How Your Money *Makes* Money

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Americans are not saving or investing money, which may have significant repercussions for the financial security of those nearing retirement age. According to the National Institute on Retirement Security (NIRS), "the median retirement account balance is $3,000 for all working-age households and $12,000 for near-retirement households." Even when accounting for Social Security income, this sum is not nearly enough to live on during retirement. As life expectancy increases, retirement periods lengthen in tandem, meaning that retirees will have to stretch their money even further. This gap in savings may illustrate that not enough Americans are investing properly, and as a consequence are forgoing opportunities to build the assets that they will need later in life. According to Gallup, only 55 percent of Americans are investing in the stock market, as opposed to the 62 percent that held stocks before 2008. This may indicate that the financial crisis has made consumers wary of investing. Of those who do invest, certain behaviors and internal biases can prohibit investors from maximizing their returns.

To better understand this phenomenon, Consumers' Research interviewed Gerard Downey, an experienced Certified Financial Planner (CFP) in Oak Park, Illinois and founder of Linden Wealth Management.

Q: *According to Gallup, the percentage of Americans who own stocks still has not recovered from the 2008 crash. Might fear or apprehension be keeping people out of the market?*

A: Yes, absolutely. I think the lingering effects of all the volatility through '08, '09, '10 and the experience of seeing their IRAs and bank accounts evaporate has left a lingering effect that made people very concerned and risk adverse. But, what also happens is there is a large behavioral aspect to investing called recency bias. What happens is they experience this [loss] and it's really vivid in their minds. That takes a long time to unwind itself. Unfortunately, recovery typically happens when markets reach new highs. When you see it reported in the media where we have things like the Trump effect and equities are doing really well, that tends to bring investors back into the market.

Case in point, I have several new clients who have come to me because they're underinvested and have been out of the market for a long time. They've been sitting on cash and are afraid now that the market is getting away from them. Now, they are trying to turn around and get exposed to the market at absolutely the wrong time. What I tell them is you have to accept the fact that you missed this big rally but let's broaden your horizon and think much longer term. If that's the case you should invest now even if markets could go down.

Q: *What are people missing out on by not owning stocks or bonds?*

A: They are missing out on long-term wealth creation. One of the keys to investing is time. The earlier you start and more patient you are as an investor, the greater the reward will be in the long run, so individuals who are not investing today aren't getting the benefits of compounding returns. The beautiful thing about investing is if you put it in the right framework and think long-term, you take out all the short-term noise. If you change your mindset away from these short-term phenomena and think in timeframes of five, ten, 15, 25 years, you can really see the benefits of investing. The bottom line is compounded annual returns build wealth, consistent savings and investing into the market builds wealth, and then a combination of stocks and bonds.

Q: *Despite having access to defined contribution plans, many 401(k)s are underfunded. Why don't more employees take advantage of them?*

A: There could be several reasons for this. Not enough education takes place within the employees' firm, so the plan's sponsor isn't educating employees about the benefits of a 401(k) plan and the long-term effects of putting money away at a tax differed rate. Employers need to do a better job explaining the benefits of why employees should have their 401(k) and receive a matching contribution as well. The other thing is lifestyle. They tend to want to support a lifestyle that is long on travel or things that they need, so savings becomes the last thing they try to prioritize. In many ways, their priorities are turned upside down. Instead of the plan as their first form of savings, they do it last.

Q: *What is the biggest hurdle that prevents people from investing, whether it is a lack of resources, information, or something else?*

A: It's a lack of education, and that has nothing to do with someone's general level of education. My observation is, and I deal primarily with high-net-worth individuals, that whether you're a lawyer, doctor, or a teacher, individuals lack investment knowledge. What is indexing? What are Exchange Traded Funds? What is passive versus active investing? They are especially unsure about the roles that bonds play in their portfolios. A lot of things meant to grab investors' attention are more about marketing than education. They don't have access to clear, concise educational tools they can use. The more educated you are the more confident you are and able to understand these different processes as well as sit down with an advisor like me. Together [you and your advisor] can assess your goals and based on that create a portfolio that shows what return [you] can expect to accomplish your retirement goal or education savings goals.

Q: *Regarding retirement savings, the vast majority of Americans are unprepared for retirement. Is the main reason people are underinvested a lack of awareness or that they feel they don't have enough income left over to invest?*

A: I think it's a combination of the two. It's kind of a passive situation where they've ignored this long looming obligation or liability if you want to look at it that way. They're a young individual in their 20s who say, 'look I have 30 to 40 years to save for retirement.' One is, it's a lack of awareness for how retirement savings work in that you're saving a modest amount yearly in the hopes that it compounds over time so that in the end you have an adequate amount to retire on and maintain your current lifestyle. The other thing is, if you take a look at the statistics the average person does not have a reserve fund greater than $400, which is nothing. People are spending way beyond their means. It gets back to notion that savings are the lowest priority for them. They spend and think about savings later, which is not how it should be.

