fact, may be more “wealthy” now, because his financial plan is sustainable and does not lead to ruin.

By looking at wealth as a lifetime pattern of sustainable expenditures within one’s budget, then people who are indeed wealthy cannot be identified solely by their current assets or income. While personal wealth should measure current financial investments and other salable assets, it should also measure your ability to sustain your household budget, build up your investment portfolio, and weather potential financial risk and misfortune across your lifetime.

The need for an automated savings rate calculator to project your sustainable lifetime savings

Your intention to meet all expenses and debts across your lifetime will influence your current financial behaviors and your current financial plan -- but only if you have a retirement savings calculator that can analyze and present the whole picture for you. You should consume and save across your lifetime in a balanced and conservative manner.

Since the future offers neither guarantees nor any predictability, you must further restrict your current consumption to build a substantial investment portfolio that can provide buffers for times of future difficulty, to fund your retirement, and to provide for an estate, if desired. You need a sophisticated and automated lifetime savings rate calculator and retirement withdrawal calculator for you to evaluate your sustainable lifetime savings and consumption rates.

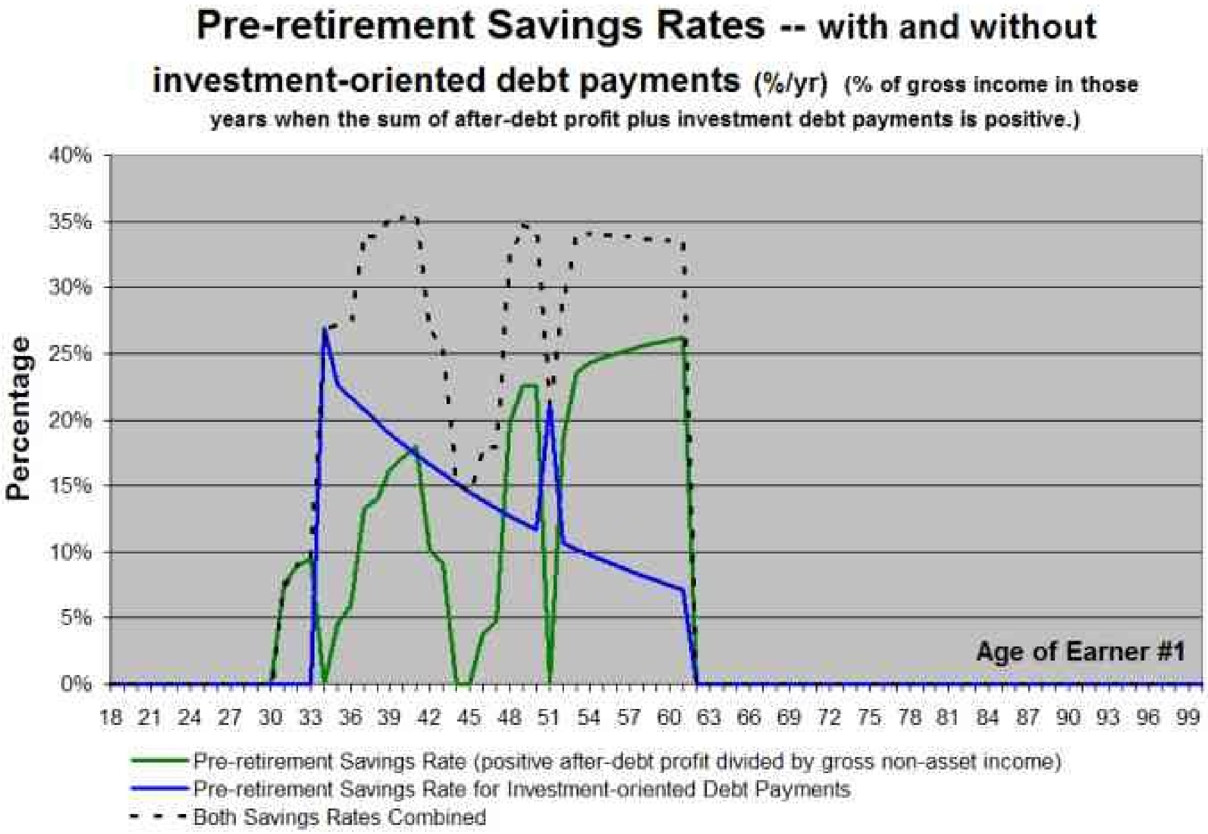
How much you earn, spend, and save are by far the most dominant determinants of your long-term financial well-being. The VeriPlan lifetime retirement saving calculator can very capably evaluate sustainable lifetime consumption rates for you. The VeriPlan retirement planning calculator software projects the present and future value of your wealth and your potential estate in each year through age 100. This fully integrated retirement income calculator and retirement spending calculator software offers you unprecedented direct control to perform your own automated home financial planning.

Understand your lifetime personal savings requirements and whether you current savings rate is sufficient

With VeriPlan's various income, expense, savings, and retirement tools, you can test whether your current and planned income and expenditure levels would provide sufficient savings to allow you to build up adequate assets that could provide enough future lifetime income. The VeriPlan compound investment calculator projects your wealth and therefore your potential estate in each year through age 100. You can adjust your projection assumptions and decide about the balance you wish to set between your current expenditures and your projected assets (or lack thereof) in the future.

In addition, while most people tend not to save enough, VeriPlan is not a "you must always save more" future value projection engine and financial retirement calculator. The small minority of people who already save significant amounts and/or who already have substantial assets can use VeriPlan as a long-term investment calculator to help decide when they are comfortable with increasing their current consumption.

This is an example of the pre-retirement savings rate graphic that VeriPlan automatically develops for all projection scenarios that you develop. As a saving for retirement calculator, VeriPlan automatically provides your projected total annual savings rates broken down into two components: A) your savings rate due to positive annual after-tax net earned income and B) your savings rate due to reducing the principal on investment-oriented debts, such as mortgage loans and college education debts.



(This is an older VeriPlan graphic. It has been retained, because it represents the scenario described in the accompanying text. See the Appendix for examples of the newer graphics.)

Particularly early in many people's adult lives, it can seem very difficult to save. Savings is always important, and it is useful to recognize that investment-oriented debt payments are a form of savings. When such debt has been retired, then your "normal" savings rates usually will still need to increase substantially to ensure that adequate assets will be accumulated prior to retirement.

Note that the standard VeriPlan retirement planning tool savings graphic above compares your projected earned income savings and investment-oriented debt reduction progress. It does not include information about the annual growth of your investment portfolio. Additional VeriPlan graphics, which also are automatically developed for you, provide a separate and more detailed picture of the projected appreciation of your cash, bond, stock, real estate, business, and other assets developed by VeriPlan's automated retirement planning calculators.

Because the future is completely unpredictable, your ability to modify any and all of VeriPlan's assumptions allows you to adjust your do-it-yourself financial plan as your financial situation changes. You can change any value in VeriPlan and instantly develop a new projection. VeriPlan allows you to update all assumptions, such as tax rates, personal asset values, asset allocations, and asset growth rates.

VeriPlan automatically projects your annual savings rates across your working career

https://www.theskilledinvestor.com/VeriPlan/

5.3: Earned income drives personal finances

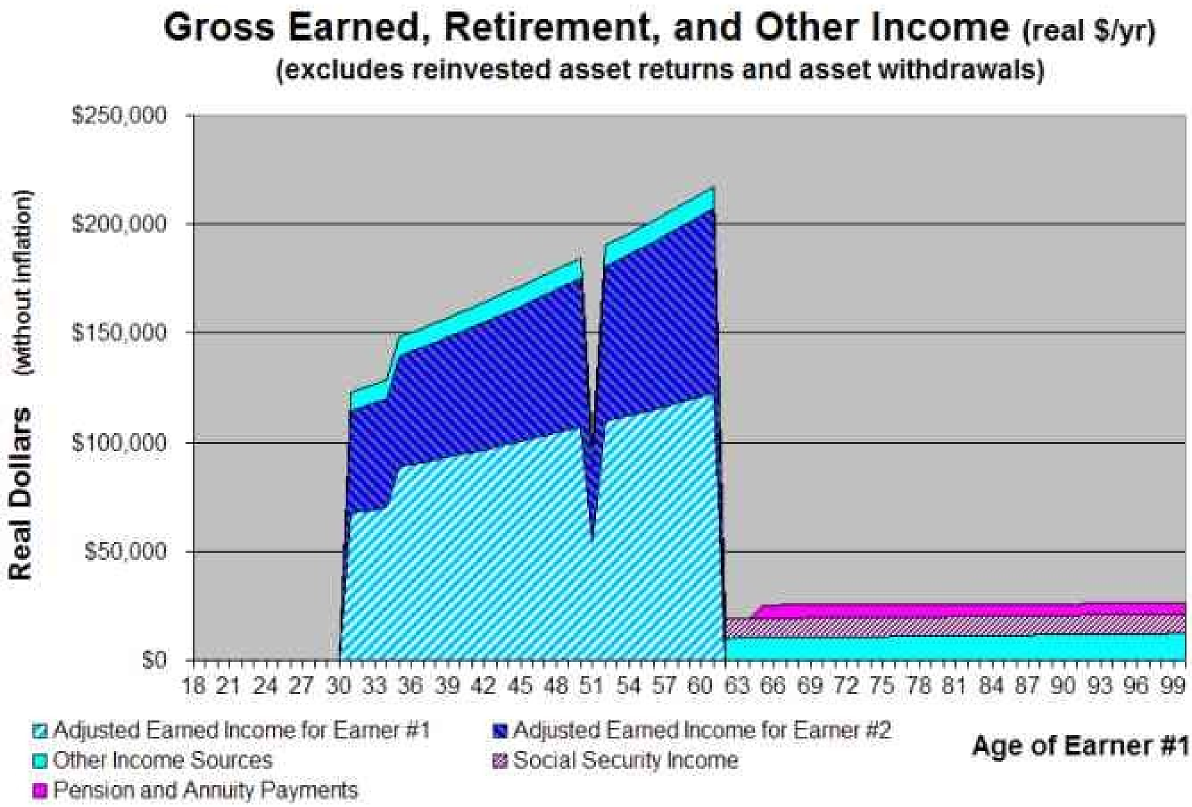
The ability to project your various income sources automatically over your lifetime is one of the first steps in creating a useful do-it-yourself personal financial plan. Whether from wages and salary or from self-employment, personal earned income drives the lifetime finances of most American families. Obviously, more income is better. In addition, dependability of income influences the income risk to a family's lifetime plan.

VeriPlan's Income graphic automatically projects your various income sources in real, constant purchasing power dollars over your lifetime. This graphic projects the income associated with earned income sources, including your:

* earned employment and actively-managed business income
* pension and annuity income
* Social Security income, and
* "Other" income"

These income sources summarize your earned income sources and that non-asset related retirement income that is generally associated with your earned income. No income from assets nor any capital appreciation is represented on this graphic. Asset income is assumed to be taxed and reinvested. Assets are withdrawn only in years when you are projected to have a cash expense to earned income shortfall. VeriPlan automatically provides many other graphics and data tables that provide lifetime projection information related to your various assets.

An example of an Income graphic for a professional couple with children



(This is an older VeriPlan graphic. It has been retained, because it represents the scenario described in the accompanying text. See the Appendix for examples of the newer graphics.)

This particular graphic for "Sue and Sam Saver" shows Sue and Sam’s projected income, which is directly or indirectly associated with earned income sources and excludes income from their asset portfolio. Your earned income will also reflect any income adjustments that you make.

In this case, Sue and Sam are testing two adjustments to Sam’s employment income. First, they project that he will be promoted in four years and receive a substantial real dollar raise. Second, they project that Sam will be unemployed for six months when he is 50 years old. These adjustments are illustrations of your ability to adjust your income projection assumptions in VeriPlan in any year or in every year.

The VeriPlan software projects each of your income sources separately. Plus, it separately projects wage and salary and self-employment earnings for two different earners. You can control the growth for any income source by setting annual growth rates that are below, above, or equal to the expected inflation rate.

VeriPlan is also a highly functional lifetime income tax estimator. VeriPlan automatically taxes your projected ordinary income at the U.S. federal income tax rates, state income tax rates, and local income tax levels, as appropriate, while it automatically takes into account your tax filing status, deductions, exemptions, and adjustments. You can select any state tax rates for your automated projections and also make adjustments, when tax rates change. State marginal income tax rates for the 50 states and D.C. are already integrated along with federal marginal income tax rates.

VeriPlan's pre- and post- retirement planning calculator features enable you to make annual positive and negative adjustments to your projected income. You can adjust your projected pre-retirement and post-retirement income at any age to reflect planned events, such as, unpaid sabbaticals, recurring or non-recurring bonuses, working part-time, expensive vacations, and other situations.

The earned income graphic above excludes the annual yield or income from your various financial asset classes, and it excludes projected capital appreciation on your financial assets. With every lifetime financial planning scenario that it develops for you, VeriPlan automatically provides separate graphics that summarize your projected asset income and asset appreciation across your lifetime. Furthermore, it automatically provides lifetime graphics and data tables that combine the effects of earned income, asset income, Social Security income, retirement annuity income, and retirement pension income.

Chapter 6: Always completely diversify your portfolio

Diversification eliminates unnecessary risks without reducing expected returns.

Always diversify completely

Diversification has become an axiom of personal investing, because the specific risks of businesses and other investment entities can be reduced or eliminated from a portfolio -- without reducing expected returns. A fully diversified portfolio is a key contributor to improved personal investment risk management.

When you hear that you should diversify your investments, this means that you should diversify your investments completely and globally – now and always. The investment research literature repeatedly demonstrates that a fully diversified, low cost investment strategy is superior. Get diversified. Stay diversified. Be globally and fully diversified all of your life.

Complete diversification is always a better idea. On average, the securities markets will not pay you to hold any skewed subset of the overall market. Doing so is just a gamble that may or may not pay off. You should not expect to be paid any more for the added risk and anxiety.

Portfolio diversification is the only genuinely ‘free’ financial lunch that is available to individuals. A diversified portfolio is expected to deliver the same expected return with lower expected risk compared to an undiversified or partially diversified portfolio. To diversify completely, hold the full market in your portfolio, instead of a subset of it. Of course, always really does mean always.

The value of diversification comes from risk reduction. Diversification reduces overall portfolio risk, but it does not increase expected returns. It produces no free money. It just helps reduce the variability of the expected outcome. Greater certainty, even if still uncertain, is highly beneficial to any risk-averse investor.

Index investment funds can provide full diversification at a very low-cost. Holding individual securities will not. Securities markets tend only to compensate overall market risk and a couple other well established, but relatively minor additional risk factors. Additional enterprise level risks that are inherent in owing individual stocks and bonds are not compensated. Bearing such risks are unnecessary and unproductive. Furthermore, tracking details about individual companies is just a huge waste of your valuable personal time, as you try to pick one company’s securities over another’s.

If you hold any concentrated position in the securities of any individual firm, you should quickly take steps to diversify. If you hold a concentrated position in the same firm that issues your paycheck, you certainly should liquidate and diversify without any further delay. If taxes or other considerations inhibit making immediate changes, consult with an advisor about alternative strategies to use, until you can liquidate your concentrated position in an orderly manner.

Click here for Diversification articles on my *The Skilled Investor* website

6.1: What is investment diversification?

Diversification minimizes or eliminates "un-systematic” or “non-systematic” risk associated with individual investments and leaves only the price volatility risk of overall securities markets

When people speak of investment diversification, they may mean different things. Therefore, clear definitions are important. Non-systematic risk is the risk that relates to company-specific risk factors, such as competition, labor strikes, faulty management decisions, adverse technological changes, etc.

By holding a very broadly diversified portfolio containing the securities of numerous companies in different economic spheres, the risk in your portfolio can be reduced dramatically. By holding the full market in your portfolio through broad-based index funds, non-systematic risk can be fully eliminated from a personal portfolio.

Non-systematic risk can be eliminated, because there is not a one-to-one correlation between the opportunities and risk factors that affect each particular firm. To the extent that you hold more than one firm in your portfolio and particularly a very large number of them, then company specific price movements tend to cancel out the securities price fluctuations of other firms. When fully diversified, securities market risk measured by its market price volatility will remain.

When you hold the entire market as your investment portfolio, then you can achieve a very significant reduction in the price volatility of your overall personal investment portfolio

What remains then is only the "systematic risk', or the impact of broader economic, policy, and political risk factors, such as general changes in economic growth, monetary policy, inflation, taxation, wars, exchange rate fluctuations, etc. A well-diversified portfolio is still subject to these systematic risks.

In summary, you diversify to eliminate the company-specific and entity-specific risks to your investment portfolio. You also do this, because the market does not compensate you for company specific risk. Equity risk premiums are paid to investors, because they are willing to expose themselves to market risks and not to company specific risk.

6.2: Why is diversification valuable?

Portfolio diversification is an extremely important investment strategy for every individual investor, and it is a genuinely free lunch. Increased diversification reduces portfolio risk or price volatility without a corresponding reduction in expected portfolio returns. Thus, if you fully diversify, you get something free – lower risk for the same expected return.

Investment portfolio is the single biggest idea of investment theory. I will not bore you with its history. If you want to understand the history of investment theory, read "*Capital Ideas: The*

Improbable Origins of Modern Wall Street" (1993) or "*Capital Ideas Evolving*" (2007) by Peter Bernstein. These books chronicle of the intellectual development of modern investing.

A very high degree of diversification can be achieved through investing in a variety of passively managed index mutual funds or similar exchange-traded funds. Such investments are also among the lowest cost investment vehicles available to individual investors in the financial markets. Given that this alternative is easily available, the relevant question is never whether a portfolio should be fully diversified. Of course, it always should be.

Instead, investors should ask what the true cost of an under-diversified investment strategy would be to their long-term investment returns and overall financial welfare. Ultimately, there are numerous paths to achieve poorly- or well-diversified portfolios. In the end, the answers are simple: hold funds and not individual securities; own the market and not a subset of it.

6.3: What is the cost of sub-optimal diversification?

How many investment eggs will you drop, if you do not compare your investment performance against diversified investment fund alternatives?

Investors more easily understand investment costs that are directly measurable, such as fees deducted on investment statements. However, many investors ignore or are unaware of the "opportunity costs" of their sub-optimal investment behaviors. Opportunity costs are usually much more difficult to measure directly, but can be even higher than the more visible costs that they do understand.

The opportunity cost of being poorly diversified can be quantified under certain circumstances. While sub-optimal diversification costs can be difficult or impossible to anticipate for individual portfolios, investors can look at studies of large investor populations for guidance on the size of investment opportunity costs. The study, "Equity Portfolio Diversification" by Alok Kumar of Cornell and William Goetzmann of Yale is particularly useful in providing investors with an indication of the scale of the opportunity costs incurred by poorly diversified individual investors.

Professors Kumar and Goetzmann analyzed over 40,000 discount brokerage equity investment accounts with over $2 billion in total assets for the 1991 through 1996 period. The equities purchased by these investors tended to be in large consumer products and technology companies with well-known names – many of the same firms that constitute the S&P 500 index.

The vast majority of these investors' portfolios were very significantly under-diversified. About 25% of accounts held only one stock, and about half held one or two stocks. On a risk-adjusted basis, this lack of diversification was quite costly to these investors. When compared to the broad market portfolio, 80% to 90% of these investors' portfolios underperformed the market over the period of the study. During the four-year period that was modeled, the total underperformance totaled roughly 10%. Given that the sum of investor assets averaged about $2.18 million, these investors had an estimated opportunity cost of over $200 million in only four years!

Owning a poorly diversified of portfolio stocks was a very poor investment strategy for the average investor in this very large sample. The average annual return of the typical investor in this study was reduced by about 2½ percent annually. For example, an average investor with a poorly diversified $100,000 account unnecessarily threw away approximately $2,500 annually or $10,000 over four years!

Compared to investing with a passive, broad market index strategy, these individual investors paid several unnecessarily prices. Because they were not diversified, on average:

* They incurred higher portfolio risk.
* They lost money relative to the passive multifactor market index return.
* They paid unnecessary transaction costs and higher taxes associated with these active management strategies.
* They simply wasted the time that they spent tracking companies, but did not achieve superior risk-adjusted returns.

This is strong evidence that the average investor simply does not know how to manage his or her own portfolio. Individual investors need either to dramatically improve their personal skills or fire themselves and hire someone who can do a better job.

6.4: Choose the broadest whole market diversification

Another risk reduction objective should be to achieve the broadest possible securities market diversification within your overall portfolio holdings. Whenever several low cost investment funds are available, I suggest choosing the fund with the broadest market coverage. This reflects a preference for owning the entire market. Such funds are often named “whole market,” “total market,” or “multi-cap” funds.

Funds that invest in company size-based subsets of the market are usually known as “large-cap” versus “mid-cap” versus “small-cap” stock mutual funds or stock ETFs. Overall, it is important to hold all different sized equities roughly in proportion to the market capitalizations of these company size groupings.

The investment research literature indicates that investors in funds with portfolios that are skewed by company size will experience greater volatility. Over time, as demand shifts from large-to-small or small-to-large capitalization companies, these portfolio are more variable compared to the returns of the overall market.

Thirty years ago, research indicated that US small capitalization stocks delivered excess returns that were disproportionately high even in comparison to the presumably greater risks of smaller firms. Research that is more recent suggests that this argument is much less conclusive today.

In addition, there are also many more mid-cap and small-cap investment funds, and vastly more assets are deployed to exploit this supposed small-cap company investment advantage. Such is the nature of investing. Apparent advantages often disappear as more assets move in to exploit suspected advantages.

However, that does not mean that you should avoid small-cap and mid-cap stocks. You should hold them in your portfolio. Too many US investors hold only large cap stocks through mutual funds and ETFs that track only the S&P 500 index. These investors miss the diversification benefits of holding the US whole market versus just the S&P 500, which represents about 70% to 75% of total US stock market capitalization and only large cap stocks.

This also begs the question of the international stock exposure of US investors. With the international share of the world's total stock market capitalization at approximately 60% and the US share are 40%, US investors who hold only US equities are significantly under-diversified.

Other more hidden problems might arise, when investing in company size-based market subsets rather than in the overall stock market. Some stock market indexes are mechanically defined, and changes in the list of company constituents of an index may be anticipated. As companies are added or are withdrawn from the company size sub-indexes, some market participants may attempt to profit by anticipate these sub-index changes and by accumulating long and short trading positions in advance.

When company size-based benchmark indexes change, the index funds that track those benchmark indexes must buy or sell to reflect these changes in their portfolio holdings. Changes in demand for particular stocks can create a potential advantage to traders who have anticipated these changes. This "front-running" could be detrimental to the performance of these company size-based index investment funds. Note, however, that adjustments have been made in the past decade to make this type of index change front-running much more difficult for traders.

Whether or not this is a potential problem when one chooses funds based on sub-indexes of the market that are skewed by company size, it is not a problem when one invests in index funds that span the entire market. When an investor holds low cost, passively managed index investment funds that represent all sizes of companies, it will not matter if individual stock prices change somewhat as companies are added or subtracted within subsets of the overall market.

Price fluctuations due to sub-index membership changes will be neutralized overall. The total market index investor holds all the stocks, including those that might increase modestly in value by being added to a sub-index and those that might decline slightly in value by being removed from a sub-index. By owning the whole market, these potential hidden cost problems related to redefining sub-indexes just disappear.

Chapter 7: Investment risk and return

7.1: Introduction to valuation and securities risk

The securities markets provide an evolving consensus of the risk-adjusted value of particular securities. By understanding how the markets value securities, individual investors can chose more durable investment strategies.

Judging the potential usefulness of different investment strategies requires an understanding of what the public securities markets really do. This article discusses how the markets price financial securities from the standpoints of risk and return. This description generally characterizes the behavior of modern securities markets in industrialized countries around the world.

Securities markets provide a continually adjusting balance of trading order supply and demand, wherein price changes enable this evolving balance. Important observations about securities markets from investment science are that:

The aggregate market return consists of payouts plus capital gains or losses across all investors. The aggregate market return is the total possible return for publicly traded securities.

Markets look forward. Participants attempt to peer into the murky and fundamentally unknowable spectrum of possible future events that could affect future asset values.

Markets price securities on a risk-adjusted basis. Current securities prices are discounted versus their projected future values to reward certain kinds of risk taking. Prices will differ from one security to another, because expected economic returns differ and because investors perceive greater or lesser certainty in the realization of those expected returns.

Current market prices reflect the current consensus or balance of expected risk and expected return. This valuation consensus reflects the balance across all active participants, including those who are paying attention, but chose not to act.

Current market prices tend to reflect fully all currently known information associated with a particular security. There may be a wide range in the interpretation of the importance of available information, and asset market values reflect the consensus across all investors.

New information disseminates widely and very rapidly. Investors quickly interpret new information for its potential impact upon both value and risk. Prices rapidly reflect new information, as supply and demand shifts quickly and market prices change accordingly.

When some investors "win," others must "lose" relative to the aggregate market return. Whether luck or skill determines who wins or loses and how one can tell the difference are pivotal questions in choosing investment strategies.

By understanding these critical investment subjects and being aware of the associated scientific evidence, investors can adopt investment strategies that are potentially more profitable. Scientific evidence indicating which strategies are preferable reduces confusion and reinforces the confidence needed to ride out market volatility.

Value fluctuations and conflicting opinions can challenge anyone to formulate and stick with a set of investment principles. Market fluctuations over time and across business cycles, industries, asset classes, geographies, etc. can raise significant doubts. The maelstrom of media and commentator truth, noise, and rubbish increases investor confusion. This very volatility and conflict of opinion requires investors to strive for an objective basis for choosing their investment strategies.

Many investors want to jump immediately to investment tactics and may avoid thinking more deeply about the underlying logic or validity of their tactics. Shooting prior to aiming generally leads to poor results and collateral damage. With investing, very often this means that you shoot yourself unwittingly in your own financial feet. Given the astonishing amount of erroneous investment information and fallacious theories circulating, tactical action without a scientific anchor can be hard on your wallet. See: How can individual investors trust, when so much investment information is rubbish?

7.2: Efficient market pricing in the securities markets

Efficient market pricing is the theory that all known information is already reflected in current securities prices

Efficient securities market pricing has become very widely accepted within the investment community. The preponderance of evidence is that securities markets are efficient and tend to reflect available information. Whether you believe markets are efficient is very important to your decisions about appropriate investment strategies and tactics.

On one end of the spectrum, if you believe that market prices fully reflect available information, then you are more likely simply to accept the current price as the fair market value. Market efficiency means that even if you were to engage in significant research you would only be reanalyzing information that has already influenced enough other market participants to be fully reflected in the current price.

If you do not believe that markets are generally efficient, you are much more likely to engage in research in an attempt to find overlooked or improperly understood information. Your objective would be to use this unappreciated information to identify securities that are not yet properly priced by the market. You would implement trading strategies in the hope that they would allow you to capitalize upon that information and earn exceptional profits.

Efficient market theory gives rise to an often-repeated investment joke that comes in many different variations. In general, two economists are walking down the street and both see a $100 dollar bill on the ground. One asks the other, "should I pick it up?" The other says, "Don't bother, the markets are efficient and therefore someone else already has." This joke reveals some of the misunderstandings that surround efficient market theory.

Markets can be efficient if they tend to reflect fully the available information in securities prices on average

Across different securities and from time to time price inefficiencies may crop up here and there, and active market participants can and will move in to profit from these inefficiencies. By picking up the occasional $100 dollar bill found on the ground, traders – or the economists in the joke – make the markets more efficient.

If securities markets are efficient, then positive and negative price inefficiencies will tend to be small and cancel each other. However, if profits net of analysis and trading costs on information-based trading strategies are significant and sustained over a long period, then this might be an indication that the market is less than completely efficient. Nevertheless, this still could just be the result of good, dumb luck. Just because one investor has a winning streak does not indicate skill. See: Distinguishing between true investment skill and luck

Incidentally, you do not really need to read the investment research literature in any detail to reach a conclusion about whether investment securities markets are more or less efficient. You can instinctively judge the likelihood of whether a huge volume of stray, investment risk-adjusted $100 bills is or is not constantly sloshing around the world's securities markets.

Think back over your lifetime and estimate that total amount of money that you have ever found. Now, guess whether you have found more or less than the average person. How long could you live on that money? A year, a month, a week, a day, a few hours, minutes? For the vast majority of people, the amount of money they have found over their lives would cover their living expense for just minutes to hours. How many homeless people do you see, who are living well off the cash accidentally spilled from people's pockets? Are you willing to quit your job for a life of luxury funded by just walking around and picking up cash that other people carelessly drop?

So, if it seems that most people are pretty good at holding on to their cash, what is the likelihood that their behavior would change in the global, real-time securities markets? After people have worked hard to earn and save money will they blithely toss it around the securities markets? After you consider that the securities industry has amassed knowledge, brainpower, and computational resources to rival all other institutions in the world, how much of investors' hard earned savings will be allowed to just slosh around the securities markets for minutes, days, weeks, months, or years, without some more tightfisted person grabbing and holding on to those $100 bills?

Now, there are many arguments that could be made whether the "cash on the street versus investment securities market" example that I have given above is comparable. Okay, narrow it down just to a comparison of cash lost on the street with cash lost in banking behaviors. For those who see mistakes on their financial statements (which are not in their favor) and blithely ignore them, then these are banking equivalent of inefficient $100 dollar bills lost in banking. Now, estimate the total amount of these inefficient and careless dollars versus the amount of dollars that the banking industry extracts from peoples' cash assets in the form of no interest, below market interest, and a myriad of fees? Get the point?

Now, to get back to the "cash on the street versus investment securities market" example. With respect to known information, the securities markets are highly efficient and, as they should, market participants are selfishly grabbing every dollar they can. The problem is that they are grabbing at future dollars without knowing which will materialize and which are chimeras.

In general, the relevant question for an individual is not whether securities markets are informationally efficient. If markets are inefficient and there are some free $100 dollar bills lying around, it is far more likely that professional participants will grab and keep them. How absurd is the notion that you can pay someone who actually has this skill (if this skill really can even exist given all the uncertainties), and that they would be willing take your lesser fee and in return give you some of the proceeds of their skill?

Individual investors should not worry about market efficiency and convince themselves that they can "beat-the-market" directly through their trading net of costs and taxes or indirectly through actively managed fund investments net of cost and taxes. Any individual investor who believes this needs to do some research or they are likely to spend their lives on the active investor hamster wheel and fall farther and farther behind a passive market return, as time passes.

Efficient markets do not mean that the current price of a particular security is either "right" or "wrong."

On occasion, the markets can seem to make specific and/or systematic pricing errors. The important thing about efficient market is that positive and negative pricing errors will tend to cancel out over the long run. These pricing errors – if indeed they are errors and not an accurate reflection of current risk-adjusted knowledge – will also tend not to be systematically detectable by investors over time.

Gains from inefficiencies would tend to accrue to investors who can tell the difference and react swiftly. Greater knowledge and swiftness tend to be more the characteristics of professional rather than amateur investors. Professionals have more research resources and the ability to pay full-time attention to portfolio selection and management. Nevertheless and unfortunately for individual investors, the data indicate that is virtually impossible to detect professional managers with superior skills. An even more unfortunately, professional managers tend to charge more than they deliver in improved performance. [1]

Certain individual investors may also have some skill in detecting price inefficiencies related to selected equities. Unfortunately, it seems that these more prescient investors can only track and hold a very small number of equities and they lose the "free lunch" risk reduction benefits of portfolio diversification. Despite their activist investment efforts, on average their gross performance still tends to trail a passive multi-factor index investment strategy. [2] When costs and taxes are considered, including the opportunity cost of their time, it is highly likely that their net returns are even more inferior to a passive index strategy. See: The value and opportunity cost of your time

1) Mark M. Carhart "On Persistence in Mutual Fund Performance." The Journal of Finance, Vol. LII, No. 1: pp. 57-82.
2) William Goetzmann and Alok Kumar. "Diversification Decisions of Individual Investors and Asset Prices." January 14, 2004: 1-58.

Chapter 8: Risk management through asset allocation

8.1: Allocate assets to reflect your relative risk tolerance

Allocate your investment assets to reflect your relative tolerance for risk, while staying in the markets to earn risk premiums.

Investing is ALWAYS inherently risky. There is NEVER a safe time to be IN or OUT of the markets.

Investment risk exists whether the financial press is screaming or complacent about "what happened in the markets" today, this week, or this month. You need to allocate your financial assets in a manner that reflects your relative tolerance for investment risk. You need to stay in the securities markets to earn market risk premiums. Since securities markets tend to pay risk premiums, you have to have your money invested in the markets to get paid. Trying to avoid risk by jumping in and out to "time the markets" does not work.

In addition, your tolerance for risk is a relative thing. Few people like risk, but some can handle it better than others can. The more risk you can tolerate, the higher the potential return and perhaps the rougher the road. How you allocate the major portions of your total assets among investments in the primary asset classes will determine your portfolio's overall exposure to investment risk and return.

To earn the risk premiums that the securities markets tend to pay to investors, your assets must be invested and exposed to potential risk. Virtually all investors are averse to risk, so risk tolerance is a relative rather than absolute issue. You need to judge your preference or tolerance for risk relative to other investors.

While very few people like investment risk, those who can tolerate it better will be those who will be less uncomfortable when risk happens from time to time, and market values decline by a little or a lot. Over the long run, these investors tend to earn more. Tolerating the potential for loss is the cost that investors occasionally pay so that they are always at the table, when the markets deliver positive rewards.

Whether held directly as individual securities or in funds, trusts, retirement accounts and other vehicles, the vast bulk of individual investors' publicly traded investment assets are held in the primary cash, fixed income, and equity financial asset classes. Your relative risk tolerance should influence how your assets are allocated among these financial asset classes. If your asset allocation is more risky than your risk tolerance, you may not be able to handle the downturns. If your asset allocation is less risky than your risk tolerance, then you are likely to need to spend less and save at a higher rate to reach your goals.

Nothing is certain about this process, and that is the nature of investment risk. However, the scientific investment literature is relatively clear on certain points. Investors are not good at timing changes in the markets. It is better to buy into the asset markets in proportion to your preferred asset allocation and just stay in.

Trying to sit on the sidelines and only get in when things seem safe does not work. The converse of trying to jump out and avoid the downturns also does not work. Active strategies that attempt to time market turns have under- performed strategies of continuous investment. Consistently and profitably calling serial market turns correctly has been a skill beyond mere mortals and certainly beyond the skill of both professional and individual investors.

Staying in the markets tends to work better. To earn an investment risk premium, you need to keep your assets in the markets through thick and thin. Reasons to withdraw funds relate to meeting necessary living expenses and taxes, and not to trying to earn a better return by timing the market.

If you are more highly risk averse, it is more appropriate for you to select an asset allocation that reflects your relatively higher risk aversion. You would hold a relatively small portion of your assets in the more risky equity asset class. Therefore, you might be more comfortable and more able to keep that smaller allocation invested at all times. Even having a smaller, but sustained exposure to equity assets generally tends to work better than jumping in and out of the equity markets.

If you stay out of the markets due to uninformed fear, you are likely to need to save far more to reach your goals. Over-cautiousness is not a free lunch. There is never a safe time to be in the markets, because investing is always inherently risky. There is never a safe time to be out of the markets, because you cannot earn investment risk premiums with your cash under your mattress.

Nevertheless, you should not carelessly bear excessive risks that your mind and gut cannot endure, when the risk materializes. Inappropriate actions at the wrong times have jeopardized the future financial welfare of many investors. Do not put yourself into a strategy that you could not stick with through very tough times.

Finally, you should rebalance you assets periodically back toward your planned asset allocation proportions. However, to minimize the negative impacts of investment transactions costs and taxes, you should rebalance infrequently and in a planned manner that takes advantage of deposit and withdrawal transactions that you would need to do for other reasons anyway.

My *The Skilled Investor* website also provides articles on asset allocation.

Click here for Asset Allocation articles on *The Skilled Investor* website

8.2: The average asset allocation of the average investor

Defining the average asset allocation of the average individual investor

Because the average risk-averse investor holds the average portfolio asset allocation, this becomes a reference point in determining how a specific individual's investment portfolio asset allocation might diverge from that of the average investor's asset allocation. The question becomes, "What is the average asset allocation of the average investor?" The aggregate values and relative proportions of the financial markets will define this average asset allocation.

For the rest of this discussion, we will focus on getting rough estimates of the primary financial asset classes — cash, bonds, and stocks — to develop a point of reference for the "average investor." Of course, there are other asset classes that some individual investors hold, such as real estate and private business interests. These other classes need to be taken into account when developing a comprehensive family financial plan. Nevertheless, cash, bond, and stock financial asset interests tend to be the most easily changeable in their composition. Each of these financial asset classes can be converted readily into the other through modern real-time securities markets, and thus an asset allocation plan with infrequent rebalancing is prudent.

Measuring the average asset allocation of the average investor is therefore the goal. This should be pretty simple, correct? Just measure all financial assets held directly or indirectly for the benefit of individuals (in our case US residents) and figure out the proportions of cash, bonds, and stocks. These asset class proportions then become the average asset allocation reference point for the average investor. A more risk averse investor would then hold a portfolio the skews toward less investment risk, and the converse would be the case for a more risk tolerant investor.

However, this is only half of the puzzle, because the average asset allocation is not always stable over time. Economic cycles and securities market cycles exist, and their movements are correlated. The economy grows more quickly at some times and goes into a reversal during recessions and depressions. Securities market cycles tend to anticipate business cycles, but without any reliable assurance that the direction and strength of current securities market anticipation is accurate. The prescience of securities markets can only be measured in hindsight, after changes in the economy have become clear and the future that was anticipated by securities markets becomes the past or history.

Since the turn of the century and the millennium, the US and the world has experienced extraordinary financial times. Two decades of expansion in the 1980s and 1990s peaked in a technology – communications – financial bubble that collapsed in 2001 and was followed by an anemic recovery and growth cycle from about 2003 to 2007. Without strong US job growth in this growth cycle and driven by rising US consumer debt obligations and a US housing value bubble, the US then lead the world into another financial or "credit crunch" crisis that was far worse than the dot com crash.

In the fall of 2008, the world stared into the abyss of global financial crisis, akin to Calypso's maelstrom in "Pirates of the Caribbean: At World's End." It did not matter whether you were in a big slow investment boat or a small, speedy investment boat. Without the real world "special effects" of massive global government intervention in the securities markets, we would have found the end of this unfolding securities horror movie would have been to find most large boats and all small boats in Davy Jones locker at the bottom of the economic ocean.

In panic, those who could not stomach this maelstrom fled to the "dry land" of government guaranteed cash investments, and away from stocks and even bonds. The remainder of this article provides a few numbers that tell this disturbing financial tale. For purposes of setting an asset allocation strategy, one needs to decide whether to pay attention to the average asset allocation "normal" of the last several decades or to decide that what we just have collectively endured is the "new normal," which it likely is not.

Before the Credit Crisis: average asset allocation percentage data for 2004

To understand the overall asset allocation percentages of the major financial asset classes, in mid-2004 I performed a detailed analysis of all US personal financial asset ownership held directly by individuals and indirectly by institutions for the benefit of individuals. Concerning the average portfolio of the average investor, I reviewed detailed data from the US Federal Reserve Bank which tracks total personal assets across all kinds of personal accounts including brokerage, tax deferred, pension, insurance, trust, and other accounts. The Fed's June 2004 Z.1 report indicates that total U.S. personal financial assets were approximately $26.9 trillion dollars. In total in mid-2004, the percentage allocation across the major financial asset classes was 26.9% in cash and equivalents, 18.9% in fixed income, and 54.2% in equities. [1]

For purposes of comparison, the Investment Company of America's (ICI) end of 2004 estimate of total US domiciled mutual fund assets, which is a subset of the personal assets that the Fed tracks, totaled $7.5 trillion dollars. [2] The percentage allocation was 27.7% in cash and equivalents, 19.7% in fixed income, and 52.6% in equities. The mid-2004 Federal Reserve and the end of 2004 ICI numbers are remarkably similar. This gives confidence that these figures represent approximately the average asset allocation of the average personal portfolio. Analyzing the Federal Reserve data takes quite a bit of time, whereas the ICI data can be analyzed and understood much more quickly.

The average asset allocation at the mid-point of economic and securities market cycle can serve as a baseline for the asset allocation of the average risk-averse investor

If we summarize the Federal Reserve Z.1 assets data and the ICI mutual fund assets data for 2004, about 27% of assets were in cash and equivalents, 19% were in bonds and fixed income assets, and 54% were in stock and equity assets. With the benefit of years of subsequent hindsight, the end of 2004 was roughly the middle of the last combined business and securities market cycle.

For an asset allocation comparison taken near the tail end of the market cycle prior to the credit crunch debacle of 2008/2009, I also looked updated ICI data for total U.S. domiciled mutual fund assets in November 2007. (U.S. domiciled mutual funds would include both domestic and international stock, bond, and cash investment assets.) The ICI reported that, at the end of November 2007, U.S. domiciled mutual fund assets totaled $12.1 trillion, which is about a 60% increase over total assets in mid-2004.[3]

Even with this huge, $4.6 trillion increase in total mutual fund value, the late 2007 percentage allocation was 25.7% in cash and equivalents, 17.0% in fixed income, and 57.7% in equities – again reasonably similar to mid-2004 with a moderate shift of value toward equities. The proportion of asset value in the equities asset class rose about 5 percentage points, as the business/economic cycle and securities market cycle advanced and matured.

What happened to the average asset allocation during the recent credit crisis of 2008 and 2009?

While we can only hope the credit crunch, financial markets crash, recession, and near depression of 2008 and 2009, is an aberration and not the new normal, it is instructive to look at a few data points to see what happened to the apparent asset allocation percentages at certain points during this crisis. Here I will use ICI mutual fund data.

Following a grinding decline in stock market values beginning in late 2007 and culminating in the free fall collapse of equity values near the end of 2008 and beginning of 2009, the stock markets bottomed out in March of 2009. The equity markets began a recovery that was surprising to many if not most investors. (Note that this is being written in October of 2009 and thus I cannot predict (nor can anyone else) what will happen going forward.)

Measured at the end of the first quarter 2009, the ICI reported total US domiciled mutual fund assets of $9.2 trillion dollars or very close to 50% of the $18.2 trillion dollars in mutual fund assets held by investors across the globe.[4] For US mutual funds, 41% of total assets were held in cash equivalent money market mutual funds, 20% of assets were held in bond funds, and 39% of assets were held in stock or equity mutual funds.

