

## **Chapter 16**

### **Putting it All Together**

*I would rather be certain of a good return than hopeful of a great one.*

*Warren Buffett*

*It requires a great deal of boldness and a great deal of caution to make a great fortune; and when you have it, it requires ten times as much wit to keep it.*

*Meyer Rothschild*

Old habits die hard. It is not easy to abandon a method of investing that you may have been using for years. The illusion of high returns is hard to turn away from. After all, we have been programmed all our lives to seek superior performance through a “beat the market” approach. The world is full of salespeople who make a living dangling the “you can beat the market” illusion in front of you. Wise investors peer through the sales hype, and look at the real risks and returns. Granted, a few lucky investors will beat the odds by beating the market, but the other 99% fall far short.

The concepts presented in this book are simple and straightforward, but may take a few years to implement. People act slowly when embracing a new investment philosophy. Money tends to suffer from inertia, and ending a relationship with a friendly broker or advisor is often difficult. Just remember that the broker or advisor has been well paid for their services in the past, and it is simply time for you to move to greener pastures.

If you take time to define your investment goals, select a proper asset allocation, plan a tax strategy, and make a long-term commitment to low-cost investing, you have the greatest chance for success. Once this new strategy is implemented, it only takes a few hours each year to maintain. There is no need to waste valuable time and money trying to find strategies that might do better than a passive strategy because all you need is to make a market return for investment success. Your rewards for following this approach will be greater wealth, lower cost, lower risk, lower frustration, and lower taxes.

### **Case Study**

This chapter sums up the important concepts in the book with a case study. A middle-aged couple has been successful in their chosen occupation, but not very successful investing the fruits of their labor. After a review of the couple’s current strategy, several changes are suggested to put their portfolio on track. You

may see similarities with your own situation. However, this is only an example and is not intended to be a model for the masses.

Bob and Betty Barnet are married and have two children ages 19 and 21, both in college. They have enough income to cover their children's education, and are now focusing on saving for retirement. The Barnet's would like to retire in 20 years when they both reach age 65. They own a medium size business that generates about \$150,000 per year before tax.

Bob and Betty have recently established a pension and profit sharing plan for their business at a local bank. It is invested in the bank's proprietary mutual funds and a money market fund. So far they accumulated \$30,000 for themselves in the plan and they believe they can invest \$30,000 each year going forward. They also have \$150,000 in personal savings most of which is in a savings account at the bank and in a few stocks Mr. Barnet bought through the years.

The Barnet's currently spend about \$8,000 per month or \$96,000 per year, although \$24,000 per year is going to tuition and other college costs. When the children are finished with school and on their own, the Barnet's figure they will need a monthly income of \$6,000 per month to cover all their needs.

### *Step 1. Defining the Barnet's Position and Goals*

- The Barnet's would like to sell their business and retire in twenty years at age 65. This means saving enough while working so that he can draw a reasonable income while in retirement. They feel \$6,000 per month would be sufficient.
- The Barnet's do not believe their business is worth much once they retire. Since it is a consulting business, when Bob and Betty go the clients will likely move on. For this reason, they value the book of business at one times earnings, or roughly \$100,000.
- So far the Barnet's have saved \$180,000 for retirement, and believe they can put away \$30,000 annually going forward. They also think they will be able save more once the children are out of college and out of the house.

### *Step 2. Adjusting the Numbers for Inflation*

- The Barnet's believe inflation will average about 2% over the remainder of their life. Adjusting \$6,000 by 2% inflation equals about \$9,000 per month needed at retirement in twenty years. That's an annual inflation adjusted income \$107,000 per year.

- Assume a portion of this income will come from Social Security. Let's guess Social Security pays the Barnet's a total of \$2,000 per month at age 65. This figure is lower than the current rate, and it is not adjusted for inflation, but it is probably closer to reality than what the Social Security Administration is quoting.
- Less Social Security income, the Barnet's will need to withdraw \$7,000 per month, from savings to meet their \$9,000 income goal. If we multiply \$7,000 by 12 months, it comes to \$84,000 per year.
- To find the total savings needed at retirement, multiply \$84,000 by 20. This means at age 65 the Barnet's need a nest egg of approximately \$1,700,000. For the purpose of this illustration, assume their business does not have any value once the Barnet's retire. Also assume they do not increase their \$30,000 savings rate in the future.
- By withdrawing 5% per year from their \$1,700,000 account, the Barnet's will have income of \$85,000 per year adjusted for inflation, plus \$24,000 from Social Security. This gives them the \$9,000 per month they desire.

