Investing for a Great Retirement (Part 2)

By Jon R. Muth

Part one in this two-part series in last month's *Bar Journal* presented a plan for a comprehensive approach to retirement financial planning. Based on the modern portfolio theory, it incorporates diversification, long-term focus, use of index or exchange-traded funds, minimal cost, thoughtful allocation, regular rebalancing, and proper asset location.

Readers may not yet be convinced the plan will work. And the world is full of people who will try to tell us otherwise. They are called investment professionals. They will have a "better approach," which will invariably require us to pay them some portion of our money. I hold the strong conviction that we can do better without all the helpers who drain billions of dollars annually from the pockets of individual investors. Theirs is a siren song best resisted, as Ulysses ordered his men to do, by putting wax in our ears.

As busy professionals, we are often guilty of insufficient attention to our own financial welfare. We can't devote hours to our investments each day. There are times when our schedules overwhelm us and we lose track of our portfolios for weeks at a time. But the good news is we all can effectively manage our own investments with a modest time commitment.

Our plan doesn't cause us to trade, because we invest. It doesn't require us to worry about the impact of Apple's new product, because we purchase broad markets. It doesn't allow us to react to momentum swings in the markets, because we are in for the long haul. And it doesn't push us to make frequent changes, because our portfolio is modified in response to changes in our lives, not in popular sentiment. Paradoxically, as Tadas Viskanta, editor of *Abnormal Returns*, wrote in the January/February 2014 issue of *Money* magazine, "The less effort you put in, the better off you are."

With advance apologies to all sincere helpers, this article first suggests certain temptations that are best avoided. It will then demonstrate exactly how to build a portfolio that adheres to our plan.

We don't need an investment advisor

"A low-cost index fund is the most sensible equity investment for the great majority of investors. My mentor, Ben Graham, took this position many years ago, and everything I have seen since convinces me of its truth." —Warren Buffett

Sendhil Mullainathan, professor of economics at Harvard, conducted a study. He hired actors who pretended to need financial advice and consulted investment advisors. When some told their advisors they already had their money in a good low-cost index fund, a significant majority of the advisors tried to convince them to switch to some undiversified high-load fund.

Even if we identify an advisor whose primary concern is our welfare, we will spend anywhere from 0.5 to 2 percent a year for something we can easily do ourselves. On top of the advisor's fee, buying the recommended funds or securities will add cost. If between embedded costs and advisory fees we spend 3 percent of assets each year, we are paying our helpers half of a reasonable return. Very few professionals consistently beat the market by 3 percent a year. Any attempt to do so usually requires the assumption of additional risk.

We don't need an advisory service to choose our investments

There is much bad advice readily available, and it is often difficult to distinguish the good from the bad. Of the 35 investment newsletters that existed in 1980, only 13 were still in business in 2006. Only three outperformed the market. Truly great investors are making money by investing, not by selling newsletters that tell others how to do it. The best advice is often free or available at very low cost: read Warren Buffett's letter to shareholders in the Berkshire Hathaway annual report or check the ratings in *Forbes*, *Fortune*, or *Money* magazines. An online Morningstar subscription is a good value. For years, I tried through independent research and investment services to pick the very best actively managed mutual funds. If I could do that, I reasoned, I would outperform the market. But I didn't. Because ratings are retrospective, I managed to pick managers who had previously achieved great results while missing ones destined to excel in the future. Plus, as we have seen, the extra cost of active management requires market-beating performance to simply match the index.

We don't need a stockbroker to help construct or manage a portfolio of stocks

Brokers working on commission only make money if a customer buys or sells something, working at cross-purposes to a strategy focused on buying and holding the market. It would be naïve to suggest brokers are never under pressure to generate revenue. Furthermore, picking the right broker isn't any easier than picking the right stock. Many are thorough professionals who sincerely want to be helpful (remember, however, that brokers are generally not fiduciaries), but a few are just plain crooks. Unfortunately, the ones who wear the best suits and deliver the best pitches are often found in the latter category. When a broker charges a fee that is either a set amount or a percentage of your assets, he adds to your costs just as an investment advisor does.