In effect, when compared to the 2004 and 2007 figures above, there was roughly a 15 percentage point shift from stock funds to money market funds.(In aggregate the total value of US mutual fund asset almost $3 trillion lower than the total value near the end of 2007.) While only a small part of this shift in percentages can be was due to actual net redemption cash flows out of stock funds, the real explanation was that the collapse of stock market values accounted for the vast majority of the shift in overall percentages. Assets did not have to move. Equity values had just collapsed, as expectations about the future economy contemplated a severe depression.

The recovery of 2009 reversed trends in aggregate asset allocation percentages

Now, let us take a look at the latest available figures at the time of this writing, which were for the end of September, 2009.[5] The ICI reported total US domiciled mutual fund assets of $10.6 trillion dollars representing an increase in total mutual fund asset values for about $1.4 trillion in that six month period. For these US domiciled mutual funds, 34% of total assets were held in cash equivalent money market mutual funds, 21% of assets were held in bond funds, and 45% of assets were held in stock or equity mutual funds. In effect, when compared to the end of March 2009 figures above, there was roughly a 6 percentage point total value shift in favor of stock funds and a 1 percentage point shift in favor of bond funds — all away from money market funds. Again only a small part of this shift in percentages can be accounted for from actual net cash in-flows into stock funds.

The vast majority of the last six months of equity market appreciation was due simply to a recovery of equity market values and not due to cash in-flows. Those who were in the market benefited with paper gains, just as the vast majority of them had paper losses as the markets collapsed in 2008 and early 2009. The real question is whether current aggregate asset allocation percentages are the new normal, or just a transition from a severe securities market crisis back toward the historical norm. This is a critical asset allocation decision for investors.

If you were an average investor and held the average asset allocation of 2004 to 2007 and had an investment policy to retain that asset allocation through periodic re-balancing, then you would have been a net buyer of equity assets as securities market values collapsed in 2008 and early 2009. While perhaps emotionally challenging to anyone, this "buy equities into a crisis" (and "sell them into a growth cycle") strategy would have positioned you for the recovery that occurred in 2009. Most who flew to cash did so after most of the collapse in equity values had already occurred (buy high and sell low), and they were sitting in cash on the sidelines in surprise as equity market values recovered. The investment research literature has repeatedly shown that market timing is an inferior strategy. In the next few years, we will undoubtedly seem more studies that repeat this finding. Even if another maelstrom reoccurs, this will be yet another opportunity for investors to achieve dramatically inferior portfolio performance, when they do not have a well-defined long-term asset allocation and re-balancing strategy in place and when they do not have the will to implement it consistently over time.

1) Federal Reserve Bank, Federal Reserve Z.1 Report. June 10, 2004. https://www.federalreserve.gov/
2) Investment Company Institute. "2004 Mutual Fund Fact Book." Note that while the balanced or mixed mutual fund category is relatively small and usually constitutes about 5% of total mutual fund assets, this category consists mainly of bonds and stocks. For purposes of analysis, I assumed that the proportion of assets in the balanced or mixed category was 50% bonds and 50% stocks and I allocated these dollar amounts to the primary bond and stock asset categories to eliminated the mixed category.
3) Investment Company Institute. "Trends in Mutual Fund Investing, November 2007″ (The same procedure for balanced or mixed mutual fund assets as described in the note above was applied.)
4) Investment Company Institute. "Worldwide Mutual Fund Assets and Flows, First Quarter 2009″ Supplementary Table S4 (The same procedure for balanced or mixed mutual fund assets as described in the note above was applied.)
5) Investment Company Institute. "Trends in Mutual Fund Investing, August 2009″ (The same procedure for balanced or mixed mutual fund assets as described in the note above was applied.)

My *The Pasadena Financial Planner* website also provides a more thorough article about asset allocation and the financial crisis.

Find this asset allocation article on *The Pasadena Financial Planner* website

8.3: Tactical asset allocation and market timing

The best individual financial planning and investment rules and practices are enduring and should not change due to market cycles or a financial crisis

This article looks at individual investor asset allocation strategies in light of the recent credit crisis. The credit crisis was a systemic, global financial event that affected any financial or securities instrument influenced by debt and borrower credit worthiness. In short, the credit crisis affected everything.

During the credit crunch, many banks had to confront the fact that some of their capital was held in toxic security assets with collapsing market values. This undermined their capital ratios and ability to lend, forcing a contraction in credit availability. Many amateur, professional, and institutional investors and speculators sought liquidity at the same time. They either had to do so to meet their cash flow obligations and/or they feared greater losses and sought "safer" places for their money.

Presto — the result was a global valuation downdraft that affected all asset classes. While some — but not all — classes of bonds did better relative to other asset classes, the real beneficiaries were those who already held bond positions before broader groups of investors got into a panic.

When it turns out that you are already invested in an asset class, it is much more likely that you are already following a passive asset allocation strategy. While tactical asset allocation strategy advocates will suggest that you can anticipate the crowd and take action, these assertions are not verified by studies of flows-of-funds into and out of investment mutual funds.

While a very, very narrow segment of investors might have some skill in anticipating trends and can actively pre-position their investments relative to the movement of the crowds, most people already have their money invested in an asset class, because they have chosen strategically to be invested in that asset class for the long-term as a buy-and-hold investor. Flow-of-funds studies show that almost all tactical asset allocation fund flows are late money flows that chase performance after valuations have already moved. On average, tactical asset allocation money is late money and these investors in motion get inferior returns.

At the end of the first decade of this new millennium, huge cash flows into bond funds still continued relative to flows into other asset classes, such as stocks. This is a trend that was many years in the making. We have not seen similar disproportionate fund flows into bonds since the 1984 to 1987 period, when interest rates were much higher than today's paltry yields.

In succession during the past decade, we have experienced a technology bubble market crash, a housing bubble crash, a credit crunch, and a resulting global economic/business cycle crash. Barring a total global economic depression, which we seem to have skirted and avoided, what will happen to the bond markets when interest rates inevitably rise? Stay tuned for whether bonds are the next sector bubble crash.

Recently, there has been more advocacy of "tactical" asset allocation strategies by certain financial advisors

The logic goes as follows. Broad passively-managed asset class diversification strategies seemingly “did not work” during the credit crisis. Even broadly diversified investor portfolios went down, although not as much as portfolios that were more exposed to particular asset classes that had suffered the worst percentage declines. Therefore, buy-and-hold strategic asset allocation apparently did not work and should be thrown out.

As a replacement, these financial advisors now advocate that it is time to employ tactical asset allocation strategies that "could" get better risk-adjusted portfolio returns in the future. You know, start moving things around to get ahead of the crowd and be there before the crowd arrives to drive up valuations.

Unfortunately, tactical asset allocation strategy advocates do not offer anything to back up their claims that tactical investment activity will actually be superior to a passive asset allocation strategy in the future. Tactical asset allocation strategies have not been superior in the past.

Advocacy for tactical asset allocation strategies flies in the face of the broad body of investment research. This research has consistently shown that low-cost, broadly diversified, passive buy-and-hold asset allocation strategies tend to yield superior long-term risk-adjusted portfolio returns.

Broad portfolio diversification has never meant that a portfolio could not and would not experience short-term losses at the portfolio level

When you have an investment banking industry that finds clever ways to repackage smelly sub-prime mortgages as gilt-edged, investment grade derivative mortgage securities and resells these stinkers in vast quantities to other supposed "smart money" financial professionals across the banking and investment world, then we just might all have a problem. When doing this over and over got a lot of clever investment banking types some very large bonuses, then there was a lot of motivation to keep that gravy train moving along.

While you might question the ethics of these clever investment bankers, you should not forget that they sold these toxic mortgage securities to other willing professional buyers in the global banking industry. Those professional banker purchasers, in turn, tucked these gilt-edged derivative securities into their banks' capital asset portfolios — the very capital portfolios upon which the banks ran their leveraged loan operations.

When the music stopped and all these wool suited emperors had no "superior skill" clothing, bank capital evaporated and so did their ability and willingness to make loans. Of course, this was all compounded by tens of trillions of dollars in CDOs (credit default obligations) that tried to pass the buck on the ultimate repayment responsibility for bad debts. Hot potato. Hot potato. But, wasn't that a golden potato just yesterday? Did the investment bankers also make some sweet bonuses on the multi-trillion dollar CDO swaps market? You betcha!

Without taxpayer dollars via the TARP US bank bailout, the US and the rest of the world would all be in the financial black hole of a long-term global financial depression. In that event, most people would not have had to worry about short-term paper losses on their investment portfolios. Instead, many would have liquidated their portfolio holdings at cents on the dollar to meet living expenses after their jobs vanished.

If you have been following the chatter, you might remember hearing that most TARP funds have been paid back and some TARP loans to the banking industry have been reasonably profitable. Of course, this supposed profitability is only positive from a very narrow perspective. Taxpayers are not normally in the business of making bailout loans to the financial industry. While unfortunately necessary, it is difficult to argue that TARP loans were profitable to taxpayers, when you consider the vast global economic destruction that resulted; the job losses and the millions unemployed and under-employed; and the un-reimbursed hole that many still have in their personal investment portfolios.

So, when a huge and systemic toxic asset problem exists in the financial system, and the credit house of cards begins to fall, why would or should a diversified strategic asset allocation strategy prevent a short-term loss at the portfolio level? Moreover, why would tactical asset allocation be a superior replacement strategy?

To the contrary, higher cost, less diversified, active investment strategies will do what they always do, which is to lead on average to inferior risk-adjusted returns at the portfolio level. Even in a dire financial crisis, you should not lose sight of the long-term and forget the lessons of financial history. Broadly diversified, passive, low-cost, buy-and-hold strategies have been superior in the past, and they are much more likely to beat tactical asset allocation strategies in the future.

Chapter 9: Cut your investment costs to the bone

Most investors' investment cost cutting habits are very rusty

If there is one idea that is most important to individual investors, it is that they should drive all investment cost out of their portfolios and cut their investment costs to the very bone. The result of doing this would be to increase your chances of a better risk-adjusted investment return. Simultaneously, this process would push the investments that you hold toward the most passive and most diversified end of the investment product spectrum, because the most passive and diversified investments tend to be synonymous with lowest cost investments.

However, I realize that only a minority of individual investors will ever wake up to the importance of low cost investments to their long-term financial welfare. This is because the majority of individual investors are naïve trend extrapolators, who do not understand the nature of auction securities markets and the complete uncertainty about what the future holds.

The first thing that the great majority of investor pay attention to is historical performance, which means so very, very little when it comes to choosing investments within asset classes. The movement of substantial investor assets over the past several decades from expensive active investments toward far cheaper passive index investments is encouraging. Nevertheless, there is no good reason to believe that the vast majority of investors will ever stop listening to the siren song of beating the market.

You can see bias for historical performance as an indicator of future performance in numerous ways. Some of this evidence will be elaborated upon in this chapter and elsewhere in this book. However, simply consider doing a study of Internet keyword search terms that compare the searcher interest in investment performance versus cost. For example, in a comparison of the monthly search volume for mutual fund performance versus mutual fund costs, there was much greater than a 10 to 1 interest in performance related terms compared to cost related search terms.

Sometimes, it is difficult for some people to interpret rational data and to understand how important certain factors like investment cost reduction can be. Therefore, I will also offer a visual example. Perhaps you saw the Will Farrell movie, "Land of the Lost." I thought that certain scenes were hysterical, and one scene is illustrative related to investment costs and your investment portfolio.

If you have not seen this movie and want to see the scene that I am referring to, just copy and paste this search phrase < "Land of the Lost" insect > into Google or whatever search engine is your favorite. You will be treated, depending upon your taste in humor, to Will Farrell playing banjo and singing the Land of the Lost theme while an huge alien mosquito bites him first on the neck and then on his back. He becomes very pale as this alien bug sucks out much of his blood. When he falls over, the alien mosquito is the size of a basketball.

While many people thing that investment costs are just "a few percent," or comparable to the irritation of a few mosquitoes on earth, when measured against your net after tax and after inflation returns, the average person's investment costs are far more like that giant mosquito in "Land of the Lost."

9.1: Excessive investment costs are a huge problem

Each and every year, the average investor wastes 2% to 3% of his total assets on unproductive, but completely avoidable investment costs.

Concerning asset management fees charged by mutual funds and ETFs, the average investor pays about .3% more than necessary on money market funds, about .75% more than necessary on bond funds, and about 1% more than necessary on stock funds. Additionally, individual investors pay sales charges, hidden transaction costs, marketing fees, and account holding fees that siphon away more of their assets and returns. The amount wasted is very substantial, because these seemingly small percentages are charged against trillions of dollars in assets. Paid year after year, excess management fees reduce returns and compound over the lives of investors.

Unfortunately, paying higher fees does not lead to better returns. Overall, investment management firms do not deliver higher risk-adjusted returns for their fees. In fact, the opposite is true. Higher investment costs simply drive down investor's net returns.

Investors can stop this waste, and they can either do it themselves or do it with a cost-conscious advisor. They do not need to pay overly expensive investment managers, advisors, and brokers. Excessive charges by industry distributors are part of the problem. Just as Americans have become more cost conscious in their pursuit of retail goods and services, they need to become much more cost conscious when they purchase investment products and services.

Beating the market is an illusion that has been disproved consistently and repeatedly through scientific studies of investment fund performance. The hope of beating a market return is fostered by the industry to drive sales. However, the intense competition of the securities markets tends to make everyone average over time, not some superior. Despite slick industry marketing, investment funds are commodities and luck rather than skill dominates fund performance over time. Therefore, investors need to shift their purchases to lower cost vendors and stop chasing historical performance that does not repeat.

When investment fees are stated as a percentage of one's assets, these fees might appear to be "just a few percent," but they are not. Investors' assets are just that -- their assets. They already own them. Investors pay management fees hoping for a better chance to preserve their assets and to improve their returns. To understand the true impact of these investment costs, annual charges should be compared to annual returns not to total assets.

When visible and hidden industry charges are calculated as a portion of returns rather than assets, it becomes obvious that industry costs are huge. With double-digit annual growth in the 1990s, costs seemed small. However, when total costs for actively managed investments purchased through commissioned advisors are compared to long-term historical investment rates of return, these costs consume between 1/3 and 2/3 of returns.

Investors have no control over the securities markets, but they can control investment costs and thus improve their net returns. In other business realms, individuals would not allow anyone to take their property without providing commensurate value in exchange. Why should they give away some of their investment returns?

Regrettably, in exchange for paying higher fees, the average investor will not obtain any better results than he would have with a passive, low-cost, market index investment strategy. In fact, the typical investor will fall further behind the market return over time as higher than necessary fees and hidden costs steadily siphon away his assets.

The average investor holding individual stocks and bonds rather than mutual funds or exchange-traded funds tends to under-perform the market to an even greater extent. These undiversified investors expose themselves to significant additional risks that are unnecessary and avoidable. Many investors pay additional fees for the dubious privilege of being advised to utilize high turnover investment strategies that cause them to trail the market return by a wider margin on average.

In summary, each year the average investor wastes between 2% to 3% of his assets on unproductive and entirely avoidable visible and hidden investment costs. Many waste much more. On a $100,000 portfolio, this is $2,000 to $3,000 thrown away year after year without receiving commensurate value. This is $2,000 to $3,000 every year that could have been reinvested and grow over time, instead of being given to financial intermediaries. This waste increases with the size of the investment portfolio. Furthermore, when one considers that these figures are pretax, it only adds to the bad news. Less than optimal investment strategies often accelerate the unnecessary recognition of taxes, which could be paid at higher short-term capital gains tax rates.

This expensive mess is completely avoidable, and astute investors themselves can be in the driver's seat and solve this problem for themselves.

9.2: Lower investment expenses lead to higher returns

Excessive investment costs are a plague on your personal financial planning

Multiple financial industry hands constantly in your wallet

Excessive investment expenses are one of the most significant barriers to lifelong family financial security. While financial services industry sales people tell you that you need to pay more to get more, the correct answer is the opposite. If you pay less, you are likely to get more.

In the uncertain and volatile world of financial investments, investment cost reduction is the one strategy that is most likely to improve the future value and investment performance of your bond and stock portfolio, while reducing your investment risk. When you drive your investment costs down to the bare bones minimum, you will simplify your personal finances. When you reduce you costs, you will also stop feeding the purveyors of bogus financial strategies who feed off your assets. If you are not willing to pay, they will go after someone else.

Over the long-term, passive investment strategies focused on very broadly diversified index funds tend to yield gross portfolio returns equaling the gross return of the broad securities markets. In addition, if these investment strategies are also highly cost-effective and tax-conscious, then net long-term portfolio returns will only be slightly lower than gross market returns due to the minimal costs and taxes associated with passive market index fund strategies.

In contrast, the scientific investment literature has repeatedly demonstrated that active investment strategies most often lead to inferior rather than superior net risk-adjusted investment portfolio returns. The primary reasons are fourfold:

The investment securities industry offers products to make a profit. If you are willing to pay more because you think superior past performance will persist, the financial industry is willing to keep accepting your money. A large part of the amateur investing public naively chases historical performance, and the financial industry has mastered this game. If they make more in fees now, they are happy. If past performance does not persist, they have no skin in your personal investment game. However, they will always have another batch of expensive funds to sell to you, some of which happened to do better in the past. Would you now like to try one of them with your diminished portfolio assets? Many individual investors seem never to learn, and their persistent demand is why the active management industry thrives. See: The illusion of superior professional investment manager performance

Actively managed investment strategies require high cost professionals to manage and high trading costs to execute. The more you try to win, the more it costs. The more it costs to play the game, the harder it is to win. See: The investment industry is not your investment partner

The financial industry incurs very significant sales and marketing costs to convince investors to take a chance and commit their money. If you become a customer, you get the privilege of paying to be sold to, when you pay sales loads charges and annual sales and marketing fees. On the other hand, if you are not willing to pay high investment fees, then you will not have to listen to all the wrong-headed promotional hype and rubbish that comes with this territory. See: How can individual investors trust, when so much investment information is rubbish?

By targeting subsets of the overall securities market, the average active strategy will incur additional investment risks without additional securities market compensation. The scientific investment literature has shown that markets pay risk premiums over the long-term, but they tend not to provide risk compensation for betting on subsets of available securities. See: Asset class investment risk premiums — your reward for taking investment risk

In effect, active strategies take on more investment risk without risk compensation compared to fully diversified passive investment strategies. In the short-term, some investors will be lucky, but most others will not. Over the long-term, however, good and bad luck tends to even out, and active investors tend to fall behind, because of their higher costs and higher taxes. Meanwhile, they take a bumpier road in terms of higher portfolio price volatility or risk. See: Passive index investment strategies are superior, because they narrow the range of outcomes

While financial services industry sales people tell you that you need to pay more to get more, the correct answer is the opposite

Excessive investment costs are a plague on your personal financial planning. Excessive investment expenses are one of the most significant barriers to lifelong family financial security. If you pay less, you are likely to get more.

The scientific investment literature provides pitifully little encouragement that individual investors can:

* predict individual prices of stocks and bonds or the future value of the securities markets
* select a securities portfolio that will beat the market consistently, and/or
* identify and hire investment managers who will deliver superior performance net of their added costs.

While there is very substantial variation in the returns achieved by one individual investor or professional investment manager, when compared to another, failure or success is overwhelmingly due to luck rather than skill. Resulting from real-time competition among armies of high and low skill investors, risk-adjusted securities market prices tend to make everyone mediocre over the long-term.

Superior and sustained skill-based performance net of costs and taxes has been too elusive to find after hundreds of scientifically constructed securities market studies. While lucky past winners may tout their historical prowess, the scientific investment literature has repeatedly demonstrated that better past performance simply is not a predictor of future performance. The small print of the legally required, "protect-your-behind" securities disclosures is actually correct.

The scientific investment literature has also shown that efforts to identify active managers who will consistently beat the market have been futile. Counting the number of years a fund manager has been with a fund, judging where she went to school, estimating the number of gray hairs on his balding head, or other such factors have not distinguished which active manager will do better or worse in the future.

While active professionals generally do better than amateurs do, overall their added costs far exceed their value-added. Individual investors face a simple cost-benefit dilemma. The average actively managed professional fund prices its services well above its value-added in terms of increased returns. Since there is no reliable means to detect beforehand which professional or fund will actually deliver superior performance, the average individual investor inevitably will pay more and get less.

The only way escape this dilemma is to avoid playing this beat-the-market game entirely. Instead, the more reliable road to higher expected long-term risk-adjusted returns involves targeting a passive market return, while aggressively driving down investment costs and avoiding unnecessary investment taxes.

Chapter 10: Investment fund illusions

Beforehand – when it only really counts, you cannot reliably identify those professional investment managers who will deliver superior risk-adjusted investment performance at a reasonable price in the future. Even if you could identify them, it is highly unlikely that you could hire them at a price that is lower than their potential value-added net of their added costs and your associated taxes. Once you understand this, then you will realize that the only sensible choice is to choose very low cost, broadly diversified market index mutual funds and exchange-traded funds.

10.1: Own investment funds and not individual securities

Owning individual securities is just a big waste of your time and money. Individuals tend to be terrible investment portfolio managers. Anyone can hire an index fund manager to do a much better job for far less time, money, risk, and consternation.

Own cash, bond, and stock mutual funds and exchange-traded funds, and avoid owning individual stocks and bonds. Funds automatically provide a higher level of diversification -- usually at lower cost, when investment expenses, taxes and the value of your time are considered. The securities industry pushes individual investors to buy and sell individual securities to earn commissions, but the markets tend not to compensate individuals to taking these undiversified risks. Under-diversified investors subject themselves to higher volatility without any reasonable expectation of better returns.

The average individual is an atrocious investment portfolio manager. Overall, the average individual portfolio self- manager probably loses about 2% each year relative to a low-cost, passive index investment strategy.

Numerous factors cause the poor results that the average individual investors achieve through portfolio self- management. The reasons vary from person to person. An incomplete list of the causes includes:

* His costs are much higher.
* He trades far too frequently and often without any real information to justify a trade.
* His screening and analysis methods are rudimentary at best.
* He only buys companies locally visible or featured in positive media stories.
* He endlessly and fruitlessly chases past performance.
* He fails to diversify and bears substantial uncompensated enterprise risks.
* He maintains overly concentrated and thus more risky positions.
* Often, he holds concentrated investment positions in the same entity that issues his paycheck.
* He holds on to his losers for too long, and he sells his winners too soon.
* He remembers his wins and may brag about them. He tries to put his losers out of his mind, yet often still holds and ignores them. After he finally sells them or they go bankrupt, he removes them from his records to eliminate any reminders.
* He pays more in taxes, usually at higher short-term rather than long-term capital gains tax rates.
* He does not accurately track his performance against any appropriate market benchmark, and therefore he does not learn how relatively poorly he has done.
* He tries to time the business cycle and the popularity of industry sectors.

Competently managed investment firms would dismiss any professional who exhibited similar behaviors.

The easy way to avoid all these problems is just to stop trying to do what professional index fund managers can do far better for you with much lower costs and with greater economies of scale. Buy only money market, bond, and equity mutual funds and exchange-traded funds.

In most cases, you should methodically liquidate your individual stock and bond holdings over time, as you rebalance or have other reasons to dispose of them in a cost- and tax-efficient manner.

There are some limited circumstances where one might continue to hold individual stocks and bonds. For example, elderly persons with substantially appreciated stocks may believe that the potential to reset the tax basis of these securities, when transferred upon death, will outweigh the diversification risk. Another example would be an executive who is required by employment contract to hold the securities of his firm.

10.2: Never invest solely because of superior past performance

Only very poor past performance tends to be a slight predictor of poor future performance. (Excessive cost is the most likely culprit.) The investment industry understands that people naively buy because of superior historical performance. Therefore, the industry markets only successful funds, while they leave laggard funds out of their ads.

Many individual investors rush around buying securities and funds that did better than average in the past. This practice demonstrates a naïve hope that such investments will deliver better returns in the future. The industry feeds this frenzy by selectively advertising funds with better than average past performance.

At best, superior past performance is only a mirage. At worst, chasing it will waste your time and can entice you to pay excessive fees for future performance that is likely just to be mediocre. In general, higher fees tend to lead to lower performance. Very low cost index mutual and exchange-traded funds track the broad markets and tend to deliver better performance after costs and taxes. They do not have "superior" performance, because their objective is to track the market return.

Everyone naturally avoids inferior performance, which in its worst form can be a very slight indicator of inferior future performance. Again, excessive costs are the likely culprit, when highly inferior historical performance persists.

Finally, beware of any recently discovered alternative "asset class" that is being promoted to you. These include hedge funds, managed futures, and other "new asset classes." Typically, with past hot streak value appreciation as bait, investors are encouraged to allocate a portion of their portfolio to these supposedly new asset classes to earn higher returns with presumably lower portfolio risk. Again, the high cost of investing in this new asset class will often be a tip off. Furthermore, when you look more closely at the data, past superior performance data often will be highly suspect and the true risks will be understated substantially.

10.3: Performance charts - How to lie with statistics

Darrell Huff wrote a short, informative, and very funny book, How to Lie with Statistics, which was first published in 1954 and was illustrated amusingly by Irving Geis. This book is still in print and remains very popular (recent Amazon book rank of around #1,000). How to Lie with Statistics plainly and humorously discusses how statistics can be distorted and misused to serve the self-interest of the presenter.

The financial services industry has a surplus of Pinocchios

Historical investment performance charts for investment funds are a case in point about how the financial industry has raised lying with statistics to a marketing art form. While the numbers that historical investment charts present may be historically accurate, their presentation in advertising, on line, and in printed materials can amount to lies from several important perspectives.

Performance charts of actively managed investment funds are used to lure gullible individual investors with an implied promise that superior past performance will continue into the future. The financial research literature tells us clearly that this is a promise that cannot be kept. Performance charts of broadly diversified passive index funds do not necessarily contain a similar lie. You would expect them to track the market benchmark less small expenses and reveal the historical tracking error of that fund.

At the outset, historical performance charts of actively managed funds are a veiled lie. They may report factual information, but their purpose is to sell. The performance they are selling tends not to persist, which introduces the lie. The fact that on average performance charts invariably sell higher cost funds that make. Since each actively managed funds would have a performance chart, it is not the individual chart that does the lying. In aggregate, actively managed funds would track the general market index, but show a substantially larger tracking error to account for the various sales, trading, and management expenses associated with actively managed funds.

Instead, the lies and deceptions of actively managed funds can be found in the following areas.

Statistical lie #1: Selecting only current "winners" to promote

When selling to you, securities industry sales people and the fund companies that advertise performance most often select only those historical investment fund performance charts that show superior historical performance. The industry sells its winners, and it ignores or hides its losers. Charts for their loser funds are available, but sales representatives are not eager to present them. You have to dig them out yourself on the web. Or, these inferior or average performance charts will be mailed to you after you have bought what you thought was a "superior" fund, but, gosh, things may not have remained so superior with the passage of time.

Except for very, very poor historical performance, which tends to be an indicator of excessive costs, the financial research literature tells us that historical fund performance is meaningless. The industry knows that many investors naively project past performance into the future. Yet the scientific finance literature simply does not support such assumptions. If investing were this easy, then those who buy based on past performance would be consistent winners in the future and would grow relatively richer and richer. The opposite turns out to be true.

For your amusement when you are being sold to by a securities industry sales person, ask to see an asset-weighted chart that combines the entire historical performance of all the funds for a fund family. Good luck in getting to see that one! I could list a dozen reasons why you will be told that such a fund family chart does not exist. However, the real reason is that this aggregate historical performance chart would likely show that the entire fund family trails a very broad market index by almost as much as the fund family charges in fees.

I use the word "almost," because professionally managed funds may have shown a slight positive ability to pick individual securities. Unfortunately, this slightly positive gross returns advantage is more than wiped out by management fees and transactions costs, which are several times greater than this small gross returns gain. Even then, this possible evidence of a slight amount of professional fund manager might also be a mirage.

Much of the academic research on investment manager skill or the lack thereof has reached the conclusion that professional investment managers lack any demonstrable skill versus a low cost, passive index investment strategy. Nevertheless, a notable portion of the academic research demonstrating positive investment management skill has been provided by Wermers, et. al. in a range of research papers. Russell Wermers, who is Associate Professor of Finance at the University of Maryland, provides on his website numerous research papers. Over the years, he and others have concluded that some investment managers apparently have some skill, which may indeed exceed their added costs.

However, in a prior research papers Wermers, et. al. suggested that apparent investment manager skill could have been due to herding among investment managers who bought and bid up the same stocks. More recently, some of the optimism that superior managers can be identified before the fact as resurfaced. For example, the conclusion of a more recent research paper stated:

"We apply the FDR (false discovery rate) technique to show that the proportion of skilled fund managers has diminished rapidly over the past 20 years, while the proportion of unskilled fund managers has increased substantially. Our paper also shows that the long-standing puzzle of actively managed mutual fund underperformance is due to the long-term survival of a minority of truly underperforming funds. Most actively managed funds provide either positive or zero net-of expense alphas, putting them at least on par with passive funds. Still, it is puzzling why investors seem to increasingly tolerate the existence of a large minority of funds that produce negative alphas, when an increasing array of passively managed funds have become available ... With our approach, controlling for luck in multiple testing is trivial: The only input required is a vector of p-values, one for each individual test." (1)

1) Barras, Scaillet, and Wermers, "False Discoveries in Mutual Fund Performance: Measuring Luck in Estimated Alphas," The Journal of Finance, February 2010, p. 179-216

The conclusions of this 2010 research paper might seem to offer some hope that there are reliable methods to discover superior investment fund managers who might earn their keep. However, earlier in this research paper they also stated that "Our previous analysis reveals that only 2.4% of the funds are skilled over the short term. Can we detect these skilled funds over time, in order to capture their superior alphas?" The methods they proceed to describe in this paper that could identify managers with longer-term superior skill are not something that the average do-it-yourself fund investor would be able to implement.

Most individual investors do not have the data set, computational resources, and understanding to develop "a vector of p-values, one for each individual test" that might enable them to be successful in identifying superior active investment managers beforehand – if indeed such managers do exist at an affordable price. They would have to rely upon the industry to act in their best interests and find those managers for them. Unfortunately, this is another weak link in the advisory chain where the interests of individual investors breaks down.

Since over ¾ of mutual fund shares are sold through brokers and other financial advisors, what are the chances that these advisors will do a good job of selecting superior funds for their clients. Unfortunately, these chances are not very good. Read the rest of this chapter and this book and follow the links to find out why.

Before we leave this particular topic of being able to identify that minority of active investment managers who can consistently deliver superior investment returns, consider that almost invariably actively managed funds are sold with either a front-end or back-end sales load. Otherwise, they may have their loads "waived" because they are sold within some kind of fee based account that takes perhaps a full percentage or two or more of portfolio asset value each and every year. Most people who pay a percent of assets fee expect their adviser to earn it and that usually means investing in actively managed funds, because passively managed funds "only" target a market return. Therefore, from a risk-adjusted standpoint the risk profile of your portfolio certainly increases for some rather small chance you might beat the market, but never with any guarantee that you will.

And furthermore, a close reading of the Wermers, et. al. paper above shows that while their data set included ongoing 12b-1 fees, their performance data did not take into account those investors who pay a front-end sales load for the privilege of having a supposedly knowledgeable commissioned broker or advisor pick a supposedly superior actively-managed investment fund for them (but again, without any guarantee).

Here is why this matters a great deal. Wermers, et. al. provide research reporting that only a small portion of active investment managers may have sustained superior performance. Many others seem to be comparable to index funds, so why take the risk of picking a loser? Moreover, many investment funds are persistent losers, but Wermers, et. al. lament that individual investors do not seem to catch on.

Yet, since the overwhelming majority of these funds are advisor sold, who is making the decision to hold funds that are supposedly inferior, and predicatively so? Might this just be that advisors will just lament the fact that a fund is a laggard, when clients complain? Then, they will just switch clients into another fund. Meanwhile, they will spend a large part of their time chasing new client prospects, when current clients do not pay enough attention and do not complain about laggards?

Here is the problem of missing front-end loads in the Wermers, et. al. analysis. When you pay a front-end load on a stock fund, you give the advisor a dollar and he or she keeps about a nickel. Only ninety-five cents gets invested on your behalf. However, that ninety-five cents becomes the basis upon which performance comparisons are made going forward. If the fund earns seven percent before inflation in the first year and inflation is the long term average, it will look like you earned 7% before inflation and 4% after inflation. But, what about the 5% you gave away to your broker at the outset? If you sell the fund at the end of the first year, you are up 2% before inflation and down 1% after inflation rather than being up 7% and 4%, respectively. If you hold the fund for multiple years, you could spread (amortize) the load over the holding period, but you still have 5% of your original dollar to recover before you start moving ahead.

If superior active managers do exist, but they take some relatively difficult work to identify is your financial advisor really trying? Or, is your broker or investment adviser is just waving 4 star and 5 star funds in your face, motivated in by their need to capture that 5% sales load? These stars are not predictive and mean nothing about future performance. Is your broker and investment advisor doing you a service or a disservice by only pushing selected active funds with "superior" performance charts and higher costs, rather than offering very low cost, broadly diversified index funds?

Statistical lie #2: Easy index benchmarking

Historical performance charts will compare a particular fund's performance against some index benchmark. An index is an index, isn't it? The question that individual investors should ask is whether the index benchmark really is appropriate. All index benchmarks are not the same, and there can be very significant differences between index benchmarks — even when indexes seem to match the particular investment style of the fund in question.

When you look at a performance chart, do you investigate whether the fund company picked a challenging index or an easy hurdle that they could more easily stumble over? For more about the variations between index benchmarks, see Craig L. Israelsen's article, "Variance Among Indexes: Don't judge an index by its title" in the May/June 2007 issue of the Journal of Indexes (Pages 26 to 29) Dr. Israelsen analyzes the various indexes published by the six major U.S. index providers (Standard & Poors, Russell, MSCI, Morningstar, Lipper, and Dow Jones). He finds very wide performance variations even with indexes that supposedly represent the same "style" of investing.

Dr. Israelsen concluded his article by commenting: "It is important to recognize that significant performance differentials among prominent indexes can lead to misleading conclusions about mutual fund performance. Funds with mediocre performance histories can be made to look better by being compared to a prominent benchmark with a weaker performance history. At the very least, the industry needs to recognize the existence of potentially sizable performance differentials among various U.S. equity indexes, and therefore view performance comparisons between Mutual Fund A and Index B for what they are: marketing materials."

Statistical lie #3: Hard to interpret cumulative historical performance charts

For humor, let us assume for a moment that historical performance charts actually do have some useful information for individual investors.

(This might not actually be very funny to many investors who have been lured into lousy and expensive investments because of historical performance charts. It can be hard to see humor, when the securities industry siphons away your assets through high fees using the siren song of superior historical performance charts. The cover-your-ass small legal print in the footnote of the performance chart is actually right. Essentially, it says, "Don't count on it." And, you should not.)

Interpreting rates of change from a cumulative performance chart is a challenge for many people. Visually, cumulative historical performance charts are just very difficult to interpret. Most people would only look at the most recent values to see whether the fund's cumulative performance to date is above or below the index. Well, of course, if you are being sold to or advertised to, then the most recent cumulative performance will always be above the benchmark, because of selectivity (#1 above, "Selecting only "winners" to promote). This is the easiest kind of fund to sell to naive individual investors — you know, "good" funds with "better" performance.

However, a fund's performance history that would truly exhibit investment management skill (or just a sting of good luck) is the relative rate of change in fund versus benchmark asset valuation. The rate of change between the fund's historical performance and the benchmark index is what counts. A consistently superior fund would have a cumulative performance line that increasingly and consistently diverges from the benchmark index. Visually, the wedge between the two lines should just keep widening. (On the other hand, a widening wedge could also describe the situation of an overly easy benchmark comparison and mediocre fund performance. (#2 above, "Easy index benchmarking)

Rarely do you see historical performance charts with increasingly widening lines — particularly since luck is a major factor and high fees and high trading costs tend to drag fund performance down relative to appropriate benchmarks. If, for example, the lines diverged quickly ten years ago and then they maintained a relatively constant gap thereafter, that could mean that a very small and immature fund got lucky and/or it had a riskier investment portfolio profile. Then, money from performance chasing individual investors flowed in, and the fund got much larger. If the gap between the lines on the chart does not increasingly widen, then this means that subsequent performance has just been mediocre. If the lines tend to narrow that demonstrates subsequent inferior performance. Cumulative performance could still be above the index due to a selectivity bias and/or an easy index benchmark, but the fund might really have been exhibiting mediocre or inferior performance for years.

Industry cynicism about unsophisticated individual investors

The securities industry knows that chasing historical performance is bad for individual investors, but they encourage this behavior by publishing historical performance charts and 4 star and 5 star Morningstar Ratings, which are also largely meaningless. For the industry not to know would imply that many very smart professional investment managers have had their heads in the sand about decades of financial research. Concerning Morningstar Ratings, see articles in this category on my *The Skilled Investor* website: Ratings Services: Morningstar and "Investment astrology – should you pick investments according to the Morningstars?"

The securities industry and many of its brokers and investment advisors know that low cost index strategies are better for individual investors. However, the "active-management-beat-the-market" industry crowd will not make any money off you, if they tell you that. They have to push the "we deliver superior performance" mantra, because that is the justification for their excessively high and performance killing fees. Since market realities make it virtually impossible for actively managed funds to beat consistently the market after their fees, they have to resort to promises, deceptions, and what Darrel Huff would call "statistical" lies. These lies include: #1 selecting only winners to promote, #2 easy index benchmarking, and #3 hard to interpret cumulative historical performance charts.

Those in the industry who do not understand this have not bothered to do their homework. And, why should they? If these superior performance hustlers learned what is good for individual investors, they might also realize that they should find another career that adds some genuine value to our society.

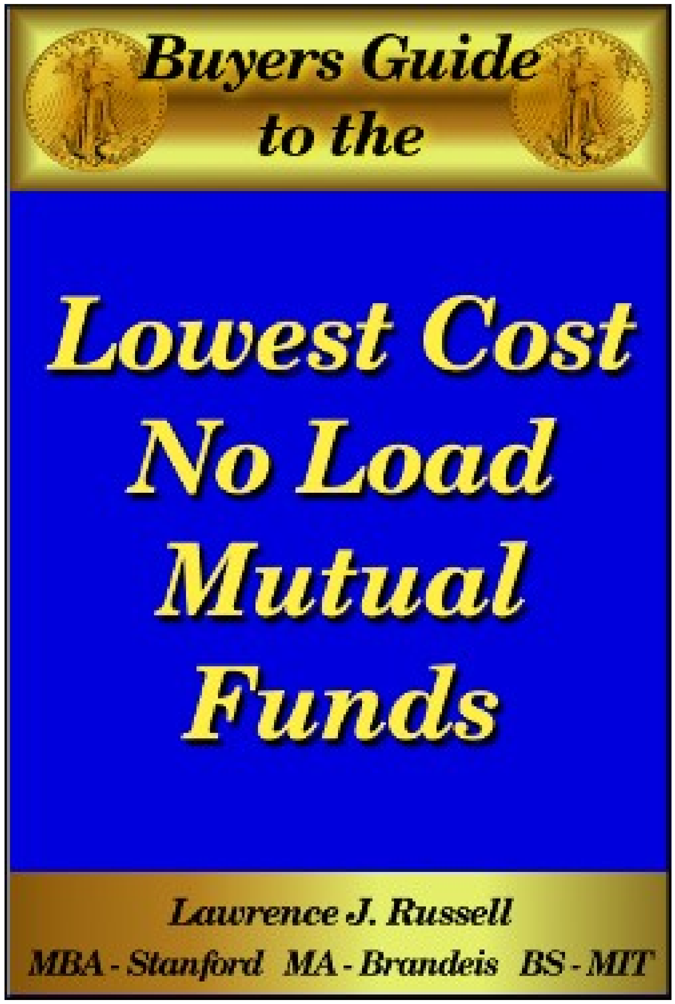
How one investment fund family solves this problem — They refuse to play the historical performance game.

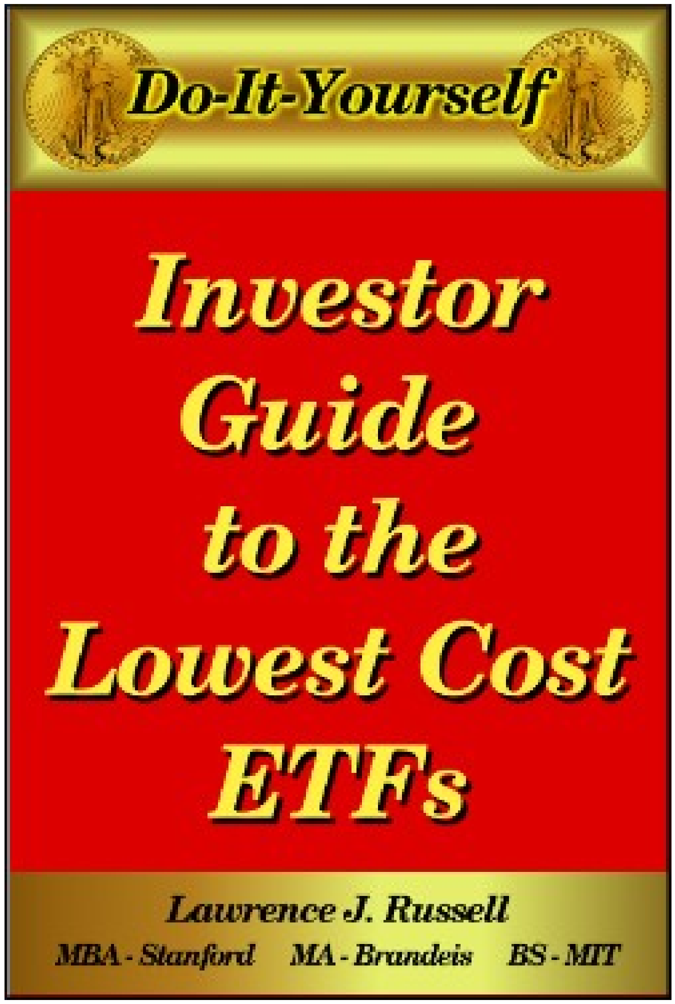
In the same issue of the Journal of Indexes, which published the Israelsen article referenced above about variance among index benchmarks, there was a "Straight Talk" interview with John Brennan, CEO of the Vanguard Group, who succeeded John Bogle in 1996. (Pages 24-25, 50) When asked about performance chasing, Brennan said the following: "The way(s) you mitigate against it are several. One, you never — in our view — never promote performance. You just never run a performance ad. I think that is endemic to our business, and I think it's a shame for our industry. When you read a performance ad, there is an assumption that the strong performance will continue. And that is not necessarily true. The second thing is … when you call Vanguard to talk about our funds, or when you read our literature, you won't find a Morningstar Star Rating. … The third way to mitigate is with communication. When you read our annual reports after a terrific year, you can be sure that we will tell investors, "please don't assume that this will continue." … Finally, you also have to be willing and able to close a fund and have a cooling off period. That's bad for business, and it always inspires some nasty letters. But it's how you build a performance track record. I have never once regretted closing a fund. At the end of the day, firms that promote performance do so at their own peril." And, I will add — at your peril too!

