

# 1

# FINANCIAL REALITIES

**S**tep one in your odyssey to accumulate and preserve substantial assets for retirement is to increase your awareness of several powerful realities that impact your investment decisions. Ignored, these realities will damage or destroy your financial future. You may have already experienced the financial impact of bad advice provided by incompetent investment professionals. Inevitably, the results are lost time and lost performance, both of which are irretrievable.

This chapter explains several of these realities and describes the only practical solution you have for the achievement of a lifetime of financial security.

## **The Wakeup Call**

Any important objective, such as accumulating and preserving sufficient assets for retirement, requires a goal and a strategy. In fact, it is

## 2 WHO'S WATCHING YOUR MONEY?

nearly impossible to achieve any type of complex, long-term objective without both. For example, suppose your goal is to accumulate \$800,000 in retirement assets by age 65. If you do not have an effective strategy for generating the savings and performance needed to reach that figure, the goal will not be realized. You will be forced to choose between several onerous alternatives: deferred retirement, part-time employment, a reduced standard of living, or inadequate assets late in life.

It is an unfortunate reality that establishing long-term goals, executing complex strategies, and maintaining investment disciplines are not enjoyable tasks. They are frequently ignored, and investors hope the assets are there when they are needed. Then, when the problem is big enough, we force ourselves to acquire the knowledge to develop and execute a retirement strategy. However, by then it is often too late. There is an old adage in the financial services industry that most investors spend more time planning their next vacation than they do planning their financial futures. This is true for many people because they fail to realize that knowledge, goals, and strategy are the keys to a successful financial future.

You may be wondering why a personal commitment to knowledge is so important to the success of financial planning. It is because the accumulation of retirement assets has a powerful opponent that competes with your interests. That competitor is the financial services industry itself, and you cannot always trust the information that is provided by its representatives. The core problem is that there are conflicting goals. Yours is to maximize financial security, whereas the industry's goal is to maximize profits. An advisor's goal is to maximize personal income. All three goals must be achieved with your assets, which produces competing interests. It is critical that you understand the characteristics of this competitor, because only then can you learn to protect your assets from an industry that more often than not places its interests ahead of yours.

### **Friendship Is Risky**

The financial services industry spends millions of dollars a year teaching advisors how to build friendly relationships with you. This is because decades ago, it learned that personal relationships facilitate

the sale of its products and increase its retention rates: you are more likely to buy and less likely to terminate the services of someone you like. Consequently, friendship is a technique that advisors use for developing trust, which in turn helps them sell financial products. The problem occurs when industry-wide goals are achieved at your expense—for example, the investment excess of the 1990s that produced seven trillion dollars of losses in the early 2000s.

You are entering into a business relationship that is based on a fair exchange: You pay the industry's advisors for value-added services that help you improve the performance of your assets. Friendship is not part of this exchange. Consider it a bonus “after” your financial goals are achieved.

### **False Sense of Security**

The financial services industry spends hundreds of millions of dollars a year on marketing the critical importance of three things: relationships, trust, and results. It has also hired hundreds of thousands of financial advisors and taught them to build personal relationships. This has been a successful business model for decades.

However, recent headlines are beginning to alert investors to the conflicts of interest that permeate the industry. Millions of investors are no longer as secure as they once were when they believed their assets were “in the right hands.” At the center of the controversy are the professionals who represent the industry's companies, market its products, and develop trusting relationships with you.

You may feel comfortable with the financial advisor who currently controls or influences how you invest your assets in the securities markets. The critical question is whether this feeling is warranted by the competence and trustworthiness of a professional who puts your interests ahead of his or her own. A major risk is that your feelings have been influenced by years of advertising, brand names, structured presentations, and relationship skills, all of which have nothing to do with competence, trust, or results.

### **Awareness Is Power**

You will be in a better position to take control of your financial future when you are aware of the powerful forces that impact your ability to

## 4 WHO'S WATCHING YOUR MONEY?

accumulate and preserve retirement assets. If you have this knowledge, you will no longer be dependent on an industry that uses your assets to maximize its revenue and profit. Control also means that you are no longer susceptible to industry strategies that deliver unfulfilled promises.