Furthermore, we don't know (and the broker may likewise not know) where recommendations come from or how sound they are. Most rise like mist out of the firm's "research department," a primary purpose of which is encouraging salespeople to generate trades. In Warren Buffett's words, "Wall Street is the only place that people ride to in a Rolls Royce to get advice from people who ride the subway."

We don't need the advice of the media pundits

Don't listen to the talking heads peddling a hot deal. Their business is entertainment. In the recently published book *Pound Foolish: Exposing the Dark Side of the Personal Finance Industry*,[1] Helaine Olen reported that a four-year analysis of the share recommendations by Jim Cramer, star of CNBC's *Mad Money*, showed that while the stocks rose on the day he mentioned them, they underperformed the market over longer periods.

There are sources for obtaining unbiased advice from people who aren't selling us something or trying to keep our attention through the next round of commercials. My favorites include Morningstar and the American Association of Individual Investors.

Don't listen to anyone who suggests the market will behave differently from historical patterns. As John Templeton has said, "The four most dangerous words in investing are: 'This time it's different.'" A predicted new paradigm is usually nothing more than an old book with a new cover.

We can't let someone limit us to poor choices

Because we want to maximize our opportunities to invest in tax-advantaged vehicles such as 401(k) plans offered by most firms, it is possible that the choices offered are inconsistent with the plan we wish to adopt. If the choices are poor or the costs of

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ownership are high, ask for better ones. Requesting a selection of low-cost diversified index funds is not unreasonable and offering them is consistent with the fiduciary obligations of the plan sponsor. In some plans, it is possible to self-direct through a so-called brokerage window.

How to create and manage an account

It's time to demonstrate how to set up an account that conforms to the principles of our plan. The examples are no more than that: examples. Many different funds can be used—there are many more mutual funds and exchange-traded funds than there are stocks listed on all U.S. exchanges. The chosen funds are ones I own or would be comfortable owning. They can be found on numerous "best funds" lists. We will use predominantly exchange-traded funds. Since we are limiting our search to low-cost passive-index funds, our task of selection is relatively easy. I have a preference for Vanguard products because they are very low cost, do a good job of replicating the chosen index, offer a number of choices, and are broadly traded. As a bonus, Vanguard is the only nonprofit mutual fund company among major sponsors. Of the 33 Analyst's Choices for exchange-traded funds at Morningstar, 17 are Vanguard. Other excellent companies offering low-cost exchange-traded funds include BlackRock (iShares), Fidelity, and Schwab.

First, we must establish a brokerage account. Use one of the established discount brokers: Fidelity, Schwab, TD Ameritrade, and Vanguard are good choices. Create an online account, then buy the current Quicken Premier software and set it up for direct download from your account. Once the information is downloaded, Quicken will help track allocations and performance and will produce various helpful reports, including the annual capital gains report needed for tax purposes. Plus, it has features to help you budget, pay bills, and analyze your progress toward a well-funded retirement. Unfortunately, Quicken Premier doesn't yet have a version that works with the Apple operating system, and Quicken Essentials for Mac isn't adequate for these tasks. A Mac user will have to select another financial management product such as Fund Manager 12 or use software like Parallels, which allows the use of Windows on Mac.

Examples of portfolios

We will now create three different portfolios for an investor with a 10-year investment horizon. All three allocate 70 percent to stocks and 30 percent to bonds, which reflects an appropriate allocation for most people looking to retire in about 2025. They are similar in the breadth of the markets covered. The differences are in the degree of fine tuning of the allocation (and, to some extent, the risks) among classes and subclasses of assets.

The hands-off approach

This portfolio uses a single fund that incorporates most of the features of our plan. It automatically does the allocation and rebalancing. An investor needs only to put the money in and nothing else—until the funds are needed for retirement.

Vanguard Target Retirement 2025 Fund—100% (VTTVX)

This fund divides money among three Vanguard funds: Total Stock Market Index, Total International Market Index, and Total Bond Market Index. As we near our retirement date, the fund will allocate increasingly higher percentages to the bond segment to better control short-term risks.

There are other Vanguard target funds for retirement dates in five-year intervals. Other companies offer target date funds as well. Vanguard's idea of the right allocation at a given point in time may be more aggressive or conservative than that of another manager, but they all fall within a fairly narrow range.

