CLOWN SHOES

Part I

At ***The Fitzpatrick Group,*** we ***Educate*** individuals and business on the impact ***Volatility, Fees, and Taxes*** can have on retirement assets. With the proper ***Education,*** we believe that businesses and individuals can make better-informed decisions regarding their financial future. This is not an easy task. The amount of misinformation that drives client behavior, as well as the number of misinformed financial advisors, is staggering. A circus filled with clowns.

Let's break down some misinformation.

Market ***Volatility*** is real. Using an average rate of return to predict future performance is not real. Financial literature is filled with projections based on average rates of return, or ***Flat Returns***, and both are terribly misleading. Dave Ramsey posts on his webpage:

A couple with a household income of $56,000 could have around $900,000 for retirement if they invest 15% of their income for 25 years.[1]

This projection assumes a return rate, or ***Flat Return,*** of 10.5% each year for 25 consecutive years. This rate is applied to $8,400 of annual household savings or 15% of $56,000. Using Dave's assumptions, if I make $200,000 a year and save 15% annually, I could have $3,100,000 after only 25 years. If things were this simple, we would all be a lot happier.

To show you how unlikely Dave's scenario is, I will add just one year of market ***Volatility***. On the same $8,400 annual investment, let us project 10.5% for 14 years, a negative (-39%) for 1-year (simulating a market crash), and another 10.5% for the remaining 10 years. This is simulating just one bad year out of 25 years. My new projected investment balance is $563,000. That one bad year costs the investor $337,000.

Just to be thorough, I ran the numbers again. If we gave the same $8,400 of annual savings a 12.5% return for 14 years, a negative (-39%) return for just 1 year, and 12.5% return for the remaining 10 years, our average rate of return will be 10.5%. This aligns with Dave Ramsey's projected rate of return. However, our ***Real*** balance will not be the $900,000 that Dave suggests. It will only be $737,000. Our ***Real Return*** is $163,000 short of Dave Ramsey's projected average.

Investors beware, using averages to project your retirement savings is a marketing gimmick. Let me explain, averages, or ***Flat Returns,*** are used by some advisors, websites, and financial marketing material, to project an unrealistic outcome by taking advantage of the compounding effect. Investment websites, books, and 401(k) enrollment programs often use what I call a ***Flat Return*** rate. *A* ***Flat Return*** *rate is the same number, or interest rate, used repeatedly to take advantage of the compounding effect on your money*. A ***Penny a Day*** compounded every day, 1 penny, 2 pennies, 4 pennies, 8 pennies, 16 pennies, and so on, is over $10,700,000 after a 31-day month. If you compound an investment by the same number or interest rate, without losses or negative interest rates, large future values are inevitable. By calling the interest rate, or ***Flat Return,*** an "average" that is based on real experience, the

marketing gimmick makes the projection seem likely. To say the S&P 500 has averaged 12.5% over the past 30 years lends dangerous credibility to anything that comes next based off that average. Watch out for the following: The S&P 500 averaged 12.5% over the last 30 years, so we should be safe assuming 10.5% ***Flat Return*** on your money for the next 25 years.

Let's look at another issue with projecting a future balance using averages or ***Flat Returns***. Most advisors and investors *should* agree that as a financial goal approaches, a more conservative asset allocation should be utilized. Some would call this a *golden rule*. Why then do many financial strategies start by grabbing an average from a set of years and applying that average to the entire timeline of that investment, i.e. 10.5% for 25 years? This would suggest that the investor is ok with the risk that is associated with a 10.5% interest rate during the last years before their goal. This marketing gimmick allows Wall Street to apply a ***Flat Return*** over the last years of an investment to compound the investment balance drastically. In our ***Penny a Day*** example, at day 28 the pennies have an approximate total of $1,300,000. That means that in the first **28 days** the pennies grew to $1.3M and in the last **3 days** the pennies grew by another $9.4M. The compounding effect is greatest towards the end of the timeline. You better believe that the marketing departments for Wall Street know this. One could argue that this gimmick goes against the *golden rule* we mentioned above. If your investment projection is not changing the return rate as the goal approaches to simulate less risk, it could be a very misleading and irresponsible projection.