### *Part 2. Determine the Minimum Required Rate of Return*

- The next step is to calculate minimum required rate of return on the Barnet's investment portfolio. Using a spreadsheet program like Microsoft Excel, or financial planning software like Quicken®, you can calculate the return they need to meet their financial goal.
- The Barnet's currently have \$180,000 in savings and need to accumulate a minimum of \$1,700,000 over the next 20 years. They can put away \$30,000 per year. Using software of a financial calculator, input \$180,000 as a present value of the investment, add contributions of \$30,000 per year, put in 20 years for time, and input an ending value of \$1,700,000. Your computer or calculator should produce a required return of 6.1%
- If the Barnet's save exactly as planned, and the account grows at a rate of 6.1% per year, they will have the \$1,700,000 needed at retirement.

In simple model we found the Barnet's have a future liability of \$1,700,000. Using the data provided to us, we calculated a minimum required rate of return on their savings to match the liability. This method is very close to the model used by large pension funds to calculate their required return.

If a person's money flow can be determined in advance, as well as an assumption about inflation, then a required rate of return can be easily found. Obviously, the situation may change, and the plan is based on everything we know about the Barnet's today. In the future they could buy another business, lose their current business, retire early, win the lottery, get sick, get divorced, inherit money, etc. Life can be unpredictable, but we still need to plan.

This case study is not over. Next we need to find an asset allocation that fits the required rate of return and the Barnet's tolerance toward risk.

### *Market Expectations and Asset Allocation*

We calculated Barnet's required return to be a 6.1% while assuming a 2% inflation rate. Now it is time to choose actual investments to meet their goals. We are looking for an investment portfolio that has the highest probability of achieving at least a 6.1% rate of return over 20 years, with the lowest risk factor.

- If there was a risk-free way to earn 6.1% annual return, the Barnet's should seriously consider that option. There is no reason to take more risk than is necessary to match an investment goal. We are only seeking an investment plan that will give the Barnet's what they truly desire, a stable and secure retirement.

Over the long-term, risk-free Treasury bonds returned only about 3% over inflation. This means a portfolio of Treasury bonds will return about 5% over the next 20 years. A portfolio of t-bonds leaves the Barnet's short of the goal retirement. They must assume some risk in order to increase his probability of reaching a 6.1% return.

### **Suggested Portfolio for the Barnet's**

Expected Return of Bonds and S&P 500  
20 Year Inflation Adjusted Returns

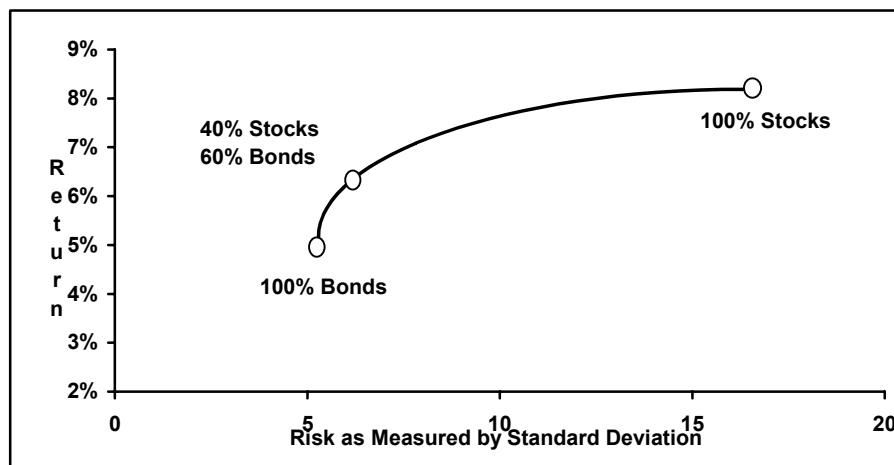


Chart #1

Using the expected return of the markets discussed in chapter 11, the a portfolio invested in 40% stocks and 60% bonds has a high probability of producing a 6.1% return in the future. Assuming a 2%

inflation rate, Chart #1 reflects this allocation. This chart also assumes the portfolio is re-balanced back to a 40/60 mix each year.

Notice the return “efficient frontier” line from bonds to stocks is not straight. It is curved. This is a “free lunch” from asset allocation. Your return (left scale) moves up as you add stocks to a 100% bond portfolio, but the risk level (bottom scale) does not move in the same proportion. Because stocks and bonds are two different asset classes, you can increase your portfolio return by adding some stocks to an all bond portfolio, with very little increase in risk.