Note: I have no business relationship with the Vanguard Group and do not receive compensation from Vanguard for discussing them here.

You should also note that Vanguard is the only major mutual fund company that does not operate for the benefit of the common stock shareholders of the overall fund company. Instead, Vanguard is owned by the Vanguard funds, which in turn are owned by the investors in those funds. Profits from Vanguard funds are returned to these funds and not to any third-party owners or competing common stock shareholders.

The lack of a Vanguard company level profit objective for external shareholders eliminates conflicts of interest and allows Vanguard to keep the cost of investing lower than at other investment fund companies. With this investment fund investor-friendly structure, Vanguard has grown to become one of the world's largest investment management companies managing well over $2 trillion in assets.


Buyers Guide
to the
Lowest Cost
No Load
Mutual
Funds
Lawrence J. Russell
MBA - Stanford MA - Brandeis BS - MIT



To learn more, click either book cover or go to this web page:

http://www.myfinancialfreedomplan.com/financial-planning/

10.4: Superior professional investment managers cannot be identified beforehand

Unfortunately, you cannot reliably identify beforehand professional investment managers who will deliver superior performance in the future, and you cannot hire them at a price that is lower than their potential value-added

Those investment managers who seemingly

had superior performance in the past based on skill

predominantly were just lucky in securities selection

Superior past investment fund performance does not predict superior future investment performance. Nobody has proven that there is any reliable way to identify beforehand which managers will have superior future performance. If you cannot predict better future performance based on past results, how could you predict them based on manager characteristics? Paying attention to managers of funds is just a useless financial celebrity sideshow, which is focused on the past and not the future. Do not waste your time.

Investing is not a matter of being smarter. A huge number of very smart investors play the global securities markets constantly. In aggregate, all investors set market values, and their competition makes relative skill largely unimportant in the long-term. Skill negates skill in auction markets, when the whole world is watching and playing. Those who seemingly had superior performance in the past base on skill predominantly were just lucky -- no matter how they score on an IQ test or how much education they have. See How stable have Morningstar Ratings for mutual funds been over time?

However, professional investment portfolio managers tend to do somewhat better than amateur portfolio managers do. The scientific investment literature indicates that, generally, this is not because professionals are more intelligent or significantly better than amateurs are at predicting the unpredictable future related to the securities they select. It seems instead to be more a matter of error control. Individual investors tend to perpetuate their investment management errors, while professionals seem to correct errors more quickly and systematically.

Securities professionals usually are well educated and experienced, and they work full-time in groups using globally networked real-time information and analytic applications. Generally, they have a significant edge over amateur investors. While professional competence can vary rather widely, the experience, competence, and profit motive within professional organizations tends to correct errors rather than to perpetuate them.

Do not waste time evaluating fund managers

Searching for superior investment fund managers wastes your money and time. Unfortunately, amateurs cannot exploit this rather narrow professional versus amateur performance differential. You cannot identify, reliably beforehand, professionals who will turn out to be better in the future using any method that is associated with the characteristics of the managers themselves.

Professionals’ education, years of experience, time in a position, and other personal attributes have not been demonstrated to predict performance. Paying attention to the background of investment manager is just a waste of your valuable time.

All that matters is the investment result for the portfolio managed by a professional, and the only reliable predictive variable tends to be investment management costs. When professional management costs are higher, then net returns tend to be lower and vice versa.

Because you cannot reliably predict which investment professionals will have superior performance in the future and because you cannot hire active professionals at a cost that is lower than their value-added, the only solution is to sidestep the game. By buying only low-cost, passively managed index funds, you do not need to play the futile and time consuming "pick a superior manager" game.

Chapter 11: Exchange-traded funds (ETFs) versus mutual funds

ETFs are investment funds that trade like stocks on securities exchanges

This chapter focuses on information about low cost ETFs, which account for only a few percent of the thousand plus ETFs and other exchange-traded products (ETPs) available to US investors. This introduction covers certain topics related to ETFs that are important to the investor who intends to use very low cost ETFs as an alternative to very low cost, no load mutual funds – when implementing a broadly diversified, passive, low tax, low effort, long-term buy-and-hold-and-hold-and hold investment strategy.

Low cost mutual funds and low cost ETFs are largely interchangeable. Either one or the other or some combination of the two will do. The commonality and interchangeability of ETFs and mutual funds is derived from an investor's commitment to choose only very broadly diversified and very low cost investment funds of either type. At the low cost and very broadly diversified end of the investment fund product spectrum, either form of investment fund can serve the needs of the passive, long-term investor.

There have been long-running and generally self-interested financial industry arguments about the structural merits and demerits of mutual funds versus ETFs. These arguments are largely canards, as are so many other supposed "debates" about investing and investment products. The financial and investment industry perpetuates "debates" whenever there is enough variability in results to enable self-interested denial or twisting of objective research evidence.

With mutual funds and ETFs, their differences and supposed advantages or disadvantages really only manifest themselves, when a sub-optimal investment strategy is attempted using either investment fund vehicle. Differences between ETFs and mutual funds can show up in less-diversified, higher cost, more active, higher turnover investment strategies. However, then the problem is not the comparative structure of the investment fund vehicle, but the lousy, sub-optimal strategy that deviates from a passive index investment strategy.

Whenever you decide to cut your investment costs to the bone, of necessity, you must choose from among broadly diversified, passive, index fund investments. Passive index tracking strategies are the only strategies that can be implemented cheaply and economically by an investment fund company. Passive index tracking strategies are the only fund strategies that can be priced very low in terms of the fees, costs, and taxes that the investor must pay directly or indirectly. Only if an investment fund operates very efficiently can it offer very low fees and be competitive.

At the highly efficient, low fee, low cost end of the investment fund product spectrum, index mutual funds and index ETFs become largely interchangeable. Both types of funds track the same passive, diversified indexes and both need to attract substantial assets to operate efficiently. Investors are cost sensitive and will direct their assets to lower cost vendors. The only way for vendors to be profitable is to run highly efficient operations, because the investors they attract refuse to pay high fees with no assurance of superior performance. With either low cost mutual funds or low cost ETFs, investor clientele have given up on the active-management shell game and are not attracted by ephemeral performance charts and stars. The just want low fees, low costs, and low taxes.

What are exchange-traded funds (ETFs) and exchange-traded products (ETPs)?

Structurally, ETFs are not as simple as mutual funds. This introduction points out a few things that you should pay attention to with ETFs. First, ETFs are a subset of the more general category of exchange-traded products (ETPs). To avoid, a longer discourse on ETFs and ETPs here, look at these two Wikipedia pages. If you have an interest and would like a starting point for your research, these Wikipedia pages are a place to start:

https://en.wikipedia.org/wiki/Exchange-traded_product

https://en.wikipedia.org/wiki/Exchange-traded_fund

This article provides an overview of some aspects of ETFs that are important in a decision about whether you might choose low cost no load mutual funds or/and low cost ETFs to implement a long-term, passive index investment strategy. Nevertheless, this introduction simply cannot offer a comprehensive treatment of the subject of ETFs and the broader category of ETPs. A proper treatment of ETFs/ETPs would be a thick book in itself.

You should be aware of these aspects of ETFs/ETPs. If you do not feel that you know enough about these topics and other features of exchange-traded products, you should do your research before investing in any exchange-traded product or ETF.

ETFs/ETPs trade on the securities markets "just like" stocks. They have a most recent trading price and a price history. Prices fluctuate, and there is a variable bid-ask spread. The bid-ask spread is an important additional cost factor to consider, since the trading spread is often much wider than you might expect. ETF bid-ask spreads increase with smaller and less liquid ETPs and with higher overall market volatility.

The largest ETFs with high daily trading volume ("liquidity") often, but not always have bid-ask spreads that are under .1% or even .05% of the price per share. However, spreads on other smaller and less liquid ETFs – which are the majority of ETFs – can have noticeably wider spreads, sometimes routinely over 1% of share price and even far higher.

ETF bid-ask trading spreads are an important subject that you should not gloss over or ignore. If you do not know how to control your total ETF trading costs, then just buy very low cost no load index mutual funds directly from a mutual fund company. You get the end of day net asset value price per share like very one else, and professional mutual fund traders manage the necessary trading efficiently.

In addition to a variable bid-ask trading spread, ETFs also may trade at a fluctuating discount or premium to the value of the underlying assets defined by the fund's index. The sizes of discounts and premiums are limited by trading arbitrage activities among professional traders who attempt to profit through the ETF share creation and redemption process. ETF discounts and premiums tend to increase with smaller and less liquid ETPs and with higher overall market volatility. Like the bid-ask trading spread, ETF discounts and premiums may be larger than you might expect.

Wide discounts and premiums are particularly a problem with bond ETFs. Just because bond ETFs trade like stocks, they do not magically overcome the high costs, complexity, and opaqueness of bond market trading. Instead, they just shift them, and their underlying existence is manifested in discounts and premiums.

Particularly during market turmoil when there is a significant imbalance in buying and selling demand, bond ETF discounts, premiums, and their fluctuations can be stunning.

JNK (SPDR Barclays Capital High Yield Bond) and HYG (iShares iBoxx $ High Yield Corporate) are two high yield (junk) bond funds have the lowest expense ratios in their category and at this writing trade with a relatively narrow discount or premium. Combined they hold about $16 Billion in assets. However, despite being large in assets and having high trading volumes, these funds were not immune to widening discounts and premiums in shorter periods. In late 2008, HYG swung from a discount of 7.9% to a premium of 12.7% in two months. In early 2009, JNK had a 9+% premium flip over to a 2.5% discount within two weeks. During the municipal bond mini-panic in the fourth quarter of 2010, most municipal bond ETFs traded at a discount to their asset value throughout the quarter. (Michelle Knight, "Rethinking Bond ETFs", Financial Advisor Magazine, August 2011, p. 85-86)

Sometimes ETFs/ETPs are described as mutual funds that trade like stocks and that can be traded intra-day on a stock exchange. Nevertheless, ETF and mutual fund pricing, purchase, and sale processes differ significantly.

"Open end" mutual funds, which is what most mutual funds are, have a once-a-day, end-of-day settlement, share pricing, and purchase/sale process. The mutual fund company manages all of this internally.

Some mutual funds allow retail investors to do business directly with the fund company, while others require you to use an intermediary. You can buy most mutual funds through a full service broker, discount broker, or other financial advisor. However, this does not mean that the mutual funds themselves trade on an exchange. It just means you are paying an intermediary for this service. Often these intermediaries steer you into significantly more expensive and more active funds that provide higher compensation to the advisor. The research literature indicates that these intermediaries have no special knowledge or skill in selecting funds, and thus you may be paying dearly, if you use an intermediary to buy investment funds.

Mutual funds internalize the costs of market trading associated a) with management decisions about composition of the overall portfolio and b) due to net investor inflows and outflows related to the purchase and sale of mutual funds. Like mutual funds, ETFs retain the trading costs associated with managing the overall portfolio. However, ETFs externalize trading costs related to investor buying and selling.

Thus, existing and inactive buy-and-hold ETF shareholders are insulated from the trading actives of other investors. ETF traders bear their own trading costs. Often, this is promoted as a relative virtue of ETFs in comparison with mutual funds, but it is only a virtue if the ETF investor trades carefully and economically and holds his or her position for a long time to amortize the buying and selling trading costs that are incurred personally.

Unfortunately, the data indicate that ETF ease-of-trading and the supposed low cost, "under ten bucks" trading via discount brokers can induce many individual "retail" investors to trade frequently. With higher trading frequency, trading costs can mount very rapidly on a percent of average asset value per year basis. It is unlikely that many individual investors track their ETF trading costs properly and carefully, including 1) brokerage fees, 2) the portion of the bid-ask spread they pay, and 3) the fact that they pay both buying and selling costs on each round-trip transaction.

While ETFs/ETPs "trade like stocks" they are much more varied that regular equity securities. For example, ETFs also include bond ETFs that "trade like stocks." While other equity security classes that can trade on the stock markets, the vast majority of equity securities are common stocks. Presumably, individual investors should know what they are buying, when they buy and sell stocks, but this is not always the case. Given the much greater variety of ETFs/ETPs, it is even more likely that some amateur traders make simplifying assumptions about ETFs/ETPs that are not always accurate.

Since the introduction of ETFs almost two decades ago, ETFs have proliferated and total invested assets exceed $1 Trillion. Nevertheless, many investors may not be sufficiently aware that "an ETF is not necessarily an ETF." Thus, I have included the term, ETP, for the more general class of investment funds that trade on exchanges.

In addition to ETFs, the class of ETPs also includes:

* closed-end funds (which are diversified mutual funds have been around and traded for decades),
* exchange-traded notes for commodities, currencies, and certificates,
* exchange-traded derivative contracts,

* exchange-traded grantor trusts,

* leveraged ETFs, and other exchange-traded instruments.

Taxation is one reason why individual, retail traders should understand differences between exchange-traded product investment vehicles. ETFs supposedly are more tax efficient than mutual funds and ETF advocates promote this as an advantage of ETFs over mutual funds.

Given excessive trading frequency, repeated brokerage charges, and excessively wide bid-ask spreads, it is unlikely that many retail ETF traders actually capture the potential tax advantages of ETFs. Short holding periods also mean that many traders do not capture long-term capital gains tax rate advantages.

In addition, if an investor does not do his research beforehand and does not understand that "an ETF is not necessarily and ETF", he may buy another type of ETP with different tax treatment. Lower long-term capital gains tax treatment is not even available with some forms of ETPs. ETPs all have ticker symbols and can be bought and sold easily. For that standpoint, they look the same. The buyer of "an ETP that is not an ETF" may be surprised to find that the tax treatment of some of these ETP vehicles differs substantially from the tax treatment of a plain old common stock ETF. That discovery might not occur until tax filing time. This is another compelling reason actually to read the prospectus BEFORE buying.

Unexpected performance characteristics of some ETPs are another reason to get educated about various special structure ETPs. For example, certain leveraged long and short strategy ETFs can have surprising performance and volatility characteristics. An uninformed individual investor might not realize the returns that had been expected, even if the market moved a desired direction.

For more information, see these webpages:

* SEC "Updated Investor Bulletin: Leveraged and Inverse ETFs" Feb. 23, 2023

https://www.sec.gov/investor/pubs/leveragedetfs-alert

* FINRA (the Financial Industry Regulatory Authority) "Exchange-Traded Notes—Avoid Unpleasant Surprises" October 20, 2022

https://www.finra.org/investors/insights/exchange-traded-notes-avoid-unpleasant-surprises

* FINRA Regulatory Guidance: "Non-Traditional ETFs FAQ "

https://www.finra.org/rules-guidance/key-topics/etf/non-traditional-etf-faq

Chapter 12: Rational investment fund selection

When viewed through the lens of the best interests of an individual investor, well over 95% of available investment mutual funds or ETFs are just chaff – not wheat. After the vast investment fund "chaff" created by a profit seeking financial industry has been removed, only low cost, low turnover and passively managed index funds remain. Assemble your investment portfolio from these low cost index mutual funds and ETFs and ignore the rest.

People simply want to invest in what they hope will be better investment funds. They want selection criteria that can lead to a higher probability of doing better in the future on both a sustained and risk-adjusted performance basis.

Millions of individual investors run futile hamster wheel races pursuing the illusion that the superior past performance of some funds and individual securities will lead to the same superior performance in the future. I have written this book for those of you who want to stop "chasing your personal finance tail" and get on with your real life.

12.1: Seven scientific criteria for screening mutual funds

Low cost no load index funds simply are better

Taken as a whole, the vast body of investment research studies show that there really are better approaches to buying and owning mutual funds. You do not need to frantically chase fund performance. Performance chasing simply does not work.

The vast majority of individuals who chase fund performance get results that are far worse than a passive approach. Better performance tends to come to those individual investors who calm down and try to understand what actually has been demonstrated to work in the investment research literature.

1) The best mutual funds have no sales loads and no 12b-1 fees

The great majority of investors buy more expensive mutual funds through advisors and pay a very, very high price over their lives for doing so. You simply do not need to pay hefty sales commissions (loads and higher annual expense ratios) to financial advisers who will only offer to you those funds that will pay them these hefty sales commissions. Alternately, you do not have to pay percent-of-assets advisory fees to have a fee-based advisor choose mutual funds for you – you can do it yourself.

Donna Donkey asks, “Do you think this makes me faster?

Why do you think they call it a load anyway?"

When you pay someone's sales commission or percent of assets fee, who in turn only tells you about expensive mutual funds, you shoot yourself in both feet. First, you pay for inferior advice. Second, you end up living with fund expenses that kill a substantial portion of the growth of your personal investment portfolio. All mutual fund sales commissions, marketing fees, and asset fees can be avoided entirely by buying from the many mutual fund families that will sell fund shares directly to the public without such fees.

This investment fund selection criterion is very simple. Zero is the maximum amount of front-end load and back-end load fees that you should to pay. Zero is the maximum marketing or 12b-1 fee you should pay. You never need to pay percent of assets fees. Just say no.

However, because you are not going to pay these fees, you will also have to find the funds yourself. The good news is that very low cost, broadly diversified passive index mutual funds are very easy to find with this book.

2) The best no load mutual funds have very low management expenses

Lower investment management fees are better. Lowest is best, and the lowest means passively managed index mutual funds. Since there are numerous funds with annual expense ratios below .25%, always look there first.

The higher the annual fund expense ratio the more you should question why you should pay such higher expenses. Paying more tends to lead to inferior rather than superior performance net of you overall investment costs and capital gains taxes.

3) The best no load mutual funds have very low portfolio turnover

Lower portfolio turnover is better. Higher turnover increases hidden fund transactions costs, which tend not to be recouped through better performance. Look for single-digit and very low double-digit annual portfolio turnover rates in the no load index funds that you purchase.

4) Avoid large actively managed mutual funds

When they trade their overly large portfolio positions, large actively managed funds tend to affect securities market prices negatively. This can only drag down their net fund performance. The more these excessively large mutual funds trade, the worse it gets.

High trading costs suck value out of the mutual fund portfolio, and these costs are on top of the management fees that you pay directly. However, these trading costs are hidden, because they lower gross returns, which are not separately reported to fund shareholders.

High turnover by large funds should be a big red flag to you. If you avoid actively managed funds altogether, then your concerns about excessive fund size can be greatly reduced. Very large index funds need to manage their trading impact, but their turnover is far lower than actively managed funds. Therefore, total index fund trading costs are much lower. Not trading is a virtue.

5) Choose mature mutual funds

The mutual fund industry throws a whole lot of new fund spaghetti on the wall to see what will stick. If a new mutual fund has a lucky streak, individual investor assets and "advised" assets come running their way. This new fund becomes an accidental success — at least a success for the fund company.

However, when you invest in a very new fund, and it fails to grow, the fund is very likely to die or to be eaten. Rarely do lousy young mutual funds fold up with the investment fund company refunding your money. Why confess to incompetence and give back assets that could still yield fees?

When new funds do no attract enough assets, these "failed" funds (along with your invested and diminished assets) most often will get merged into other funds controlled by the fund family. Unfortunately, new failed funds tend to get merged into larger funds with noticeably inferior historical performance.

Investment fund companies do not want to take any of the luster off their currently hot funds, by blending in assets from these inferior funds that they intend to euthanize. Therefore, more likely than not your money will get tossed into one of their bigger funds with “doggy” performance or into one of their average funds.

To avoid participating in this frenetic new fund infanticide process, only pick funds that have been in business for at least a few years. Three years is probably enough.

6) Avoid very small mutual funds

Small funds cannot operate efficiently. They need a minimum critical mass of assets to fund required management expenses. Simply avoid very small funds. One or two hundred million dollars is probably the minimum. A higher minimum would also be fine, since there are still many larger funds to choose from that would meet these other criteria.

7) Screen to eliminate significantly inferior mutual fund performance

Evaluate the historical investment performance of mutual funds, but only after using other screening criteria. Superior or average past fund performance tells you absolutely nothing about how a fund will perform in the future. Pay attention to the fine print in the prospectus that says that past performance does not indicate future performance, because this has been shown to be true.

Ignore all the fund industry's selective marketing of only their past winners. Individuals need to move beyond their naive and flawed notions about projecting superior historical investment performance into the future.

Modern, highly competitive, and real-time securities markets are auction price setting mechanisms that force the mass of smart and not-so-smart professional and amateur investors to accept average returns over time. Only very poor past performance tends to indicate potentially sub-par performance in the future, and that is probably itself due to higher costs. Therefore, eliminate only the very worst of historical performance during fund screening and choose from the remainder — despite whether a fund has had superior, average, or even somewhat below average performance in the past.

Net of costs, four and five star funds are no better than three star funds and probably no better than even two star funds. Eliminate the bottom one-tenth to one-third of funds on a historical performance basis and choose from the remaining nine-tenths to two-thirds without stressing their past performance.

Instead, choose no load index funds with no sales charges, very low costs, and very low turnover. You should note that after applying the first six of the seven investment fund screening criteria, it is very rare than any funds with substantially inferior performance remain on the screened lists. As you cut investment costs of all kinds to a minimum, you automatically knock out the dogs, without having to do so directly.

Passive, low cost, no load index mutual funds usually have higher net risk adjusted performance

If you evaluate the investment research literature, you will find that portfolios that hold passive, low cost, no load index mutual funds are far more likely to lead to higher risk adjusted net investment performance over the long run. You can help to break the cycle of frequent fund buying and selling. You can get off the performance chasing hamster wheel that the securities industry wants you to keep running on for your entire life.

Securities sales people and financial advisors get paid more, when you pay more. That is why they shamelessly tell you that you must "pay more to get better performance." This is complete rubbish. The investment research literature says the opposite. When you pay less, you tend to get more.

Push the button — get some sales incentive cheese. Tell naive investors to pay more — get some more expensive cheese in the form of big bonuses. That is why financial sales people keep hitting their incentive buttons over and over with their clients. Their incentives are to sell you expensive financial products, because that is where their bonuses and their employers' profits come from – not from low cost investments.

When financial salesmen push their buttons and sell expensive funds to you, they get paid very well and their firms get paid very well. You end up being the one who pays them out of your own investment returns. However, there is no researcher to watch over the process by taking notes and rigorously comparing performance.

Very few individual investors take a close look at their risk-adjusted results and compare them to the net results they would have gotten from the passive, low cost investment strategy that was also available to them. Had their financial advisor been willing to over-come these inherent conflicts of interest and suggest a low cost, passive strategy, the investor would more likely have done better.

Most incentivized financial advisors are just salespeople, and they are trained to disparage low cost investing. Just ask about buying low cost investment funds, and you will find that the most common tactic is for the advisor to laugh at the idea. This client humiliation tactic deftly avoids a rational discussion. Since the logic and evidence is consistently on the side of low cost strategies, why even engage in a rational discussion with a client? Most clients are uncertain about the complexity of investing and many unjustifiably view financial advisors as masters of the investment universe. Too many clients will just shut up and go along with these advisors.

Most clients do not realize that many financial advisors just parrot the sales talking points they are trained to deliver and that these advisors never bother to track and understand investment research. If financial salespeople really understand the investment research literature, — and most do not — they just hope that you will never figure it out. Or, they hope that you will not realize the problem until years later, after they have been paid their bonuses and your personal investment portfolio is smaller than it could have been.

However, if you have already figured out the problem, then these 7 selection criteria offer you a better solution and a relatively straight-forward way to pick better load mutual funds. Become an extremely cost-conscious consumer of financial and investment products today, and you will start to control the only lever you really have available to improve your future net investment performance.

12.2: Valid, research-based selection criteria for ETFs

Rational selection criteria for ETFs have significant similarities with those of mutual funds. US investors have a universe of about 1,500 available ETFs and other exchange-traded products to select among.

High cost ETFs do not justify their existence through better risk-adjusted results. While there is a great deal of variability performance outcomes across ETFs, these results predominantly demonstrate just random chance patterns associated with index selection. Very low cost management expense ratios tend to be highly correlated with other important investment cost-efficiency factors, such as very low fund portfolio turnover, and the absence of unwarranted financial advisor sales fees. While the presumption might be that higher cost ETFs lead to superior returns, the research literature indicates that the opposite is the case.

You can buy these ETFs through a discount broker and cut out the expensive middle-man. The investment research literature does not indicate that financial advisors and full-service brokers have any better insight or any consistent skill in picking superior actively managed funds. The high fees of financial advisors and brokers just erode your returns and cause you to fall further behind a passive, buy-and-hold index fund strategy that uses ETFs that are purchased via discount brokers.

Passively managed index funds are designed to track a market index and almost all ETFs are passive index tracking funds. They do not need to repeatedly buy and sell securities and thus turn over their portfolios in pursuit of superior returns. Passively managed index funds are designed to track a market index. Therefore, index funds do not need to incur the increased trading costs that are associated with higher "alpha-seeking" portfolio turnover.

With investment portfolios, trading can be very costly, and less trading is better than more trading. Pay attention to turnover and other factors as you evaluate any particular investment. If you do not have a compelling reason to choose a fund with higher turnover, then do not buy them.

Choose ETFs with the lowest management fees

The higher the annual management expense ratio of a fund, the more you should question why you should pay higher portfolio management expenses for that fund. Paying more tends to lead to inferior rather than superior performance net of your costs and taxes. Lower investment management fees are better. Lowest is best, and the lowest will always means passively managed index funds. Since there are numerous ETFs with annual expense ratios below .25%, always look there first.

A higher management expense ratio and greater inefficiencies tend to cause an ETF to trail the returns of other lower cost ETF in the same asset category. You should note that most of the investment fund research data focuses on mutual funds. Compared to ETFs, mutual funds which have decades more data and ten times the invested assets. The great majority of mutual funds have been actively managed funds with significantly higher management expense ratios. A higher management expense ratio can only be justified, if an investment fund earns an even higher net return that compensates for its higher expenses. The research literature on higher cost actively managed investment funds is very instructive. In a nutshell, the more you pay, the less you keep.

The best ETFs have very low portfolio turnover

Lower portfolio turnover is better. Higher turnover increases hidden fund transactions costs, which tend NOT to be recouped through better performance. Look for single-digit and very low double-digit annual portfolio turnover rates in the ETFs that you purchase. The only exception is shorter-duration bond funds, which by their very nature must be replenished more frequently and thus tend to have higher turnover ratios. Nevertheless, you can still use the turnover to detect excessive turnover. For example, if a short-term bond fund has an average duration of two years, then around 50% would be its natural portfolio turnover ratio.

Avoid actively managed ETFs

In the research literature, actively managed mutual funds have a poor record of risk adjusted performance relative to passively managed index funds. Their excessive trading drives up costs and when they are very large their trading temporarily affects market prices to their detriment of their shareholders.

Active ETFs have different problems, but they still have problems. First, the good news is that there are relatively few actively managed ETFs, even though more have been introduced to the market in recent years. Unlike actively managed mutual funds that can hide their investment changes, ETFs cannot. Regulatory requirements still allow for delayed reporting of mutual fund portfolio composition by many months, but ETF composition is known daily to outsiders.

Also, certain leveraged and/or inverse long and short strategy ETFs can have surprising performance and volatility characteristics. Leveraged and inverse ETFs tend not to be appropriate for long-term buy-and-hold investors. Investor might not obtain the returns that they expect with these ETFs, even if the market moves in the desired direction. Leveraged and inverse ETFs tend not to be appropriate for long-term buy-and-hold investors. Before you invest in any leveraged or inverse ETF, see this SEC webpage:

SEC “Updated Investor Bulletin: Leveraged and Inverse ETFs” Feb. 23, 2023

https://www.sec.gov/investor/pubs/leveragedetfs-alert

Choose more mature ETFs

The fund industry throws a whole lot of new ETF spaghetti on the wall to see what will stick. Individual investor assets and "advised" assets run to investment funds with lucky streaks, because they chase after past performance. Many small, new funds becomes accidental successes — at least successes for their fund company parent.

Since most ETFs are just index funds, success with the majority of new ETFs is largely a function of lucky market timing for the index itself and not apparently clever securities selection. Sometimes narrowly constructed indexes are designed cynically to cherry pick investment history. The problem with cherry picking indexes is that the cherries tend not to re-grow.

The longer experience of the mutual fund industry is informative about the risks of investing in very young funds. The most significant problem is that performance chasing investors will buy into hot investment funds with high fees, but not pull out their money when performance cools off or turns to ice. These investors keep hoping for a revival of prior hot performance and they leave in their money and keep paying excessive fees. However, when new funds fail to grow, they are very likely to get shot and/or be eaten. This is also becoming a regular feature of the ETP market, just like it has been in the mutual fund industry for a long time.

Fund innovation to meet investor demand?

Investment fund companies always argue that they are trying to offer innovative new stock and bond funds to meet evolving "investor demand." This is largely rubbish. Most fund companies are trying to get your assets into their funds and make a profit off the fees. A true innovation motive is quite unlikely, because tens of thousands of mutual funds and ETFs of all types already exist worldwide.

A more cynical view of this frenetic fund birthing process is that fund companies recognize that fund performance is much more a matter of luck than skill. If fund families keep forming new funds, then some of these new funds will perform better by chance than the average fund within a particular investment category.

In the Warner Brothers movie *300*, the Spartans tossed to their deaths those babies whom they deemed to be inferior. Investment fund companies also are quite Spartan in this respect. Unfortunately, most fund companies do not extend this Spartan mentality to the management expense ratios that they charge investors across all their funds.

The founder of the Vanguard Group, John Bogle, has a similar opinion of innovation in the financial services industry. He said, "One thing you can easily say is that we're over-innovated in the financial markets. We innovate because we find a "product" – a word I detest using in this business – that we can sell and make a lot of money on. That's the system. That's the way capitalism works. But with these brilliant quantitative croupiers taking those unusual derivative risks that they may not even understand, the more they take, the less the investor earns. An asset delivers a certain return over time, and trading back and forth with one another doesn't increase that return. Since trading is costly, it actually reduced the return. We've complicated the system. Innovation makes it worse." (Journal of Indexes, September/October 2013, Volume 16, No. 5, p. 40)

Avoid very small ETFs

Small ETFs cannot operate efficiently. They need a minimum critical mass of assets to fund required management and trading expenses. Simply avoid very small funds. Minimum required assets for a fund to have a reasonable level of efficiency are probably in the $50 million to $100 million range. You should look at the asset base, the age of fund, the sponsoring vendor's commitment to a broad line of low cost ETFs, etc. and make your own judgment whether the fund you intend to purchase will have enough assets to operate efficiently in the future.

To keep things in perspective, if an ETF has a management expense ratio of .25%, then $50 million in assets would generate about $125,000 per year, which is a rather modest sum in the world of investment management. This is why even greater levels of invested assets are preferred. However, investment fund companies with numerous ETFs can obtained increased operational economies of scale across their family of funds. This allows them to operate smaller funds efficiently with lower expense ratios and reduces the risk that these smaller funds will be shut due to lack of profitability as assets grow.

Screen to eliminate significantly inferior fund performance

Use the other screening criteria above, before evaluate historical investment fund performance. Very inferior historical performance could be a slight indicator of possibly inferior future performance. However, after you have screened funds using the other criteria listed above, you will have already eliminated all diversified funds with significantly inferior performance. In effect, this last screening criteria is redundant.

The valid use of fund performance data needs to be stated explicitly, because the very first thing that a large majority of investors will look for is the historical performance record of a fund. However, those investors are not looking to eliminate significantly poor performance. Instead, they are looking for superior past performance, so that they can toss their money in after the fact and naively hope that the performance trend will continue.

Pay attention to the fine print in every prospectus that says that past performance does not indicate future performance, because this has been shown to be true. Ignore all the fund industry's selective marketing of only their past winners. Individuals need to move beyond their naive and flawed notions about projecting superior historical investment performance into the future.

Modern, highly competitive, and real-time securities markets are auction price setting mechanisms that force the mass of smart and not-so-smart professional and amateur investors to accept average returns over time. Only very poor past investment fund performance tends to indicate potentially sub-par performance in the future, and that is probably itself due to higher costs. Therefore, eliminate only the very worst of historical performance during fund screening and choose from the remainder — despite whether a fund has had superior, average, or even somewhat below average performance in the past.

When you buy an index fund, you should get close to the return for that index - less whatever fees you choose to pay. Superior historical performance is just a mirage that makes too many naive investors buy certain funds, but only after their superior performance is likely to have waned. Because the financial industry and the financial press keeps pushing historical performance information in front of you, you need consciously to ignore it and instead focus on only buying funds with lower costs.

Chapter 13: Financial advisors and the financial services industry

Most of the financial services industry does not even attempt to train their employees to tell you what is best for you. It trains them to be persuasive and to sell to you what is more profitable to them as quickly as possible. Most information provided by the financial industry is self-serving and is designed largely to ease this sales process. If you have some notion that this industry really wants to do what is best for you, then you need to get a clue. This industry self-interest problem is particularly acute with investments.

Because realized investment values will be known only in the sometimes very distant future, individuals can hear both good and bad advice, and they may have no way to tell one from the other. Unfortunately, investments do not have warrantees. If your financial plan and your investment portfolio fall short in the future, all you will have is an empty wallet, when it may be far too late for you to recover.

Directly or through insinuation, the "we are superior" mantra of the financial services industry has been never-ending. Securities price volatility permits the false appearance of skill among industry practitioners, when most lack superior skills. Claims of superiority are based predominantly on the selective marketing of investment products that happened to have done better than average historically. Other products with inferior performance from the same organization are forgotten conveniently, or they are relegated to small print in a footnote.

Because financial product quality is so highly variable, many individuals cannot objectively determine who is and who is not expert and honest. It is difficult to find another industry where ignorance, self-interest, and double-speak are so prevalent. Is it any wonder that millions of people are confused and frustrated about personal finance and investing?

As a result, many people are very distrustful of the financial industry. A 2002 U.S. public opinion survey of trust in various industries indicated that distrust of the financial services industry is deep and widespread. This post-dot-com crash Golin/Harris survey of 700 Americans found that the average industry had a -20% rating on an opinion scale of -100% to +100%. The "Brokerage/Wall Street" (-58%) and "Insurance" (-59%) industries ranked near the bottom of all industries in terms of public trust, with only the "Oil & Gas" (-63%) industry scoring lower. While I am curious what these statistics would be after the more recent credit crisis and "Great Recession," a follow-on survey has not been published. I suspect that public opinion now would still show these three industries tied in a race to the bottom.

13.1: Your best interests versus the financial industry

Financial science drives industry product development, but not necessarily toward the best interests of individuals. Personal financial decisions seem to have become very complicated. To add to the confusion, the financial services industry develops an unending array of supposedly innovative new products. However, a large part of the complexity that individuals face results from the proliferation of repetitive financial products in a myriad of flavors with different features and different financial trade-offs. What is "best" and "right" for individuals easily gets lost in the ensuing confusion.

Well-educated specialists in the financial services industry have been the primary non-academic consumers of academic research in finance. Creative "sell-side" professionals select from this research to develop sometimes innovative, but most often simply repetitive financial and investment products for sale to "buy-side" institutions and to individuals. The institutional "buy-side" of the financial industry tends to be more knowledgeable and discerning consumers of these innovations, when compared to individuals. However, in turn, the institutional "buy-side" of the industry also develops innovative and/or repetitive financial products and services, and then offers them to individuals either directly or through the financial advisor network.

Along this chain, objective academic knowledge of what is "best" and "right" for individuals tends to morph into product development and sales strategies that appeal to people's personal insecurity, greed, and ignorance. Sales messages pander to people's frustrations and need for simplification of what the industry itself has turned into a highly complex subject. In addition, along this chain of financial product development, many offerings to individuals tend to pick up extremely undesirable characteristics, in particular, high risk and high costs. Furthermore, products and indexes may be developed to exploit erroneous investor beliefs, such as trend extrapolation related to superior historical performance.

Much of the financial product complexity that individuals face is unnecessary and can be dispensed with through use of scientifically based product screening criteria. Much of the complexity that individuals face results from the proliferation of repetitive financial products in a myriad of flavors with different features and different financial trade-offs. In an often highly arbitrary sales process, industry agents attempt to sell this vast array of financial products to consumers. Without doing highly personalized and sophisticated needs analysis, a thin veneer of ersatz financial planning is offered. This faux financial planning is followed rapidly by a "consultative" sales process that usually pushes excessively risky and costly products.

In their pursuit of sales compensation, it does not really matter to many sales agents that your particular financial needs are square-shaped or octagonal-shaped. You are the sales prospect at hand. If you are susceptible to the sales pitch de jour, your real financial needs may get hammered into the round hole that that a particular sales person has a personal financial incentive to fill. What is "best," "right," or even appropriate to an individual's needs and circumstances may take a back seat to making the sale.

After intelligent individuals wade through the intricate tradeoffs between financial alternatives, decision fatigue is highly likely. It is no wonder that many people just want someone to trust who will give them a simple answer to this largely industry induced complexity problem.

Because the preceding paragraphs might seem to have a cynical tone, it may be necessary to remind you that there are many, many thousands of good and ethical financial advisors in the profession. Furthermore, scientific studies of the practices of individual investors who lack good advisors have demonstrated that many individual investors are sorely in need of competent help. With that in mind, however, you should be very careful about your advisor selection process.

You might like to read a recent and very enlightening study that touches on some of the problems discussed above. After reading this study, you might change your mutual fund buying habits and save yourself substantial sums of money for the rest of your life. In this Harvard Business School finance working paper, "Assessing the costs and benefits of brokers in the mutual fund industry, "Professors Bergstresser, Chalmers, and Tufano analyze the value-added of the broker sales channel for mutual funds. [1] In their conclusion, they state that "We begin with a positive hypothesis: the prominence of funds sold through brokers implies that brokers provide consumers with valued services. Our study has identified few, if any, of these benefits."

In fact, out of the six potential benefits of broker sold mutual funds, Bergstresser, et. al., found no value provided by brokers in five of the six hypothesized potential benefits. For the remaining value hypothesis, which was that brokers could help investors find less well-known mutual funds, they did find evidence that brokers could held investors to find these more obscure funds. Unfortunately, the less well-known funds that they put investors into tended to be smaller in-house proprietary funds with higher expenses and inferior performance.

In short, brokers provided either no value added or negative value added in the selection of mutual funds for their clients. This is a rather stark conclusion, when you consider that over three-quarters of mutual funds are now sold through brokers and other financial advisors. In buying mutual funds through brokers and advisors rather than purchasing them directly from fund companies, individuals incur very substantial front-end or back-end sales load charges, and they pay substantially higher ongoing fund management and marketing expenses. Individual investors unnecessarily waste many, many billions of dollars every year by purchasing mutual funds through brokers and advisors rather than buying directly.

1) Bergstresser, Daniel B., Chalmers, John M.R. and Tufano, Peter, "*Assessing the Costs and Benefits of Brokers in the Mutual Fund Industry*" (January 16, 2006). AFA 2006 Boston Meetings

13.2: The securities industry is not your partner

Individual investors need to understand that their interactions with financial industry intermediaries are a "zero-sum game" before transactions and other costs and a "negative-sum game" after costs. The industry's visible fees and hidden costs can siphon away a significant part of potential returns without providing individual investors with commensurate value.

The financial services industry offers products and services for investors to buy at prices that include both the market value of the investment securities plus the costs and profits related to the sale. Often the true cost of the industry's markup is obscured and hidden behind a veneer of "advice."

Individual investors need to understand that their interactions with the financial markets through these industry intermediaries are a "zero-sum game" before transactions and other costs. In and of itself the industry does not create any additional securities market value beyond providing liquidity, efficient pricing, and convenience. However, the industry can siphon away a significant portion of individual investors' potential returns through its visible fees and hidden costs. See: Passive investors are "free riders" who let active traders pay the bills

Adopting investment strategies based on scientific investing is the first part of investment cost reduction. Scientific investment strategies are inherently more cost-efficient, which contributes to improved risk-adjusted returns. This should not be surprising, because a primary goal of investment science is to discover cost-effective strategies that maximize individual investors' economic welfare.

However, even with optimal investment strategies, there is still substantial room to improve upon net investment performance. Skilled investors must carefully identify and control visible and hidden investment costs and taxation to ensure that they obtain the best net returns from their securities assets. Through continued and vigilant focus, investment costs can be reduced and tax realization minimized.

Investment cost control also calls investors' attention to the potentially negative impacts of biased and sub-optimal advice. The costs associated with these conflicts of interest between individual investors and the financial services representatives continually threaten investors' net returns. See: Does it matter how financial planners and investment advisors are paid?

Particularly with the abnormally high market returns for equities-based securities during the last two decades of the 20th century, many individual investors became very lax about managing their investment costs and minimizing tax realization. The fees extracted by the financial securities industry increased substantially during this period. At the same time industry deregulation, market innovation, and increased competition provided many new and useful mechanisms for individual investors to manage their assets in a much more cost- and tax-efficient manner.

Many investors need to give this topic a far higher priority. Securities investment costs are not "just a few percent." Instead, they can be a huge portion of your gross returns, and they can dramatically reduce you net long-term investment portfolio assets.

13.3: Independent investment advisors and counselors

Pick financial advisers and investment advisers solely to obtain objective and high quality financial advice. Specific financial counsel and investment counsel is potentially of high quality, only if it is carefully customized to your particular needs and only if it is given by an adviser who is independent, knowledgeable, and competent. If you agree with the advice being given, then buy the recommended securities and other financial products through the most inexpensive channels possible.

The only reliable way to ensure the potential objectivity of any financial planning advisor or investment counselor is to pay directly for the adviser's services, after investigating the adviser's background, competence, and work ethic

There are no shortcuts. "Free" advice is NEVER free. In fact, free advice is usually far more expensive than the advice that you receive from an advisor whom you pay directly. When you choose to obtain "free" advice, in lieu of paying fixed hourly services or a fixed fee for a planning project, the long-term costs to you can be horrendously high. However, these huge costs are largely hidden and that is why this industry game of "free" financial advice keeps going on.

Advice that is contingent on any expectation that you will purchase products through your financial counselor or adviser is subject to a major conflict of interest. Financial advisers, who are not paid directly by you, must instead derive their compensation from commissions and other fees paid by the financial services industry. By following "free" financial recommendations, you are much more likely to pay a significantly higher price over the long term.

"Free" investment and other financial advice can become incredibly expensive advice – not just because of the high commissions and high visible and hidden costs. In addition, you may end up buying inferior financial products, because the free recommendations lead you to buy financial products that were not the best for your needs and that are not the best products available.

