Investing for a Great Retirement (Part 1)

By Jon R. Muth

It is difficult to think about saving for retirement when there are bills to be paid and children to be educated, but we must not only think about it, we must do something about it. Since lawyers rarely receive defined benefit pensions, we are solely responsible for our own financial security.

It is equally difficult to know where to turn for advice. A great deal of bad advice is available, and separating the good from the bad isn't easy, even for an experienced investor.

One certainty, however, is the magic of compound interest. I recently opened a small investment account for my grandson with a $500 deposit. Assuming a compound return of 10 percent, that $500 will increase in value to $126,000 by the time he is my age. If he invests only $500 in each additional year, he will have an account worth almost $1.4 million at age 66. The lessons are clear: start early and stick with it.

This article and one that will follow in next month's *Bar Journal* are intended to provide a simple and effective path through the investment wilderness. I am not an expert, but as an investor for more than four decades, I have learned much by doing almost everything wrong at least once. Through trial, error, and study, I have developed an approach that has worked well for me. More importantly, far brighter people than I have reached the same conclusions: investors Warren Buffet, John Bogle, Benjamin Graham, and Charles Schwab; Nobel Prize-winning economists Paul Samuelson, William Sharpe, and Daniel Kahneman; and endowment managers David Swensen (Yale), Burton Malkiel (Princeton), and Jack Meyer (Harvard), to name a few.

At the core of this approach is the modern portfolio theory. It is supported by a wealth of academic literature. David Swensen, the highly successful manager of the Yale Endowment, cogently illuminates its mathematical and statistical underpinnings in *Unconventional Success: A Fundamental Approach to Personal Investment*.[1] His thesis is that it is a fool's errand for an individual investor to attempt to outperform the market. A shorter and less scholarly resource is *The Little Book of Common Sense Investing* by John Bogle.[2]

The modern portfolio theory has its detractors, but as the military theorist Carl von Clausewitz is credited with saying: "The greatest enemy of a good plan is the dream of a perfect plan." With this approach, we should beat the vast majority of investors who, burdened by emotion and the payment of excessive costs, consistently underperform the market.

First, we must save regularly—an elusive goal for many. According to the Census Bureau, the average savings of a 50-year-old are only $43,797. Yet to generate $5,000 a month for a 30-year retirement requires an investment of $1,060,751. According to one study, a worker who saves consistently from age 25 to age 66 must set aside 16.8 percent of his earnings to provide income for the rest of his life equal to 40 percent of his preretirement income.

Second, intelligent investing requires an understanding of risk. Simply put, the higher the return potential, the greater the risk. While we want to avoid losing money, we must accept some risk if we are to achieve our goals. There is risk even in holding cash, which is constantly exposed to one of the greatest of all investment risks: inflation. While risk cannot be eliminated, it can be managed.

Our approach should be guided by the principle of Occam's razor: when there are multiple solutions to a problem, choose the simplest one. Almost all complex investments are designed to enrich the middleman. If you don't understand it, never buy it (remember mortgage-backed derivatives).

Our first priority should be to invest as much as possible in tax-advantaged vehicles such as IRAs, Roth IRAs, and 401(k) plans. The Roth is arguably the best, but it cannot be used by everyone (eligibility depends on tax filing status, income, and age.) But even if a Roth is not immediately available, it may be obtained as a rollover from a 401(k) or IRA on change of employment or attaining age 59½. When considering a rollover, seek advice from a benefits expert.

The approach we will now examine ("the plan") has several elements:

- Diversification
- Buying and holding for the long term
- Using passive broad-index funds or exchange-traded funds
- Keeping costs to a minimum
- Thoughtful allocation
- Regular rebalancing
- Proper asset location

Diversification

A fundamental tool for managing risk is diversification: spreading investments over different types of assets. Bonds often will do well when stocks do poorly; big company stock prices often move differently than those of small companies; foreign markets don't rise or fall in the same sequence as domestic markets; and real estate has its own cycles. By dividing assets among classes of investments that behave differently, we avoid the worst repercussions of a collapse in one class.

Obviously, if we create a basket of diverse assets, some investments will always perform better than others. Envy and greed are our biggest enemies: envy because someone will always be doing better than we are, and greed because of the siren song of the quick profit. We must be content to move with the market and let time and compounding work their magic.

Our plan suggests we should diversify broadly.