Q: *Is it still possible for people in their 50s or older to plan for retirement?*

A: Yes. It helps if you have higher income no doubt about it. I'm dealing with some affluent individuals who for whatever reason have not really invested in the market. They're in their early to mid-50s and realize they're going to be retiring in 10 to 15 years. Some even realize they're going to have to work longer than that. It's never too late to save. If you think that market has an average return of eight to nine percent annually, you can double your investment about every eight years based on the 72-rule. So, if you're in your early 50s, by your early 60s your savings will have doubled and that will have doubled by your early 70s. It helps if you have higher income and can divert more towards your savings. For individuals who don't have the income, it's a looming catastrophe in a lot of ways.

The other thing that's a huge issue is individuals are living longer. No longer are we running projections in your early 80s, we're running them to your early 90s. Not only will you live longer, your retirement costs will go up exponentially. It is all dependent on how much an individual can bring in at latter stages of life. Those with more income can more easily get out of the hole but it's a much bigger challenge for those with lower income.

Q: *Related to this, how prepared do you believe the average American is to make investment decisions?*

A: They are poorly prepared. If you think that the average investor underperforms the market at an average of three to five percent annually, any given year that doesn't sound like a lot but over time that's a huge amount. The reason why they underperform is behavioral aspects of what they're doing. They make emotional decisions, they chase the market, they try to market time, they heard something down the street where this guy's just invested in that and they decide, 'I'm going to go invest in it too.' The other problem that I see with a lot of individual investors is they don't do their homework. If they invest in a fund they don't realize it has front loaded fees in it, or it has annual expenses that are extremely high, it tends to underperform an index. You combine all those things together, it is a poor investment.

Q: *Do you feel that Americans have an appropriate understanding of asset diversification?*

A: No. I think the biggest stumbling points are two things: the role of bonds in terms of what they do for a portfolio and international exposure. We have a strong home bias to the U.S. so most investors who own stocks are heavily invested in the U.S. They lack global diversification. What diversification gets you is reduced volatility and, ideally, higher risk adjusted returns. If an individual takes on a lot of risk by investing in high beta sectors, sectors that are extremely influenced by the direction of the market, their portfolio is going to have higher volatility. Diversification allows you to do two things: get rid of idiosyncratic risk by buying an index over individual stocks and tie into all sectors of the markets. If I gain some international exposure, I'm also getting further diversification, in that, international stocks tend to outperform when U.S. stocks underperform, and vice versa. Bonds are another form of diversification in balance. They are less volatile and tend to be less correlated with stocks so as equities go down bond valuations tend to go up.

Q: *For a little more about financial literacy, how do emotions play in investment decisions, and what prevents investors from making rational decisions with their money?*

A: There are seven key behavioral heuristics that impact whether someone is a good investor. Gender-associated biases affect behavior since men and women embrace different elements of these biases. Many of the individuals

I deal with are men, who tend to be extremely unobjective and are concerned that if they open up and share information they will be perceived as a poor performer. Women tend to be less confident, more risk-adverse, and want a lot more collaboration. Investors are affected by recency bias as well, but if you are chasing returns you are almost certainly going to lock in underperformance. If you market time so you sold, you made a bet that you can outperform the market or that you know when to invest or not. The market timer has a habit of sitting on the sidelines once the market goes down but has a difficult time getting back into the market. There's a combination of all these behavioral heuristics that impacts their ability [to invest].

Q: *How should people evaluate how much risk they should take on in their portfolio, and what level of risk is appropriate?*

A: Risk will vary based on the individual. Just because someone is wealthy or poor does not make them more or less risk adverse than another. What I do is, I have a 20-point questionnaire that walks them through: what is their time horizon, how comfortable are you with the concept of investing more once the market goes down, and other indicators. Based on their risk tolerance level, there's a score. That tells us their asset allocation, which could be anything from 50-50 to 75-25 to 90-10 in equities versus bonds. We don't just leave it at that. We try to make sure they are comfortable and fully understand what risk is.

At the end of that process, we put together a model portfolio, and then we show them how that portfolio would have performed over periods of time including the subprime crisis, long-term capital, and the Russia crisis. It's a backward looking data point for them to better understand there will be up periods and down periods. We really take the time to educate them to see not only, here's your risk score, but also here's what would have happened if you invested that way. It helps builds a confidence factor on how their portfolio will do over time.

Q: *Should consumers try to pick and choose individual stocks or focus more on Exchange Traded Funds (ETFs) and mutual funds?*

A: There is very strong evidence that active managing underperforms a passive indexing approach. I tend to be a disciple of John Bogel at Vanguard who is a strong proponent of indexing. In order to outperform [the market], you have to make bets on what the market is going to do or where there's greater value. That speculative bet, given the behavioral heuristics I talked about, are more often than not going to be wrong. It is a select group that can consistently outperform an index. If you cannot find a person who can do it consistently you are better off buying ETFs and mutual funds and indexing your portfolio to get the best returns you can at low fees.

