The Colorado Springs
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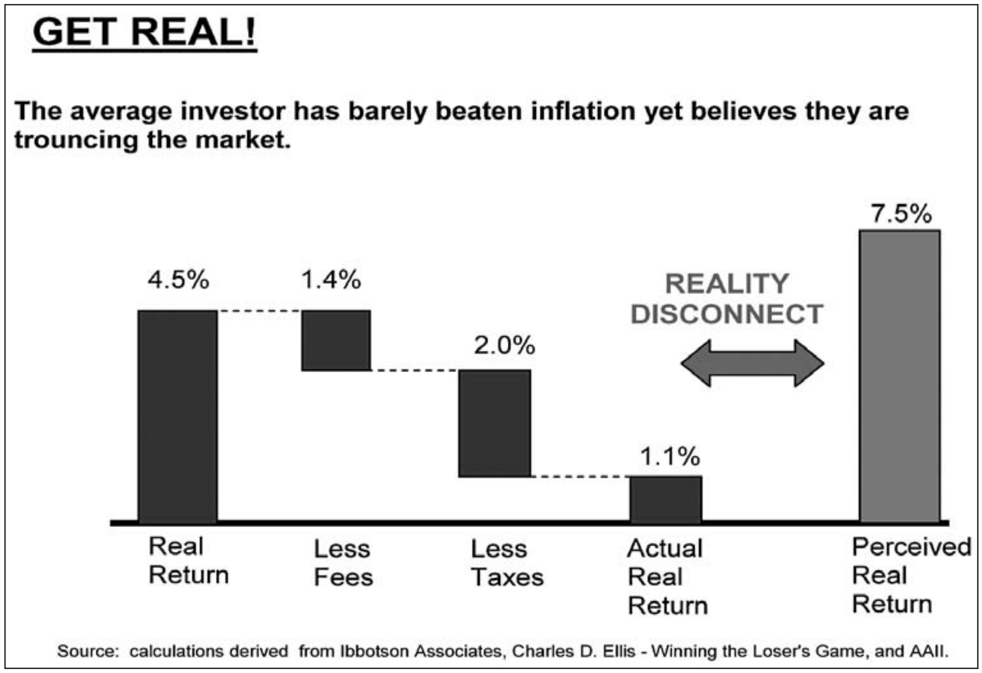
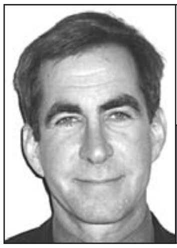
Be realistic when it comes to your investments



GET REAL!

If you want to get rich, the first step you will need to take is to get real! This involves both:



Personal Finance

By Allan Roth
Business Journal Columnist

- Thinking of your investment returns in inflation adjusted **REAL** returns and
- Being **REALISTIC** on how your investments are performing.

Now that the stock market has had two good years in a row, I'm hearing many people express belief that the market will continue to chug along yielding double-digit annual returns. That's not only wrong, it's also irrelevant!

What really matters is how much your buying power increases. It's not a good thing if the market goes up 10 percent and inflation increases by 12 percent. Over the long run, the U.S. stock market averages a 4.5 percent annual real return. As we know, it often comes in years of positive 30 percent or negative 20 percent returns. Nonetheless, capitalism has rewarded investors a long-term real return of 4.5 percent annually.

Unfortunately, most investors have given away the vast majority of that real return in the form of paying unnecessary fees and taxes. Let's look at fees first.

Investors pay an average of 1.4 percent annually in fees. These can come in all sorts of forms from advisory fees, mutual fund expense ratios or hidden fees such as costs from portfolio turnover. If you are invested in mutual funds, for example, you are likely paying more than 2 percent in fees in the form of expense ratios averaging about 1.24 percent annually and hidden turnover costs of about 0.85 percent annually. You may be saying that you are paying those fees in order to achieve better performance, but the overwhelming evidence points to the contrary. In fact, mathematically speaking, those fees can't add value in the aggregate.

Taxes tend to eat up even more than fees at about 2 percent annually. As investors, we are hard-wired to do the wrong thing. We tend to sell our winners to lock in the gain and keep our losers to wait for their prices to bounce back. Unfortunately, all this does is generate more income taxes. Heaven knows, with the humongous size of the current US budget deficit, the government needs all the tax dollars it can get. Nevertheless, I still advise clients to minimize their tax bill. Therefore, I generally recommend harvesting tax losses and holding on to winners to delay or eliminate the need to pay taxes on those gains.

