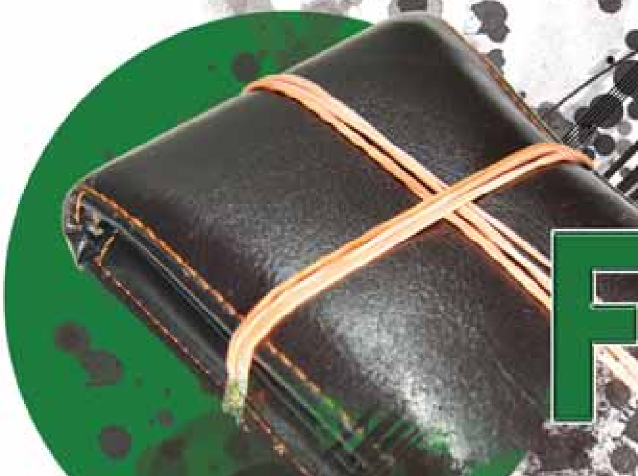


Do-it-Yourself FINANCE PART IV Savings and Investing

One of a series of do-it-yourself personal finance articles.

by Douglas Carlsen, DDS

[Author's Note: Investing information included below provides a broad perspective and should not be construed as specific financial advice. Please consult with a professional adviser and/or spend considerable time studying academic-based literature. See the end-notes for further study or contact me for educational resources.]

Saving and investing can be quite complex. Thousands of books are available, almost all claiming to make you rich. This distillation provides the research viewpoint, augmented with wisdom gleaned from doctors who have generated real wealth, not just high income.

In my February 2013 article on cash flow, Dr. Bill and Jennifer looked in detail at their after-tax budget of $193,000 per year on a combined income of $300,000. They contribute $11,500 to a simple IRA annually, yet found they had only $2,000 left to contribute to additional retirement savings, college savings for their two daughters, other short-term savings needs and an emergency fund.

Later, Jennifer found additional savings of $30,000 per year from clothing, vacation, entertainment and home improvements/maintenance allowances. We will see how they divvied up that $30,000.

Bill and Jennifer's Financial Savings Goals:

- Emergency fund
- Retirement savings of 15 percent per year ($45,000 per year with their income of $300,000)
- Home repairs: new roof and furnace
- New bathroom
- College savings for two daughters

Emergency Fund

First, Dr. Bill and Jennifer need an emergency reserve of six months of spending, or $80,000. The most disastrous calamity that can occur to a dentist is the inability to practice. Illness, office fire, flood or personal accidents can financially debilitate a family for years. Insurance helps, yet loss of one's building for several months and disability insurance waiting periods of 90 days can cause huge cash flow disruption.

You should place emergency funds in a money market account – no CDs, no HELOCs (if one can't return to work for an extended period, one may lose one's home), no stocks or bonds. *You need immediate liquidity.* Do not play games with "but inflation will eat up any possible growth." This account needs to be rock solid.

Dr. Bill and Jennifer realize that for the next three years they will be growing their emergency fund, using money market funds.

After establishing an emergency fund, it is preferable to extinguish all debt except home mortgage and practice loans. No auto loans, student loans or credit card loans. These beasts' interest rates will normally overwhelm any but the most risky investments and delay one's ability to save consistently.

The next step is to consistently save for retirement. Other goals become secondary. The new roof, furnace, bath and college savings will be funded after retirement savings annual goals are met. Of course, if the roof collapses, emergency funds will be used.

Long-term Investment Strategy

Basic Investment Strategy

Research shows that active investment strategy cannot overcome manager's fees over any extended period. Passive management with index funds wins in the long run.

From Warren Buffett:

Most investors, both institutional and individual, will find that the best way to own common stocks is through an index fund that charges minimal fees. Those following this path are sure to beat the net results (after expenses and fee) delivered by the great majority of investment professionals.[1]

From Larry Swedroe:

We have seen that the average actively managed fund under-performs its benchmark by close to two percent per annum… With the availability of tax-managed [index] funds… we can now raise our underperformance estimate to perhaps as much as three percent per annum.[2]

John Bogle, founder of Vanguard, says, "The stock market is a giant distraction from the business of investing."[3]

There are many investment assistance options available. They include:

Brokers: These people sell products. Many charge front-loaded fees and a yearly "wrap" fee for active management. Your investment growth may be impaired using a traditional broker in many cases because of the high fees and active strategy.