Q: *Now on to the fiduciary rule. The current administration is in the process of delaying or possibly revising it. How will this affect consumers?*

A: I personally think the rule is an extremely important one. It serves an important purpose for investors. I think there is a big difference between the culture of a firm that is a broker-dealer and a fiduciary. There are two aspects to that. One is a fiduciary is required to invest clients the best way possible in ways that always puts their interest first. The costs of a fiduciary are totally transparent. I charge a fee for assets under management and you know what that fee is. The fees for brokers are less transparent and often clients are befuddled when they realize that not only are they paying a transaction cost, they may be paying a commission on top of that or even be in a high-fee fund that will then pay the broker additional fees.

But, a fiduciary may actually cost an individual more. That's part of the concern individuals now have. It serves a great purpose aligning the interests of a fiduciary and client, but at the same time it potentially introduces higher costs that can lead to lower returns. The fundamental question is how can we best inform the investor of a fiduciary and broker and keep fees as low as possible so the client can earn the highest return without losing money to hidden fees. I think [the rule] speaks to the culture of investing that brokers are inherently out there to get clients' money while fiduciaries serve their best interest. That's my own personal experience. I've brought in clients from broker firms who thought the quality of service was very poor, and they paid a lot of different fees they didn't realize.

Q: *What steps should investors take when considering someone managing their money? What questions should they ask?*

A: First, is the person a broker or fiduciary? What is their investment philosophy and the process that they go through? Third, what are the implicit and explicit fees I will be paying you? How do you communicate with clients? Ideally, get as many reviews of a financial consultant as possible. You do not have to immediately sign with that person. You can do other things like review their website or go to FINRA's online broker check to see if they have any violations. Also, sit down with multiple candidates to get a sense for the culture of a firm and the advisors' experience. What is their succession? If anything were to happen to your advisor, who would take over for them? That's important and often overlooked.

Q: *What tools can investors use to improve their own financial literacy?*

A: There are numerous online tools available. There is the Khan Academy, Investopedia, FINRA itself, Fidelity, and there are extensive online materials that provide the basics for investing. I don't want to plug Vanguard too much, but they are a leader in investment education. They make their materials available to the public free of charge. There is also a growing trend of new groups focused on education. I'm trying to form my own financial literacy non-profit in the Chicago area to provide basic materials and a portal people can go to access them. We're also starting to see more high schools make it mandatory for students to attend a graded financial literacy class.

Q: *When is it helpful to hire a financial advisor? At what point should people consider that?*

A: I personally believe that since behavioral problems and lack of education are the biggest single determent to performance, individuals should seek out an advisor as early as possible. It shows a commitment to their investment, it will get them more educated, it will get them invested in the market in the most diversified way possible, and it prevents them from making emotional, ad hoc changes over time.

Here's something that also works. Let's say I just graduated from college and only have $5,000: go to Vanguard. Vanguard will assist you over the phone and will help you invest. Let's say I've accumulated $100,000 and I need more wealth-building strategies. Find a local individual in your neighborhood, through the things we talked about before, and develop a relationship with them. An advisor is going to want someone who will come to them with a core amount of assets. Let's say arbitrarily that's $50,000. If you have less than that go seek out a larger service like Vanguard or Fidelity. I would stay away from robo-advisors. What they do is put you in a model, sometimes it works sometimes it doesn't, but it still doesn't solve the behavioral issue. No one is there to advise you to stop what you're doing. I have discretion over my clients' assets and we have a dialogue. If they want to pull money from the market, I'm there to advise them not to do that and how that will hurt their long-term performance. An advisor serves as an important stopgap to keep you from making errors.

Q: *What strategies are helpful for adopting the right mindset for long term investing and managing emotions?*

A: Investments work best over time. Do not follow an investment over a short horizon, a six-month to three-year period. Dollar costs average into the market over long periods of time, which gives you the effect of always investing at lower prices. If you know the tendency is for markets to go up, if you dollar-cost-average you can buy at lower prices. Think about when you are going to need this money. If your time horizon is three years or longer, you can invest in the market and not actively change your allocation. Let that play out over long periods of time. If your time horizon is shorter, these investments are not suitable for you because they are too volatile. Keep it in safe secure assets. If you can invest in long horizons, invest in a well-diversified way and then, importantly, fight your own behavioral tendency to make changes.

In conclusion, consumers should remember that not all solutions for saving and investing will work for everyone. Before making any substantial financial commitment, consumers should give serious thought to their future financial needs, their current and future cash flows, and their investment goals. They should seek out the best education and expertise they can find on the topic. Doing this will enable consumers to save and invest for the future while hopefully avoiding the financial mistakes that hurt many people. ◂

Gerard Downey is a Certified Financial Planner and the founder and principal of Linden Wealth Management, a boutique Registered Investment Advisor and fiduciary. Linden is dedicated to helping clients realize their full investment potential with informed advice, education, and sound investment management.

Disclosure: Colin and Gerard Downey are related, which is why David Weissman participated in the drafting of this article. No financial compensation was exchanged in relation to this interview and article.