Mutual fund managers often take the same approach as individual investors. The average mutual fund turns over 75 percent of their portfolio each year. Thus, most of the gain becomes ordinary income rather than taking advantage of the long-term capital gains tax rate. Now if you are invested in variable annuities, you don't have to pay income taxes until you liquidate but you are likely paying 3% in fees and turnover costs.

So, if the market continues to earn a 4.5 percent annual real return in the long-run, the average investor may only see about 1.1 percent of that return, as you can see in the first chart. For the typical investor, the magic of compounding is tragically transformed to the tyranny of compounding.

The second step in getting real is to take a **realistic** look at your investment performance. When it comes to investing, we all live in "Lake Woebegone" where everyone is significantly above average. Such idealized thinking leads to 90 percent of us (including myself) believing we are above average drivers. Or my personal favorite, and perhaps most analogous fantasy, is the firm belief held by the majority of people returning from Las Vegas that they have won money at the tables. They are all math-

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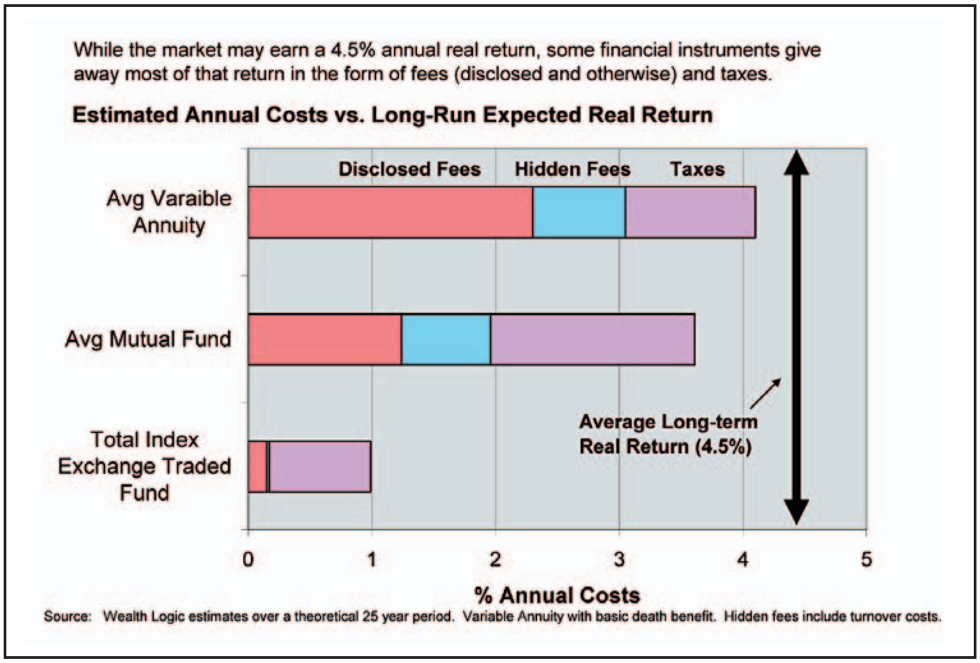
ematically impossible,

There is a ton of data that shows investing is a very unfair game - the large institutions such as pension plans earn a bit more than the 4.5 percent annual real returns and the individual investor earns far less. Why? Because the individual investor falls prey to emotions often inspired by the constant bombardment of sales pitches from professionals. We tend to buy assets after they have appreciated and sell after they have declined which virtually assures us that we will buy high and sell low. It feels really good to believe that we are beating the stock market but that reality disconnect costs us dearly in the way of economic return.



So what should you do? Stay away from high cost investments and avoid portfolios with high turnover. For example, the VTI (Total Stock Market Exchange Traded Fund) has an annual expense ratio of 0.15 percent and turnover of only about 2 percent annually. This results in total estimated annual costs of about 0.17 percent and a very tax-efficient vehicle. You also get, in one neat package, the most diversified U.S. portfolio around. Other low-cost options exist for different asset classes that can be used to build a balanced portfolio that meets your willingness and need to take risk.

So, if you want to get rich, keep those investment fees and tax bills to a minimum and stop fantasizing on how your hot investments are going to continue to beat the market. Perhaps the best investment advice ever given came from Albert Einstein when he called the magic of compounding the most powerful force in the universe. My advice is merely to harness that power instead of giving it to others.

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