If you take the "free" advice of financial advisors and investment counselors who are paid by the financial services industry, you are more likely to achieve inferior long-term investment returns

For example, many people pay investment front-end sales loads for advice that seems free. Industry representatives willingly tell you that their advice is both free and good. Advice paid by the financial services industry is neither free nor necessarily good. You just end up paying a financial sales rep to sell to you and in the process perhaps to confuse or mislead you about the facts.

The industry argument is that the advice is free and that you only have to pay, if you do follow the good advice that is given so freely. Well, sales loads and good financial advice are a contradiction in terms. For example, industry-paid financial advisors do not get paid to push better investment index mutual funds with the lowest costs and the best future prospects.

Much better advice can be found, when you look of it. If you buy and hold very low cost, low turnover, and broadly diversified passive index mutual funds, you are more likely to get better net long-term total returns after taxes, fees, and other costs are taken into consideration.

Unfortunately, when you follow this kind of "free" investment advice, it often leads you to pay a sales load, which compensates your adviser and his firm. When you pay a front end sales load, your initial assets are lower, which obscures the huge long-term cost of the load itself. In addition, the mutual funds that are recommended tend to carry more expensive management expense ratios and higher hidden investment portfolio trading costs.

Furthermore, a 12b-1 fee gets tacked on every year. With a 12b-1 fee, the same investment counselor who gave you the "free" advice will get paid over time to stick around and sell you more of the same. Financial sales loads, excessive asset fees, high cost active investment strategies, and a myriad of other suboptimal financial industry strategies and products typically bleed 1/4 to 1/3 of the typical individual investor's portfolio annually. This waste compounds year after year after year, until individuals and their families get smart and realize that "free" is not really free and that "just of percent or two" has a huge cumulative negative impact on their financial welfare.

A financial advisor or investment counselor who has a conflict of interest can be very dangerous to your long-term personal finance interests

Many industry-paid advisers are ethical and helpful. However, others who are just salespeople masquerading as advisers taint reputations of ethical advisers. Furthermore, even industry paid advisors face a career-long struggle to be independent of financial industry influences. They must spend their careers balancing the best interests of their clients against the interests of the financial companies that employ them. They must weight continuously the best interests of their clients against their own personal financial interests, paychecks, and bonuses.

Think about the continuing dilemma that an ethical person faces, when the financial services industry and not their clients pay them. Training programs for industry compensated financial advisors and investment advisors focus on selling, selling, and more selling. These people are classified as "producers" by the industry, because that is what they do. They produce revenue and profits for their companies. These revenues and profits come from you. See: The Financial Services Industry is Still the Largest S&P 500 Sector – Even after the Collapse of its Stock Values.

When a financial advisor is not independent of the financial services industry, you can never be certain whether you are getting the best advice or just falling for the latest financial sales pitch

Once an ethical and newly minted financial counselor emerges from a financial industry training program and starts a financial sales career, the pressure to produce is constant. His compensation program will provide incentives to take more and more from his clients and will pressure him to pull in more and more assets to manage.

His company will constantly pressure him to perform and produce more revenue. If you have any doubt about this, you should investigate the financial incentives that are offered to retail financial advisors and investment counselors. The financial sales and marketing programs are designed to drive higher revenues and higher profits. Again, you are the source of these higher revenues and profits. See: The Securities Industry Calls Marketing and Selling – "Advising"

Now, think about the not-so-ethical financial advisor who is paid by the industry and thinks first about his or her paycheck and bonus, before taking care of your personal financial interests. You do not stand a chance. In the name of supposed "innovation" the financial industry has introduced so many new products and services that they greatly confuse the personal financial planning and management process. In and of itself, financial product innovation can be a good thing. However, large problems arise when this flood of new and expense financial products combines with not-so-ethical advisors and the marketing and sales culture of the financial services industry.

US financial services industry regulation is minimal at best. When a loose regulatory environment is combined with not-so-ethical financial advisors and investment counselors, almost anything goes. Most financial consumers are confused and outgunned. If industry sales reps can push expensive, high compensation products into the "retail" financial consumer channel, they will. There is little to stop them from emptying the wallets of naive retail financial consumers and individual investors.

You have to seek out and find independent financial advisors and independent financial counselors proactively

Most of the financial counselors who will actively approach you are industry paid "financial consultants." They just want to add your financial assets to their "book of business." When control of your assets is the primary objective, where will your best interests fit into the picture?

You should never have to waste your time and emotion second-guessing your advisor's motivations. Often, self-interested advisors are well trained, and their sales presentations are sophisticated and polished. It may be a challenge to tell whether the advice given is in your best interests or whether it serves the financial interests of your adviser and the company he represents. If you become more knowledgeable about how the personal finance advisory industry works, you can better assess the quality of the financial and investment advice that you receive.

Chapter 14: Paying financial advisors

14.1: Economically paying a good advisor for good advice

Good financial advisors can be valuable to you, and they deserve reasonable compensation. VeriPlan can help you to determine how much you are paying for financial advice, so that you can decide whether your advisory costs are reasonable. The Skilled Investor website also provides informative articles on the subject of advisor selection and compensation.

The compensation of financial and investment advisors is both an extremely important and complex topic. If you choose to use financial and investment advisors, you need to decide how much you are reasonably willing to pay them. This section provides some observations that may help you to decide how to set your maximum reasonable investment costs related to advisory payments above. Also, read the numerous articles on the subject of advisor compensation, which are available at my *The Skilled Investor* website.

First, you obviously only want to pay good advisors who give scientifically-based and objective advice. With that in mind, you should be very careful about the advisor selection process. There are many good advisors in the profession, and scientific studies of the practices of individual investors who lack good advisors demonstrate that many individual investors are sorely in need of competent help. Unfortunately, there are also many less competent and some ethically compromised advisors. Furthermore, many good advisors simply charge more than their services are worth. Good advice versus no-so-good advice and reasonable versus unreasonable fees are difficult issues for investors. If this topic is important to you, you may wish to review the numerous articles on the subject of advisor selection available on *The Skilled Investor* website.

This is a short list of possible value-added services that a good advisor might provide:

* comprehensive, detailed, and written financial and investment plans that you understand and agree with
* savings and expenditure control coaching
* broad, low-cost diversification
* accurate risk preference assessment with low-cost asset allocation strategies
* portfolio optimization across all assets including cash, bond, and equity financial assets and across property, private business interests, and labor income
* tax optimization
* education and counseling on behavioral biases (e.g. familiarity, performance chasing, overconfidence, herding/media, holding on to losers, mental accounting, etc.)
* referrals to competent and ethical specialists
* administrative convenience

The following is an very incomplete list of dis-services that a not-so-good advisor might provide:

* using your assets to try to beat the market with costly active strategies that make money for him and not you
* selling you whatever you are emotionally predisposed to buy and can be more easily talked into buying
* pushing investment products and services that involve layers of visible fees and other hidden charges
* churning your account by frequent buying and selling, which is designed primarily to generate commissions
* excessively fine tuning your portfolio's asset allocation, while generating fees and incurring taxes
* putting your assets into a fee-based investment program and providing services of far less value than you pay

This list of dis-services could be much longer, but you get the idea. The fundamental sources of the problems typically are twofold:

* The advisor does not either understand or believe in scientifically-based financial planning and investing. He just makes the same mistakes you could have made on your own without paying him. OR
* The advisor puts the financial interests of himself and his firm before yours, whenever you let him.

Concerning reasonable advisor compensation, consider these thoughts:

You need to determine how much help your really need and to estimate the value-added that you expect from an advisor. Use this investment cost-effectiveness tool to test the full lifetime cost of the direct and indirect fees that you pay your advisor.

Be willing to pay a clearly defined and fully visible fee for the value you receive. Valuable advice from a good advisor deserves to be compensated reasonably. Nevertheless, the value you receive should always clearly exceed what you are paying.

Be wary of advisors and firms who get paid repeatedly for numerous services. For example, if you are willing to pay a moderate percent of your assets annually as an advisory fee, are you also paying additional fees for actively managed asset strategies plus load charges to buy the funds to implement the strategies plus ongoing annual sales charges, etc.? Many good advisors have a very simple compensation schedule, and they avoid a proliferation of fees and multiple levels of visible and hidden charges. They focus on finding low-cost investments for you, and low-cost investments tend to lack incentive payments for advisors.

Be wary of advisors and firms who are not willing to spell out clearly all sources of their direct and indirect compensation and/or those who make you feel uncomfortable when you inquire about the subject or attempt to negotiate about services and related fees.

14.2: Does it matter how financial advisors are paid?

Yes, it can matter significantly how a financial advisor is paid. The heart of the compensation issue is an advisor's potential "conflict of interest" with respect to payments from third parties. Does third party compensation change the quality of the recommendations that the advisers make? If an advisor works on sales commissions or accepts other third party payments, will he still provide the best recommendations based solely on the client's best interests?

The good news is that the great majority of advisors are ethical. They work to manage properly the conflicts of interest associated with third party compensation that most advisors receive. Many objective, competent, and ethical practitioners are doing excellent jobs for their clients – no matter what their source of compensation.

Fee-only advisors, receive compensation directly and solely from their clients. Other advisors receive compensation from third parties. Some may receive both. When choosing an advisor, individuals should first decide the type of advisor compensation that makes them most comfortable.

However, the problem for individual investors is not the ethical majority of practitioners. The problem is the ethically challenged minority. The heart of the conflict of interest issue is whether a client can tell the difference between an ethical practitioner who "just happens to be paid by third parties" versus an unethical advisor to whom the client's interests are secondary.

As you might expect, substantial controversy exists within the advisory industry about which forms of advisor payment are better for the client. Fee-only advisors argue that they have absolutely no conflict of interest in their obligation toward their clients. Assuming that a fee-only advisor is competent and diligent, a client can reasonably expect that the advisor's recommendations will be objective and in the client's best interests. Fee-only advisors say that commissioned advisors are just disguised salespersons.

Advisors who accept various forms of third party compensation insist that they can be objective. They also contend that they still can and do offer the best products to their clients. I have a lot of doubts about this contention.

Some commissioned advisors suggest that they are more motivated to meet clients' needs. They say that their advice costs nothing, unless the client acts on a recommendation. Commissioned advisors may say that fee-only advisors are too disinterested, because they are paid whether or not a client acts upon their advice. They also argue that a client will still have to pay a transaction charge, if he were to go elsewhere to make the recommended purchase. Note that the size of the transaction charge is the crux of the issue, as well as the ongoing charges.

Note also that conflict of interest relates only to suboptimal advisor recommendations and to associated actions that confuse fiduciary priorities. Clients will still receive legitimate financial products for their money. These products just might not be the best or the most cost effective product available. More severe ethical shortcomings involve outright fraud. For more information on protecting oneself from advisor fraud, see other parts of this book.

14.3: The true cost of financial advisors

Financial advisor costs and the value of their investment strategies determine your return on investment from these investment advisor services

Whether good or bad, financial advisors are expensive. If you need a financial advisor's help and you carefully select a good financial advisor, the value of the personal finance and investment advice that you receive might easily repay the advisor cost. However, bad financial advisors can cost you dearly, though both high financial expenses and poor investment strategies.

You should manage your financial advisors proactively and ensure that they add financial value overall. If a financial advisor consistently delivers value in excess of his cost, you should be very happy to pay a fair price for competent financial advisor services. Knowledgeable and competent financial advisors with efficient services can help you to formulate comprehensive financial plans, keep you on track toward your financial goals, and gently steer you away from foolish financial decisions. They can deliver passive investment strategies that are low-cost, can align your asset allocation with your investment risk tolerance, and can rebalance your investment portfolio in a cost- and tax-efficient manner. Good financial advisors deserve reasonable pay for their advisor services.

On the other hand, some financial advisors are overly costly, and they drain rather than add net present value to your finances. It is very easy to overpay for financial advisory services. You can pay too much for your financial advisor via your direct fee payments and/or through the higher investment costs that you pay, which compensate your advisor indirectly.

Many financial advisory fees and other investment advisor costs are charged annually as a percentage of your portfolio assets, rather than as a percentage of your investment returns. However, your assets are already "your" assets. If you pay a percentage of your portfolio assets to an investment advisor, then reasonably you might presume that this advisory cost will be recouped through increased return on investment. Sadly, the opposite is often true.

Furthermore, you can over-pay repeatedly on a percent of assets basis. When measured on a percent of assets rather than percent of returns basis, advisory costs may appear to be quite modest. As a result, many investors never understand the true long-term impact of excess fees. However, when calculated on a percentage of returns basis, advisory costs simply can be huge, and you keep paying these excessive costs year after year. See this article: Excessive investment costs are a huge problem for individual investors

Furthermore, unless advisory percentage charges decline over time, you will pay much more as your assets grow. Without these charges, your assets likely would have grown much more rapidly. Individuals need to evaluate dispassionately whether an advisor really contributes enough to justify the percentage of assets that they pay to the advisor. Some advisors may justify these costs and others may not.

In addition, you can overpay very substantially for advice, because the strategy advocated by your advisor is itself excessively costly and thus more likely to be suboptimal. Through ignorance or self-interest, many advisors lead investors into excessively costly and unnecessarily risky active investments, instead of counseling them to adopt low-cost, passive, index investment strategies.

In general, advisors receive much more compensation from the industry to put individual investors into more active investments with higher costs. Some advisors' planning services are just superficial facades designed to sell high fee active strategy products. If you do not pay your advisor directly, then the financial services industry will pay him to put you into investments that are more profitable to your advisor and to the industry, but not necessarily to you. Many investors do this unwittingly, because they are told that active strategies are better. Most often, they will pay the bill through poorer performance and higher visible and hidden costs over their lives.

14.4: The economics of financial industry compensation

Everyone has similar, yet distinct, financial planning needs regarding their families' financial futures. More wealthy people (think millions of dollars) have greater complexity to their financial affairs – caused in large part by our incredibly convoluted U.S. personal tax codes. However, everyone needs some level of reasonably sophisticated lifetime financial planning. Whether wealthy or not yet wealthy, families need a personalized way to understand how their current financial behaviors could affect their families in the future.

Few people already own enough assets to justify the high cost of a competent and objective advisor

Only those who are wealthier now can afford to pay directly for highly personalized, professional financial planning assistance. Direct client payments help to avoid the conflicts-of-interest that are inherent and pervasive in the structure of the financial services industry.

The financial services and advisory industry is almost exclusively focused on the interests of those who already have substantial financial assets and not on the mass of Americans who were trying to become more secure financially. Using many hundreds of thousands of what the securities industry calls "producer" employees, the brokerage industry sells investment products and services to clients for transactional fees, asset holding charges, and many other more or less visible investment costs.

Governed by the Securities and Exchange Act of 1934, as amended, and state laws, the legal standard of client care by these brokers is the "suitability" of an investment to a client. However, there is huge latitude in what a suitable investment is and how much it costs a client.

From the brokerage industry's perspective, the wealthier the client is the better. Greater assets yield more revenue and higher profit per hour spent with clients. For example, before the financial crisis Morgan Stanley's 2007 compensation plan for their personnel serving retail clients eliminated all compensation for household accounts below $50,000, and it reduced compensation on household accounts under $75,000, unless these client accounts were being charged a percent of assets fee. Clearly, the message to Morgan Stanley sales personnel was and is to chase wealthier fish. Similar messages are given to broker producer employees in all brokerage firms across the industry.

As the recent and severe financial crisis arose and subsided, those who occupied many of the musical chairs of the financial industry changed. However, the financial incentives and compensation practices of the industry changed hardly at all. Since increasing industry concentration had never been challenged before the financial crisis, we were all faced with the "too-big-to-fail" conundrum. The professional — supposedly "smart money" — financial industry created a toxic financial environment for everyone, but they just "had" to be bailed out by taxpayers, so that the values of all of our houses would not burn to the ground collectively.

Subsequently, little if anything has changed — even with passage of Wall Street reform act in 2010. Before most of the country had realized just how persistently bad things would become in the general economy, the securities markets turned around in anticipation of future improvements. And, huge Wall Street bonuses started all over again. Yet, it was the taxpayer bailout money that keep the financial industry and the general economy away from the precipice of another great depression. Thus, financial market expectations rose off of extremely pessimistic depression expectations, allowing the industry to restore its profitability and fat paychecks.

Concerning how the financial advisory industry deals with the "retail public," which is discussed in this article, little has changed. If anything the industry's pursuit of the rich has intensified, while services to the middle class have declined. In summary, if you don't have substantial investable assets, then expect little attention and overly expensive commissioned products. If you do have substantial investable assets, then hold on to your wallet with both hands! You will be asked to pay a substantial percentage of your assets year after year with no reliable assurance that these fees will improve your welfare in the long-term.

Most registered investment advisor compensation is proportional to client assets — the more assets you have the better for your financial adviser

Another large segment of the financial services industry that serves the public consists of about 100,000 independent investment advisor consultants, who are regulated at the federal and/or state levels. Governed by the Investment Advisers Act of 1940, as amended, and by state laws, these advisors have a seemingly more stringent standard of client care. However, again there is huge latitude in what constitutes minimally acceptable advisor service quality and how much advisory services will cost a client.

Most registered investment advisors deliver services that are charged as a percent of client assets under management. However, often many of these same advisors obtain additional revenues from the securities and insurance industry, when they sell commissioned financial products to their clients.

The wealthier the registered investment advisor's client is, the better it is for the advisory practice. The greater the client assets under management, the more total revenue for the advisory firm and the higher the client service profit per hour will be. The economics of the financial consulting industry create a mad dash to catch the wealthy.

If clients are to be given personalized attention and the valuable time of the advisor, each client must generate at least several thousand dollars in fees annually one way or another

Whether served by a broker or by an independent financial advisor, if an individual wants personal professional attention, that individual must already have substantial assets that can generate revenue to compensate the advisor. If clients are to be given personalized attention and the valuable time of the advisor, each client must generate several thousand dollars in fees annually one way or another.

The math is simple. For example, if average client servicing requires a skimpy 20 hours of attention yearly and a profitable hourly rate is $250 per hour, then the required average revenue per client is $5,000 per year. If $5,000/per year is the client revenue minimum for a practice, then the client needs to have $500,000, if the fee is 1% of assets per year. The lower the assets, then the higher the percentage necessarily must be – year after year after year.

Since clients usually balk at much higher fees, the revenue requirements of advisory practices mean that people with less assets will not get personalized services. Clearly, the vast majority of Americans do not fit the industry's economic profile of a profitable advisory client on an hourly basis. This is why there is so much effort to obscure and hide the financial and investment costs that clients actually pay.

The financial services industry and full service brokers hide their fees within and supposedly "free" but excessively costly financial products sold to the affluent middle class. The more the true cost can be hidden and the services offered as supposedly "free," then the easier it is to profit from the client, but not necessarily serve his or her best interests.

14.5: Industry-paid financial advisor compensation

This article focuses on third party paid compensation, which is by far the most prevalent method of adviser compensation. There are three primary types of third party or commission-based compensation:

* Commission-only: A third party pays commission fees, referral fees, or other fees to your advisor, and you pay nothing directly.
* Fee-based commission: Your advisor accepts commissions and fees from third parties in addition to fees he charges against your assets.
* Fee-offset commission: Your advisor accepts commissions and fees from third parties in addition to fees he charges against your assets. Your advisor rebates to you some or all of the fees he receives.

With commission-only advisors, there is no direct cost to the client for planning and advice. This makes third party compensation appealing to many people – it appears to be free.

Many individuals do not want to pay for directly for advice. By avoiding direct payments to an advisor, they hope that they will get a better deal. In addition, commission-only advisors argue that individuals only pay, when clients choose to follow the advisor's recommendations.

Since commission-only advisors are not paid unless they sell products, most clients find that 'planning' conversations focus quickly on the purchase of specific investment and financial products through the advisor. When the client buys a product, such as an investment security or an insurance contract, fees will either be deducted from the client's investment funds or will be related to the advisor by the financial industry firm that sold the product. The specifics about advisor commission payments may or may not be disclosed.

With the purchase of an insurance product, a commissioned advisor collects a fee, which could range upward to the amount of the first year's premium. He may also collect a smaller trailing fee each year, as long as the policy remains in effect.

For securities investments, some specific third party compensation may be disclosed.

For example, when one purchases mutual funds through a commissioned advisor, you will pay some combination of a) a front-end load or sales charge, b) a contingent deferred sales charge, and c) annual/periodic 12b-1 marketing fees, which are added to annual management fees. See:

Avoid mutual funds with sales commissions and 12b-1 fees,

How much do hidden mutual fund trading expenses cost you?, and

Beware of large and hidden mutual fund costs.

Mutual fund investors, who purchase shares through a commissioned sales advisor, are asked to make choices between Class A, Class B, and Class C mutual fund shares. As clients decide which of these share classes to purchase, the exercise appears to be about how to minimize investment costs. In reality, the client is deciding how their advisor and his firm will be compensated by the mutual fund for selling commissioned mutual fund shares to the client.

These Class A, Class B, and Class C mutual fund shares create an illusion of choice, yet more cost-effective alternatives will probably go unstated.

Were the investor to purchase shares directly from the same mutual fund or chose an equivalent no-load fund, they would purchase a different class and pay none of these fees. For more background on these mutual fund share classes, see this SEC Bulletin on "Mutual Fund Classes"

https://www.sec.gov/resources-investors/investor-alerts-bulletins/mutual-fund-classes

and FINRA "Investment Products: Mutual Funds

https://www.finra.org/investors/investing/investment-products/mutual-funds

Regarding the other two third party compensation methods, fee-based commissions and fee-offset commissions, these involve indirect compensation from the client to the advisor. The client does not pay a check directly, but fees will be charged against his assets and transferred to the advisor.

Regarding fee-based commission compensation, it is reasonably clear why this method is appealing to advisors. They receive payments from multiple sources, including you. However, you pay an annual percentage fee drawn against assets, and because of commissions, you still could receive biased advice that favors the financial interests of the advisor.

Regarding fee-offset commission compensation, this arrangement is a bit of an oddity. You will pay for the advisor’s services through asset management fees. In addition, your advisor will accept third party commission payments, but will rebate some or all of these third party payments to you. On the surface, this seems appealing, and the advisor may argue that this compensation approach is the best of both worlds. Seemingly, you pay for unbiased advice and, if there is a third party commission, some or all of these commissions may go toward reducing your asset fee payments.

What could be better? Well, there are some inherent difficulties with this approach. To ensure that the advisor remains completely unbiased from a financial conflict-of-interest standpoint, he should rebate 100% of commissions to you. However, advisors can have significant costs in maintaining commissioned sales relationships with financial services companies. These costs include demands to meet sales quotas plus order processing and other administrative costs.

If an advisor does not keep some of these commissions to cover his costs, then he will incur extra overhead without compensation. To cover these costs, the advisor would need to increase the fees that he charges against the client's assets. This negates the supposed advantages of fee-offset compensation. On the other hand, if he keeps some of the commissions, then how does the client know that the original advice was completely unbiased? Note also, that an advisor might be legally barred from rebating fees -- see NASD Rule 2420.

14.6: Client-paid financial advisor compensation

This article focuses on client paid compensation. These bullets summarize the three primary types of client paid advisor compensation:

* Hourly-fee: You pay your advisor an hourly cash fee for services rendered.
* Fixed-fee: You pay your advisor a fixed or negotiated cash fee for an advisory work product.
* Asset-fee: You pay your advisor a percentage of the assets that he manages for you.

Hourly-fee and fixed-fee are the most simple and direct compensation methods. Hourly fees for a competent advisor can vary substantially, usually ranging from $150 to $300, although advisory fees above or below this range can be found. Fixed fees for a truly comprehensive financial and investment plan might range from about $1,000 to well over $5,000.

With asset fee based compensation, the advisor provides a set of services and takes an annual fee, which is a percentage of your assets under the advisor's management

The advisor will take custody of your assets, and periodically he will charge a management fee against your assets. This fee is usually based upon an annual percentage agreed to by contract. Annual percentages vary greatly by advisor and by the services rendered. TIAA-CREF estimated that fee-only asset management charges typically range from 1% to 3% of managed assets annually. [1]

In addition, asset management fees are usually charged as a declining percentage as the amount of assets under management rises. A sampling of fee-only investment adviser websites indicates that listed percentages typically range from 1% to 1.5% for smaller asset balances and may decline significantly in percentage terms as assets under management increase to $1 million and beyond. Most asset fee based advisors require a minimum asset balance, often in the $100,000 range. Because asset management fees vary substantially, shopping around may be advantageous.

Whether any direct payment method is right for you will depend upon the value you expect to receive. If you pay hourly or for a fixed-fee deliverable, you also need to consider whether you have sufficient assets to amortize the cost of the advice. Will the advantages of the advice, such as lower financial product costs and/or improved personal investment performance, be substantial enough to offset the cost?

Direct adviser payments are a visible, current expense. Many people hesitate to pay directly for professional advice, because they do not know how to value it. Even if real advisory value is there, it could take a long period to manifest itself.

The decision to pay directly for planning advice is sometimes prompted by disappointment in prior experiences with commissioned advisers

Any competent and helpful financial advisor – fee-only or commissioned – deserves reasonable pay. Advisors have business and personal costs and profit objectives. Competent advisors will not work without compensation, when there is no charitable reason to do so. Often individuals will work with a variety of “free” commissioned advisors, before they decide that paying for advice might be a better alternative.

Of course, with direct advisor compensation the question remains whether the fees charged are reasonable. Some fee-only planners and advisors deliver superior price/performance compared to others. You advisor must set the quality standard for his value to you. Excessively priced advice warrants seeking assistance elsewhere.

Many people get comfortable with the personal relationship that they develop with an advisor, and they neglect to question the value delivered by the advisor. Investors should never lose sight of the fact that a paid client adviser relationship is still a business relationship. Clients also have ongoing ways to manage costs, when they work with an advisor. These methods include:

* controlling the number of hours billed by obtaining prior estimates of how much time a particular task will take
* negotiating the price and other parameters for a particular work product
* doing some of the work yourself

Do not to be bashful about managing your financial relationship with a paid adviser

The subject of the relationship is your money, and your future assets are at stake. It is not impolite to ask about and expect straight answers about compensation, expense control, and the value of an advisor's services.

A quotation from a letter written by Abraham Lincoln seems appropriate here. Corresponding with a legal client regarding a bill that had been paid, Honest Abe wrote, "Dear Sir, I have just received yours of 16th, with check on Flagg & Savage for twenty-five dollars. You must think I am a high-priced man. You are too liberal with your money. Fifteen dollars is enough for the job. I send you a receipt for fifteen dollars, and return to you a ten-dollar bill. A. Lincoln" [2]

1) TIAA-CREF website, "Choosing a Financial Advisor," May 26, 2004
2) The Living Words of Abraham Lincoln, Hallmark Editions, Library of Congress Card Number 67-21536; 1967, page 17

14.7: Interest alignment with fee-only compensation

Client paid fee-only compensation aligns client and advisor interests

Several important considerations favor using fee-only financial advisors over advisors and investment counselors who accept third party commissions and other payments. Fee-only payment arrangements with advisors allow clients to: 1) maintain trust and reduce unethical behavior, 2) separate financial decisions from purchases, and 3) obtain lower cost financial products. Percent of asset fees align client and advisor interests. Hourly fees and fixed fees unrelated to amount of assets can be even better from the standpoint of the client, when the advisor is competent and the advice is focused on the best interests of the client. With hourly and fixed fees that client knows what he or she is paying and keeps the full benefit of the advice.

Fee-only compensation arrangements allow individuals to maintain trust more easily. The client and advisor relationship should be based upon a bedrock of trust. Investors prefer never to feel the need to question the motivations behind any particular financial recommendation made to them. As in any other professional relationship, an investor wants to have absolute confidence in the competence, objectivity, ethics, and goodwill of his financial advisor.

When you engage a doctor for medical services, you do not want to worry continually about whether your doctor is competent and ethical or whether your medical interests will be sold out to the higher bidder?

In the practice of medicine, the lines of demarcation regarding ethical behavior and patient's interests seem much clearer than in investing. Doctors have an ethical tradition dating back at least to Hippocrates that has been honored by each new generation of doctors. (Recently, of course, escalating costs and managed care have intervened to place some ethical stress on the doctor-patient relationship. Interestingly, financial interests are at the heart of this conflict of interest in a doctor/patient relationship.)

As with the doctor-patient relationship, you want your financial advisor to put your interests on top. This often is difficult when money is involved. Except for the comfortably rich, whose means far exceed their desires, everyone else, including financial and investment advisors, feel financial pressures. Their kids need braces... a vacation would be nice... that sports car would be fun to drive...

When you want the best financial plan and personal investment strategy that you can get for you family, do you really want to have to worry about your financial advisor's ethics?

Do you want to wonder whether he is glibly spouting well-crafted sales messages, while he loads up your portfolio with high commission financial products to pay for his car, his vacation, and his kid's braces and not yours?

Fee-only advisors can better separate financial decision-making from the purchase of financial products. This helps to assure that the decision process is unbiased and that better financial products can be found for the client. Fee-only advisors can more objectively determine which particular financial products will better meet their clients' needs.

Firms in the financial services industry compete for the business of individuals and their financial advisors using different distribution strategies.

All financial services firms face challenges in finding efficient ways to advertise, market, and sell their products to advisors and individual investors. The net cost to an individual to acquire a particular kind of financial product with the same intrinsic value as another can vary dramatically due to these distribution issues.

To earn their compensation, objective and competent fee-only advisors will find better, more cost-effective options for their clients. Often the most advantageous products for individuals are those that do not bear substantial up front and recurring distribution channel costs. There will always be an associated distribution channel cost to pay your commissioned advisor.

Investors who use commissioned advisor are far more likely to acquire financial and investment products with higher distribution costs. Commissioned advisors will claim that their products are better, but such claims lack a factual basis. The scientific investment literature consistently has demonstrated that higher distribution costs mean lower returns for investors.

Saving on distribution channel costs is just one very important way that a fee-only financial advisor can save money for clients.

In addition to the high distribution channel cost, commissioned products may not necessarily be the best available from the point-of-view of the client. Fee-only advisors can identify the best products from across the industry. They are not restricted only to those that pay commissions.

Like ancient maps of the unknown seas, navigating the sea of advisor self-interest requires us to put the label "Here There Be Dragons" on some parts of the advisory map. The simplest way for an individual to avoid conflict-of-interest problems is to employ a fee-only advisor, after also assuring that he or she is competent, hard-working, and reasonably priced.

14.8: Can you get the best advice paying sales loads?

Can you get the best advice, when you pay sales loads?

This article focuses on investment sales loads and other investment costs borne by investor that are related to marketing costs. Numerous and excessive investment costs are a plague on your personal financial planning. Excessive investment expenses are one of the most significant barriers to lifelong family financial security. While financial services industry sales people tell you that you need to pay more to get more, the correct answer is the opposite. If you pay less, you are likely to get more.

Through intense competition, the investment industry pursues individuals who have money to invest. Industry sales representatives will try very hard to induce you to purchase their investment products and services. The terms "advice," "counsel," "recommendation," "trust," "relationship," etc. are used constantly during this sales process.

Most individual investors have a great need for competent and objective investment advice. At the same time, they are suspicious and do not want to pay directly for advice of uncertain value. The industry has found a way to deal with these contractions. The industry directly compensates its brokers and many “independent” advisors who act as sales agents. Commissioned brokers and commissioned advisors promote their “advisory” services as being free and objective – the best of both worlds. They tell you that you are getting good advice without having to pay anything for this good advice.

In theory, only when you decide to act upon this allegedly good and objective advice will there be any cost. You will pay a supposedly reasonable sales load charge, when you purchase a recommended investment. Sales load charges take several forms: front-end loads, back-end loads, and/or higher expense ratios, including various combinations.

Ultimately, individual investors are the source of sales load-based investment advisor compensation, but the money flows indirectly. Concerning front-end sales loads, these fees are taken out of your initial investment. Load charge are routed through firms in the industry, and some but not all of your load charge will be paid to the broker or advisor who works directly with you. A substantial portion of sales loads are retained by industry firms to cover their costs and to make a profit.

The "ABC Share Class Shuffle"

The industry will be gracious enough to offer you a supposed choice in this matter, when you buy mutual fund shares. You can choose between A, B, and C share classes. In doing so, industry sales representatives may suggest that you get to choose what is “best” for yourself. In this faux decision process, which I have dubbed the "ABC Share Class Shuffle," individual investors choose a share class. In the ABC Share Class Shuffle you really just choose one form sales fee over another.

As long as you buy, the sponsoring firm and the sales rep do not care which choice you make. The A, B, and C share classes are priced to be roughly equivalent from the perspective of the firm, and the firm will, in turn, compensate your broker or advisor for making the sale. Many funds offer additional share classes with no load and lower annual expenses for direct consumer purchases, but your advisor not tell you, if such classes exist.

Sales loads have evolved over time to be one of the major forms of compensation for financial services industry sales personnel. However, investment sales loads are anything but free to the consumer. Investment sales loads do not and cannot improve your investment performance. Instead, investment sales loads could do significant and continuous harm your lifelong financial interests. If you measure the full lifecycle costs of the investment sales loads that you pay, you will find that these investment sales fees can be a huge and increasing drain on your lifetime assets.

The only way to avoid sales loads and other industry investment marketing charges is to proactively search for investments that you can buy either directly or through very low cost discount financial services outlets. Any investment sales person who approaches you will sell you investments that are far more costly. Not only will you pay unnecessary purchase charges when you buy investments with sales loads, your not-so-objective advisor very likely will induce you to buy inferior long-term investments due to their higher ongoing costs. Free advice is one of the most expensive "free lunches" that you will find in personal finance.

The investment advice you get from commissioned advisors is often anything but "objective."

The scientific investment literature has demonstrated repeatedly and consistently that lowering your investment costs is one of the most important factors toward increasing the performance of your investment portfolio. The quality and objectivity of the advice that you get from commissioned "advisors" becomes more suspect, when you consider that advisors who promote investment products with sales loads will not mention or suggest much cheaper, no-load products as an investment alternative. When you consider that the recommended funds that emerge from this "free and objective" advisory process will typically have significantly higher annual expense charges, then you have even more reason to be suspicious.

In this “free advisory” sales process, you may encounter both direct sales representatives/brokers and “independent” advisory industry professionals. When a broker is employed by and directly compensated by the firm trying to sell an investment to you, is it reasonable or naïve to expect that any recommendation will be in your best interest? Many people are taken in by the terms brokers use to describe themselves, such as "advisor" and "counselor." Be careful and read the fine print in the disclosures you are given by brokers. They have absolutely no legal obligation to act in your best interests. See: SEC's Merrill Lynch Rule Struck Down by the US Court of Appeals

Often, you will find reasons to question whether supposedly “independent” advisory professionals really are independent. Investment advisors are regulated by the Investment Advisers Act of 1940, and are supposed to act in your interests and not in theirs. Yet, when the industry is paying your advisor – even though your sales load expenses provide the funding, you have good reason to question whether your best interests are paramount.

Many independent advisors obtain much of their information about investments to recommend from the securities industry. Industry paid advisor compensation arrangements create significant conflicts of interest between your interests and your advisor's interests. Will these independent advisors really serve your best interests, when they are being paid by the industry?

The argument that you are getting objective advice that is free because you do not have to act on it, rapidly becomes hollow as the sales process moves forward. Many industry representatives will imply or suggest that the investments they recommend are better investments, while they usually walk a careful semantic line concerning the words they choose.

Typically, for example, you will be told that XYZ Fund is a “good” investment, and you will be given glossy brochures and color printed summary sheets with 4 and 5 Morningstar Ratings. The pretty graphics and large text will focus on historical performance, while the legally required small disclosure print tells you not to count on this history. The small print tends to be far more reliable investment advice than the rest of these pretty marketing materials.

Some less sophisticated advisors and brokers will ignore these semantic niceties and flatly tell you that recommended funds with sales load charges are “better.” Sometimes they will even assert that their recommended investments with sales loads actually are superior investments, when compared to lower cost no-load funds. Given that sales loads create higher costs which tend to result in lower investor returns, there are very significant reasons to wonder about the independence of advisors who sell funds with loads and avoid offering cheaper no load funds.

14.9: Advisor sales load compensation is expensive

How expensive is advisor compensation paid via sales loads?

Even if you actually are getting good financial advice, paying your investment advisor via a sales load charge is just one of several potential compensation methods. A sales load might be the method that you prefer to compensate your broker or advisor. If your advisor is truly competent and ethical, he may be able to manage properly the inherent conflicts of interest that are associated with commissioned investment product sales.

If the sales load charged truly is reasonable for the value of the services rendered, then you might consider a load to be a convenient compensation method. However, this convenience could be very, very expensive. When you buy an investment that involves a sales load, you write one investment check and the load is taken out of this check.

Alternatively, you could write two checks – one check for the investment and one check to pay your advisor (which may be paid to your non-commissioned advisor in advance of any investment). What is the real cost of this “convenience?” What is the value of being able to defer you advisor’s payment until your make the investment, and/or what is the value of perhaps never paying the advisor, if you choose not to take his advice?

The key question is whether the cumulative lifetime cost of the investment sales load charges you pay is reasonable in the context of your lifetime financial affairs.

Are there any other cheaper compensation methods? How would the cost of direct hourly service payments compare to the cost of paying sales loads? Does separating advisor compensation from the selection of investments improve the quality of investment alternatives that are suggested to you? You need to have a much better understanding of the lifecycle cost of sales loads, so that you can assess whether the cost is lower than paying for advice directly.

For two primary reasons, I have concluded that compensating advisors through sales loads is extremely expensive. First, the lifetime value of the assets you give away through sales loads can be huge. There are much better and much cheaper ways to pay advisors. Instead, just find a competent advisor who charges reasonable hourly rates and who does not try to live off of your assets. See: Fee-only financial planner and investment advisor groups

Sales load and more expensive investments go hand-in-hand

Many commissioned advisors and brokers who charge sales loads are far more expensive year after year, because they will only recommend more expensive investments. These advisors will never suggest that you buy no-load funds, and they will rarely ever suggest that you adopt a passive and very low cost index fund investment strategy that targets a market return.

Instead, to justify their value to you, commissioned advisors will put you into more expensive active investments, and they will hope that they will be lucky in their selections. In short, they will gamble with your money by taking excessive and undiversified risks. The scientific investment literature has repeatedly demonstrated that the securities markets do not compensate undiversified risk-taking. With a more expensive investment strategy, you are much more likely to lose than to win on average over the long term.

Appendix: Personalized lifetime financial planning software

To enhance the lifetime financial planning process for my clients, I have designed and developed VeriPlan during the past decade. VeriPlan is a sophisticated and automated personal lifetime financial planning application for individuals and families.

This Appendix explains VeriPlan's features, capabilities, and applications toward personal lifetime financial planning and investing. I use VeriPlan with clients who want to develop a comprehensive picture of their financial affairs projected across their lifetimes.

Individuals can buy a copy of VeriPlan and do their own lifetime personal financial planning. For do-it-yourselfers, I make VeriPlan available for a very modest licensing fee through one of my websites:

https://www.theskilledinvestor.com/VeriPlan/

If you go to the link above, look in the left hand sidebar for the blue link titled; "Download the free VeriPlan User Guide in PDF format." When you click that link, you will get an instant download of the latest VeriPlan User Guide, which is extensive and detailed.

1.1 A tool to improve your lifetime financial planning

VeriPlan projects fully integrated scenarios about your income, expense budget, debts, investment portfolio assets, investment returns, and investment costs within the context of the U.S. federal, state, and local income taxes that apply to you. VeriPlan presents all your personal lifetime financial modeling information in clear graphics and data tables.

VeriPlan is a self-learning lifetime financial planning and investment projection application. VeriPlan gives you significant personal insight into your most important personal finance and investment portfolio decisions. Through comprehensive and customized lifetime projections, VeriPlan's fully integrated financial and investment calculators model your particular financial situation across your adult lifetime.

You can easily customize any of your personal data and settings in VeriPlan. After you make any modification, VeriPlan automatically and instantaneously revises your complete lifetime projection. When you use VeriPlan's rich set of fully integrated “what if” financial modeling tools, you can take control of your own financial, investment, and retirement planning.

VeriPlan helps you analyze important personal finance questions.

Here are some examples of the kinds of questions VeriPlan can help you to answer:

A) Career planning:

* What are the long-term economic benefits of changing positions or employers?

* Would it make economic sense to return to school and improve my skills?

B) Debt management:

* What tradeoffs are associated with accelerating mortgage loan payments or other debt repayments?

C) Education expenses:

* Will I be have enough college savings to pay for my children’s education while saving for retirement?

D) Estate planning:

* How could my savings rate and investment strategy affect the size of my estate?

* After my expenses, how much could I give or bequeath to family and charities?

E) Insurance budgeting:

* How large might my exposures to insurable financial risks be over time?

* How might different budgets for insurance premiums affect my financial plan?

F) Investment cost reduction:

* What investment returns might I earn net of investment costs?

* How much could I waste on unproductive investment costs?

* How might I improve my investment returns by keeping costs to a minimum?

G) Investment returns:

* How does my current investment strategy compare to a passive strategy focused on long-term, risk-adjusted returns net of investment costs and taxes?

H) Investment risk management:

* What returns might I expect from the balance of expected asset class investment returns and risks that I have chosen?

* Am I saving enough to stay within my investment risk and return comfort zone and still reach my financial planning goals?

* If I were to lose income in the future, how long would my liquid investment portfolio assets cover my projected expense budget?

I) New business ventures:

* What are the likely long-term benefits and risks, if I forego current income to start a business?

* Could I self-fund my business venture or would I need external capital?

J) Real estate planning:

* When will I have sufficient capital to buy real estate?

* How does mortgage debt affect my investment portfolio and financial goals?

K) Retirement planning:

* Would I have sufficient investment assets to retire early?

* Would my investment assets cover my expenses, if I live a very long time?

* What is a relatively safe asset portfolio withdrawal plan?

L) Saving goals:

* Am I saving at a sufficient rate to fund all my future financial planning goals?

* How much benefit might I expect from increasing my income and/or reducing my expense budget?

* What is the long-term value of saving some or all of my bonuses?

M) Tax reduction:

* Am I managing my investments from an income tax efficiency standpoint?

* How much should I put into either taxable, traditional retirement accounts, or Roth retirement accounts?

* Would my retirement portfolio assets be adequate after income taxes and other taxes are paid in retirement?

1.2: Executive Summary of VeriPlan

Organization, Graphics, and Data

VeriPlan provides 34 user worksheets organized into groups. VeriPlan is a lifetime projection model for 1 or 2 earners from 18 to 100 years old. Projections can begin at any age from 18 to 99 and continue through age 100. VeriPlan automatically provides 18 graphics and a consolidated worksheet with the data for these graphics. All VeriPlan projections extract inflation and use real or non-inflationary dollars with constant purchasing power over your life.