- Diversify among types of equity securities:
  – Size of companies' capitalization
  – Growth and value objectives
  – Income and capital gain objectives
  – United States and foreign markets
  – Types of foreign markets (mature or emerging)
  – Special areas of interest (commodities or real estate)
- Diversify among types of debt securities:
  – Corporate and government
  – Taxable bonds or nontaxable municipal bonds (taxable in a tax-advantaged account and perhaps municipal bonds in a taxable account, depending on tax bracket and comparative yields)
  – United States and foreign debt
  – Risk profile (from AAA to junk)
  – Maturity (how long before payment of principal is due)

Buying and holding for the long term

If we invest in regular installments, whether the market is then high or low, over time we will buy at average market valuations.

We won't try to time the market. A majority of those who do invariably give way to emotion, purchasing when euphoric and

FAST FACTS

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selling when discouraged. Time in the market, not timing of the market, leads to long-term profits. Once invested with a diversified portfolio of well-allocated stocks and bonds, we will stay put.

Over time, the investment returns of stocks will equal the business returns of the companies. Short-term anomalies are based on unrelated events or investor emotion and resulting speculation. Since no one can forecast investor emotions or tomorrow's events in the Ukraine, short-term movement must be ignored.

Using passive, broad, no-load index mutual funds or exchange-traded funds

Never pay a broker's commission (load) to purchase a mutual fund. The best funds don't charge one.

Use passive index funds. Index funds are designed to replicate a given market or portion of the market. Instead of trying to figure out which stocks will outperform others, the fund simply buys everything in the index. An index is nothing more than an arbitrary grouping of similar stocks, whether by size, industry, or country. For example, the widely quoted Standard & Poor's 500 is made up of the largest 500 publicly traded companies in the United States. Some indexes are so broad as to track all U.S. stocks. Others are created by the sponsor to represent a very narrow band, such as gold mining or coffee growing.

Do not use actively managed equity funds. According to Swensen, "A minuscule 4 percent of [actively managed] funds produce market-beating after-tax results with a scant 0.6 percent (annual) margin of gain. The 96 percent of funds that fail to meet or beat the Vanguard 500 Index Fund lose by a wealth-destroying margin of 4.8 percent per annum."[3]

In 1970, there were 355 equity mutual funds offered. By 2005, 223 had gone out of business; 60 underperformed the S&P 500 by more than 1 percent a year; 48 nearly matched the S&P 500; 24 beat the S&P 500 by more than 1 percent a year; only 9 beat the S&P 500 by more than 2 percent a year and, of those 9 funds, 6 beat it when they were very small funds and then steadily gave ground in percentage terms as their success resulted in large infusions of new investors' cash. Therefore, of the 355 mutual funds that started in 1970, only three had records of sustained excellence until 2005.

The primary reason actively managed funds fall short is found in the expenses charged. The bright people who are trying to beat the market (and each other, since 95 percent of all trades are placed by professionals) want to be handsomely paid. The expenses incurred by managed funds average about 1.5 percent of fund assets per year. Sales charges (loads) or advertising charges (called 12-b.1 charges) may add more. Hidden costs include the opportunity cost of the fund not investing a portion of its money (holding it as cash) and bid-ask spreads. The total cost of owning an actively managed mutual fund can be more than 2 percent of assets a year. Compare these costs with the expenses and fees of a broad index fund, usually in the range of 0.10 percent to 0.30 percent. The Vanguard Total Stock Market exchange-traded fund has a miniscule expense ratio of 0.06 percent—that's 6 cents for every $100—and it replicates the performance of the entire U.S. stock market.

Actively managed funds are generally tax inefficient, adding yet another layer of cost in a taxable investment account. Most fund managers trade regularly as they attempt to beat the market. Each time they trade, they incur a capital gain or loss. If they trade often, some gains will be short-term, taxed at ordinary income rates. All capital gains and losses must be passed on to you annually on an IRS Form 1099. That creates tax consequences for you, even if you did not buy or sell a single share of that mutual fund or if the market price for the fund declined in that tax year.

Costs must also be considered when choosing an index fund. There are dozens of S&P 500 index funds alone, bearing annual expense ratios and sales charges ranging from 0.06 percent to 1.45 percent. If you are so inclined, you may pay 24 times as much for exactly the same services.