Just think about the catastrophic consequences if the opposite were true—maybe you already have in the early 2000s. Lack of awareness transfers your power to an industry that has proven its willingness to compromise your financial future to satisfy its own needs.

### **Critical Financial Needs**

There are three investment-related needs for retirement that, if you meet them, will produce a secure financial future:

1. Substantial assets that produce sufficient income to fund your lifestyle during retirement and provide financial security late in life.
2. Competitive returns that produce the assets.
3. Competent, trustworthy advice that produces the returns.

### **How Much Is Enough?**

Most investors do not know how much money they will need for retirement or financial security late in life. This lack of awareness is a paradox because this target number is such a critical variable when planning for retirement. One easy way to determine the monetary figure is described in a 2002 Charles Schwab study. It concluded that you will need \$230,000 of assets for every \$1,000 of monthly income (\$230 of assets for every dollar of monthly income, an annual payout rate of 5.2 percent during your retirement years). At \$5,000 per month, you will need \$1,150,000 of assets. At \$10,000 per month, you will require \$2,300,000. At \$20,000, you will need to accumulate \$4,600,000.

Longevity is one of the primary reasons that creates the need for substantial assets. According to the Annuity 2000 Mortality Table, the joint life expectancy of a couple age 65 is 92—a horizon of 27 years or more if you retire at age 65. There is a 25 percent chance one partner will live to age 97. Life expectancy has increased two or three years in just the past decade alone. You can thank modern drugs,

genetic therapies, technology, and healthier lifestyles for this dramatic increase.

Pre- and early retirees are just beginning to recognize the financial implications of living longer. They will need substantially more asset value than their parents did if they want financial security late in life. In addition, they will have to generate higher returns and take more risk for as many as fifteen years after retirement to protect their principal and purchasing power. Running out of assets and returning to work at age 80 is simply not a viable strategy.

### **Competitive Returns**

Your need for substantial assets drives the need for significant investment performance. This is based on the premise that millions of future retirees with a few hundred thousand dollars in their retirement accounts will have no way to “save” their way out of financial uncertainty. They will need significant performance in order to increase asset amounts—this is their only viable option.

Most of your annual increases in assets will come from performance and not savings because the principal amount in savings accounts is or will be larger than net income from salary and investment rates of return are higher than savings rates. As an example, suppose your one-year investment return on \$300,000 was 12 percent, producing \$36,000 in new assets. This compares to a savings rate of ten percent on your personal net income of \$80,000, yielding \$8,000 of new assets to invest. In this example, 82 percent of your increased assets comes from investment performance. As you can see, unless you have the unusual ability to save very large sums of money, performance is the critical component to a comfortable, secure retirement.

### **Competent, Trustworthy Advice**

To achieve the performance you require from your assets, you will need competent advice from a professional whom you can trust. This person must possess the requisite knowledge and have access to sophisticated services in order to advise you on the optimum strategy for investing your assets. This means that the advisor must have substantial knowledge obtained from formal education programs and years of experience. The advisor must also provide objective,

## 6 WHO'S WATCHING YOUR MONEY?

high-quality advice that puts your needs for assets and performance ahead of his or her personal need for income. Most importantly, the advisor must have a history of integrity. After all, how valuable is investment advice if you cannot trust it?

Advisors who meet these criteria are the exception rather than the rule. They are the most successful professionals in the industry, because all investors would like to use their services. They are the topic of this book.

### **What Are the Obstacles?**

You have very specific financial goals. You need a specific asset value by a certain deadline in order to retire and enjoy financial security for the remainder of your life. Then you need a strategy that will maximize the chances of achieving that goal. Unfortunately, there are several daunting obstacles that stand in your way, and left unattended, they will destroy your plans.

#### **You May Be an Obstacle**

You may be your own worst enemy when it comes to selecting competent, trustworthy advisors for your assets. Why? Because you are susceptible to the overtures of an industry that make it easy to select and retain advisors for the wrong reasons. This susceptibility exhibits itself when you select advisors based on their carefully crafted sales presentations. It is also common to retain advisors for long periods of time, even when they are not delivering competitive performance for reasonable levels of risk and expense. It is always easier to maintain the status quo and hope that future performance will be better. "Hope springs eternal," as the saying goes, and the financial services industry is very skilled at marketing hope. It is an unfortunate reality that your hopes are in direct conflict with the industry's need to maximize profits for its companies and income for its advisors.