Earned and Other Income

Regular employment and/or self-employment income can be projected for either earner. You can also enter separate information about other income sources that you expect to have.

Pensions, Annuities, Deferred Compensation, and Social Security Income

VeriPlan projects up to 10 separate pension, deferred compensation, and annuity payouts. For each pension or annuity, VeriPlan automatically projects: a) the dollar amount of the monthly payment, b) separate real dollar growth rates before and after the first payment, c) whether payments begin at a specific age or at either user's retirement, d) duration of payments, and e) taxability of payments. Concerning your Social Security retirement payments, you can set current dollar levels for your entitlements, adjust the age to begin to receiving payments, and scale back the amount of your projected payments, if you wish.

Debts

VeriPlan automatically projects the pay-off of up to 25 current debts. You can plan for the accelerated repayment of any or all debts. Interest on selected debts can be tax-deductible. Also, VeriPlan automatically manages mortgage repayments on your planned future purchases of up to three homes.

Financial Assets, Real Estate, and Property

VeriPlan projects your asset holdings in five asset classes. Individually and automatically, VeriPlan will manage separately up to 24 cash assets, 24 bond and fixed income assets, 99 stock and equity assets, and 20 property, real estate, and other assets. For each of your asset holdings, VeriPlan collects information about share ownership, values per share, investment costs, and account taxability.

VeriPlan's integrated, automated, and high performance asset projection facilities enable the rapid evaluation of a wide range of customized financial plans. Growth of your projected "centerline" investment asset values are based on 85-year historical risk-adjusted and inflation-adjusted asset class growth rates. Asset class growth rates are fully user-adjustable using either VeriPlan's systematic and/or judgmental growth rate adjustment tools.

For each of your financial asset holdings, VeriPlan separately and automatically projects annual returns, return variability, taxes, and investment costs. VeriPlan automatically projects your net annual holdings by asset class, including new investments from future positive annual net earnings, reallocations, and withdrawals due to projected negative net earnings. VeriPlan automatically assesses your overall annual net portfolio returns, tax-efficiency, and investment cost-efficiency.

VeriPlan can project these asset class aggregates, even though the net valuation of your individual financial asset holdings may change at different rates due to return adjustments you make, varying investment costs, uneven taxable distributions, and legal differences in account taxability. VeriPlan can provide significantly more personalized insight, because its projections focus on your particular projected financial life situation, instead of relying upon arbitrary averages across a general population.

Taxes

VeriPlan automatically projects your lifetime tax obligations in eight separate tax categories. It automatically projects your particular federal, state, and local income tax rates and limitations; your tax exemptions, adjustments, and deductions; and your property and other taxes. VeriPlan supports the 'Single' and ''Married, Filing Jointly' federal income filing statuses and automatically applies the tax rates and limits associated with these filing statuses. To prevent obsolescence, you can change VeriPlan’s tax rates and limits, if laws change.

VeriPlan applies current variable U.S. federal ordinary income tax rates and limits. It contains tax rate information for the 50 United States and Washington, D.C. and automatically applies either variable, flat, or no income tax for any state that you choose. VeriPlan can automatically apply any local ordinary income taxes. Furthermore, it can develop projections using different levels of federal, state, and local taxable income.

VeriPlan automatically projects annual tax exemptions and their phase-outs for up to 10 dependents and up to 6 different adjustments to your taxable income. VeriPlan automatically projects your federal income tax deductions and applies the more favorable of either the standard deduction or your itemized deductions. VeriPlan automatically applies Social Security (FICA) and Medicare taxes, and projects either employee or self-employment tax rates, as appropriate.

Concerning your assets, VeriPlan automatically applies long-term capital gains tax rates on capital appreciation and qualified dividend distributions including asset withdrawals net of your accumulated asset tax basis. Over your lifetime projections, VeriPlan will automatically track your cumulative cash, bond, and stock asset class tax basis. VeriPlan also automatically projects your property, real estate, and other assessment taxes.

Traditional and Roth Tax-advantaged Retirement Plans

VeriPlan has automated your lifetime projections regarding employer retirement plans and personal IRA accounts that allow you to defer taxation or to avoid future taxation altogether. VeriPlan automatically projects separate values for your taxable accounts, traditional retirement accounts, and Roth retirement accounts. For traditional and Roth IRA and employer-sponsored retirement accounts, VeriPlan automates the projection of your lifetime contributions, deductions, asset growth, withdrawals, and taxation. It automatically assesses federal and state early withdrawal penalties, as required.

Updates and enhancements

VeriPlan has been updated and enhanced at least once each year for almost twenty years. However, since VeriPlan is designed to be user updatable, there is no requirement that you purchase an enhanced version of VeriPlan and there is no requirement that you purchase a support contract. Your initial, very modest license fee is the only charge for VeriPlan.

VeriPlan has been fully functional and robust since 2006. Each year since then some additional functionality has been added, but VeriPlan's core functionality has been very complete for many years.

The primary reason for annual updates to VeriPlan are to update:

* US Federal and 50 state + DC tax rates, limits, phase-outs, and other tax parameters, including retirement plan rule changes, and

* historical asset class returns, inflation, and volatility data for 1928 through the most recent year

Because facilities are provided within VeriPlan for current licensees to update these parameters in their own copy with more recent information, it is not necessary to upgrade.

If you would like to understand the updates and enhancements that have been made to VeriPlan in the past several years, go to this web page:

VeriPlan Lifetime Financial Planner - Annual Version Enhancements

or

https://www.theskilledinvestor.com/VeriPlan/1915/veriplan-lifetime-financial-planner/

Documentation

VeriPlan's worksheets provide extensive, integrated documentation. VeriPlan is designed to be self-training, and you do not need a user manual. Just read and follow the instructions on the spreadsheets.

Nevertheless, a separate and free *VeriPlan User Guide* with additional information is also available. The *VeriPlan User Guide* is free to anyone – whether or not you have a license to the VeriPlan software. You can find where to download this user guide in PDF format by going to this web page. (Look for the green book cover and click it to download the free PDF.)

https://www.theskilledinvestor.com/VeriPlan/financial-planning/

To download this VeriPlan User Guide in PDF, MOBI, EPUB, and other formats go to this web page:

https://www.smashwords.com/books/view/372828

Systems Platforms

VeriPlan is a fully self-contained Microsoft Excel spreadsheet application that runs in a standalone configuration with local data storage. To operate, VeriPlan requires a Microsoft Windows PC or Apple Macintosh with ANY Microsoft Excel version from 2002 up to the most recent version release. VeriPlan will run on your Windows PC or Mac with Excel, even if you have a relatively "ancient" system.

License and Purchase Information

VeriPlan is licensed and is for personal, non-commercial use by one (1) household. Buyers receive an unconditional thirty-day (30 day) satisfaction guarantee.

The price for VeriPlan is lower than all other full featured cash flow projection modeling tools. You can learn all the details about it and order it from this web page:

https://www.theskilledinvestor.com/VeriPlan/

1.3: VeriPlan's lifetime financial planning decision tool sets

Asset Allocation Tools

Your asset allocation strategy allows you to align the risk of your investment portfolio with your risk tolerance. VeriPlan provides five user selectable and adjustable asset allocation methods for your lifetime projections. Fixed, variable, and age-based allocation mechanisms are provided. Reallocations are performed automatically at the beginning of all subsequent projection years.

Cost-Effectiveness Tools

Excessive investment costs are a huge problem for the average investor. VeriPlan's projections automatically analyze the impact of five types of investment expenses across your lifetime: 1) purchase fees and loads, 2) management fees, 3) marketing fees, 4) transactions costs, and 5) account custody fees. VeriPlan fully automates the comparison of lifetime investment costs between the investment costs of your current financial asset portfolio and the costs that you believe are reasonable to pay.

Expense and Savings Tools

VeriPlan allows you to set you annual expenses, and change your future expense levels and expense growth rates. VeriPlan also allows you to enter major planned expenses year by year and change growth rates relative to average inflation. You can enter positive and negative expense adjustments and growth rates in any projection year.

VeriPlan's expense planning tools can be used as a "Children's Education Expenditure Planning Tool", and as a "Mid-Career Education Planning Tool" to model tradeoffs associated with returning to school for career advancement.

VeriPlan also provides a 24-month household expense tracking, budget planning, and expense versus budget variance analysis tool. This optional use budget tool includes both standard expense categories and user defined expense categories. If you already use another budgeting tool, you are not required to use VeriPlan's budgeting tools. Instead, you can use the budgeting system that you already have to derive the expense numbers that you would enter into VeriPlan.

Current and Future Debt Tools

Regarding any current debts that you have, VeriPlan automatically repays interest and principal as you specify. You can use VeriPlan’s debt management facilities to analyze and plan for the accelerated repayment of any or all of your current debts.

In addition, excess consumption and the cost of associated debt can be very destructive, when you do not live within your means. This tool allows you to set a debt interest rate for future unfunded consumption. When your projected expenses exceed your projected income, VeriPlan automatically accumulates excess consumption debt and unpaid interest, after your cash, bond-fixed income, and stock-equity financial assets would be depleted. If subsequent positive net income becomes available, VeriPlan will automatically retire some or all of this unfunded consumption debt.

Historical Asset Class Returns

VeriPlan's automated "centerline" projections are based on the very long-term, historical securities market rates of return that have been achieved in the cash, bond-fixed income, and stock-equity asset classes over the past 95+ years. You can adjust these projected rates of return, using VeriPlan’s various portfolio risk tools.

VeriPlan’s projections automatically deduct your taxes and investment costs from your financial asset class returns. Furthermore, across your lifetime, VeriPlan will automatically project the value of your real estate, property, and other assets, which are not priced currently on real-time securities markets. VeriPlan uses the current fair market value and future growth rate assumptions that you set for these real estate, property, and other assets.

Home Purchase Tool

VeriPlan provides this tool for users who plan to purchase from 1 to 5 homes at various years in the future, as well as up to10 rental real estate properties.. For such future home purchases, this tool automatically takes into account: a) the planned purchase price, b) closing costs, c) settlement cash required, d) mortgage debt to be assumed, and e) expected interim and subsequent price changes.

Portfolio Asset Class Rebalancing Tools

VeriPlan aids in reallocating currently held financial assets, according to both the asset allocation and the asset tax location models chosen. Thus, it simultaneously takes into account the distribution of cash, bond, and stock assets across taxable accounts, traditional tax-advantaged retirement accounts, and Roth tax-advantaged retirement accounts.

Portfolio Risk Tools

VeriPlan provides several combinable methods to develop projections automatically using asset class return assumptions that differ positively and/or negatively from VeriPlan's "centerline" historical assumptions:

1) The Projection Variance Tool allows you to vary asset class returns upward or downward automatically in proportion to their historical volatility or risk.

2) The Asset Class Return Adjuster allows you to vary financial asset growth rates automatically on a one-by-one judgmental basis.

3) The Current Portfolio Revaluation Tool to help users understand the potential effects of substantial changes in near-term portfolio asset values.

Portfolio Safety Tools

Individual investors face a dilemma. Both less risky and more risky investment strategies may not achieve desired results for different reasons. When assessing investment strategies with different risk levels, it can be helpful to understand how the "safer" portion of your portfolio assets might evolve across your lifecycle. VeriPlan's Portfolio Safety Tools automatically project how long your cash and shorter-term fixed income assets would cover your projected expenses, if all your expected income sources ceased at any point. It automatically measures your projected financial capacity to weather future financial risks.

Retirement Planning Tools

With this tool, you can set individual retirement ages for either earner. You can select whether or not to retire simultaneously. You can also adjust your expected ordinary living expenses in retirement and the growth rate of those expenses. Concerning Social Security retirement payments, you can set the levels of your entitlements and adjust the age at which you would first begin to receive Social Security payments. Furthermore, you can scale back the amount of your projected Social Security payments, if you wish. Finally, because much older workers can face significant erosion of real dollar wage rates, you can adjust VeriPlan's assumptions about real dollar wage erosion for earnings at ages over 65.

Tax-Advantaged Plan Tool

VeriPlan has automated your lifetime projections regarding employer retirement plans and personal IRA accounts that allow you to defer taxation or to avoid future taxation altogether. VeriPlan automatically projects separate values for your taxable accounts, traditional retirement accounts, and Roth retirement accounts. For traditional and Roth IRA and employer-sponsored retirement accounts, VeriPlan automates the projection of your lifetime contributions, deductions, asset growth, withdrawals, and taxation. It automatically assesses federal and state early withdrawal penalties, as required.

Your settings on this tool control your projected tax-advantaged plan contributions funded from your future positive net income and/or from your future taxable financial assets, up to current legal annual contribution limits. This tool allows you to determine the portion of your projected annual contributions that would be deposited automatically into either traditional tax-deferred accounts or Roth accounts.

1) The Total Contribution Limitation Tool allows you to set your personal limitation on overall tax-advantaged account deposits, as a percent of your future annual positive net cash flows.

2) The Roth Contribution Limitation Tool allows you to set the percentage that Roth contributions would be of your total annual contributions into both traditional and Roth accounts.

3) The Roth year-by-year Conversion Planning Tool helps you to understand which years in the future might be better to do Roth conversions, and it helps you to

judge the federal tax rates on the amount of Roth conversions you plan to make in each year. Depending upon the year-by-year Roth conversions amounts that you manually enter into the table to the right, VeriPlan will automatically assess federal, state, and or local income taxes in you projections. Any state or local income taxes would be in addition to the federal tax information provided below. VeriPlan's Roth conversion tool also allows you to understand the current and future impact of annual conversions on Social Security retirement income subject to taxation and on any IRMAA Medicare insurance premium subsidy reductions related to relatively high income in retirement.

1.4: VeriPlan’s Comparison Tool highlights differences between projection models

Once you have loaded relatively complete financial data and set your assumptions, you can begin to evaluate alternative financial decisions. By comparing one VeriPlan projection scenario to another, which uses somewhat different data and/or assumptions, you can evaluate the relative desirability of these alternatives. Through an iterative process of evaluating alternatives, you can refine the lifetime financial plan that you intend to implement. In general, to determine whether personal financial "Strategy A" or "Strategy B" is likely to be preferable to you, compare two VeriPlan projection scenarios to see which yields a better long-term financial result.

VeriPlan is built on the Microsoft Excel spreadsheet engine, and runs on any Windows PC or Mac with any version of Excel. In spreadsheets, normally any change that you make to one cell will change the results of all other spreadsheet cells that are connected by the underlying logic. Therefore, spreadsheets do not automatically "save the state" of the model that existed just before the most recent change. Nevertheless, model comparisons are possible, if you first lock or "save the state" of a projection model, before making further revisions.

The VeriPlan Comparison Tool allows you to lock the state of any of your projection models. This is achieved by following some simple procedures to copy all of VeriPlan's output data and paste them into another spreadsheet as values only. Doing this will lock the "state" of the data values from your prior baseline model. Then, you continue to revise one or more assumptions and/or data inputs within VeriPlan to reflect any alternative personal financial strategy. VeriPlan's Plans Compared worksheet will then automatically subtract the "live" data being output from the revised model from the "locked" data values of the prior baseline model. This allows you easily to evaluate the differences between two lifetime projection models.

There is also another use for VeriPlan's Comparison Tool features. Some spreadsheet users might wish to develop external spreadsheets for specialized purposes and link those spreadsheets to VeriPlan's projection data output. VeriPlan Comparison Tool allows external copying and live linking of all VeriPlan output data.

1.5: VeriPlan’s graphics and data outputs

Overview of VeriPlan's graphics and data outputs

VeriPlan's graphics and data tables allow easy comparison of projection scenarios. VeriPlan presents your projections in 25 graphics, which are described below. Whenever you make any change, VeriPlan will automatically and instantly revise these graphics. In addition, the data worksheet will be updated automatically, as well.

You can find all the data for all the projection series that VeriPlan uses to draw these graphics on the "GRAPHICS DATA" worksheet which is the right most spreadsheet tab within VeriPlan. The Graphics Data worksheet lists the data for all graphics in the order that the graphics tabs appear within VeriPlan.

VeriPlan projects your individual or family financial affairs over a lifetime, as if you were a business using cash flow planning methods. VeriPlan puts you in the position of general manager, and it provides graphics and data worksheets that a general manager might need to understand long-range financial projections regarding your personal financial planning.

The unit of time on the horizontal axis of every graphic is one year, and all graphics cover ages 18 to 100. Your particular projections will begin with the initial age of Earner #1. All graphics lines begin with the initial age of Earner #1.

VeriPlan's automated financial projection graphics

This numbered list of VeriPlan’s graphics is current as of 2023. Following this numbered listing are sections that correspond to each of these graphics and that provide a description of each graphic with an example.

The sample graphics below with a gray background are from an earlier version of VeriPlan. They have been retained here, because each of these graphics presents a particular projection scenario that is described in the text along with the graphic. These prior graphics are the same in the latest version of VeriPlan, except that the background are white rather than gray. If you see a graphic with a white background, these graphics were more recently added to VeriPlan.

1) INCOME: Non-Asset Income -- Earned, Pension, Annuity, Social Security & Other

2) EXPENSES: Ordinary Living Expenses with Other Planned & Adjusted Expenses

3) DEBT PAYMENTS: Debt Payments

4) PERSONAL TAXES: Tax Payments

5) RENTALS+PROPERTY: Income, expenses, debt payments, taxes, and cash flow from for rentals and other properties

6) CASH FLOW: Non-Asset Cash Flow

7) SAVINGS RATES: Pre-Retirement Savings Rates with Investment Debt Repayments

8) HUMAN CAPITAL: Expected Income and Savings Before Retirement

9) ALLOCATION: Financial Asset Allocation

10) TOTAL ASSETS: Financial Assets, Property, and Debts with Assets Lost to Excessive Investment Costs

11) ASSET FLOWS: Non-Asset Cash Flow with Cash, Bond, and Stock Financial Asset Returns

12) DEBT OWED: Personal, real estate, and business debt principal owed

13) ASSET TAXABILITY: Taxable, Traditional & Roth Tax-Advantaged Financial Assets

14) TRANSACTIONS: Taxable & Tax-Advantaged Deposit & Withdrawal Transactions

15) RETIREMENT INCOME: Retirement income sources and pre-tax Required Minimum Distributions (RMDs) after Earner #1 retires

16) WITHDRAWALS: Withdrawal Rates from Cash, Bond & Stock Assets

17) RETIREMENT SHORTFALLS: Cash flow shortfalls after Earner #1 retires including RMDs

18) SAFETY MARGIN: Emergency asset coverage of expenses without other income

19) VALUE OF TIME: Hourly wage equivalent value of income, expenses, and financial assets

20) COST-EFFICIENCY %: Net Cash, Bond & Stock Financial Asset Returns with Returns Lost on Excessive Investment Costs

21) COST-EFFICIENCY $: Net Cash, Bond & Stock Financial Asset Returns with Returns Lost on Excessive Investment Costs

22) SALES LOADS: Lost Returns on Past and Future Financial Asset Sales Load Purchase Fees

23) LIFE EXPECTANCY: Average U.S. male and female total life expectancy and remaining life expectancy by current age

24) HISTORICAL RETURNS: U.S. Financial Asset Class Returns from 1928 to the present

25) ROLLING RETURNS: Annualized U.S. Financial Asset Class rolling 5-year real dollar asset class returns and CPI inflation from 1928 to the most recent year

VeriPlan's graphics provide an integrated projection of your lifetime finances. Summaries of each are provided below

VeriPlan uses real, constant purchasing power dollars with inflation removed. All dollar based numbers in VeriPlan are "real" in the sense that they assume constant purchasing power for currency over time. To understand more about the 90+ year history of US inflation and major financial asset class returns and variability, inspect the Historical Returns graphic and read the Risk & Returns worksheet.

Inflation (and sometimes deflation) are facts of financial life, but they are not systematically predictable. Making dollar projections that include an inflationary component adds little value to projection modeling. To the contrary, nominal dollar projections that include inflation assumptions tend more often to confuse decision-making. Projections with inflation may create an illusion of growth, when the opposite might be true. Your nominal assets could increase by five times, but the price of a loaf of bread could increase by ten times. Projection modeling using real, constant purchasing dollars solves this problem.

The impact of inflation on various investments needs to be considered when making investment choices. Inflation's unpredictability limits your strategic investing options. Generally, a fully diversified asset strategy will reduce the variability associated with inflationary differences between sectors, while leaving an exposure to the general rate of inflation. Your asset allocation can be used to adjust investment exposure to asset classes that historically have exceeded inflation by a lesser or greater amount.

1) INCOME Graphic

Non-Asset Income -- Earned, Pension, Annuity, Social Security & Other

(Real $/year by age; Excludes reinvested asset returns and asset withdrawals)

This INCOME graphic projects the income associated directly or indirectly with earned income sources (excluding income from your asset portfolio), including:

* Earned employment and actively-managed business income with your real dollar growth rates for Earners #1 and #2 that you entered on the income worksheet. (Note that earned income for Earners #1 and #2 will also reflect any year-by-year income adjustments that you have made on the income worksheet.)
* Pension, annuity, and Social Security income from the retirement worksheet
* Other income with adjustments from the income worksheet

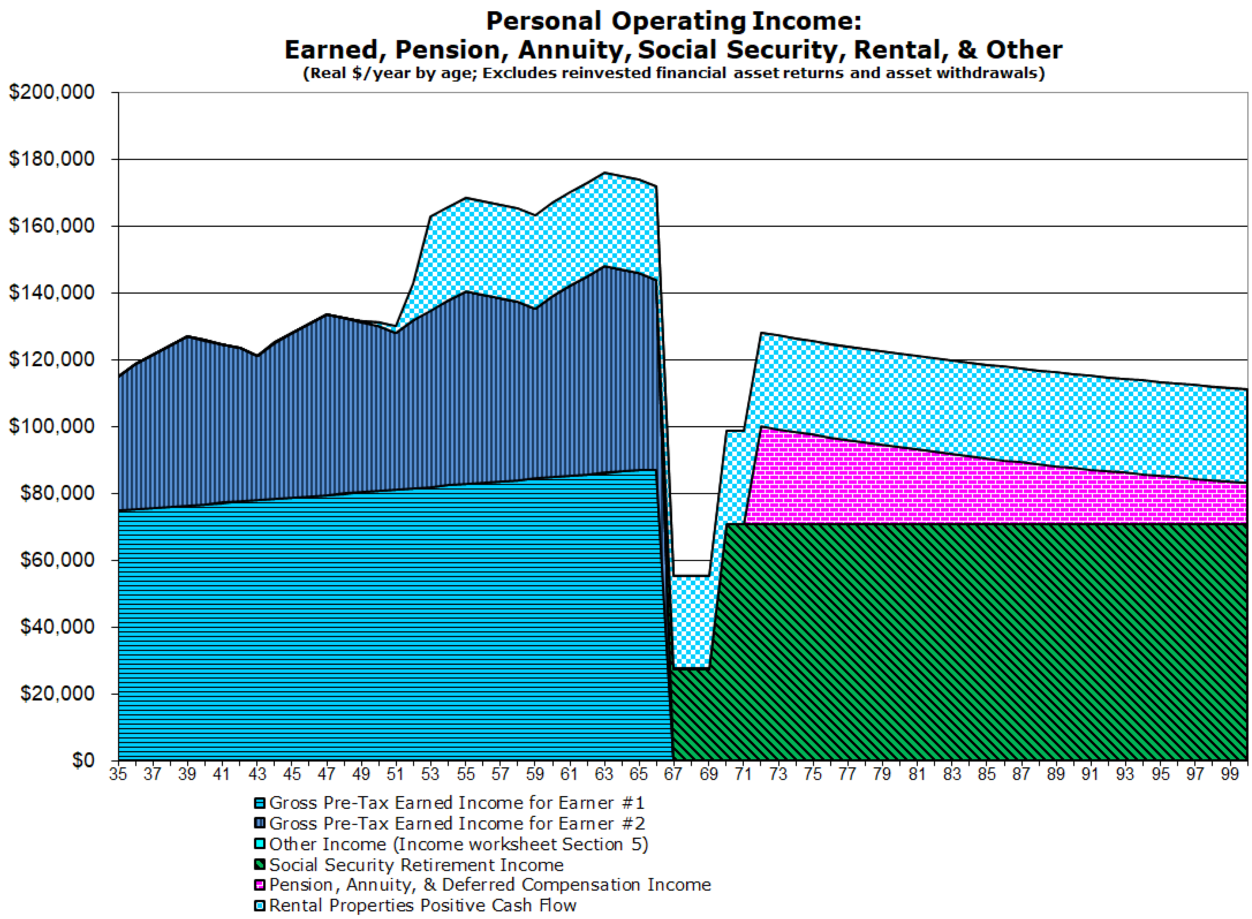
No income from assets nor any capital appreciation is represented on this graphic, because this information is provided on other asset related graphics. Asset income is assumed to be taxed and reinvested. Assets would be withdrawn only in years when you are projected to have a cash expense-to-earned income shortfall.

INCOME graphic example

In this sample income graphic below, Earner #1 is projected to have moderately increasing real dollar wage and salary income reflecting a .5% annual income increase relative to consumer price inflation. Earner #2 is self-employed and earns less, but projects a slightly steeper increase in annual income at 1% above inflation. In addition, Earner #2 has used VeriPlan's year-by-year positive and negative income adjustments facility to model that the vicissitudes of four primary business cycles in the future. Because both of these earners are relatively young, motivated, and intent upon career advancement, they have developed income projections that exceed inflation, which is atypical of most workers.

This graphic also demonstrates VeriPlan's ability to project other sources of income. First, they own a small rental property that they expect will produce modest but steady income, and this is reflected in the cross-hatched and light-blue colored bar that extends across their projections. While they currently own this rental property, the debt is being paid down and is not yet cash flow positive. At about age fifty, this rental property is expected to begin to be cash flow positive and the taxable net income will flow into the family's overall income picture.

Second, in retirement, they both expect to have Social Security retirement income, that one person will first accept at age 67, while the other will wait until age of 70 to maximize these Social Security cost of living adjusted retirement income sources.. These Social Security retirement income payments are projected to maintain their purchasing power due to cost of living increases in retirement.



Finally, Earner #1 is among the lucky and relatively few young workers with a funded, albeit modest, traditional retirement pension. This pension is projected using VeriPlan's pensions, deferred compensation, and annuities features. This particular pension projection assumes that the retirement pension will keep pace with inflation up until retirement, but once pension payments begin at age 70, they will not be subject to cost of living increases and will decline annually by close to 3% due to expected inflation. This accounts for the declining slope of the solid pink bar from age 70 to 100.

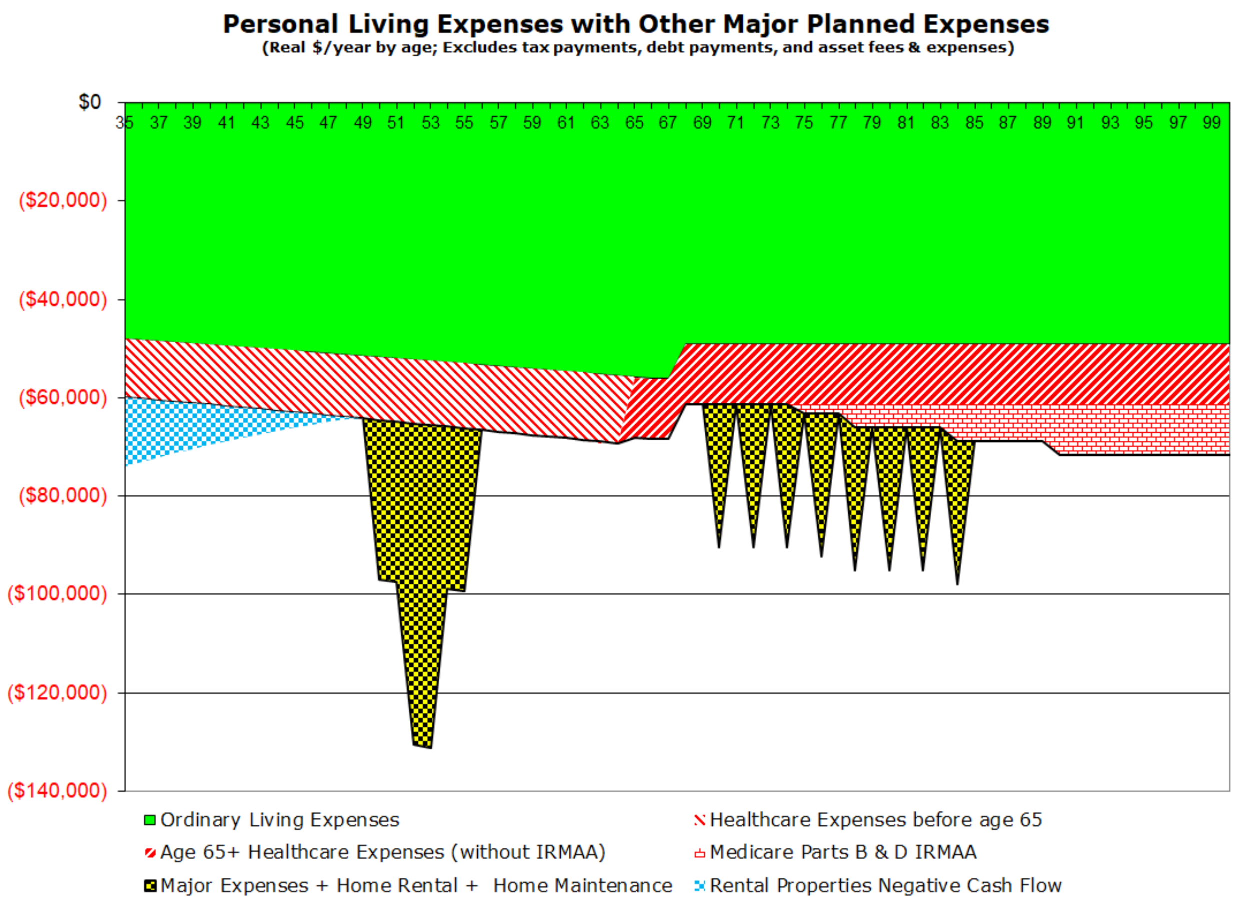
2) EXPENSES Graphic

Ordinary Living Expenses with Other Planned & Adjusted Expenses

(Real $/year by age; Excludes tax payments, debt payments, and asset fees & expenses)

This EXPENSES graphic projects your expenses related to living, but not the cash outflows related your debts or taxes or any current additions to savings or investments. This graphic includes your ordinary living expenses and major planned expenses with year-by-year adjustments and any real dollar growth rate adjustments relative to general CPI inflation that you might set on the Expenses worksheet.

EXPENSES graphic example



Similar to their assumptions about real dollar earnings growth, this couple has assumed that their ordinary living expenses, will increase by .5% above the prevailing rate of consumer price inflation. Then, VeriPlan allows them to adjust their ordinary living downward somewhat when Earner #1 retires at age 67. After that, their ordinary expenses are expected to track the average level of CPI inflation.

In retirement, they expect that their ordinary expenses will be 90% of their expenses immediately prior to retirement and then will remain constant with respect to inflation. However, just after retirement and every three years thereafter through age 85, they have also used VeriPlan's year-by-year expense adjustments features to add $25,000 in expenses to fund a cruise or similarly expensive vacation. These expenses are represented by the expense spikes with the yellow and black cross hatched area during retirement.

They also have two young children, separated in age by two years. The yellow and black cross hatched area from ages 50 to 56 projects the expected net cash cost (after scholarships) of sending both children to four-year colleges in consecutive years with two years of overlap, when both are in college. They have used VeriPlan's year-by-year expense adjustments features to model annual college costs of $30,000.

This graphic also shows a light blue wedge that declines from ag 36 to 48. This represents the negative cash flow related the rental property that they own and that must be funded. As the rental real estate debt is paid down, they begin to breakeven and thereafter have positive cash flow.

Finally, this couple has used VeriPlan's Medicare cost features to project their healthcare costs in retirement, as well as their out of pocket healthcare costs prior to retirement. The various red layers below the green ordinary expense amounts represent these healthcare cost projections.

VeriPlan explains the Medicare retirement healthcare system and provides Medicare expense defaults that users can change to project their retirement healthcare costs. In addition, VeriPlan will automatically track your total retirement income and calculate when you might have high enough retirement income that would make you subject to IRMAA Medicare insurance premium subsidy reductions. Knowing in advance that you could be subject to IRMAA reductions allows you to use other VeriPlan features, such as VeriPlan's Roth year by year conversion analysis features that could reduce your IRMAA liabilities later on.

3) DEBT PAYMEBTS Graphic

Debt Payments

(Real $/year by age; Nominal dollar debt payments are converted to real dollars with a 3% inflation adjustment.)

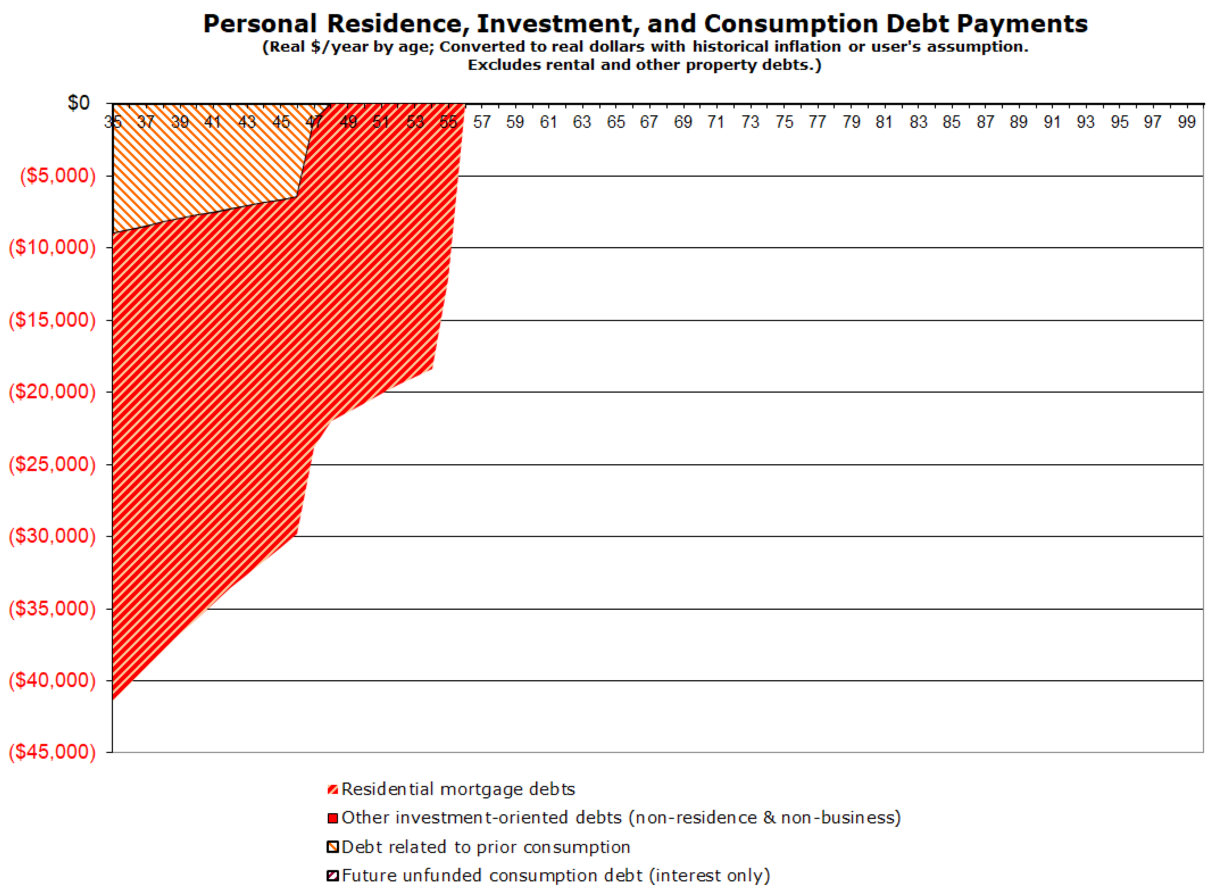
This DEBT PAYMENTS graphic projects your annual debt repayment obligations according to your settings on the debts worksheet. On the debts worksheet, you can classify your debts as consumption-oriented or investment-oriented. Consumption-oriented debts represent past consumption that you have financed. Investment-oriented debts are those you take on with a rational expectation that they will increase the value of your human capital and/or portfolio assets.

Because VeriPlan uses real or constant purchasing power dollars with inflation extracted throughout your projections, your future debt payments related to your current debts will be discounted. If at any point in the future, your expenses would exceed your net income and would fully deplete your accumulated cash, bond, and equity financial assets, then VeriPlan automatically would begin to accumulate an "unfunded consumption debt" loan for you. On the debts worksheet, you can set a projected loan interest rate for any such unfunded consumption debt. Were this undesirable situation to occur in the future, then the required interest-only annual payment on this accumulated unfunded debt would display automatically on this DEBTS PAYMENTS graphic.

DEBTS graphic example

The sample Debts graphic below reflects two different. The first thing to note is that debt payments decline significantly over time. This decline in annual real dollar payments is due the fact that VeriPlan's projections are presented in real, constant purchasing power dollars. In life, when you pay off debts, debts that require a fixed nominal dollar amount to be paid per period are actually paid with cheaper and cheaper dollars as time goes on. General inflation undercuts the value of the dollar over time, and thus your future debt payment cost less in real dollar terms. are repaid in nominal dollars that inflate with time.

The lighter red cross-hatched area represents higher interest rate credit card debt that they intend to pay off over ten years. The bulk of the debt represented in this graphic with red diagonal lines is due to a 30 year fixed rate mortgage on a home that this couple owns, which is expected to be paid off by age 58.



4) PERSONAL TAX PAYMENTS Graphic

Personal Tax Payments

(Real $/year by age; Includes all federal, state, and local earned income taxes, employment taxes, property taxes, and realized asset-related federal, state, and local short-term & long-term capital gains taxes and penalties.)

This PERSONAL TAXES graphic lists all projected tax payments across your lifecycle, and reflects your settings on the tax worksheet and your tax-related entries on the tax-advantaged plans and financial assets worksheets.

This PERSONAL TAXES graphic includes your projected taxes related to:

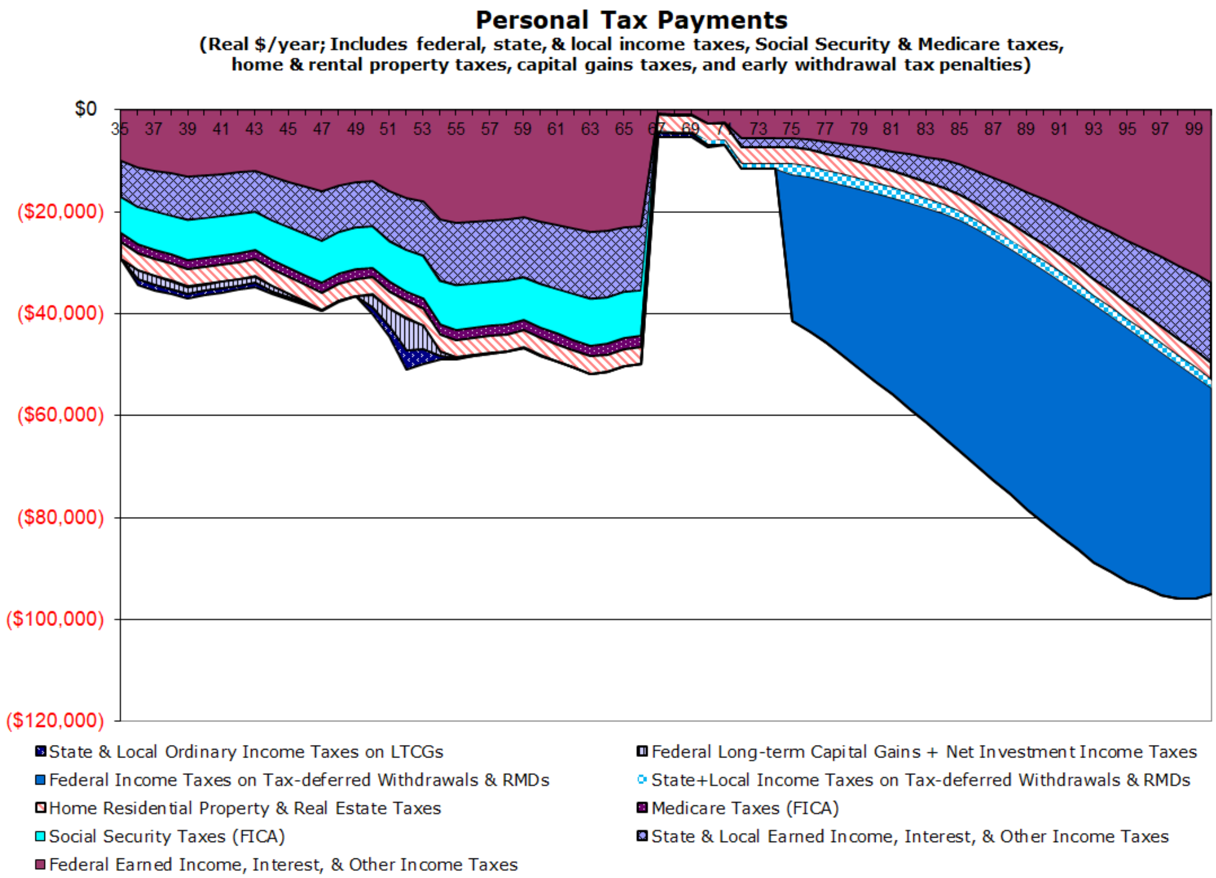
* Federal, State and Local ordinary income taxes on earned, interest, retirement and other income calculated with the marginal or flat rate taxes that apply to single or married taxpayers filing jointly

* FICA/Social Security and Medicare taxes for both salaried and self-employed workers
* Property and real estate taxes
* Ordinary Federal, State, & Local taxes on mandatory and needed tax-deferred account withdrawals
* Federal long-term capital gains taxes
* State and Local ordinary income taxes on long-term capital gains

Note that this taxes graphic also reports "realized" asset taxes related to asset withdrawals, ordinary income, and capital gains distributions, including early withdrawal penalties. Long-term capital gains are calculated at the federal tax level and assessed at ordinary rates at the state and local income tax levels. Federal, state, and local ordinary income taxes on reinvested interest are also assessed automatically.

The information that you enter on the financial assets worksheet related to taxation, including that tax basis in your various accounts, will affect your tax projections. Ordinary earned income and ordinary short-term capital gains asset income tax treatments are similar, and therefore VeriPlan combines both earned income and asset income sources here for taxation purposes. Generally, most asset income taxes will be from current interest and dividend payments on cash and bond/fixed income assets.