Insurance Companies: Please be very careful, as many high fees and costs will not be be divulged. Other than USAA and TIAA-CREF, be very cautious.

Investment Managers: These people and companies manage your assets, often starting at a one percent fee per year for assets under management. Many use active strategies that cannot overcome their fees. Passive managers, such as Wealthfront and Betterment, charge 0.25 percent per year for passive portfolio management. They are worth a look!

Fee-only Financial Planners: A certified financial planner (CFP), certified public accountant (CPA) or chartered financial consultant (ChFC) can provide full-service advice including estate planning, insurance advice, tax-planning and other services. Oftentimes, a planner will offer to handle your investments. Fees are either hourly, flat fee or a percentage of assets. A fee-only planner who provides all services including passive investing with a discount brokerage may be a great asset.

Automated Portfolios: Several brokerage houses now offer automated investment programs with lower fees than provided by a typical adviser, yet higher than target-date funds. These normally offer an initial visit with an investment adviser, phone support during the year and often a year-end evaluation.

TD Ameritrade, Merrill Lynch, USAA, E-Trade, Charles Schwab and Fidelity offer automated programs. Annual fees range from a 0.5 percent to 1.75 percent.[4] The fees may not justify one annual evaluation and limited phone support.

Target-date Funds: Target-date funds offer a life-long managed investment strategy without the need for monitoring or rebalancing. Only one fund, invested in a wide variety of asset classes of stocks, real estate, commodities and bonds, is needed. Target-date funds invest heavily in stock funds during one's early years, gradually becoming more conservative with more bond funds as one ages.

According to Kiplinger, "Target-date funds' big advantage is that investors tend not to panic and don't buy high and sell low."[5]

Investing on One's Own

To actively invest on one's own using timing strategy and picking individual stocks and bonds is often a loser's game. Daniel Kahneman reflected on a University of California study of individual investors' decisions in the *AAII Journal* recently: "…every action the individual investor takes has negative expected value. On average, they lose, and the more ideas they have, the more they lose."[6]

Chris Gay remarked in a 2012 *U.S. News Money* article:

- The average equity investor underperformed the S&P 500 by an annualized 4.32 percent over the past 20 years.
- In 2011, the average equity-fund investor lost 5.73 percent, compared with the 2.12 percent simply holding the S&P 500 would have generated.[7]

1. *Larry Swedroe, The Only Winning Guide to a Winning Investment Strategy, Truman Talley Books, New York, NY, 2005, page 229.*
2. *Ibid, page 242.*
3. *Carolyn T. Geer, "Sometimes, Enough Really is Enough," Sunday Wall Street Journal, Dec. 23, 2012.*
4. *"Are prefab portfolios right for you?" Consumer Reports Money Adviser, July 2012, page 6.*
5. *"Target-date funds: the easy solution," Kiplinger's Retirement Planning 2012, May 2012, page 44.*
6. *Daniel Kahneman, "Behavioral Errors Hurt Your Return," AAII Journal, July 2012.*

continued on page 68

 continued from page 67

Newsletters: These are doctor's favorites. A newsletter can be very hazardous to your financial health. If the "guru," book, or system promises returns above average of the total stock or bond market, be very wary! For information on newsletters' performance, check Hulbert Financial Digest.[8]

Lazy Portfolios: These are an excellent option for the do-it-yourself investor. At Market Watch (www.marketwatch.com/lazyportfolio), Paul Farrell lists eight "lazy" portfolios that have done quite well over the 2000-2010 period with yearly gains of three to six percent. So much for the lost decade! These are all passively invested index funds with super low fees.