DAY	Investment
1	$0.01
2	$0.02
3	$0.04
4	$0.08
5	$0.16
6	$0.32
7	$0.64
8	$1.28
9	$2.56
10	$5.12
11	$10.24
12	$20.48
13	$40.96
14	$81.92
15	$163.84
16	$327.68
17	$655.36
18	$1,310.72
19	$2,621.44
20	$5,242.88
21	$10,485.76
22	$20,971.52
23	$41,943.04
24	$83,886.08
25	$167,772.16
26	$335,544.32
27	$671,088.64
28	$1,342,177.28
29	$2,684,354.56
30	$5,368,709.12
31	$10,737,418.24

Is there a better or more responsible way to illustrate these projections? Of course, and it can be as simple or complicated as you want it to be. Advisors and Wall Street marketing could just as easily project the S&P 500's average (easy), or actual returns (complicated), for 15 years, and then the Bloomberg Barclays Bond Index average, or actual returns for the remaining 10 years. Simply put, show different return rates over the stated period. One return rate could represent more risk, the other return rate could simulate less risk. Using Dave Ramsey's example from above, the same $8,400 annual savings earning 10.5% (riskier) for 20 years and 5% (less risk) for the remaining 5 years would result in a lower projection of $696,000. This approach, while arguably less attractive (it is $200,000 less than Dave's original projection) would certainly be

more responsible and less reckless. At the very least, this projection follows that "golden rule" that suggests a more conservative end to your pre-retirement timeline.

If you really want to have some fun, project 12.5% for 14 years, then a negative (-39%) for 1 year, then 5% for the remaining 10 years. This could simulate market ***Volatility***, investor behavior, and a more conservative asset allocation toward your retirement goal. Honestly, the numbers and market returns could mean all kinds of things. The point is, do it. The result would be $399,000. This result is down over $500,000 from Dave's original $900,000 projection. Ask yourself, which is more likely, a 10.5% ***Flat Return*** for 25 consecutive years, or 12.5% for several years, a negative (-39%) for just 1 year, and several years of 5%?

Again, why don't money managers and authors do this? The answer is simple; investors would steer clear of the market, authors would not sell books, and money managers would have a very hard time justifying any ***Fees***, and/or convincing you to invest with them. All of this before ***Fees*** and ***Taxes***.

Now, I have spoken with all kinds of advisor's about showing what I call ***Net Numbers***. I have also spoke at length about adjusting the future projection for lower risk at the end of a timeline. Over my career, I have taught hundreds of clients and advisors about what a negative year or two does to a portfolio. Even though all of this is in the best interest of the client, and advisors are taught to do by the industry's suitability guidelines, you would be shocked at the amount of push back I get… *"The market averages 10,15,17% returns consistently". "IF you would've invested this much money back in the year XYZ you'd be rich by now."* Or *"The market always returns a large positive year after a large negative year." "You should only reallocate to a conservative portfolio in the last 3 years, 1 year, 6 months…".* I have heard it all. The funny conclusion I have drawn is that advisors and even clients are fighting for reasons to justify showing these higher irresponsible projections. I have also concluded that these are the same individuals that are "always up" at the casino.

The fact is, I have run as more scenarios than I can remember. Advisors and investors should too. Wherever possible, steer clear of using averages, or ***Flat Return*** rates, to project your returns in the market. If you are going to use an average, make sure it is risk adjusted. In other words, are you willing to take on the risk associated with the return you are expecting? Also, do yourself a favor and no matter what interest rate you run, factor in a bad year every 5-10 years. The market does not go up every single year, so why should your projection? Maybe calculate the last several years of your projection at a conservative rate of return. 10% return for 30 years looks a lot different than 10% for 25 years and then 3% for 5 years. If you like this sort of thing, buy yourself a financial calculator and have fun with it. I promise you it is cheaper than advisory ***Fees***.

For some of you this may sound very simple, for others I hope this helps you steer clear of the gimmicks. Have you ever seen a pair of Clown Shoes? They are big, often colorful, and hilarious. Very similar to the financial marketing, and the Dave Ramsey's, influencing your

decisions today. Do what I do, have a laugh, but leave the gimmicks and the shoes to the clowns.

Next up, the ***Fees*** that can be associated with these projections. Clowns are expensive!

[1] daveramsey.com. 2020. *Build Wealth And Save For Retirement*. [online] Available at: <https://www.daveramsey.com/retirement> [Accessed 19 November 2020].