#### **Bad Advice**

Our research indicates that up to 84 percent of investors with more than \$100,000 place their financial futures in the hands of investment advisors who have a broad range of credentials and capabilities.

Based upon my experience, the large majority of these advisors are not the competent professionals you think they are. Instead, they are representatives who are paid commissions to sell particular types or brands of financial products. When you hire inexperienced or poorly trained professionals, there is a high probability that you will receive bad or tainted advice.

This is one of your major obstacles. If you are going to entrust your financial future to a professional, you had better be sure that the professional is competent and worthy of your trust. The advisor must meet certain minimum standards, or you will pay a severe price later in life, often when it is too late.

### **Savings and Debt Rates**

Another obstacle is your ability to save your way out of a retirement asset deficit. Baby boomers, the next generation to retire, have the lowest savings rates in history. This reality has been fueled by a number of contributing factors. The securities performance of the roaring '80s and '90s led many investors to reduce their savings rates, thinking the extraordinarily high returns would go on indefinitely. The same generation is also experiencing the highest debt in history, and discretionary income that could be going into savings accounts is diverted to interest and principal payments. High debt payments and low savings rates dramatically affect your ability to accumulate assets for retirement. If this describes your situation, your only recourse is to try to catch up by maximizing the performance of your assets.

Personal assets, held outside company pension plans, are a critical component of any retirement planning strategy. The Social Security Administration estimates that the average American of modest income derives 24 percent of retirement assets from qualified plans, 21 percent from Social Security, and 55 percent from personal assets and income. It will be very difficult for most Americans to retire with financial security if they are overly dependent on income from retirement plans or Social Security.

The extraordinary popularity of 401(k) plans in the '80s and '90s also increased your need for higher investment returns. Previous generations retired from companies that provided benefit plans with

## 8 WHO'S WATCHING YOUR MONEY?

guaranteed incomes for life. Underperformance was the employer's problem, and the company would make additional contributions to make sure that there were adequate assets for required distributions.

If you are a baby boomer, it is likely that you work for a company that sponsors a 401(k) plan and not a defined benefit plan. When you contribute pre-tax dollars to the plan, the company may or may not provide a matching contribution, and the amount of assets you will have for retirement is determined by the performance of the plan. In other words, unlike your parents, you are impacted by the performance of the plan's investments—just as you are in your IRA and other personal investment accounts.

Competitive performance is the only way you can adequately protect your lifestyle.

### **Erosion**

Your need to produce competitive rates of return on your assets does not stop the day you retire. Your tolerance for risk will decline, but the need to produce high single-digit returns is still a reality. You will need performance to offset the four principal forms of erosion: distributions, inflation, and investment expenses. Rising longevity exacerbates this problem, because the longer you live, the more erosion you will experience, especially from inflation. Your only solution is to increase your assets by an amount that produces enough return to offset distributions, expenses, and the impact of inflation.

### **Complex Markets**

Performance requires investment in stocks, bonds, real estate, and other types of assets that appreciate and/or produce income. According to Federal Reserve data, 75 percent of all retirement assets are invested in the securities markets because they do both. This brings another reality into play: the extraordinary complexity of the financial markets and your understanding of those markets.

Some of the smartest people on earth manage money, but even their track records are lower than the market averages a significant percentage of the time. When intelligent, experienced, educated, and focused specialists have trouble producing competitive returns, you get some idea of just how complex the securities markets really are.

Producing consistent, double-digit returns is exceptionally difficult when you are trying to predict the unpredictable. However, that is exactly what you need to do for a secure, comfortable retirement.

There are no “free lunches” when you invest in the securities markets. If you want to earn higher returns, you have to assume more risk. If you are risk-averse, then you have to accept lower returns. For example, if you are seeking higher returns, you will invest more of your assets in the stock market. If you are satisfied with moderate returns, you will invest in the stock and bond markets. If you are seeking low risk and are willing to accept lower returns, then you will invest in the short-term bond and cash equivalent markets. There is no way around this reality, even though investment-scam representatives say that they have discovered a way to achieve high returns for low risk—the ultimate free lunch that does not exist.