PERSONAL TAXES graphic example



For the sample graphic above, note several things about this couple's projected taxes. This projection assumes that this couple lives in Connecticut and works in New York City, subjecting them to New York City local income taxes, which are also supplied by VeriPlan. Additionally, this couple pays substantial Social Security payroll taxes throughout their working years. They pay more than two wage and salary employees would, because Earner #2 is self-employed and pays both the employer and employee portions of these Social Security payroll taxes, which VeriPlan assesses automatically.

In the middle of their working years you will notice spikes related to the withdrawal of assets from traditional retirement accounts to fund some of their children's educational expenses. When this couple gets closer to paying their children's education there are steps that they could take to lower taxes related to education funding.. VeriPlan acts as an early warning system, so that they can understand the short-term risk of depleting assets in taxable accounts that would not be subject to early withdrawal penalties.

Finally, note that in retirement, this couple would pay increasing taxes on withdrawals from tax-advantaged retirement plans to cover retirement living expenses and to satisfy requirements for Required Minimum distributions which also are automatically projected by VeriPlan. They can use VeriPlan's automated Roth contribution limitation tool to test whether lower or higher Roth contribution percentages could be more optimal while they work. Furthermore, they can use VeriPlan's Roth conversion tools to see whether a series of annual conversions following retirement might be a more tax cost effective way to acquire Roth retirement investment account assets.

5) RENTALS+PROPERTY: Income, expenses, debt payments, taxes, and cash flow from for rentals and other properties

Net Cash Flow from Rental Real Estate and Other Investment Properties (Excludes residential real estate; Real $/year by age)

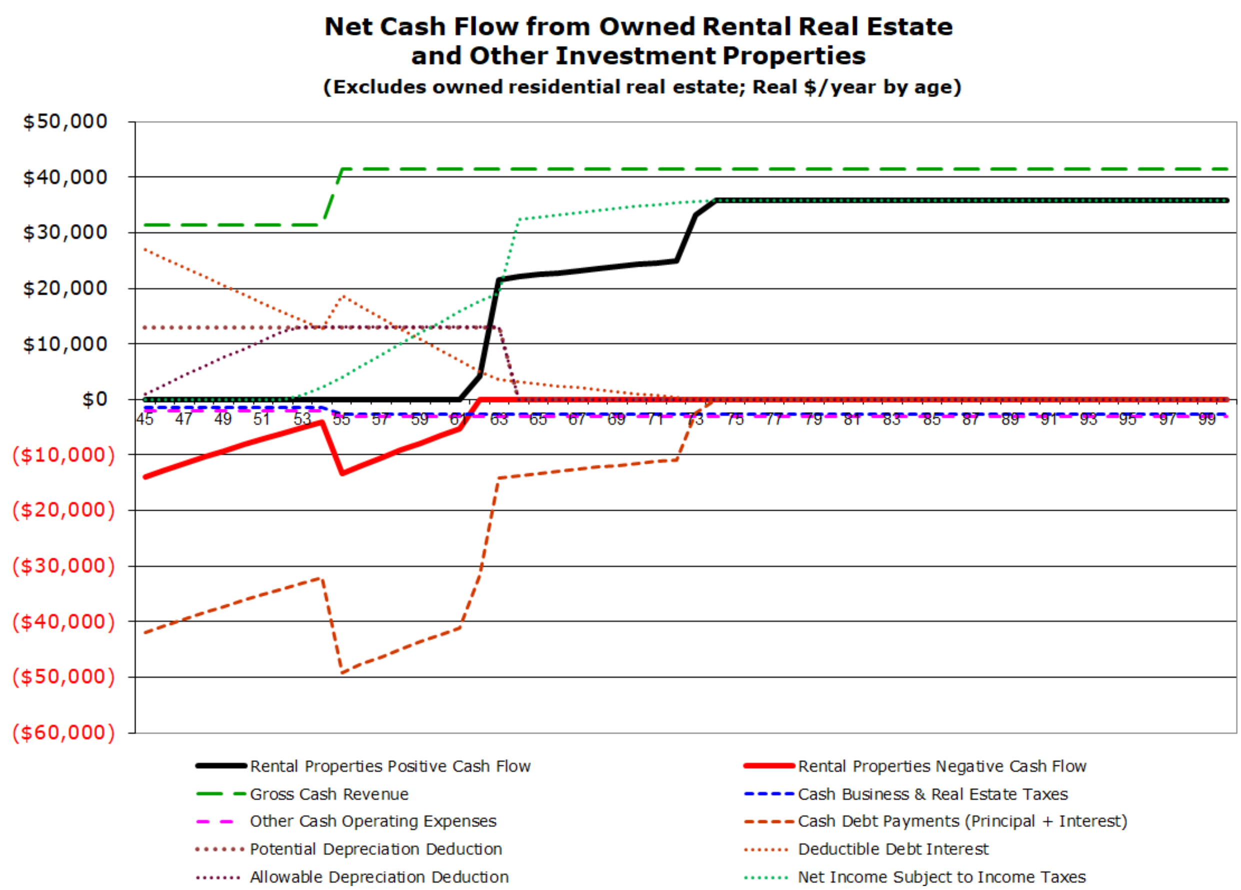
VeriPlan's yellow-tabbed Property+Debts worksheet allows you to enter information concerning up to 10 rental properties and up to 10 other investment properties, including information about asset values, income, operating expenses, taxes, depreciation, and debt payments. In addition, it allows you to plan the future purchase and sale of rental real estate and other property assets. This graphic shows aggregate cash flows across all these assets including gross income, operating expenses, real estate taxes, and debt payments. The solid black and red lines show the annual positive and negative cash flows respectively for all of these property assets.

In addition to cash flow information, this graphic also presents some additional information used to project net positive or negative cash flow from rentals and other properties. Positive net cash flow less depreciation would also flow onto the personal tax return. This additional information is the interest only portion of debt payments which would be deductible and the depreciation allowance for rental real estate properties. For depreciation, two columns are provided: A) total potential depreciation and B) the amount of depreciation projected to be deductible in a particular year. Then, total taxable rental and other property income is projected for each year, as well. This taxable total income equals A) gross revenue minus the combination of B) business and real estate taxes + other expenses + the interest only portion of debt payments + deductible depreciation.

RENTALS+PROPERTY graphic example

This graphic combines all projection factors for a rental real estate property that is owned currently and has a debt that is being paid down. Income, operating expenses, real estate taxes, and depreciation are all taken into account automatically. The net cash flow, when positive, would flow onto the personal tax return and be subject to automatic projection income taxation by VeriPlan taxation processes.

In the tenth year, a non-real estate property with accompanying debt, income, expenses, and associated property taxes is planned for purchase. VeriPlan will handles everything automatically, including the purchase economics. This purchase accounts for the cash flow trend reversing and turning more negative in the tenth year. As the debts on both of these investments are paid down, net combined cash flow turns positive at about age 62. Cash flow becomes increasingly positive after that, until it levels off at about age76, when all debts would be retired.



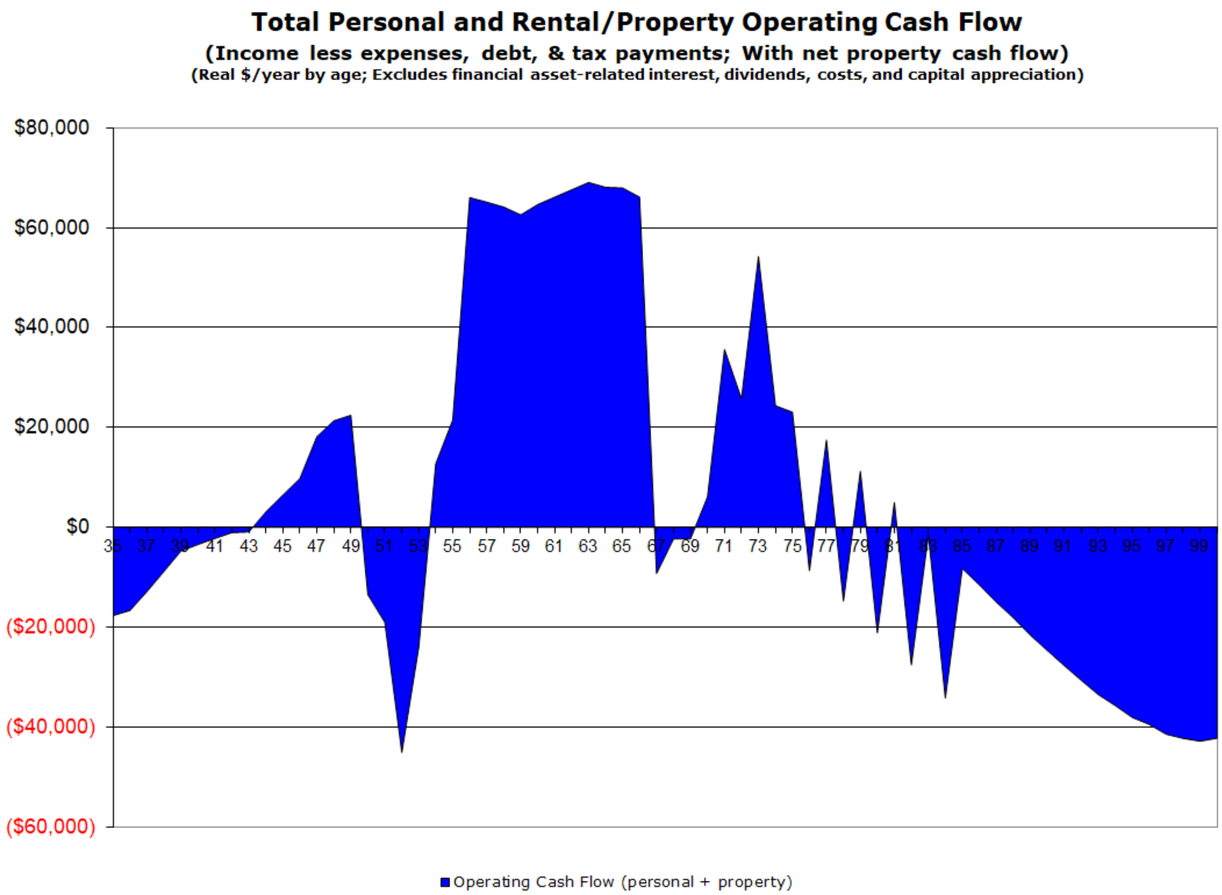
6) CASH FLOW Graphic

Non-Asset Cash Flow – Income less Expenses, Debt, & Tax Payments

(Real $/year by age; Excludes asset-related interest, dividends, costs, and capital appreciation)

This CASH FLOW graphic projects your net earned and other non-asset income -- reduced by all expenses, taxes, and' debt payments. The graphic is a summary of all projected financial activity, but without any asset-related returns or appreciation net of investment costs. However, it does include the projected impact of required taxes related to assets.

CASH FLOW graphic example



For this couple, they are projected to be net savers during the earlier and later working years. For part of the period when their two children are in college, they are projected to have negative cash flow. In retirement, their projection shows an increasing cash flow gap between retirement expenses and retirement income sources, such as Social Security and pensions as they age.. Therefore, they will need to draw upon investment assets to make up the difference.

This gap is primarily driven by increasing taxes related RMDs as they get older. This Operating Cash flow graphic does not include the financial asset side of overall cash flow and assets would be required to make up any negative cash flow in retirement. Note that VeriPlan adds investment asset projection information to this Cash Flow information in the “Asset Flows” graphic. (For more information, see the Asset Flows graphic section below.)

7) SAVINGS RATES Graphic

Pre-Retirement Savings Rates with Investment-Oriented Debt Repayments

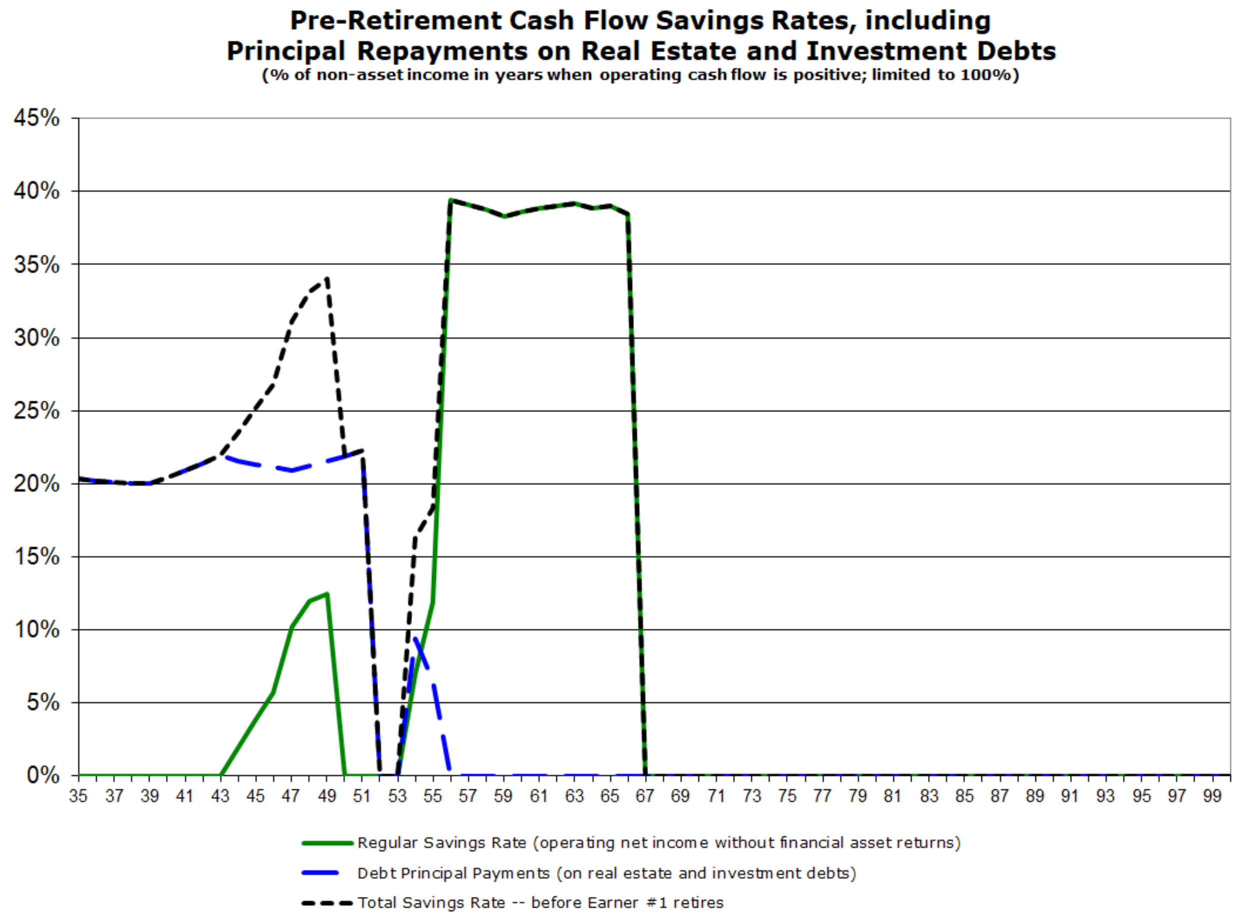
(%/year by age; % of non-asset income in years when non-asset cash flow is positive.)

This SAVINGS graphic projects your annual savings rates up to the planned retirement age of Earner #1. Up until retirement, saving rates will be zero for any projection year when expenses, taxes, and debt payments exceed non-asset income.

The graphic does not show savings rates in retirement, even if non-asset income is projected to exceed expenses, taxes, and debt payments in some retirement years. Because non-asset income in retirement is usually much less than pre-retirement income, this would distort pre-retirement versus post-retirement savings rates. Therefore, to understand potential savings situations during retirement, instead, you should refer to the asset flows graphic.

This graphic projects your savings rates with and without your investment-oriented debt payments. Particularly early in many people's lifetimes, it can seem difficult to save. Savings is always important, and it is useful to recognize that investment-oriented debt payments are a form of savings. When such debt has been retired, then your "normal" savings rates usually need to increase substantially to ensure that adequate assets will be accumulated prior to retirement.

SAVINGS RATES graphic example



For this couple in the sample graphic above, they are projected to have very high personal savings rates. In addition, to living within their means, and saving normally from their earned income, VeriPlan also includes the payoff of the principal on their on their mortgage as additional "investment oriented debt savings."

8) HUMAN CAPITAL Graphic

Expected Income and Savings before Retirement

(Real $ beginning balances by age; Depletion of expected future gross and net pre-retirement earned & other non-asset income)

This HUMAN CAPITAL graphic projects the cumulative remaining gross and net human capital for Earners #1 and #2 up until the retirement age of Earner #1.

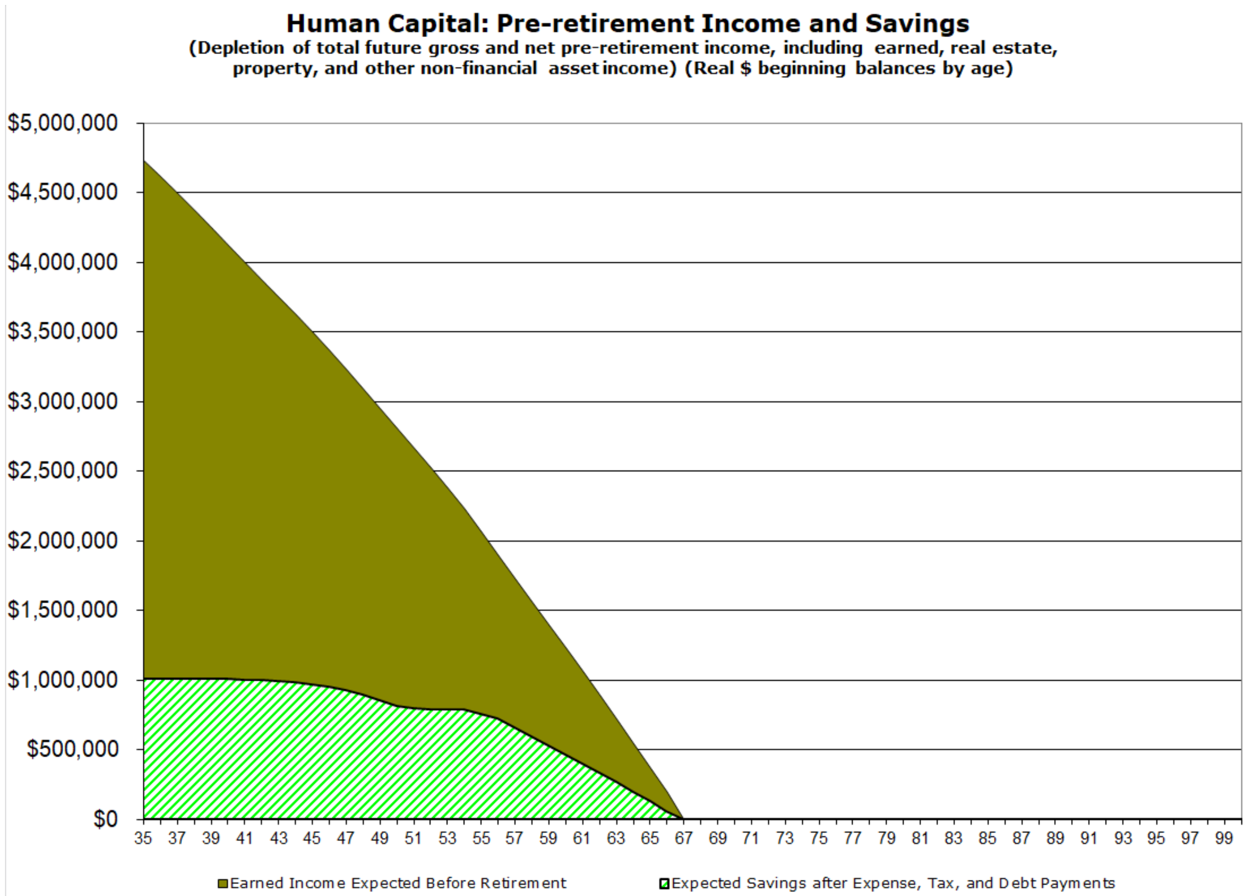
Human capital is a depletable personal asset. Without substantial inherited assets, gifts, or lottery winnings, human capital is the only asset one has. It must converted into earned income to pay ongoing expenses. Some of it must also be saved and converted into valuable assets, if one is to have assets to live on after human capital is gone.

VeriPlan measures your gross human capital as your cumulative yet-to-be-earned real dollar income prior to retirement. Your gross human capital depends upon your entries and growth rates on the income worksheet. These entries are related to your: A) wage and salary income, B) actively-managed business income, and C) other income sources, which may or may not be associated with active income generating efforts on your part.

You can spend and/or save your gross human capital. To the extent that you save it rather than spend it, you will have projected net human capital. Your projected net human capital is your cumulative yet-to-be-saved real dollar net earned income or savings after expenses prior to retirement. Your net human capital can be converted into other assets, which can increase in value and be withdrawn in the future to fund expense shortfalls.

On other asset related graphics, VeriPlan will display your net human capital to illustrate the projected depletion of your human resources. As you move toward retirement and as you convert net income into other assets via savings and new investment deposits, net human capital must fall. The current balance of your net human capital is not a bankable or spendable asset, but you can increase or shrink it through your projected savings rate. Both your gross and net human capital illustrate the aggregate future value of your labor related earned income stream. Human capital is another way to measure future income that could also be at risk due to other factors such as unemployment, underemployment, early disability, and/or premature death.

HUMAN CAPITAL graphic example



This couple's lifetime cumulative gross earnings are expected to exceed $4,500,000 and they are projected to spend about $3,500,000 of that for ongoing expenses, debt payments, and taxes during their working years. The good news is that this couple is projected cumulatively to save about $1,000,000 of their gross projected income, which they will put toward their investment program.

On the Human Capital graphic their cumulative expected net savings are represented by the area with the diagonal green lines. On all of VeriPlan's other area graphs that project this couple's lifetime investment assets, you will notice that his Net Human Capital will also be included. This is done to illustrate the conversion over time of their valuable labor into valuable investment assets.

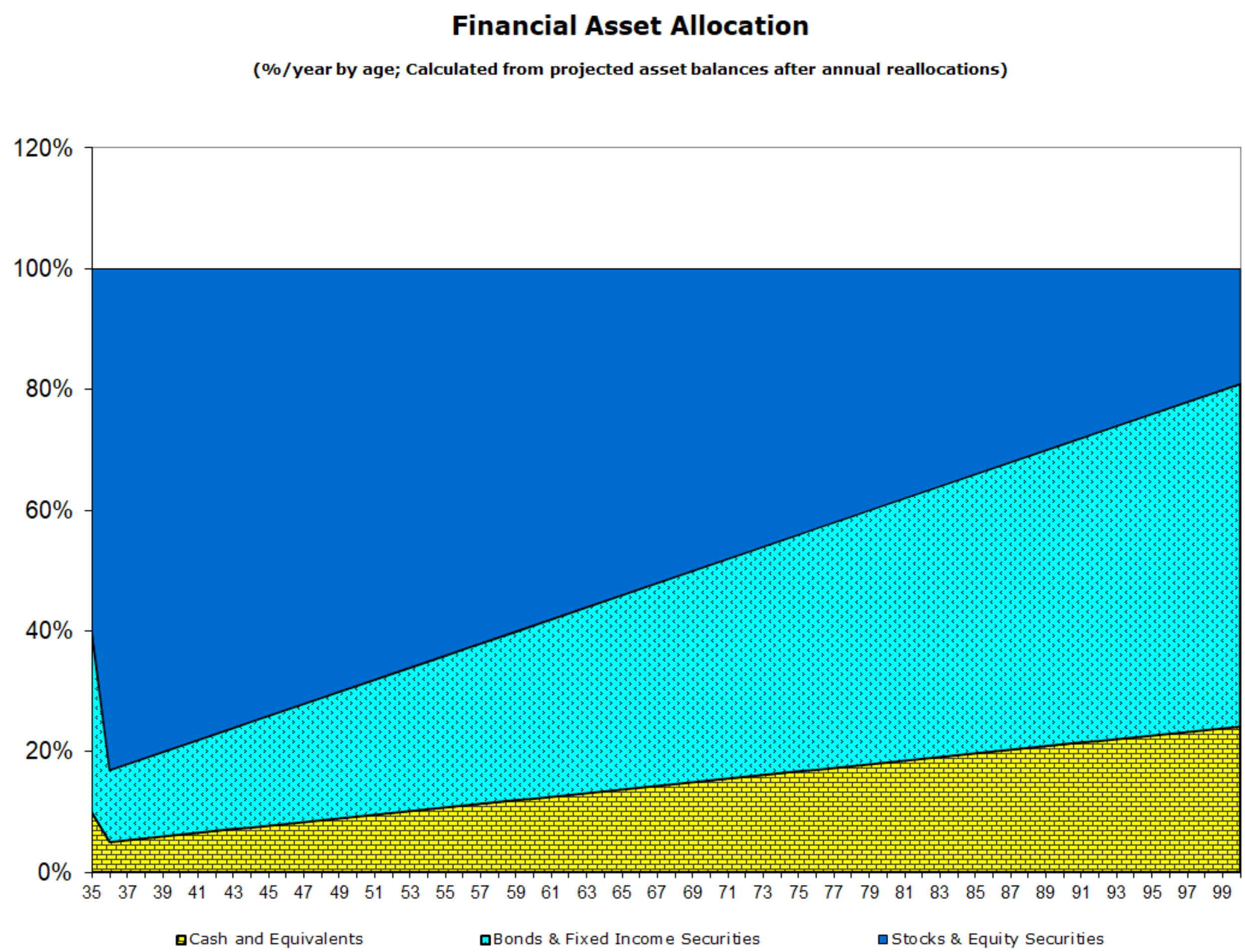
9) ALLOCATION Graphic

Financial Asset Allocation

(%/year by age; Calculated from projected asset balances after annual reallocations)

This Asset Allocation graphic shows your projected annual financial asset allocation across your lifetime. This graphic depends upon your settings on the allocation worksheet. VeriPlan provides five asset allocation methods with flexible user adjustments.

ALLOCATION graphic example



In this sample graphic, this couple has chosen to adopt an asset allocation strategy more weighted toward equities while they are younger. Over time, they will steadily increase their allocation to bonds and cash and decrease their allocation to equities. In this particular projection, this couple has chosen the VeriPlan asset allocation method that set a fixed ratio between bond and cash.

10) TOTAL ASSETS Graphic

Financial Assets, Property, and Debts with Cumulative Assets Lost to Excessive Investment Costs

(Real $/year by age; Beginning balances with reallocations; Debt causes assets to display below 0)

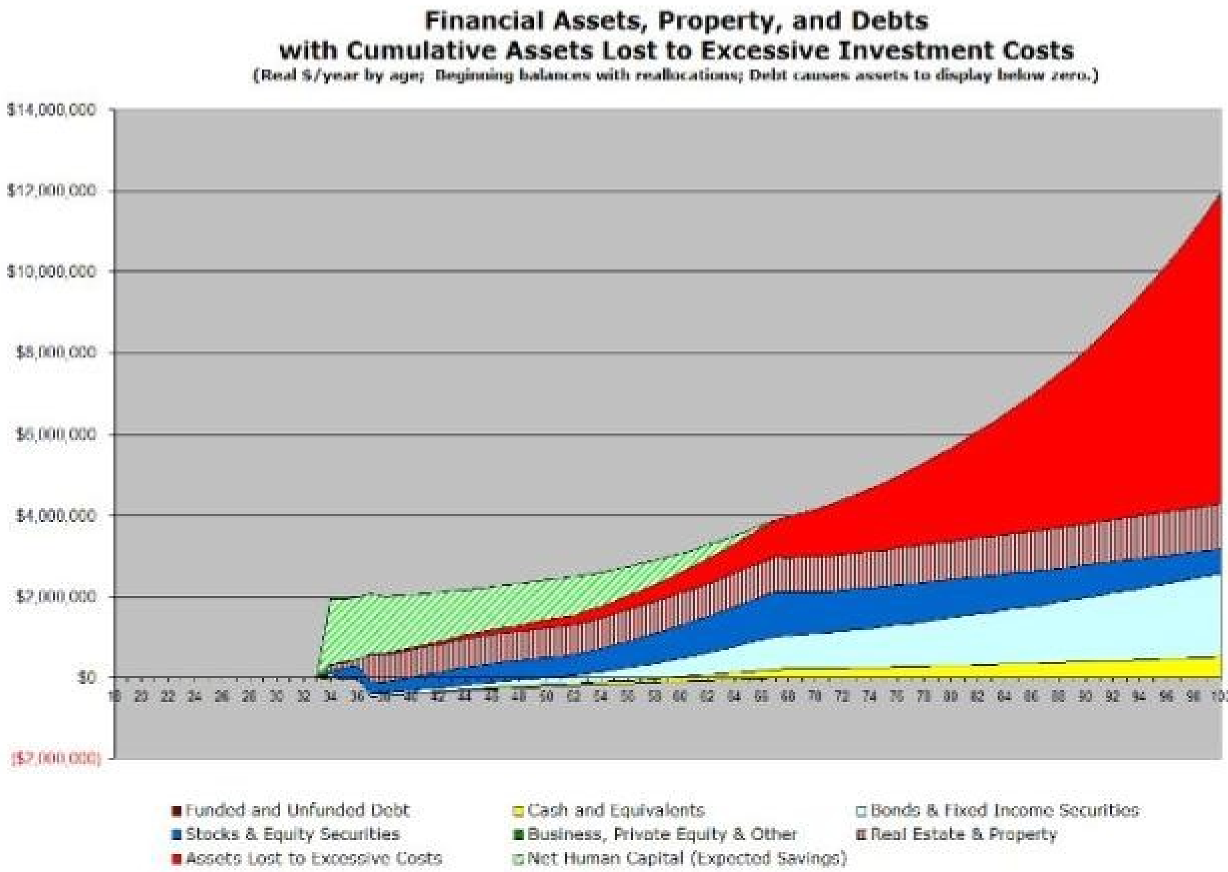
This TOTAL ASSETS graphic shows your projected cash, bond/fixed income, and stock/equity financial assets and property. Your net human capital is also shown to illustrate the conversion of your net earned income into financial assets through your savings. Cash, bond/fixed income, and stock/equity financial assets and property assets are graphed in layers. On top of your financial assets, this graphic also displays the projected values of your property and other assets that you entered on the property worksheet.

Debts display differently. This graphic includes the value of your current debts, as they are paid down, plus any future debts that you accrue. Because of how the graphics drawing facilities of the underlying spreadsheet engine work, your debts will not display directly when you have other positively valued assets. However, your current and future debts will affect how your positively valued assets are displayed.

The presence of your current or future debts can be detected easily on these graphics. Whenever the lower edge of any positively valued asset falls below zero, your outstanding debts are the cause. How much your positively valued assets will be pulled downward depends upon the total principal amount of your debts with any accrued interest.

TOTAL ASSETS graphic example

(This is the older style of this VeriPlan graphic. Because it represents the projection scenario with investment costs that is described in the accompanying text below, this older graphic has been retained.)



Graphing investment cost inefficiencies in the Total Assets graphic

In this sample total assets graphic, this couple's lifetime asset projection indicates that they would have increasing amounts of cash, bond, and stock financial assets and real estate property over their lives. However, due to the various costs of their investment portfolio, they would spend their lives paying unnecessarily high investment expenses. In effect, they would throw away almost as much in total assets by age 100 than they would have retained.

VeriPlan provides easy to use investment cost analysis facilities that help users understand the lifetime impact of the investment fees they pay. The sad thing is that this couple's lifetime projection graphic reflects the average investment costs paid by the average investor. Like other average investors, if they do not slash their investment costs, they will significantly stunt the growth of their retirement portfolio by paying excessive fees to the financial services industry.

In addition to projecting your cumulative cash, bond, and stock financial assets and property assets, this TOTAL ASSETS graphic also projects your cumulative assets lost to excessive investment costs associated with your financial assets and your settings on the investment costs worksheet.

Your property and other assets are graphed with your financial assets and cost-inefficiencies and have been arranged on these charts to demonstrate how long your total assets are projected to last. If you are projected to have expense shortfalls that will reduce your assets in the future, then your more liquid financial cash, bond/fixed income, and stock/equity assets will be depleted first. After they are exhausted, VeriPlan assumes you will deplete your other assets (business interests, private equity, etc.) followed thereafter by your real estate property assets.

11) ASSET FLOWS Graphic

Non-Asset Cash Flow with Cash, Bond, and Stock Financial Asset Returns

(Includes Required Minimum Distributions, & Unfunded Consumption) (Real $/year by age)

The graphic provides several summary financial projections. First, it graphs both annual financial asset returns net of current year investment expenses. Second it graphs your total annual cash flow from non-asset related activities, including all earned and other income, living expenses, debt payments and taxes -- including investment taxes. (This line is equivalent to the CASH FLOW graphic.) Then, it graphs the combination of your projected non-asset cash flow and current year net asset appreciation.

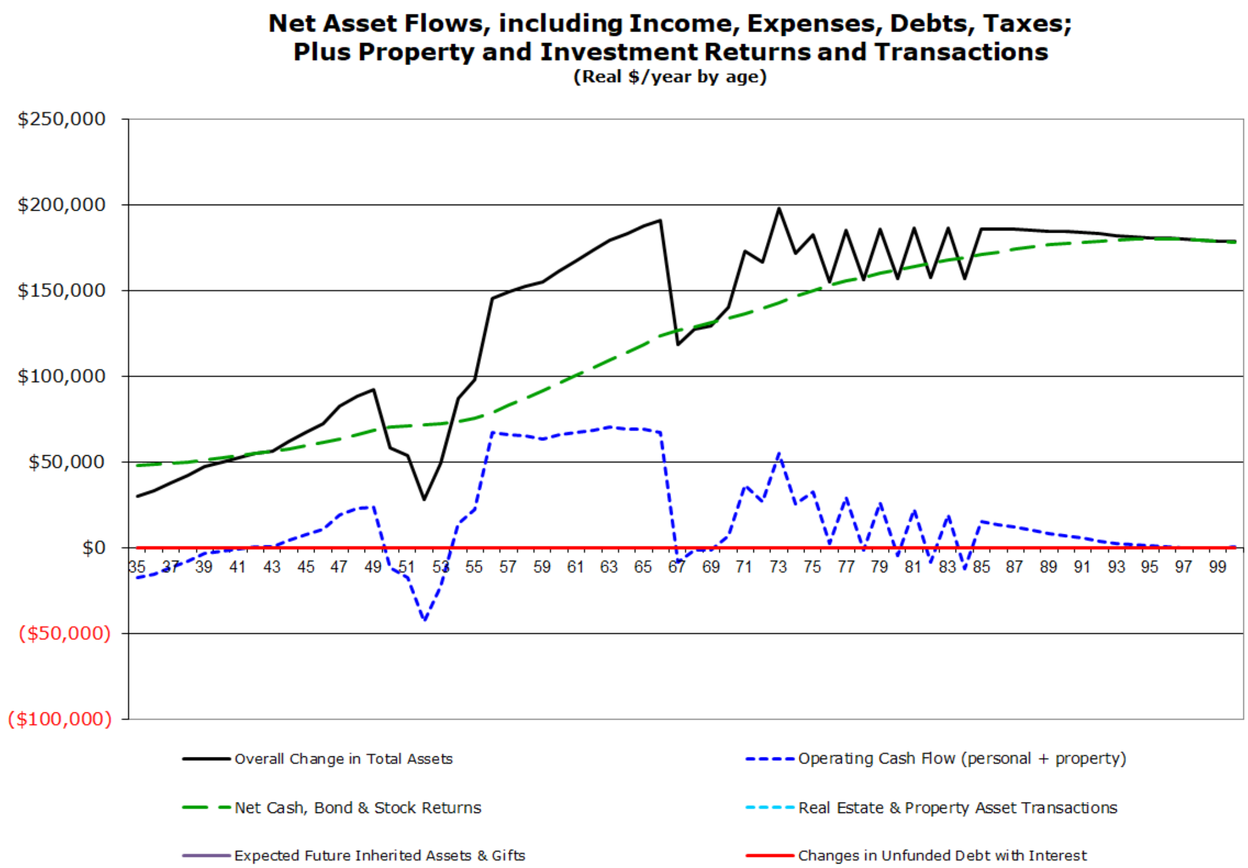
This ASSET FLOWS graphic also indicates total projections annual Required Minimum Distributions (RMDs) from traditional tax-advantaged retirement accounts. Finally, it graphs unfunded consumption expenses, if and when projected cash, bond, and stock financial assets are exhausted. These unfunded consumptions expenses would need to be paid through borrowing or the sale of property and other assets or they would be entirely unfunded.

ASSET FLOWS graphic example

Some VeriPlan users find the Asset Flows graphic to be very useful, because it combines the effects of lifetime cash flow from earnings, expenses, debts, and taxes with the effects of lifetime appreciation of their cash, bond, and stock financial asset portfolio. In this sample graphic, this couple's projection data from their Cash Flow graphic is drawn as the blue line. The projected annual return on their investment portfolio is graphed as the green line, which steadily increases during their working years. During their retirement years, the projected annual return on their investment portfolio levels off but still grows moderately, as they utilize some of their investment returns to fund their negative cash flow in retirement.

The black line on the Asset Flows graphic combines this couple's cash flow from earnings, expenses, debts, and taxes with the appreciation of their cash, bond, and stock financial asset portfolio. Whenever that black line is above zero, then their total family assets are projected to increase by that annual amount. Correspondingly, when the black line falls below zero, this would mean that their cash flow gap exceeds the projected investment return of their financial asset portfolio.

(This is the older style of this VeriPlan graphic. Because it represents the projection described in the accompanying text, it has been retained.)



Required Minimum Distributions from tax-advantaged retirement accounts

After age 73, tax laws specify that a portion of the assets held in traditional tax-advantaged IRAs and employer sponsored retirement plans must be withdrawn as Required Minimum Distributions (RMDs). The initial age for RMDs used to be 70.5. This was increased to 72 by the SECURE Act of 2019. Then, the SECURE Act ("2.0") of 2022 increased the initial age for

RMDs to 73 and to 75 starting in 2033. Thus, currently the initial age for RMDs depends upon your age now.

Calculated according to actuarial tables, RMDs force assets out of traditional tax-advantaged accounts and into taxable accounts solely to assess income taxes on the taxable proceeds (above any tax basis that these retirement account assets might have, which is usually quite small or zero). For user convenience, this graphic also lists this couple's projected Required Minimum Distributions from traditional tax-advantaged retirement accounts. However, users should understand that RMDs are not retirement "income," but are simply legally mandated withdrawals from tax-advantaged accounts to create "income taxable" events and corresponding income tax payments. RMDs occur whether or not the retiree(s) need the after-tax funds to live on in retirement. If they do, then RMDs can fund negative cash flow. If they do not, then the after-tax funds are simply reinvested in taxable accounts. The Withdrawals graphic, immediately following, discusses RMDs in greater detail.

12) DEBT OWED Graphic: Personal, real estate, and business debt principal owed

DEBT OWED graphic example

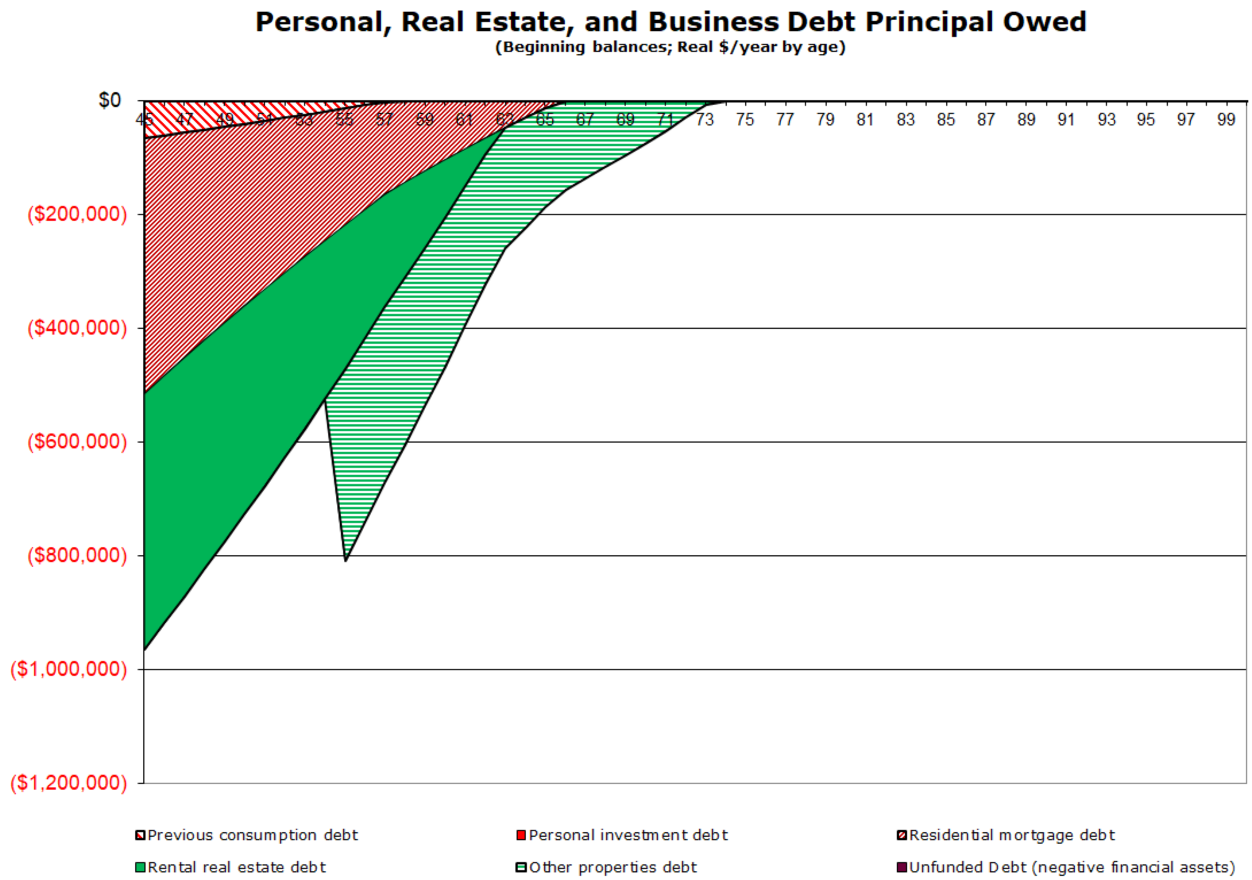
This Debt Owed provides projected annual beginning principal balances for all personal and business debts. Debts are categorized as:

a) previous consumption debt,
b) personal investment debt,
c) residential mortgage debt,
d) rental real estate debt,
e) other properties debt, and
f) unfunded debt.