The modest manager

This portfolio requires little more than basic asset allocation (and reallocation as you get nearer retirement) and annual rebalancing.

Vanguard Total Stock Market Index—50% (VTI)
Vanguard Total International Stock—20% (VXUS)
Vanguard Total Bond Market—30% (BND)

The modest manager uses the same three funds that Vanguard Target Retirement 2025 uses. The only difference is that the investor takes the responsibility to determine the allocation and do the rebalancing. More or less exposure to the different markets may be chosen as the individual's goals and risk tolerance dictate.

The active manager

This is for those willing and able to more actively manage the allocation and rebalancing of their portfolios. All these funds are Vanguard except for TIPS, which is an iShares product.

US Mega-Cap ETF—30% (MGC)
US Mid-Cap ETF—10% (VO)
US Small-Cap ETF—10% (VB)
FTSE Developed Markets ETF—10% (VEA)
FTSE All World Small-Cap ETF—5% (VSS)
FTSE Emerging Markets ETF—5% (VWO)
Total Bond Market EFT—20% (BND)
Treasury Inflation Protected Securities ETF—10% (TIPS)

An even more nuanced allocation may include some of the following options.

Bond funds may be chosen for different maturities, e.g., Vanguard's long-term (BLV), intermediate-term (BIV), or short-term (BSV) indexes. A focus on corporate debt is available, both short (VCSH) and intermediate (VCIT) term. Without going into too much detail here, long-term and short-term interest rates do not move in lockstep and, further, it is generally true that the longer maturities pay a higher interest rate for a higher risk. Bond prices increase as interest rates decline and decrease when rates rise. Unless you want to figure this out, stick with the Total Bond Market Fund or consider an actively managed bond mutual fund discussed in the following paragraph.

As an exception to my prejudice for index funds, a good case can be made for active management of bonds. Two excellent funds are Harbor Bond Fund (HABDX) and Dodge & Cox Income Fund (DODIX). While both are considered intermediate-term funds, the managers can and do alter maturities to reflect what they think are advantages in the yields. They also can change the blend among government and corporate bonds to capture what they think are the best yields for the risk and try to pick the best bonds available in the market at any particular time. Their expense ratios are higher than the index funds, but are low compared to most actively managed bond funds.

In a taxable account, you might consider substituting municipal bonds for a portion of your bond portfolio. The actively managed Fidelity municipal bond funds are excellent: consider their Tax-Free Bond Fund (FTABX), Municipal Income (FHIGX), or, for exemption from both federal and state income taxes, Michigan Municipal Income (FMHTX).

For further diversification into real estate, consider a Real Estate Investment Trust (REIT) index for a small portion of the portfolio, such as Vanguard REIT Index EFT (VNQ) or SPDR Dow Jones REIT ETF (RWR). If you think buying gold is a good idea (I don't, and it is never a good idea for more than a very small portion of your portfolio), consider iShares Gold Trust (IAU).

Whichever approach you choose, it is possible to construct a portfolio for which the overall annual cost is less than 20 basis points (0.2 percent or 20 cents out of each $100 invested).

Any successful approach to retirement funding has two essential components: aggressive early savings and commitment to a comprehensive plan. No matter our age, the need for retirement income will be upon us more quickly than we ever thought possible.

A more actively managed portfolio does not guarantee a better result than the hands-off option. It simply gives an investor greater control over the process—for better or worse.

Final words

There we have it—a comprehensive plan that should stand the rigors of time. To succeed, we must remain committed to it. A new plan every year or two is almost as bad as no plan at all. Between July 2007 and the end of 2008, the S&P 500 dropped from 1503 to 638—a low not seen in the prior decade. Other markets suffered more. The temptation to cut losses and bail out was almost overwhelming. But sticking to the plan and doing nothing other than rebalance, which forced the purchase of more equities at low prices, yielded good long-term results. On March 31, 2014, the S&P 500 closed at 1872.

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Happy retirement! ■

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.*

ENDNOTE

1. Olen, *Pound Foolish: Exposing the Dark Side of the Personal Finance Industry* (New York: Penguin Group, 2013).