Index funds can either be mutual funds or exchange-traded funds. Either is good, but I prefer exchange-traded funds. They trade like stocks and generally have lower trading costs. They also have a significant tax advantage over mutual funds: they do not have to declare gains and losses annually. A gain or loss is realized only when the fund is sold. If you buy and hold, you decide when to realize gain or loss and, if exchange-traded funds form a part of a decedent's estate, the gains receive a stepped-up basis.

Keeping costs to a minimum

Costs have been discussed already, but it is useful to underscore the basic message: we want to own the market at the lowest possible cost. If we own the market, the market will always beat us, simply because we have certain unavoidable expenses in pursuing the investment. The question is, how far will our return lag the market? Using mutual funds alone, our costs can range

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from a low of 0.06 percent (6 basis points) to a high of 3.5 percent (350 basis points) each year. Assuming equivalent investment performance, the investor who minimizes costs will be far ahead over time.

Thoughtful allocation

This part of the plan requires the most attention and could be the subject of a separate article. All that can be said here is that we must allocate our investments by percentage among the types of securities as our investment objectives and risk tolerance dictate. Typically, allocations will evolve slowly as the investor's financial situation and age dictate.

Suggested allocations at various stages in life can be found at the following websites: Morningstar,[4] Vanguard,[5] Fidelity,[6] TD Ameritrade,[7] and Schwab.[8] You can also reference a target date retirement fund (e.g., Vanguard Target 2040) and see how it alters the allocation as one nears the stated retirement age.

The chosen allocation must be based both on investment horizon and risk tolerance. Use the published formulas only as a guide. If two individuals are the same age and plan to retire at the same time, the one with a net worth of $5,000,000 is likely to be a great deal more risk tolerant than the one whose net worth is $50,000.

If you find allocation difficult or confusing, guidance from a fee-only financial planner may help.

Regular rebalancing

Rebalance to the chosen percentage for each asset class about once a year. In a tax-advantaged account, if the value of one asset class moves 5 percent over or under target before 12 months have passed, rebalance earlier. This discipline forces us to sell some winners and buy some laggards, meaning we are selling high and buying cheap. In a taxable investment account, be careful not to do it so quickly as to generate short-term gains, which will be taxed as ordinary income.

Proper asset location

Asset location addresses the question of what types of assets should be put in what types of accounts. The division is between tax-advantaged accounts, such as an IRA or a 401(k), and taxable accounts. Although a Roth is a tax-advantaged account, it is created with after-tax money and properly belongs in the same category as taxable investments. Generally, the portion of your investment portfolio that produces ordinary income (bonds, REITs, and nonqualified dividends) should be in a tax-advantaged account to avoid the creation of a tax liability.

All tax-advantaged accounts except Roths are taxed on withdrawal at ordinary income rates. It makes no sense to produce capital gains within those accounts only to convert them to ordinary income on withdrawal.

Conversely, the stocks with potential for long-term capital gains should be held in taxable accounts, where the lower capital gain tax rates apply, or Roths, where there are no taxes upon sale.

Two caveats are in order. First, if tax rates or tax policies change from those now in effect, your approach to asset location may need to be altered because it is driven by tax consequences. Second, asset location strategy changes once you are in retirement.

Conclusion

Forbes' 2013 Investment Guide included an article titled "Top Secrets from 20 Wealth Wizards."[9] Consistently, the "wizards" said: save and save early, avoid debt, establish a plan and realistic goals, put most of your money in a low-cost index fund, get your asset allocation right, diversify, keep your emotions in check, and be patient. Our plan will adopt all that advice.

Part 2 of my article in next month's *Bar Journal* will discuss common pitfalls and demonstrate the creation of a specific plan. ■

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Jon R. Muth has been State Bar president (1994–1995), a Roberts P. Hudson Award winner, and trustee of the Michigan State Bar Foundation. He was named in Super Lawyers Top 10, Best Lawyers in America, and Chambers USA Leading Lawyers of Business, and was Michigan Lawyers Weekly *Lawyer of the Year 2011. He currently limits his practice to mediations and arbitrations at Muth ADR, PLLC.*

ENDNOTES

1. See Swensen, *Unconventional Success: A Fundamental Approach to Personal Investment* (New York: Free Press, 2005).
2. See Bogle, *The Little Book of Common Sense Investing* (New Jersey: John Wiley & Sons, Inc., 2007).
3. *Id.* at 33.
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8. <https://www.schwab.com>.
9. Forbes 2013 Investment Guide, *Money Magic: Top Secrets from 20 Wealth Wizards*, June 24, 2013.