Unfunded debt is equal to cumulative negative financial assets, if financial assets are projected to be depleted.

In the graphic example below, there are three current debts that are all projected to be paid off by age 66.. The smaller wedge at the top is credit card debt related to prior consumption, The light red area is the mortgage on the personal residence. The dark green wedge is the mortgage debt on the rental real estate property that is currently held.

The fourth debt represented by the lighter green area with horizontal lines has not yet been incurred. In ten years, they plan to purchase a small business property, which will involve taking on more debt. VeriPlan handles all the financial parameters of future purchase and/or sale of any business property, as well, as for residential real estate and rental real estate.



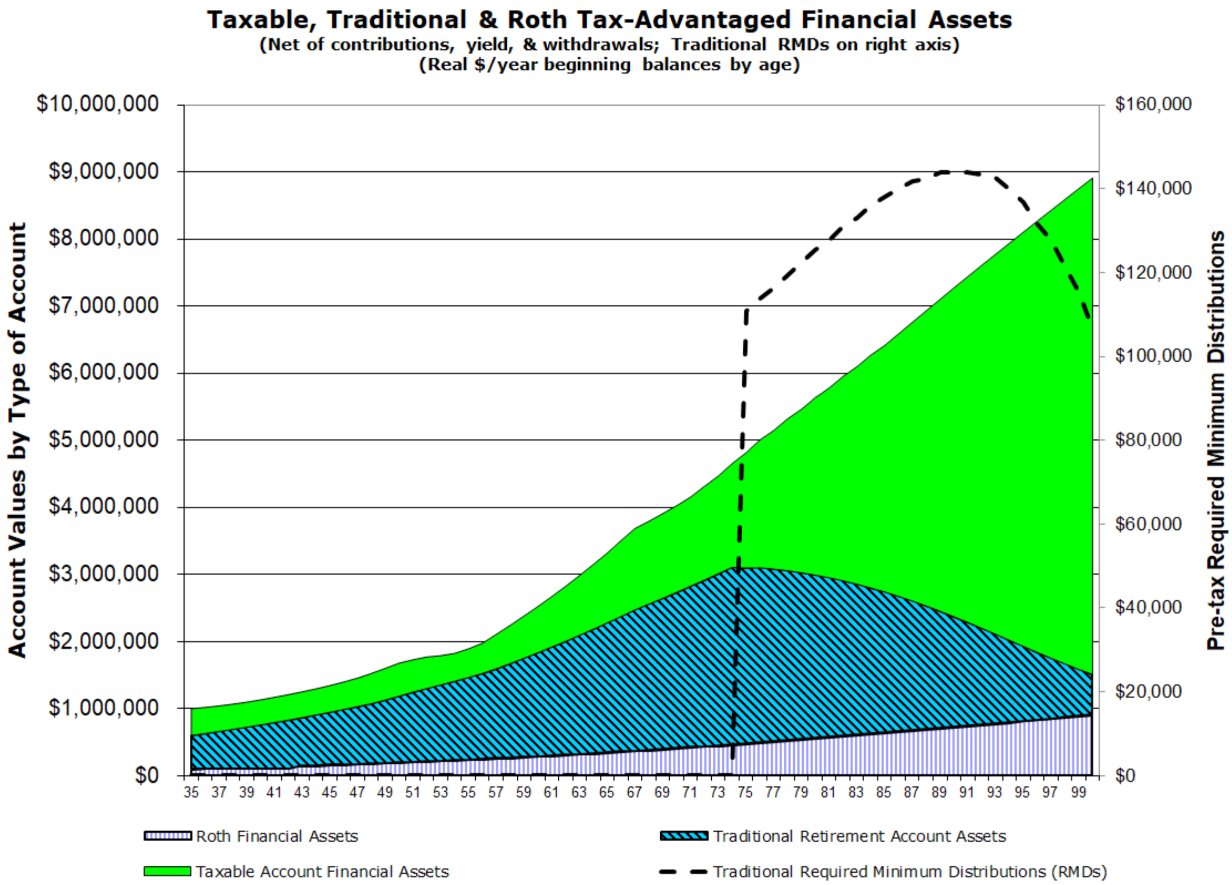
13) ASSET TAXABILITY Graphic

Taxable, Traditional & Roth Tax-Advantaged Financial Assets

(Real $/year beginning balances by age; Net of new investments, yields, transfers, and withdrawals)

This ASSET TAXABILITY graphic projects your holdings of financial assets between your taxable and tax-deferred accounts. These assets depend upon the tax characteristics your current holdings, which you entered on the financial assets worksheet. This graphic also depends upon your settings on the tax-advantaged plans worksheet regarding your future contributions into tax-advantaged retirement plans.

ASSET TAXABILITY graphic example



The Asset Taxability graphic for this couple indicates that their modest contributions to Roth retirement accounts would grow steadily. Concerning their traditional tax-advantaged accounts those assets would grow and then decline in retirement with RMDs. Throughout their working years this couple plans to take maximum advantage of tax-advantaged retirement investing. This means that they need to keep an eye on their ongoing contributions to deal with years where assets in taxable accounts would not fund near term expense needs.

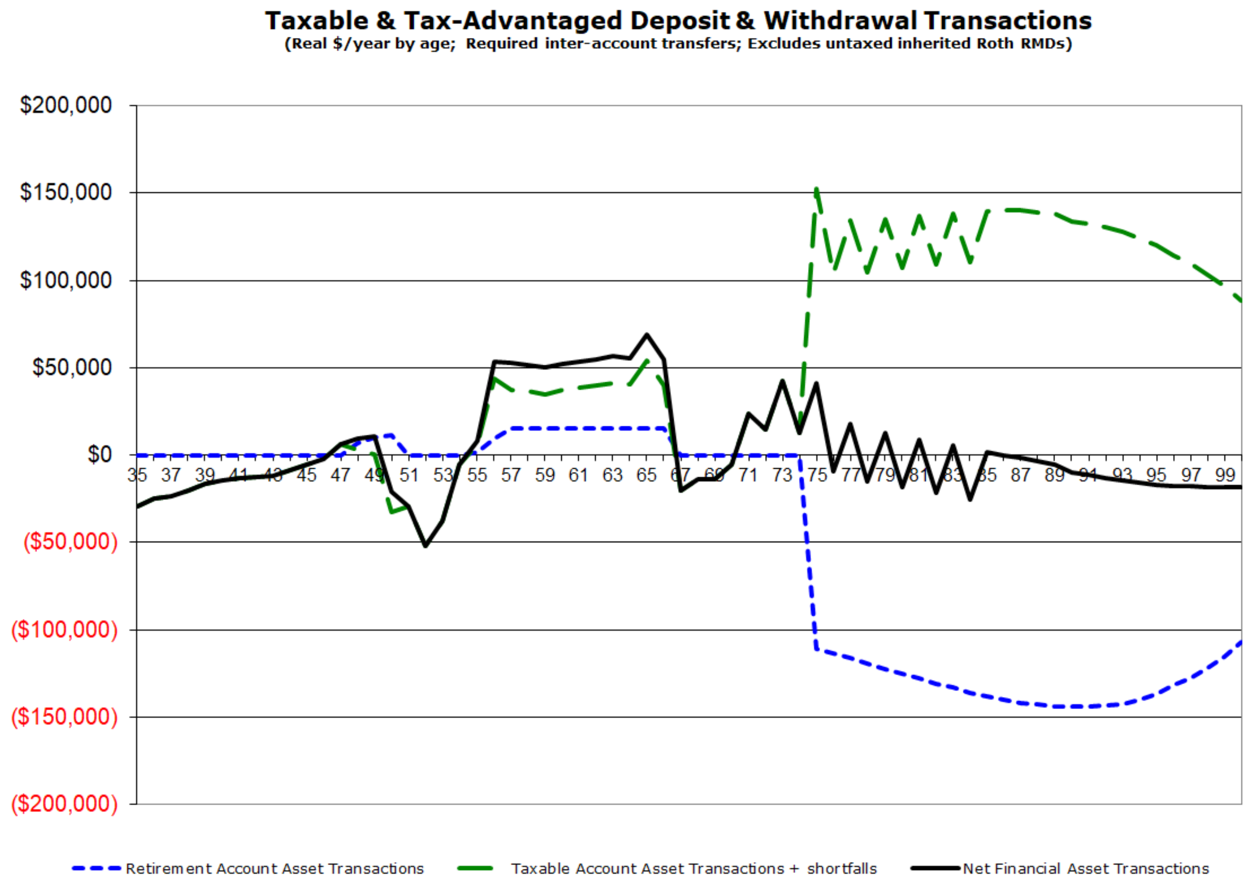
14) ASSET TRANSACTIONS Graphic

Taxable & Tax-Advantaged Deposit & Withdrawal Transactions

(Real $/year by age; Required inter-account transfers)

This TRANSACTIONS graphic shows your projected annual net financial asset cash flows into and out of both your taxable and tax-advantaged accounts. It also shows your net overall financial asset transactions, which is a combination of your taxable and tax-advantaged accounts transactions. This combined annual transaction line indicates whether you are adding to or withdrawing from your financial asset accounts to meet your expense, debt, and tax obligations. Annual costs without interest that cannot be funded with financial assets are also included in the taxable and net asset categories.

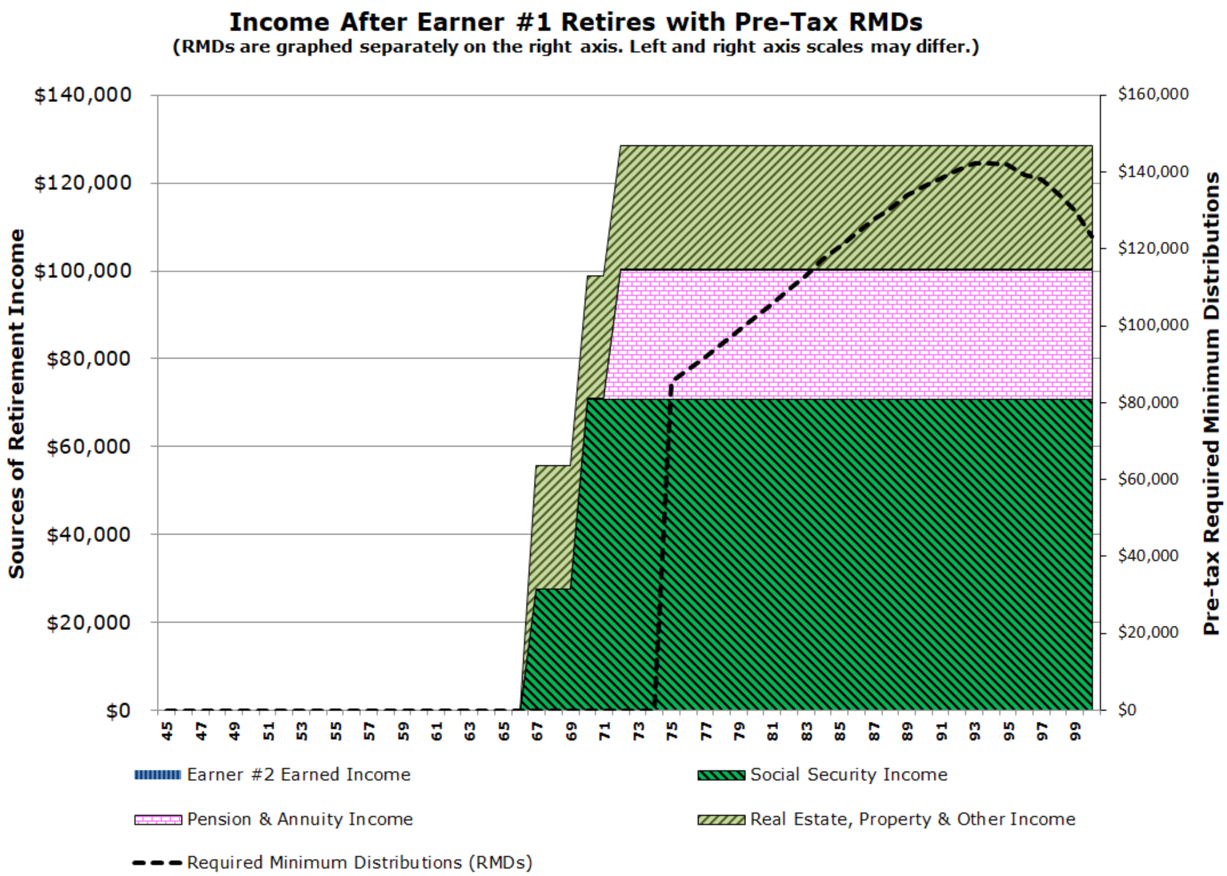
TRANSACTIONS graphic example



This graphic is helpful when you wish to assess whether withdrawals from tax-advantaged accounts are being made to cover necessary expenses and/or to meet mandatory tax recognition and taxation requirements for RMDs. If tax-advantaged account withdrawals are indicated simultaneously with deposits into taxable accounts, then some or all of your tax-advantaged account withdrawals are being made to satisfy mandatory withdrawal rules. This graphic focuses on transactional cash flows only. It does not show your overall projected net financial asset yields. All your financial asset deposits, distributions, and other withdrawals are included. However, capital appreciation that is not recognized for tax purposes is not. Instead, capital appreciation that does not involve taxation is simply reinvested and is reflected in your financial asset balances on VeriPlan's various financial assets graphics.

15) RETIREMENT INCOME Graphic: Retirement income sources and pre-tax Required Minimum Distributions (RMDs) after Earner #1 retires

RETIREMENT INCOME graphic example



This graphic projects various income sources in retirement after Earner #1 plans to retire. Retirement income sources may include continuing earned income from Earner #1, Social Security retirement income, and pension, deferred compensation, and/or annuity income.

This graphic also includes Pre-Tax Required Minimum Distributions (RMDs). RMDs are not strictly an income source. Instead, they are required distributions of invested assets from retirement accounts that force taxation in the process. If you would need some or all of the after-tax RMD proceeds to pay your bills, then you can think of them as income. Whatever might be left of these RMDs after taxes and after expenses would then be deposited into taxable asset accounts.

Pre-tax RMDs from traditional retirement accounts are projected as a dashed overlay line measured by the right vertical axis. Note the retirement income sources on the left vertical axis and RMDs on the right vertical axes are usually not the same numerical scale. Also, note that if any RMDs are indicated before age 73, these could be associated with inherited traditional retirement accounts. Alternatively, if the Earner #2 spouse is older than Earner #1, they could represent RMDs associated with the spouse's traditional retirement accounts.

RMDs are not strictly an income source. Instead, they are required distributions of invested asset from retirement accounts that force taxation in the process. If you would need some or all of the after-tax RMD proceeds to pay your bills, then you can think of them as income. Whatever might be left of these RMDs after taxes and after expenses would then be deposited into taxable asset accounts.

16) ASSET WITHDRAWALS Graphic

Withdrawal Rates from Cash, Bond & Stock Financial Assets

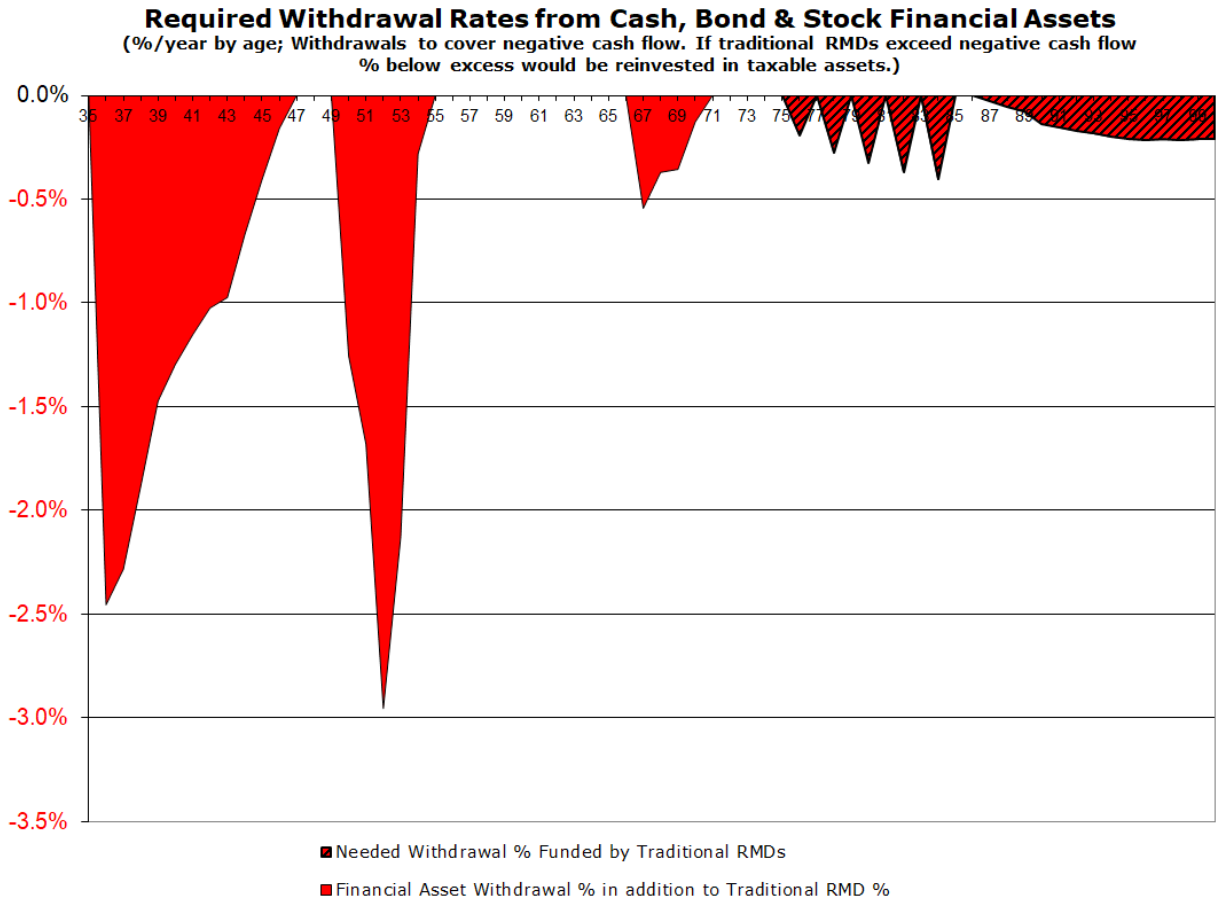
(%/year by age; Withdrawals for net cash flow shortfalls, RMDs, & associated taxes)

This WITHDRAWALS graphic presents your net overall annual financial asset withdrawal rates as a percentage of the beginning balances of your then current financial asset holdings. An asset withdrawal rate can only be shown, when your total cash, fixed income, and equity financial assets are positive.

This graphic also indicates how much of withdrawals are attributable to annual Required Minimum Distributions (RMDs) from traditional tax-advantaged retirement accounts. In any projection year when negative cash flow requirements exceed RMDs, additional withdrawals will be indicated. In years when RMDs exceed cash flow requirements, then any excess RMD withdrawal beyond cash flow requirements with not be shown here. Instead, that RMD excess will be deposited automatically in taxable financial asset accounts.

WITHDRAWALS graphic example

While those planning retirement seek rules of thumb about asset withdrawal rates, the future unfolds unpredictably and withdrawals over a lifetime will depend upon the net effects of a myriad of financial factors. Retirement withdrawal studies that discuss methods of gauging and planning safe withdrawals of 3%, 4%, or even higher percentages from retirement portfolios have utility and are very important to consider.



For this couple, their withdrawals graphic provides information about a variety of projected events over their lives that would involve withdrawals of assets from their cash, bond, and stock financial asset portfolio – exceeding the projected yield of their financial portfolio at that point in time. The first percentage drawdown occurs early in their projection, when their portfolio is the most modest and when they need to cover negative cash flow from financial assets that they were fortunate enough to have inherited.. The second drawdown occurs during some of the consecutive years when their two children are in college. The third drawdown occurs in their early retirement years when that have a larger cash flow gap, because they have chosen to increase their Social Security retirement payments by delaying acceptance of their first payment until they are age 70.

Finally, the fourth and longest drawdown event begins around age 75 for Earner #1, which illustrates the projected amount they need to withdraw to fund negative cash flow once they have begun to receive Social Security retirement payments and are also subject to Required Minimum Distributions. The good news for them is that VeriPlan projects their withdrawal rates would be less than half of one percent in late retirement. This is fortunate, because their shift to a bond and cash heavy investment portfolio as they age would mean both lower expected risk but also lower expected rates of return.

17) RETIREMENT SHORTFALLS Graphic: Cash flow shortfalls after Earner #1 retires including RMDs

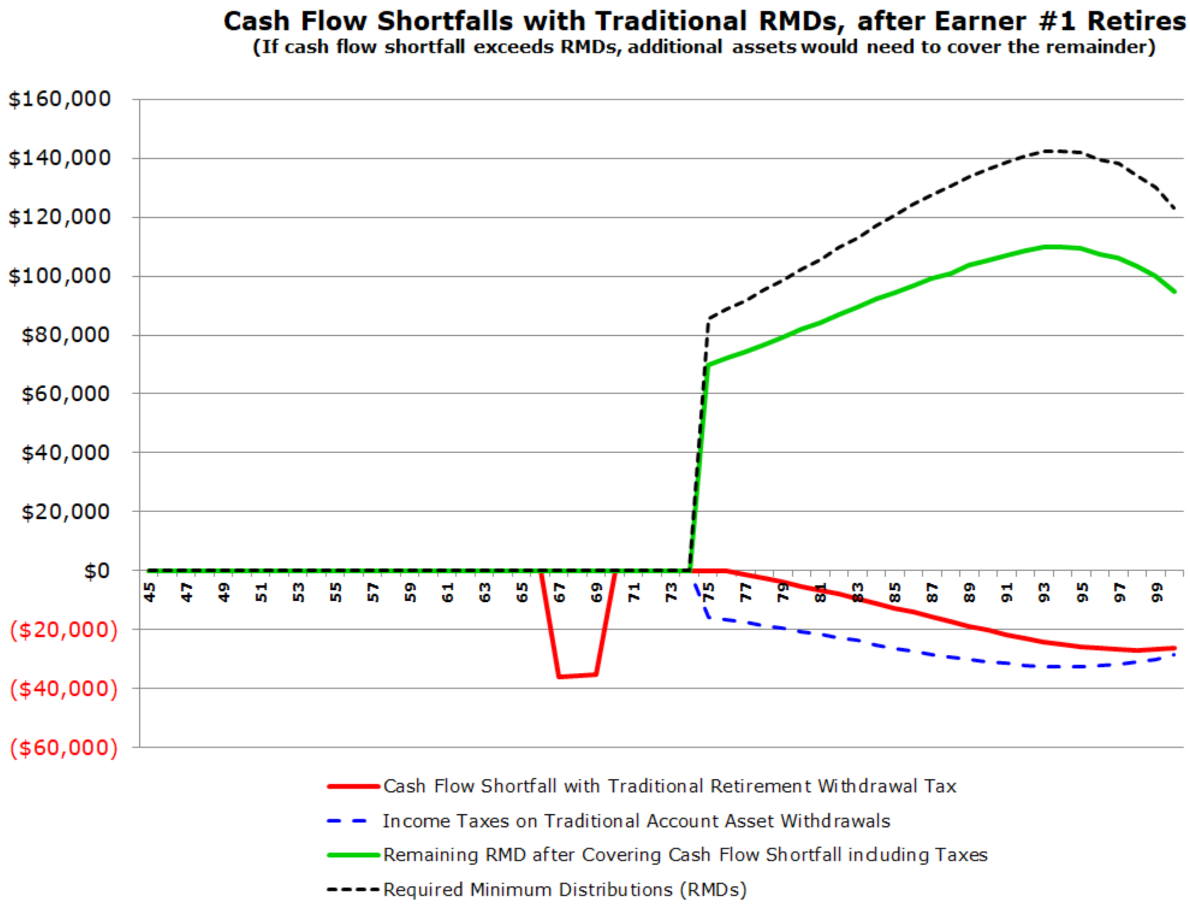
RETIREMENT SHORTFALLS graphic example

This graphic projects any yearly cash flow shortfalls after Earner #1 retires. These cash flow shortfalls have already taken into account the retirement income sources projected on the previous RETIREMENT INCOME graphic. However, the cash flow shortfall line does not include the impact of your projected RMDs from traditional retirement accounts.

RETIREMENT SHORTFALLS demonstrates whether your RMDs are projected to be sufficient to make up for any cash flow shortfall that you might experience during various retirement years. If the cash flow shortfall in any projection year, which includes income taxes on traditional account asset withdrawals, were to exceed your projected RMDs, then other assets would be needed to cover the remaining shortfall.

To provide a better understanding of traditional retirement account RMDs and taxes, this graphic also includes a dashed line indicating total federal, state, and local ordinary income taxes on withdrawals from traditional retirement accounts to cover RMDs and for income taxes on any additional withdrawals needed in excess of RMDs.

This graphic displays a continuous green line that indicates any net RMD remaining after RMD income taxes and cash flow shortfalls have been covered. When this line is positive, this means that these excess RMD assets would be automatically reinvested in your taxable accounts as financial assets.



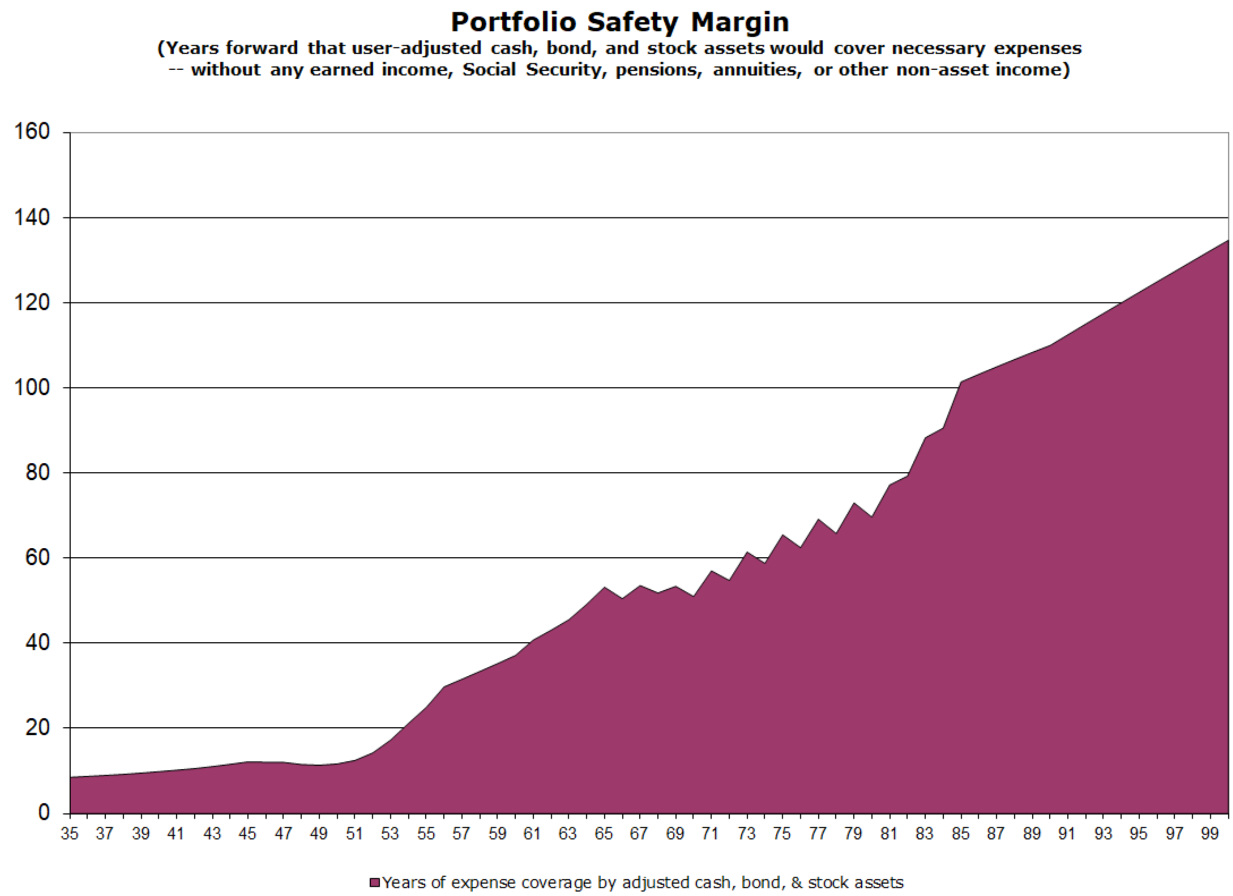
18) ASSET SAFETY MARGIN Graphic

Emergency asset coverage of expenses without other income

(Number of years forward from any projection year that financial assets would cover necessary expenses -- without the receipt of other expected earned income, Social Security, pensions, annuities, or other non-asset income)

This SAFETY MARGIN graphic provides a measure of how long, measured in years going forward, that your projected financial assets would cover your projected necessary expenses, if you lost all your expected sources of income. In effect, this is a stress test of the unusual situation where all personal income sources ceased, and you needed to fund needed living expenses solely from your financial investment assets.

SAFETY MARGIN graphic example



Particularly after this couple puts their two children through college (by the time that Earner #1 is in his or her early 50's), their portfolio safety margin keeps increasing. Some of this is due to aggregate long-term portfolio appreciation, and some of this is due to the fact that they have chosen an asset allocation strategy that increasingly shifts toward bonds and cash over time.

19) VALUE OF TIME Graphic: Hourly wage equivalent value of income, expenses, and financial assets

VALUE OF TIME: Hourly Value of Income, Expenses, and Financial Assets (Number of years forward that cash, bond, and stock portfolio financial assets would cover necessary expenses -- without any expected earned income, Social Security, pensions, annuities, or other non-asset income)

Given all the uncertainties in personal financial planning, it can be very difficult to make major life decisions, such as the choice of when to retire. Viewing finances on an hourly basis can be helpful, and this is another way to think about how one must or would like to spend one's time. Regarding the retirement decision, the trade-offs between working longer versus retiring can aided by understanding income, expenses, and financial assets on a standard hourly basis.

When they are sufficient in retirement, your financial assets act as a replacement worker for yourself. Financial assets can replace earned income and close the gap between Social Security, pension, and annuity income and expenses in retirement.

While other VeriPlan graphics project financial resources assuming that the primary Earner/User(s) will live to age 100, that very conservative planning assumption clearly exceeds the average life expectancies that you can see on VeriPlan's Life Expectancy graphic. To help you think about the differential impact of an earlier demise, this graphic provides three lines measuring financial assets on an hourly basis, if death were to occur at 80, 90, or 100 years of age.

All the lines on this graphic present information on an hourly basis assuming a 2,000 full-time work year, since 8 hours per day times 5 days per week times 50 weeks per year equals 2,000 hours per year.

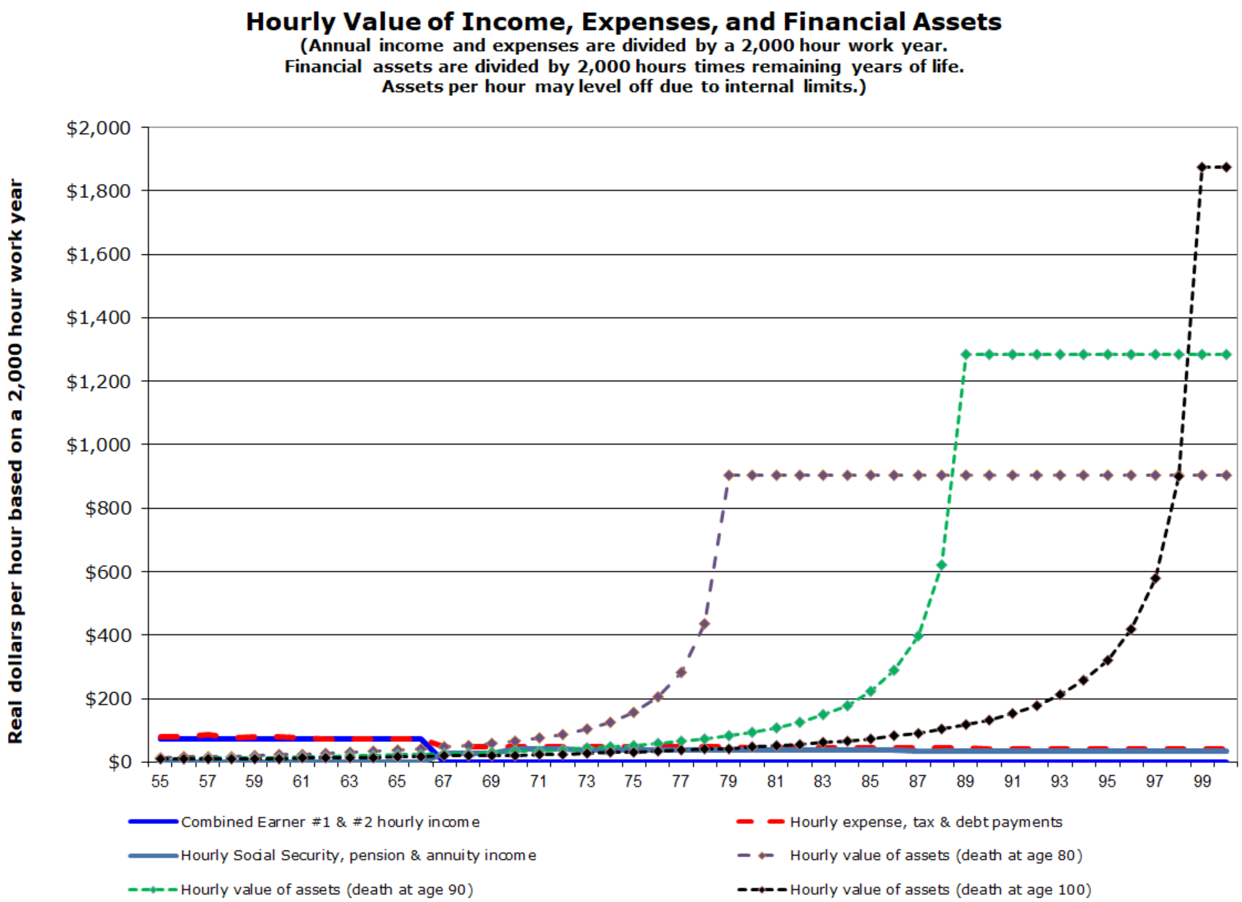
Because the earned income, retirement income, and expenses lines measure a single year, this is how they are calculated:

- Combined Earner #1 & #2 full-time equivalent income: Combined earned income is calculated as if that income was obtained by a single worker working 2,000 hours per year. If your total household earnings are obtained with more or less than 2,000 hours of work, make a mental adjustment, but keep in mind that it is necessary to standardize the hours per year for comparisons across the various lines.
- Social Security, pension, and annuity income: All retirement income sources are combined and then divided by 2,000 hours.
- Total expense, tax, & debt payments: All cash outflows are combined and then divided by 2,000 hours.

The three "Hourly value of assets" lines with projected death at age 80, 90, or 100 measure the hourly remaining lifetime value of total financial assets through those three ages. The hourly amounts are calculated by dividing the total financial assets at the beginning of each projection year by 2,000 hours per year times the number of years of life remaining.

Note that each of these age 80, 90 and 100 asset lines may level off due to internal limits for some projections, if total projected total assets are very large. Without such a limitation in some projections, remaining asset values can be very high with only a few years remaining. In these situations, the hourly financial asset value could become very large and would far exceed hourly living costs.

Sample VALUE OF TIME graphic



20) COST-EFFICIENCY % Graphic

Net Cash, Bond & Stock Financial Asset Returns with Returns Lost on Excessive Investment Costs

(Real $/year by age)

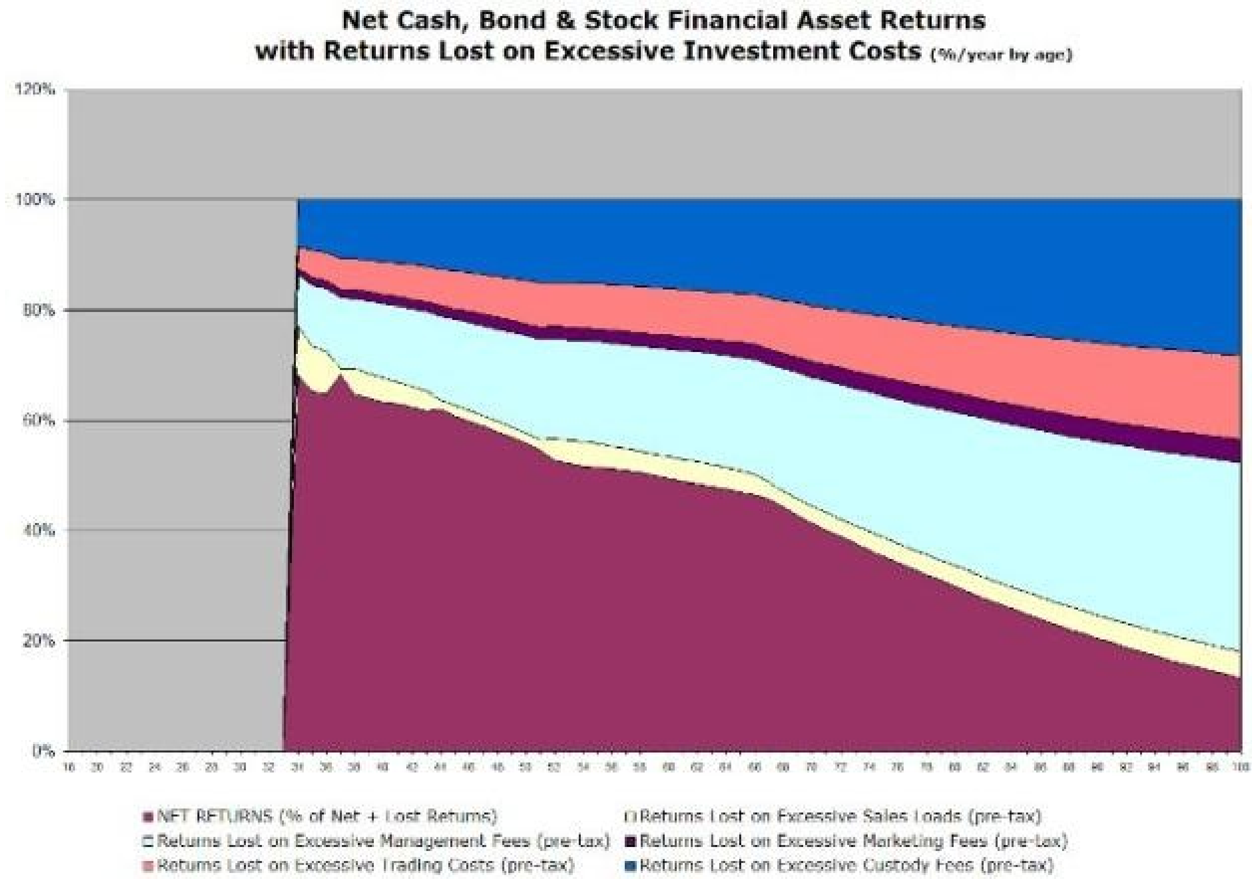
By comparing your current portfolio's investment costs to the investment costs that you believe are reasonable to pay, this and the next graphics illustrate your potential returns with a more cost-efficient strategy versus your projected asset returns and portfolio values with your current costs.

The COST-EFFICIENCY % graphic presents the same information as the following COST-EFFICIENCY $ graphic, but in percentage terms. For people who must draw down their financial assets at various points in their lives to make up for expense shortfalls, the percentage of returns lost to cost-inefficiencies will increase. Of course, almost everyone will have to draw down their assets at various points, because their earned income will not exceed their expenses during all years of their lives.

Because investors only can pay expenses from their tangible retained assets, expense shortfalls will only eat into these assets. In contrast, because the assets that they gave away to cost-inefficiencies are phantom assets or opportunity costs that cannot be used, then those lost assets will grow increasingly faster than your tangible and depletable retained assets.

COST-EFFICIENCY % graphic example

(This is the older style of this VeriPlan graphic. Because it represents the projection scenario described in the accompanying text, this older graphic has been retained.)



The couple depicted in these sample VeriPlan graphics pay investment costs that are typical of the average investor. While surprising to most investors, the lifetime costs of excessive investment costs for the average investor are simply huge. Most investors think that the investment costs that they pay are small, but the compounded and accumulated lifetime value of assets lost to the financial services industry are anything but small.

For this couple, they are losing to fees and taxes about one third of their potential investment returns on their retained assets each year. However, the situation deteriorates thereafter. Keep in mind that all VeriPlan graphics are based upon "real or constant purchasing power" dollars and all these graphics have removed inflation. Investment costs are assessed on nominal or inflationary dollars, but the investor has to live with what remains.

Investors absorb 100% of the negative impacts of inflation. Therefore, when percentages are calculated with real dollars, investment costs take a larger piece of the pie. Net returns after expenses and taxes are what count to the individual investor. As a visual analogy, think of each individual investor who pays unnecessarily high fees as an unfortunate fisherman. Moreover, think of the average investor as Santiago, the fisherman in Ernest Hemingway's "*The Old Man and the Sea.*"

Santiago takes the risks of going to sea and finally hooks a big marlin (his gross return). However at age 85, he does not have the strength to pull the marlin into his boat. By the time Santiago returns to shore, the sharks have reduced his marlin to only the skeleton, which equals his net return. The sharks of the financial world are nicer in the sense that they usually take less than half of the flesh through excessive fees and unnecessary taxes, before you make it to shore. Unfortunately, these financial sharks circle every investor's boat year in and year out feeding off your catch.

In the short-term, what remains for the couple in this graphic are significantly diminished net percentage returns after excessive investment fees and after unnecessary investment taxes. Then, these investors need to live on those assets through years of negative cash flow related to their income after expenses, taxes, and debt payments. However, phantom investment assets lost or given away through excessive fees and taxes are not similarly drawn down to cover negative cash flow. Thus, these "phantom" assets compound in the future much more rapidly than the assets that this couple would retain and draw upon, as needed. Thus the proportion of lost assets grows across their lives and comes to dominate their financial projection – particularly as the time horizon increases into multiple decades.