### *Risk Tolerance*

In order for an account to grow after-tax and inflation, the portfolio must take some risk. History shows the long-term return from a risk-free t-bill portfolio is negative after taxes and inflation<sup>1</sup>. While some risk is necessary, if a person assumes too much risk, they tend to abandon a plan at the wrong moment, causing poor performance over the long-term. Added risk means added volatility. There are times when a portfolio will go down in value. Investors must be prepared to see their account value go down once in a while. How a person reacts to the loss is extremely important.

There are two questions every investor needs to answer. First, how much risk do you need to take? Second, how much risk are you capable of taking? If an investor takes more risk than they need, or they assume more risk than they can handle, they are making a critical mistake. A portfolio should have a low enough risk level so the investor will not be compelled to change their asset allocation during adverse market conditions.

In our example, if the Barnet’s hold a 40% stock, 60% bond portfolio throughout their working years, there is a good chance they will reach their financial goal at retirement. As a result, they need to be prepared to buy stocks during poor market conditions and sell stocks when the market moves higher. As a competent investment advisor we must determine to the best of our ability if the Barnet’s can handle the risk implied in a 40% stock, 60% bond allocation.

- There is no easy way to assess risk. Most people claim they are risk takers, but history has proven otherwise. One way to gauge the risk tolerance of an investor is to work the 73-74 Stress Test explained in Chapter 14. Using the test would determine if the Barnet’s could hold onto a 40/60

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<sup>1</sup> According to Ibbotson Associates, since 1926 an investor in 100% Treasury bill would have compounded at a -0.9% return after tax and inflation.

allocation during the 73-74 bear market. If they do hold their position, there is a good chance this allocation will work for them in the future.

All successful investors know their personal risk limits, though they may describe them differently. Warren Buffet invests within his circle of competence. Benjamin Graham only bought stocks that had a high margin of safety. International investor John Templeton does not invest in a country until there is blood in the streets. These people thought long and hard about controlling risk. As Warren Buffet reminds us, “risk comes from not knowing what you are doing.”

### *Case Study Recommendations*

Here is my recommendation for the Barnet's:

- Save \$30,000 per year in the sheltered retirement plan to avoid current income tax. It is always better to save with pre-tax dollars than after-tax dollars. See Chapter 15.
- Move the pension account from the bank to a low cost fund mutual fund company. This has several advantages. First, it will save thousands of dollars in bank fees over the years, second, it gets the plan out of the banks proprietary (high fee) mutual funds and into a company that has low cost index funds.
- Once the pension account is reestablished at the mutual fund company, the Barnet's should invest 60% in an intermediate term bond index fund, 25% in a US total stock market index fund, and 15% in a total International stock index fund. This is a great mix for long-term investors. Each year, after a new contribution is made, they should balance the portfolio back to it's original weighting. See Chapter 12.
- With \$100,000 in personal money, build a five-year municipal bond ladder. Place \$20,000 per year in high quality bonds that mature in each of the next five years. The Barnet's should use a broker at a large, established brokerage firm and ask for only new issue municipals. See Chapter 13.
- Place \$30,000 of personal money in a market fund at a brokerage house. This is emergency money. Money market funds at brokerage houses pay higher interest rates than the banks. Almost every brokerage house offers checking. It helps to have checks for quick access to your money and in case you need cash on a weekend.
- Finally, leave Bob \$20,000 in personal money to play the stock market. He enjoys following the market and picking a few stock now and then. I recommend buying stocks in a personal account because the losses can provide tax deductions. For planning purposes, the account should *not* be expected to grow over the years, or counted on in retire. See Appendix #2.

The recommendations in this case study focus on the four rules of a solid retirement savings plan:

- 1) Keep investment costs low with stock index funds and straight bonds
- 2) Diversify stocks holdings across a wide spectrum of index funds
- 3) Use a consistent asset allocation and do not try to time the market
- 4) Implement a sound tax strategy

These four rules will add more wealth to more retirement savers than anything Wall Street has to offer. The more you think about these rules, the more they become clear. Following them will make your investment plan a success.

### ***Concluding Remarks***

*Truth must be repeated again and again, because error is constantly being preached around it.*

*Johann Wolfgang Von Goethe*

I hope you have enjoyed reading *Serious Money*. As each day passes, the information in this book becomes more relevant. During his 1999 State of the Union Address, President Clinton acknowledged the impending crisis in Social Security. As we become more responsible for our own retirement income, costs must come down and investment skills must improve.

Contrary to popular belief, there is no secret formula to saving for retirement. It is a long-term commitment. The concept in this book promotes an investment philosophy that has a high probability of success because it ignores Wall Street hype and cuts costs. Indexing the markets work because it is simply, low cost, and is not speculative.

**The markets make people wealthy, not complex strategies designed to beat the markets.**