You will most likely have to earn at least a ten- to twelve-percent return during your working years and a seven- to nine-percent return during the first two-thirds of your retirement years to achieve your lifetime financial goals. Neither return can be achieved with 100 percent of your assets invested in bonds. A reality is that you will have to invest in the complex stock market to achieve these returns.

### **Time Commitment**

The next obstacle is the amount of time that it takes to successfully invest your assets in the securities markets. A substantial amount of time must be devoted to developing outlooks, researching alternatives, making decisions, monitoring, replacing managers, and updating your analyses. It stands to reason that the investment of your retirement assets is not the place to take shortcuts when allocating your time.

Investing is a time-consuming process because there are so many choices, massive amounts of data, and continuous changes. If you are like most investors, you do not have sufficient time to analyze all of the data, make investment decisions, and monitor outcomes. This is because you are busy in your career or are enjoying retirement activities. It requires substantial discipline to devote several hours per week to investment activities—even more discipline than exercising or eating the right foods in moderation.

## 10 WHO'S WATCHING YOUR MONEY?

Investing may be your hobby, but there should be nothing casual about the accumulation and preservation of retirement assets. You need goals, a strategy, knowledge, and time to be a successful investor. If you do not possess all of these things, then you need a personal financial advisor.

### **Smart Decisions**

Another potential obstacle is the constant pressure to make smart investment decisions with your assets. The pressure is constant due to the frequent changes that occur in the financial markets. Every mistake you make will reduce your future asset value as well as the time you have available to compound higher returns. For example, assume that you should have earned 12 percent in a particular year, but you earned only 7 percent. Because you have lost time and money, you now need above-average rates in subsequent years to offset the loss. The bottom line is that small amounts of underperformance equal large amounts of lost assets over long time periods.

### **The Impact of Insufficient Assets**

There are also several realities related to having inadequate assets for retirement, and all of them are onerous. You already know what they are, and as you get closer to retirement, you will probably spend some sleepless nights worrying about them. Avoiding these realities means having sufficient assets to produce the income you need to maintain your desired standard of living for the rest of your life.

### **Deferred Retirement**

According to several polls, boomers who are currently in their fifties say that they will not mind working past age 65. The reality is that they will not have a choice. They will have to continue working because they will not be able to retire and support their current lifestyles. In addition, their attitude about working longer will change as the aging process and health problems take their toll. At a minimum, the motivation, if not the physical ability, to work full-time declines with age.

Deferring retirement to age 70 or 75 increases the amount of time that you have to accumulate assets and compound higher rates of return. It also postpones the need to take distributions. If this is your best option (and it will be for millions of Americans), then you will have to adjust to this reality.

### **Part-Time Work**

Another alternative to having insufficient assets is to supplement retirement income with part-time work. There will likely be a labor shortage as boomers begin retiring; you can take advantage of this shortage by working part-time. Assuming the activity is desirable, working part-time may be more palatable than deferring your retirement date because a higher portion of your time will be available for leisure activities.

### **Reduced Standard of Living**

Reducing your current standard of living is another alternative that may be less onerous when compared to your other choices. The reduction process cuts expenses and may also free up assets that can be used to produce additional income. For example, you could sell your large expensive home, use part of the proceeds to buy a smaller, less expensive one, and invest the remainder in assets that produce retirement income.

### **Financial Insecurity**

The impact of insufficient assets is most devastating late in life when you have no way to accumulate more—unless you are the heir to a significant fortune. It is at this stage that older retirees who have run out of assets become wards of the state or move in with their children. People who have been independent their entire lives are suddenly dependent on the generosity of others. Add a disabling illness to the equation, such as Alzheimer's disease, and you have a recipe for personal disaster.

Just the thought of this possibility produces a substantial amount of stress for millions of current and future retirees. The only solution is to take action as soon as possible—time delays make the task of accumulating assets that much more daunting.