21) COST-EFFICIENCY $ Graphic

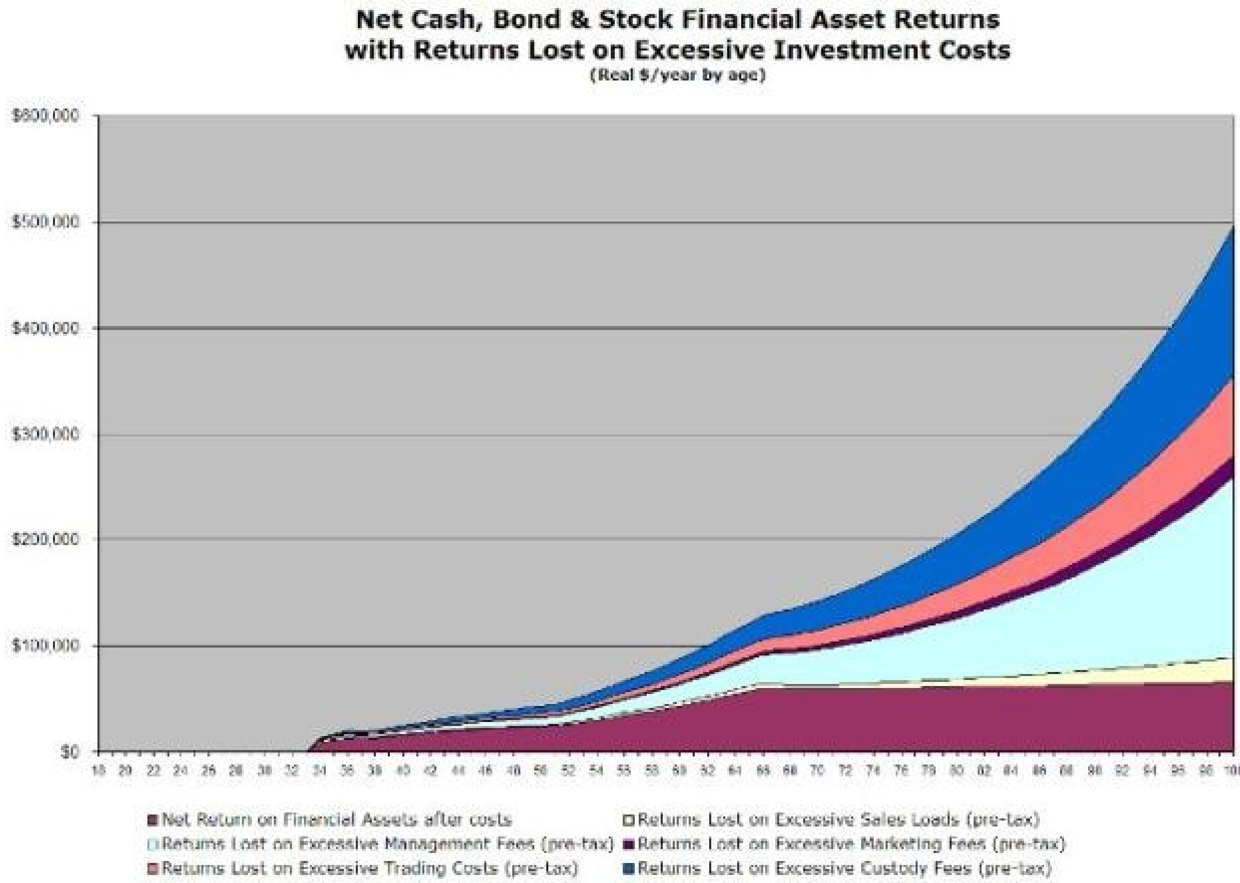
Net Cash, Bond & Stock Financial Asset Returns with Returns Lost on Excessive Investment Costs

(Real $/year by age)

Rather than being presented in percentage terms, the graphic below is a projection of annual real dollar net returns and of returns lost to various types of investment cost inefficiencies.

COST-EFFICIENCY $ graphic example

(This is the older style of this VeriPlan graphic. Because it represents the projection scenario described in the accompanying text, this older graphic has been retained.)



The COST-EFFICIENCY $ graphic projects the net real dollar returns your portfolio will earn each year. In addition, it projects each of the five investment cost-efficiencies that your portfolio may have. If your current investment portfolio is as efficient as the maximum reasonable costs that you have set above on this worksheet, then your portfolio projections will show no cost-inefficiencies. If this graphic projects inefficiencies, then you may have opportunities to make improvements by reducing your investment costs.

If you have cost-inefficiencies, you should also note that they will continue to grow, even if all your retained financial assets have all been depleted to cover expense shortfalls. The foregone value of these annual costs will continue to increase even after your actual owned assets are gone. These assets still exist and still grow, but they do not in your accounts, since in effect you gave them away.

VeriPlan projects the rate of increase of these lost assets to be equal to the long-term historical weighted average gross (pre-tax) real returns using your chosen asset allocation model, less your reasonable maximum costs assumptions. These lost assets may compound rapidly compared to your retained assets. You retained assets may be depleted by your negative cash flow for living expenses, debts, and taxes, while these lost assets are not subject to these burdens.

22) SALES LOADS Graphic

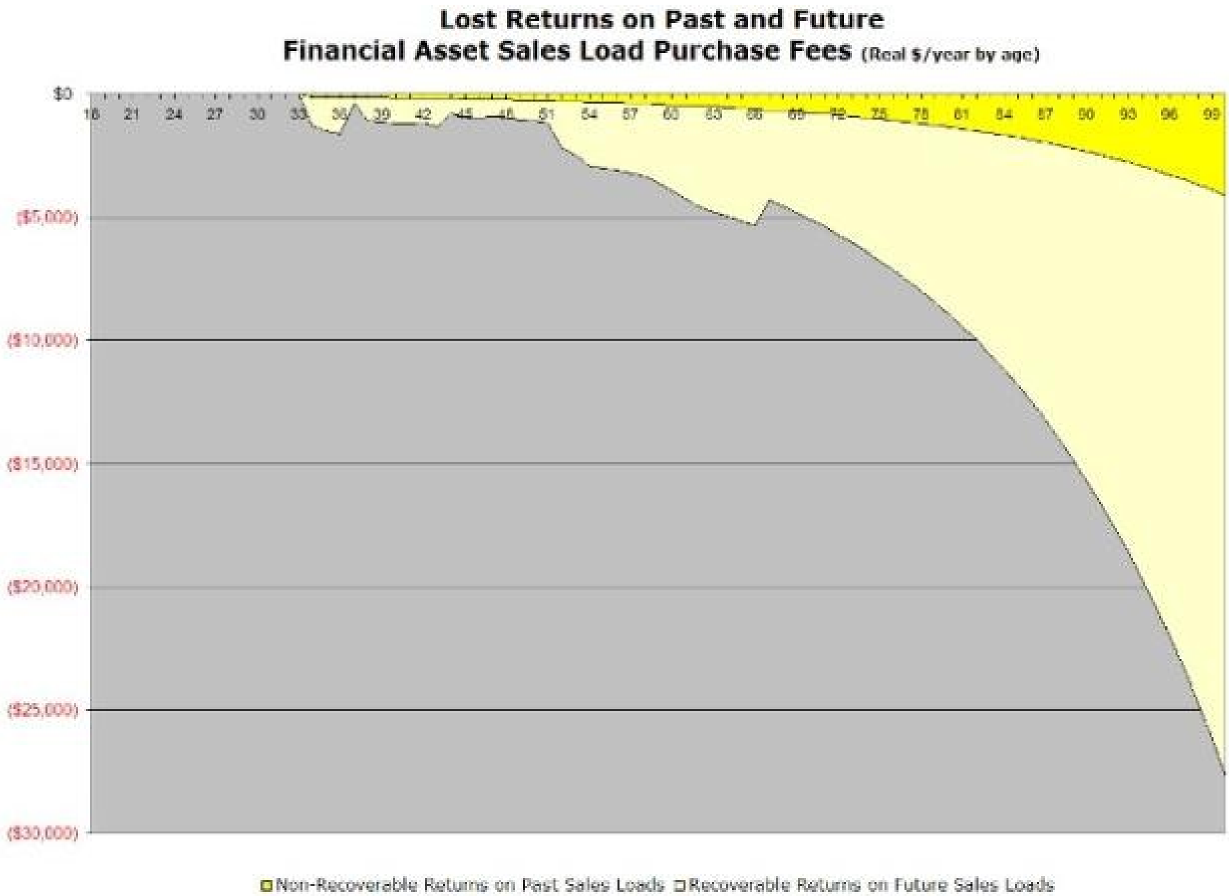
Lost Returns on Past and Future Financial Asset Sales Load Purchase Fees

(Real $/year by age)

VeriPlan presents information about annual returns lost to both your past and future sales load payments on this SALES LOADS graphic. To quantify the financial impact of loads that you have paid in the past to acquire your current portfolio, VeriPlan uses both the tax basis that you report for each of your assets and the sales load percentages that you report that you paid on the financial assets worksheet. Then, it projects future lost returns related to these past load payments.

SALES LOADS graphic example

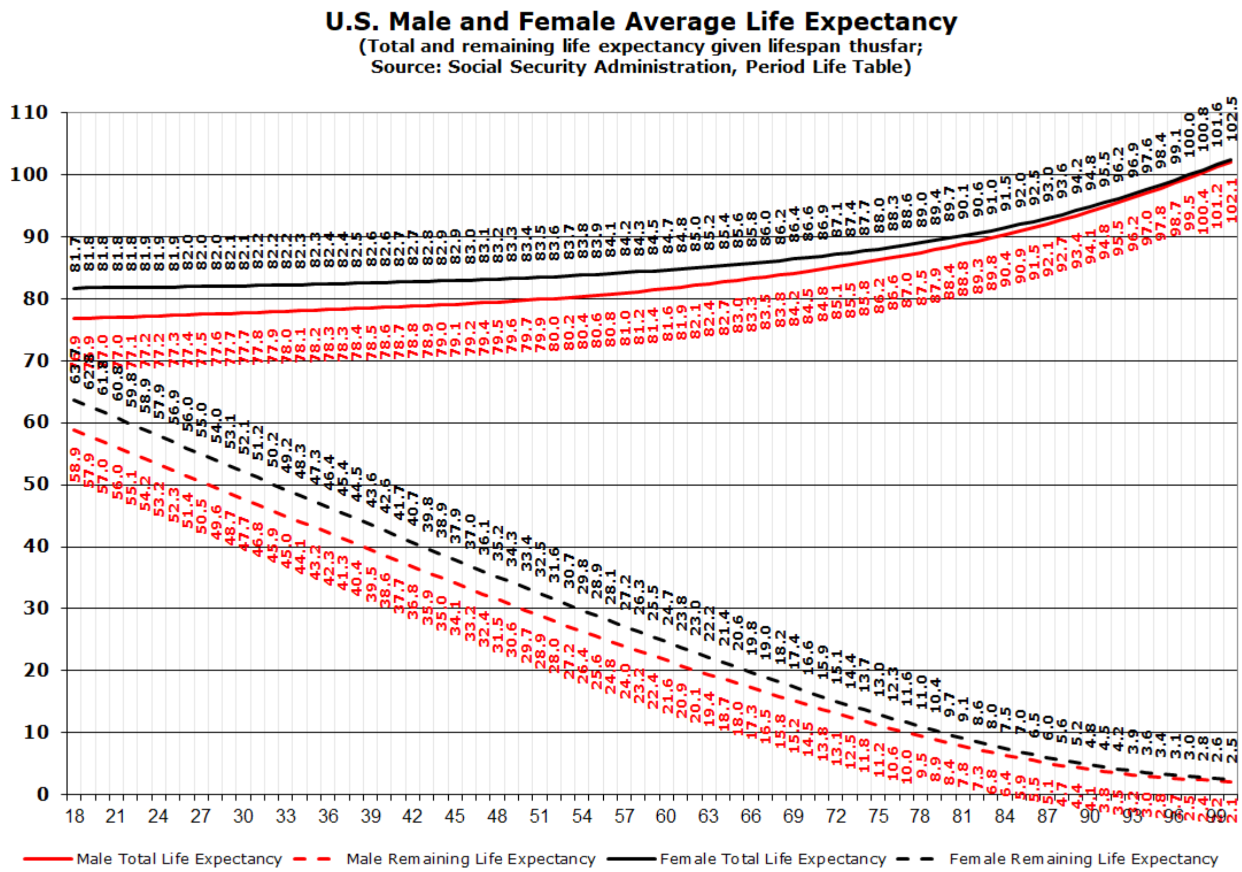
(This is the older style of this VeriPlan graphic. Because it represents the projection scenario described in the accompanying text, this older graphic has been retained.)



While you cannot recover sales loads that you have paid in the past, VeriPlan can help you to understand their potentially very substantial impact on your lifetime projections. In the sample graphic above, this couple cannot avoid the lost returns on investment sales purchase loads that they have paid in the past. However, they can stop paying sales loads in the future and eliminate the much larger beige area of the graph below. If you seek out diversified, low cost investments proactively, you will find vendors willing to supply them without middleman charges.

23) LIFE EXPECTANCY: Average U.S. male and female total life expectancy and remaining life expectancy by current age

LIFE EXPECTANCY graphic example: (Bold lines are total expected male and female lifespans given current age. Dashed lines are expected average remaining lifespan for those who have attained an x-axis age. Source: Social Security Administration, Period Life Table)



VeriPlan makes no assumptions about the mortality of Earner/User #1 or #2. This mortality chart is just here for your information. As a lifetime cash flow model, VeriPlan projects total cash flows through age 100 without making any assumption about death prior to age 100. For example, if your projection model with whatever assumptions you have chosen projects that your assets would last through age 100 as it automatically covers all of your costs, then your demise in any year prior to age 100 would simply represent the projected gross value of the estate at death.

Four life expectancy lines are graphed on this chart:

- Total life expectancy of a female given one's current age on the X-axis
- Total life expectancy of a male given one's current age on the X-axis
- Remaining life expectancy of a female given one's current age on the X-axis
- Remaining life expectancy of a male given one's current age on the X-axis

It is helpful to understand this U.S. life expectancy data for men and women at birth and for those who live to be 65. Particularly, in the context of political discussions about the viability of the Social Security retirement system given the stresses caused by the baby-boom generation cohorts moving through the system, people can be careless or selective in their interpretation of life expectancy statistics.

Sometimes you hear that when the Social Security system was founded, life expectancy beyond traditional retirement ages was only a few years, and now retirees are living a couple of decades beyond retirement. Therefore, the system must be fundamentally flawed. Unintentionally or otherwise, this is a misinterpretation of life expectancy data.

Life expectancies have certainly increased, a proper comparison should be across age cohorts for those who have reached retirement age. At birth life expectancies have risen dramatically, but much of that is due to a significant reduction in child mortality. Those who died before working age neither contributed to the Social Security system nor made retirement demands upon it. When trying to understand the Social Security system, changes in mortality and many other factors are in motion, so it is very helpful to read the annual Social Security Administration Trustee's Report.

24) HISTORICAL RETURNS Graphic

U.S. Financial Asset Class Returns and Inflation for 1928 to the most recent calendar year

(Real dollar return percentages -- Annual asset class rates of return have been adjusted for the CPI inflation/deflation rate.)

These historical US asset class total investment returns are provided for reference. These total returns are calendar year returns, including both interest or dividends and capital appreciation. These data sources have been transformed for their use within VeriPlan. In particular, the US 3-Month Treasury Bill, US 10-Year Treasury Bond, and S&P 500 Stock Indexes have been transformed from "nominal dollar" percentage returns to "real dollar" percentage returns. This means that the percentage Annual Inflation Rate (CPI) figures on the chart have already been subtracted from the investment asset class returns that are graphed.

These historical asset class returns series are used to calculate

A) the historical real dollar "compounded or geometric average" asset class returns measures

and

B) the historical statistical standard deviation asset class volatility measures, which are used in VeriPlan's default projections.

These compounded asset class returns parameters can be changed downward or upward by the user in the risk and returns worksheet, either arbitrarily or systematically with respect to asset class volatility.

When interpreting these historical asset class returns, note the asymmetric nature of percentage change data relative to absolute dollar returns data. For example, when an asset begins at a particular dollar value and then increases in value by 100%, it only needs to fall by 50% from that increased dollar value to return to the original dollar value. Conversely, when an asset begins at a particular dollar value and then falls in value by 50%, it must increase in value by 100% from that decreased dollar value to return to the original dollar value.

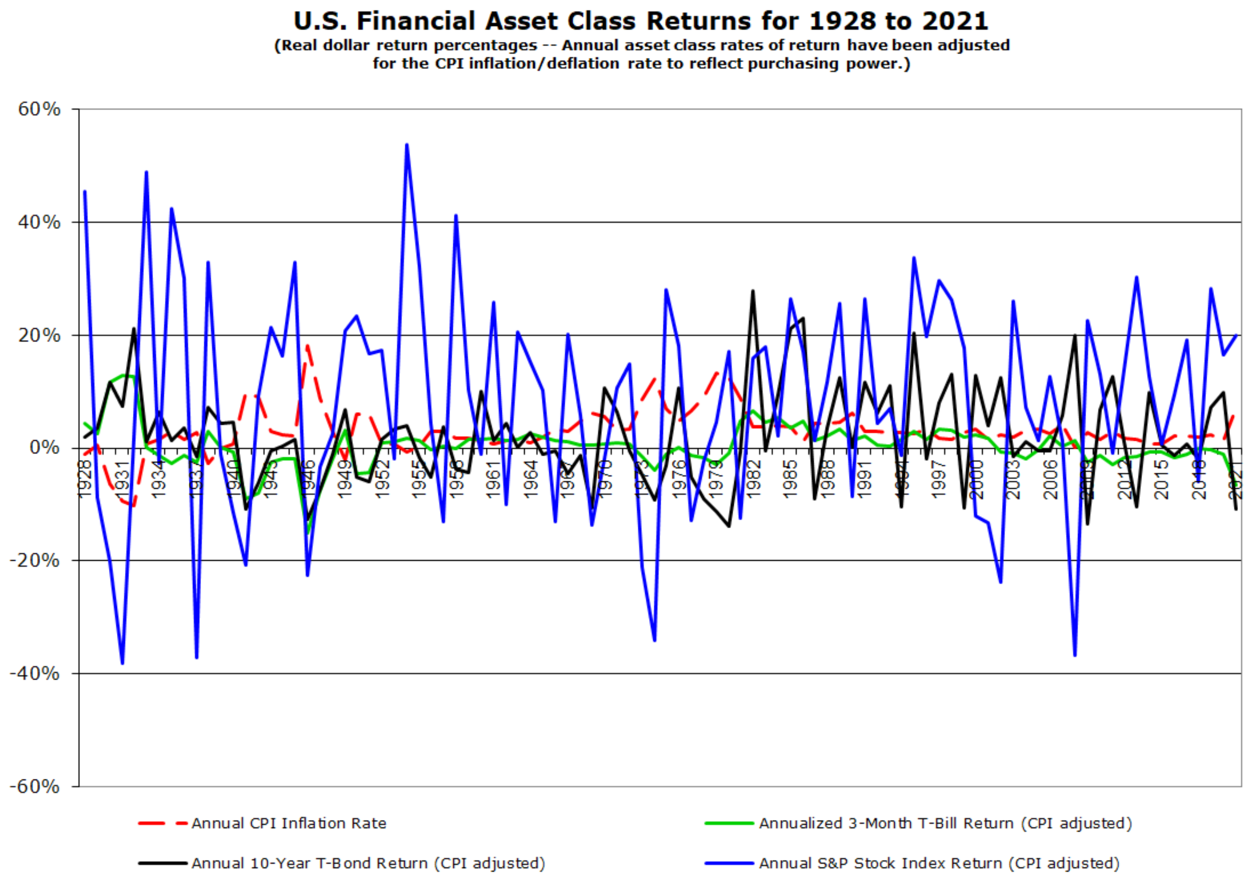
The HISTORICAL RETURNS graphic

This graphic provides a visual history of the annual asset class percentage changes that underlie the compound annualized baseline asset class growth assumptions of VeriPlan's asset projection logic. Two versions of this graphic are provided:

A) annual real dollar returns by asset class from 1928 to the most recent year, and

B) the same data presented as a series of overlapping five year rolling returns.

With the risk and returns worksheet, a VeriPlan user has several mechanisms to change these asset class growth rate assumptions going forward -- either systematically with respect to volatility or judgmentally/arbitrarily. However, of course, those user adjustment would not affect this graphic, since it is historical in nature.



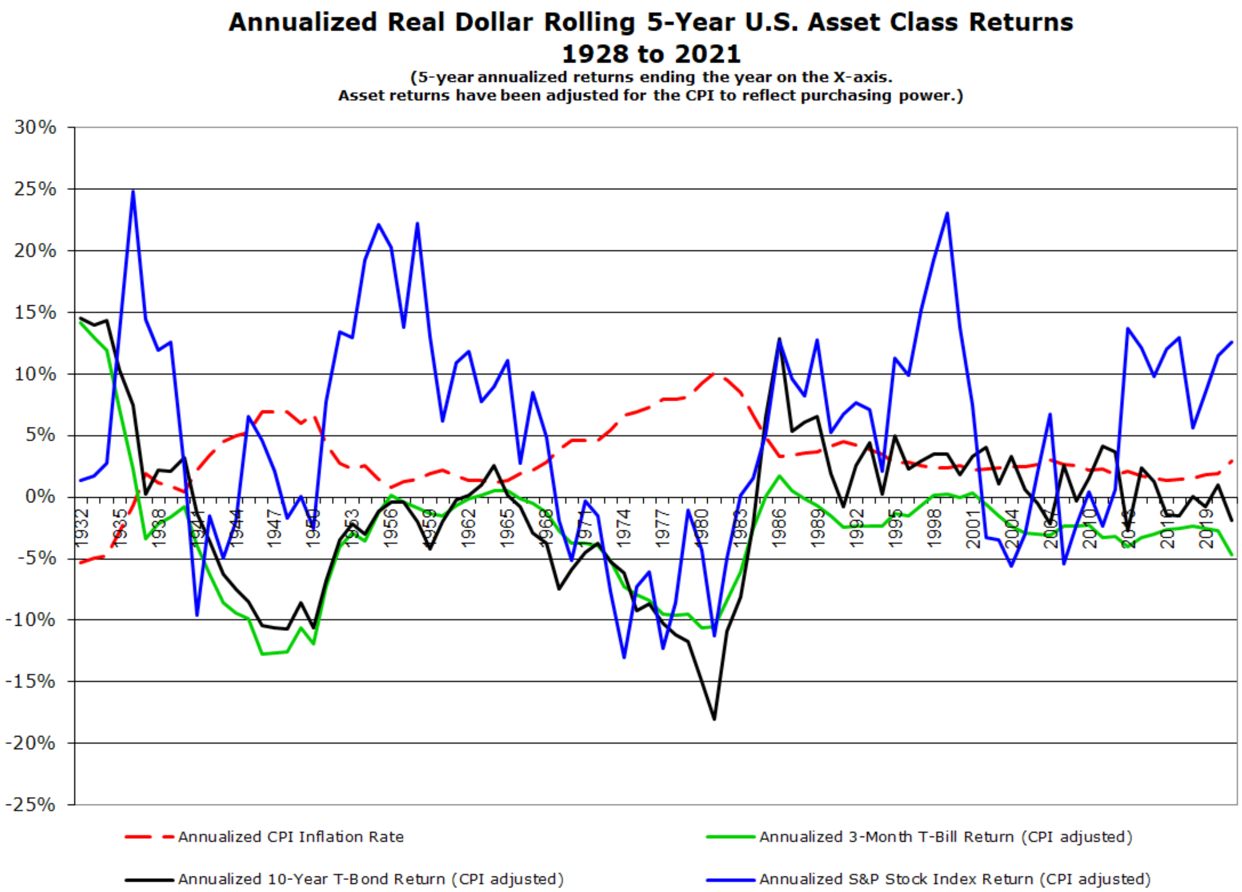
These historical US asset class total investment returns are provided for reference. Note that they are calendar year returns, including both interest or dividends and capital appreciation.

25) ROLLING RETURNS Graphic: Annualized rolling 5-year real dollar asset class returns and CPI inflation from 1928 to the most recent year

The ROLLING RETURNS graphic

This chart uses the annual data from the HISTORICAL RETURNS chart above to develop the annualized real dollar returns for rolling five-year periods that end on the year indicated on the X-axis.

Annualized rolling averages, such as these five-year rolling averages can be easier to interpret visually. Just keep in mind that any rolling average will provide an understanding of cumulative returns for the period of the rolling average, but also may smooth out the variability of returns when both negative and positive returns have occurred for a particular asset class over that same period. Therefore, it is useful to inspect both annual returns and rolling period returns.



The best home and family financial planning software available

https://www.theskilledinvestor.com/VeriPlan/

Appendix: Author's background

Lawrence (Larry) Russell is the author of this book. Since 2001, I have been President and Managing Director of Lawrence Russell and Company, a personal financial planning services provider and registered investment adviser in Pasadena, California. I am also a former technology industry business executive with a background in corporate business management, technology start-ups, financial modeling, investment management, economics, statistics, taxation, and accounting.

For my resume, see my LinkedIn profile page:

https://www.linkedin.com/in/larryrussell

To find my books and publications see:

https://www.theskilledinvestor.com/VeriPlan/financial-planning/

Overview of my financial planning and investment management background

My knowledge of financial planning and investments has been developed through:

* education at M.I.T. (BS-1975), Brandeis University (MA-1979), and Stanford University (MBA-1982) [That's right. I'm getting older every day.]

* twenty-five years of corporate and start-up management experience in the business development, financial planning, corporate development, and investment functions

* studying the scientific finance research literature in depth to find evidence about which investment and financial planning strategies do and do not work

* design and development of VeriPlan, a lifetime financial planning software product

After graduating from MIT in 1975, I conducted statistical research on employee benefit programs at the National Manpower Institute in Washington, D.C. In 1978, I moved to beautiful California and joined the Institute for the Future, a think tank in Menlo Park, California.

Using sophisticated computer projection methods for Fortune 100 clients, we developed long-range planning scenarios incorporating demographic, econometric, financial, and technological factors. My experience at the Institute for the Future was helpful later in the design of VeriPlan, since VeriPlan functions as a fully integrated and automated lifetime scenario projection engine and financial planning decision support tool.

Completing his MBA at Stanford in 1982, I joined Hewlett-Packard's computer systems division and led business development and marketing initiatives. At Sun Microsystems from 1991, I acquired product lines from technology companies via negotiated licensing arrangements. As Director of Corporate Development, during my last four years at Sun Microsystems, I directed mergers and acquisitions projects, evaluated investment proposals made to Sun's senior executives, including external investments in private firms.

In 1999, I co-founded Codexa Corporation in Altadena, California with my friend and MIT undergraduate roommate, Dr. David J. Leinweber, an expert on computationally driven institutional investing. As Codexa's EVP and CFO, I directly managed the finance, accounting, business development, human resources, and legal functions. I developed Codexa's information service provider business plan, hired the executive team, and helped to raise an $8M Series A venture round.

Codexa developed an advanced and automated systems service that provided Internet information filtering services to Wall Street securities industry professionals. Our service architecture is described in detail Chapter 6 of "*J2EE Technology in Practice: Building Business Applications with the Java 2 Platform, Enterprise Edition*" by Rick Catell and Jim Inscore.

Our company's early stage clients included numerous major Wall Street firms. Despite having developed working technology, Codexa was still a development stage company with an unsustainable negative cash burn rate. In 2001 the securities, technology, and telecommunications industries fell off the cliff and needed Series B financing was not available, as the dot bomb bubble imploded.

With the technology and securities industries on their backs in 2001 with all four legs in the air, there were few long-term career opportunities for a person with my background. I decided I was not going to hunt for nonexistent tech industry positions along with the haystack of other unemployed professionals in the wake of the dot com crash. Given the economy in 2001, I soon reached the conclusion that, however unwillingly, I must be retired – at least from the high tech industry – at the ripe old age of 50. In 2001, I established Lawrence Russell and Company, initially as a management consulting firm, and it later evolved into a financial planning services firm.

As a self-directed investor during my corporate career, I saved my pennies and invested them according to the principles that I had learned at the Stanford Business School, Thus, retiring at 50 was feasible, while not desirable to me. Since I was too old for basketball and did not care for golf, I began to catch up on the investment and personal finance research literature to see what was new, since I had been at Stanford in the early 1980s.

As I searched the web, university libraries, and on-line scholarly paper repositories, I was impressed by how much useful personal financial planning information was scattered around the academic world. It seemed to me that many individuals and families were starved for just this kind of objective financial and investment information. At the same time, people were drowning in a sea of self-interested securities and financial services industry sales pitches that pushed overly expensive and unnecessarily risky investment products.

After a year of full-time reading, clarity began to emerge. Then, and in the decade following, I have read thousands of research papers in their excruciating economic and statistical details. These scientific finance papers hold information that is directly useful to individuals for financial planning and investing. Yet, academic papers are written for an audience of other academics and highly trained industry research professionals and not for individuals.

Through this research, I reached these primary conclusions:

1) The financial research literature clearly demonstrates that the optimal investment strategy for individual investor is a completely passive and most broadly diversified strategy that cuts all investment fees, costs, taxes, and time commitments to the very bone.

2) Lifetime family financial planning should never be one-size fits all or even several sizes fit all. While there are commonalities, every family's current and intended future financial situation is unique and must be modeled to develop a customized and implementable long-term financial plan.

To make some of this academic finance information more accessible to the general public, in 2002, I began to write summary articles and publish them on the web. In the past decade+, I have published well over a thousand financial and investment articles on the web. The easiest way to find them is to go to my *The Skilled Investor* website: http://www.theskilledinvestor.com/ On the front page of The Skilled Investor you will find a hierarchical listing of many of these articles. In addition, the red colored links in the left-hand sidebar of *The Skilled Investor* website will take you to my other personal finance, financial planning, and investing websites.

I also became convinced that I understood more efficient and scientifically verifiable pathways for individuals to optimize their financial planning and investment strategies. Furthermore, I realized that the computational details and complexity of the subjects involved prevented individuals from focusing on financial decision-making. Simple spreadsheets, free online financial tools, and back-of-the-envelope calculations were generally useless when hundreds of personal income, expense, debt, tax, investment, and other factors unique to each family were in play.

In 2002, I had begun to design and develop a financial and investment planning spreadsheet for my own family. I got a bit carried away with this project. In 2003, designed the architecture for a fully automated, completely integrated, and highly customizable lifetime planning software tool build upon the Microsoft Excel spreadsheet engine. This software eventually became VeriPlan.

I designed VeriPlan to be a decision support tool set for a financial planning advisory business that I intended to set up. I also designed VeriPlan to be self-learning and self-updatable, so that do-it-yourself users could purchase personal use copies and licenses through the Internet. I realized that the mass of Americans would never have access to a personalized lifecycle planning application, unless an inexpensive software product was developed. Furthermore, I decided that VeriPlan must be priced very low, so that everyone could afford it.

I estimate that I put between 3,000 and 4,000 personal hours into the development of VeriPlan between 2003 and 2006. When you are "retired" and self-employed you do not have to keep a time card. By 2006, the functionality of VeriPlan was complete and robust. Since 2007, I estimate that I have spent between 300 and 500 more hours annually working on VeriPlan. Over these twenty years of software development and enhancement, total cumulative hours are roughly 10,000. These hours of effort are an indication of how complex it is to develop a fully integrated, automated, and robust lifetime financial and investment planning application.

Before starting my development of VeriPlan in 2003, I had searched for a sophisticated and customizable lifetime financial planning tool to use myself. I was unimpressed with what I found. Instead of providing an interactive and personalized modeling environment that a client could use interactively with an advisor, many professional financial modeling tools had significant functional and analytic limitations. They also required extensive training to be used properly. Worse, all of these professional tools just cost too darn much.

Furthermore, and perhaps most dismayingly, many of these computerized professional planning tools are largely designed to channel clients toward the selection of more costly financial, securities, and insurance products. Through my research, certain scientifically verifiable selection criteria for financial and investment products had become very clear to me. The cost of any financial or investment product is at the top of this list of selection criteria.

With the scientific planning and investing knowledge that I gained from my reading and publication of financial articles on the web and from the development of VeriPlan, I also decided to become a financial and investment planning adviser. In 2004, I passed the Series 65 "Uniform Investment Adviser Law Examination" administered for the North American Securities Administrators Association (NASAA) by the Financial Industry Regulatory Authority (FINRA). In 2005, my firm, Lawrence Russell and Company, became a Registered Investment Adviser in the state of California (Certificate #133101).

Using VeriPlan as an integral part of my financial services offering, I began to deliver comprehensive financial planning services to clients residing primarily in the Pasadena, California area. To avoid all conflicts-of-interest, I set up a purely fee-only advisory practice. I charge hourly or fixed fees for customized planning services. To avoid conflicts-of-interest, I do not sell any investment or insurance product of any kind. I do not charge any percent of asset fees. I do not accept or pay third party fees of any kind.

I refused to adopt the percent of assets advisory compensation model that is standard in the industry. I did not set out to “gather assets” to increase my fee revenue and live off of other people's hard-earned investment assets. Instead, I chose only to bill clients directly for services on a fixed fee for project and hourly basis.

Direct compensation paid by my clients is less lucrative than the commission or asset fee models that absolutely dominate the financial services industry. Direct income from clients paying reasonable fees combined with additional income from writing personal finance software, ebooks, and websites has been enough for me.

Furthermore, this is a far superior approach to compensation, because all these activities allow me to develop and implement the best financial practices for my clients and readers. In contrast, the commission or asset fee models dominating the financial services industry force almost every professional to spend an inordinate amount of their time hustling to attract very well-off clientele who already have substantial investment assets. All this hustling for new, wealthy clients leaves these advisors with much less time either to understand or to deliver high quality financial services in their client's best interests. In fact, this leads to a never-ending cycle, wherein most advisors charge their current clients far too much, while they spend much of their time chasing new clients who will in turn be charged too much.

Direct compensation from my clients and income from my financial planning books and software has been very liberating. I can tell my clients and the readers of my books exactly what the financial research shows. I can say and write what I think has been proven by sound academic research to be in the best interests of real people without giving any thought to my own interests. This is the very definition of the fiduciary care standard that financial advisors are supposed to use with respect to the primacy of the interests of their clients.

This approach is also allows me to help my clients and my readers get the myriad of financial industry hands out of their family wallets. Some people feel that they pay too much for financial services, but they keep paying anyway, because they do not understand that they have do-it-yourself alternatives. Most others have no idea of just how ghastly costly their relationship with the financial services industry will be over their lifetimes. This book can help you to understand the huge costs that the financial industry imposes upon their "retail" clientele to the significant lifelong detriment of these retail clients.

When some of these retail clients finally get fed up with the self-interested greed of the financial industry, they must have an alternative way to do-it-themselves or they just become more frustrated. Just pointing out the problem is not enough. In place of the frustration, people need practical solutions that enable them to self-manage their own financial affairs. In reality, financial self-management is not very difficult, but it takes a commitment on your part both to understand what is better to do and then the sustained will to do it.

Over the past several years, I have developed financial planning and investment management materials and processes for my clients and to allow them to cut out unnecessary and vastly overpriced financial industry "services." My focus with my direct clients is to work cooperatively with them:

a) to develop a durable lifetime plan that they can implement themselves,

b) to increase their knowledge and competence in self-management, and

c) to supply them with sophisticated, yet easy-to-use software planning tools.

My clients can use this knowledge and these materials to implement their own plans without having to repeatedly pay more and more advisory fees and many other excessive financial costs year after year. In addition, to helping directly some of the do-it-yourselfers out there, I have spend thousands of hours over the past decade plus, making these materials available to the general public in the form of web articles, ebooks, and lifetime financial planning decision support software.

I have researched and written various objective books that can help you cut your investment expenses and increase your wealth. To learn more, click the book covers or go to this web page:

https://www.theskilledinvestor.com/VeriPlan/financial-planning/

Notice: This financial information is for educational purposes.

This book provides financial information, and all information in this book is solely for informational and educational purposes. This book does not provide financial advice or investment advice of any kind. Under law, specific investment advice can only be dispensed to you by someone who is authorized to do so and who has an understanding of your particular financial situation.

This book attempts to provide information that focuses on the best interests of individuals and families. Fiduciary care of people's financial interests requires knowledge, experience, and the absence of financial conflicts of interest that distort the quality of information and advice given to people.

Global securities markets have a dog-eat-dog ethos with winners and losers. Highly competitive and ruthless securities markets are necessary for efficient price setting and capital allocation. I applaud when full-time financial professionals engage in competition among themselves with knowledge, resources, and skill.

However, when similar strategies are applied to individuals who lack knowledge, education, and resources, then this is just an unfair fight. When the inadequacies, ignorance, biases, and misperceptions of individuals are exploited systematically, this is deplorable. Unfortunately, this approach is standard operating procedure for many parts of the financial services industry.

When financial industry marketing and promotions imply that there is a partnership or advisory role, but actions taken indicate that this is not the case, then this is moral bankruptcy. When the financial industry is so strong that it distorts fairness in governmental regulation, then many deplorable behaviors are not criminal, largely because laws, regulations, and enforcement are too weak.

I believe that enlightened individuals should never naively expect fairness, when they deal with much of the financial services industry. Despite the financial industry's recent self-induced credit crisis, self-immolation, and taxpayer bailout, there is no reason to believe that this industry will ever change voluntarily. The game is just too profitable for the financial services industry and its excessively compensated employees to expect things ever to change fundamentally.

The mass of American financial consumers are trusting, docile sheep regarding their personal financial affairs. The amount they are willing to waste on overpriced financial services is astonishing. Far too many US consumers pay far too much and get woefully little value in return from the financial services industry. The industry repeatedly scrapes the consumer excess off the table and stuffs it into its salaries, bonuses, and corporate earnings reports. The only salvation for most individuals is that eventually some of them will wake up and decide to stop paying tribute to this beast.

Do not be naive about financial advisors. Figuratively, (and literally) they come in all shapes and sizes. In general, financial "advice" laws, regulations, and enforcement related to financial "advisors / advisers / planners" are weak and are riddled with loop holes. Survey's have clearly demonstrated very widespread consumer confusion about different types advisors and their responsibilities related to their clients. Caveat emptor or "let the buyer beware" is the reality related to all financial advisors, but far too many people are naive and trusting in the face of the complexity of finance.

It is a very bad idea to go into any advisory relationship assuming that the advisor will automatically have your best interests in mind and act solely for your benefit. If this were the reality, then the financial services industry would not be so very large and so very profitable. If the global financial services industry were to put the interests of their customer ahead of their shareholders, then the financial industry simply would not be one of the largest industries on earth.

Anyone with a bit more than a vague interest in the financial world around them grows up to understand that the capitalist business model and its associated self-interested profit motive predominates. Shareholders demand maximum returns on their invested capital. Capitalist enterprise executives, who are the agents of these shareholders, are tasked with maximizing shareholder returns. Incentive systems attempt to align manager and shareholder interests. When these self-interests conflict, sometimes the manager agent tail can wag the shareholder dog. Nevertheless, such agent and shareholder conflicts almost always are focused on how the maximum profit pie gets split and not on the "best interests" of customers.

Regarding the profit motive and the financial services industry, see this five-part article series that I published in 2007 prior to the financial crisis. It is entitled:

The Biggest Personal Finance Story of the Past 30 Years

https://www.theskilledinvestor.com/ss.item.270/the-biggest-personal-finance-story-of-the-past-30-years.html

I urge you to read this five-part article series -- before your hire any financial advisor and their firm.

Here are some highlights from what I wrote in this series of articles:

> "The biggest personal finance story of the past 30 years has been the dramatic growth of the market capitalization of financial services firms within the U.S. equity markets. ... The reason that this is so important to your personal finances is pretty straightforward. Simply put, most individuals pay far too much for financial products and services. Their continuing overpayments show up in the increasing value of financial services company stocks. People have paid far too much for years, and the industry's excessive charges have been increasing for years."

> "In return, individuals receive far too little. Exorbitant and increasing investment costs, high banking fees, predatory credit card charges, excessive insurance costs, etc. simply represent a massive wealth transfer from the personal pocket books of average individuals into the coffers of the financial services industry and into the high paychecks of its employees."

> "There is no reason to believe that industry self-regulation or governmental regulation will ever fix these conflict-of-interest problems. Only those individuals who become wise enough to be proactive and seek out lower cost financial products will stop getting fleeced. The vast majority or individuals will just keep on paying excessive costs to the financial industry, while they receive inadequate value in return. ... The choice is yours as to whether you want to keep pouring in your money or whether you want to adopt a lower cost personal finance strategy."

So, if you really do need financial or investment advice, you should hire a financial advisor, but you should do so with your eyes wide open to avoid getting fleeced. Understand and remember that advisors are expensive, yet some of them could be worth paying for. If you do not feel you can manage your finances entirely by yourself or you have particular needs that require professional expertise and advice, I suggest that you interview several advisors carefully.

Be proactive in looking for the right advisor and do not simply follow the lead of a friend who happens to recommend an advisor that they trust. While that recommended advisor might be fine, "trust referrals" are potentially problematic. Problems can arise, because along that chain of trusted recommendations, it is possible/probable that nobody really did any actual due diligence that might have unveiled potential advisory problems. Some of the most pernicious advisor frauds and scams have been perpetrated against religious and other affiliated groups that have been infiltrated by fraudsters who gained the trust of few members and then widely expanded their network of fraud through trusting referrals.

When a family member, friend, or co-worker makes a recommendation of a financial adviser, that could be a good start. However, that recommendation does not absolve you of your personal responsibility to do your own due diligence. Before you start to trust that this advisor and commit your hard-earned money, check out the advisor and decide for yourself whether he really will take care of you and your family and will always put your interests ahead of his and his firm's interests.

I have published a set of almost 40 articles about financial advisor selection, regulation, payment, frauds, and scams. These articles might be helpful in your search, and you can find here:

https://www.theskilledinvestor.com/financial/financial-advisors-investment-counselors.html

Read and understand these web articles and this book. An advisor acting in your best interests would tend to follow the investment principles that I discussed in my books and my web articles. I never change my fundamental financial planning and investment principles. That is the whole point about developing lifetime financial principles. Financial principals should valid, research based, and durable to navigate an uncertain and unpredictable future.

I strongly suggest that you choose an advisor whom you pay directly. Furthermore, choose an advisor who does not accept compensation from the industry in any form. Seemingly free financial advice can cost you very dearly over your lifetime. Never lose sight of the stark fact that throughout your life you are a walking, breathing financial industry profit center.

So to summarize: This book DOES NOT constitute or provide personalized financial planning advice, personalized investment advice, or any other kind of personalized financial advice under the laws and regulations of the United States of America and its various States or of any other country in the world. In no way does this book constitute a

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