## 12 WHO'S WATCHING YOUR MONEY?

### **You Need a Personal Financial Advisor**

Your critical need for assets produces an equally critical need for performance, which creates a requirement for knowledge. This knowledge can only be provided by a personal financial advisor who is competent and trustworthy.

These needs, plus the complexity of the securities markets, are the principal reasons why 84 percent of investors seek the advice of professionals to help them make investment decisions. You expect that the advisor's education, experience, and full-time commitment will produce superior returns (net of all expenses) compared to what you could do on your own. In addition, the right advisor can help you overcome all of the obstacles that were described earlier in this chapter.

#### **Quality Advisors**

If you decide to outsource the work of investing, you are faced with another reality: most advisors sound good, but only a small percentage actually possess the qualities you need. Your challenge, as with researching and selecting your own investments, is to obtain enough reliable information to tell the good ones from the bad. Then you can select an advisor who is qualified to help you achieve your financial goals for retirement.

The best advisors comprise the upper echelon of the profession (less than five percent). They possess the competence and integrity you are looking for. They are well educated, have years of valuable experience, possess important certifications, belong to the right associations, and have clean compliance records.

Another 20 percent of advisors possess characteristics of both low- and high-quality advisors and are transitioning to the upper echelon. These professionals are currently acquiring credentials, gaining experience, and evolving from selling commission products to providing value-added advice for fees.

The remaining 75 percent of advisors are representatives who sell financial products for commissions. They add little or no value to the investment process because value is not their focus, nor is it the way they are measured or compensated. They recommend particular products as part of a sales process that is loaded with conflicts of interest, and it is up to you to identify them.

This tremendous range in advisor quality is not readily apparent and it makes sense for the industry to hide advisor ineptitude from you, because it knows that you would never knowingly turn your assets over to a weak advisor. Consequently, that is exactly what millions of investors do every year because they base their decisions on advisor-controlled sales presentations instead of more objective criteria.

### **Conflicts of Interest**

Perhaps you blindly trusted the financial services industry to invest your assets in the past. The blinders have been removed, though, by the recent headlines that described the extraordinary conflicts that permeate Wall Street. Because you know that the industry is loaded with conflicts of interest—a long-standing problem that is now in the limelight—it is up to you to use that information to minimize its impact on your assets.

Whenever an advisor places his or her interests ahead of yours, there is a conflict. Inevitably, it means that the advisor is benefiting financially at your expense. The reality is that there will always be competing interests when one person can take advantage of another for personal gain—the problem is as old as time. The insidious part of the financial services industry is that it sells trust and then deliberately abuses it. Knowing this reality exists means that you have to be exceptionally careful when you rely on the advice of advisors for your financial future.

### **The Selection Process**

The selection of quality advisors requires a completely objective process in order to gather the information necessary to compare several professionals to each other. You will also need to conduct an interview, because you should never use the services of an advisor without meeting him or her in advance.

This book will help you select quality advisors and avoid professionals who are not focused on your best interests.

### **Advisor Monitoring**

Once you have selected a professional, it is critical that you monitor the quality of advice you receive for your assets. This means that you need benchmarks which accurately reflect your return objectives and

## 14 WHO'S WATCHING YOUR MONEY?

tolerance for risk. Advisors must be held accountable for the quality of their services, just like other professionals.

*Who's Watching Your Money?* will help you develop monitoring systems that you can use for evaluating your advisor's services.

### SUMMARY

- ✔ You will need substantial assets for your retirement years due to increasing longevity and rising expenses.
- ✔ Investment performance is even more important than your savings rate for the accumulation of these assets.
- ✔ You will have to invest in the complex and volatile securities markets to obtain the performance you need to maximize asset values for retirement.
- ✔ 84 percent of investors rely on personal financial advisors for the help they need to invest in the securities markets.
- ✔ Most investors do not know how to select quality advisors. Their choices are based on nothing more than advisor-controlled sales presentations and gut instincts.
- ✔ Due to their general lack of knowledge, investors have introduced a new risk into their financial futures: the risk of bad advice in volatile markets.
- ✔ Inadequate assets for retirement produce onerous choices: deferred retirement, part-time employment, a lower standard of living, and reduced financial security late in life.