For example, here is Dr. Bernstein's No-Brainer Portfolio:

Vanguard Total Bond Market Index Fund 25 percent
Vanguard 500 Index Fund 25 percent
Vanguard European Stock Index Fund 25 percent
Vanguard Small-Cap Index Fund 25 percent

The beauty of lazy portfolios is that you buy and hold, then rebalance once a year. Too simple? Sorry math geeks, it worked.

Long-term Investing Bottom Line

Investing by picking individual stocks and bonds with market timing normally leads to poor to disastrous long-term results. Using target-date funds (Vanguard and others) may offer a good solution. Lazy Portfolios' allocations are similar to target-date funds; yet one needs to rebalance. Why spend the time when the price is essentially the same? If you wish to use an investment manager, a good option may be Wealthfront. They have a great online tool to find your ideal investment mix. And their 0.25 percent wrap (assets under management) fee is not a big drain on one's savings.

Where will Dr. Bill and Jennifer invest? At ages 40 and 39, Dr. Bill and Jennifer's only savings is $11,500 in a simple IRA. It currently sits in a money market fund. Let's assume that the couple will continue to invest $11,500 in their simple IRA for the next three years, using the additional $30,000 Jill identified to establish their emergency fund. Finally, when Dr. Bill is 43, they will up their savings to a total of 15 percent of their total income until retirement.

Jennifer is interested in investing in either a Lazy Portfolio, the Vanguard 2035 Target-date fund, or possibly with a broker in diversified American funds. I also compared to a similar American fund, often offered by brokers.

When can they retire? Using Financial Engines Monte Carlo software analysis:

With the Vanguard target-date fund or the lazy portfolio, they may retire safely at age 66.5. With the American balanced growth fund, at age 67. Each fund has similar risk.

Jennifer decided the safety and ease of the Vanguard Target Date fund was worth not hassling rebalancing or dealing with a broker.

Short-term funds are used for one-time expenditures families may need in the next few years. These would include the roof, the furnace, the bath and college for the girls. This may include auto purchases, major home repairs or upgrades or special family events.

For up to a two-year time horizon, saving for anything other than emergency funds, Christine Benz says to stay solid in money market funds or short-term CDs.[9] For funds needed from two to five years, Vanguard total bond fund (VBMFX) provides inflation protection, potential growth and very low risk.

> *"It's OK to speculate five percent of one's investment portfolio. But keep it to five percent!"*

Dr. Bill and Jennifer's short-term plan is for 2013-2015: half of any *extra* savings beyond the $11,500 IRA and $30,000 emergency fund contributions will be used to fund college expenses for Dr. Bill and Jennifer's two daughters, aged seven and 10.[10] The other half will go into a money market fund, separate from the emergency fund, for the roof and furnace. If one succumbs before full funding, the emergency fund is used, and then reloaded with future savings. After 2015, the emergency fund is now complete. Dr. Bill and Jennifer have decided to divide extra savings – half for the college funds and half for home repairs. If home repairs aren't needed, then more money will go toward the college funding. The new bathroom can wait for now.

But, Dr. Bill, along with about 90 percent of you doctors out there, want to play *beat the market!* Technical analysis, fundamental analysis and Fibonacci numbers are fun!

7. Chris Gay, "Are Individual Investors Destined to Fail? US News Money," downloaded from http://money.usnews.com/money/personal-finance/mutual-funds/articles/2012/07/27/are-individual-investors-destined-to-fail? December 21, 2012.

8. Find at http://store2.marketwatch.com/index3c.html?link=djmc_search_googleHulbert

9. Christine Benz, 30-Minute Money Solutions, Morningstar Inc., Hoboken, NJ, 2010, pg., 93

10. For excellent college planning advice, go to www.savingforcollege.com for complete information on 529 plans and Coverdell ESA's.

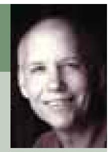
Unfortunately, all this number crunching, research and brain trusting is normally not good financial strategy. I spent the first two years of my financial education studying fundamental and technical analysis through the American Association of Individual Investors (AAII) and most of the Barnes and Noble Business/Investing wall. I'm quite familiar with price-to-book, cash-flow statements, MACDs, stochastics, Bollinger Bands and candlesticks.

The academic research is compelling: an individual investor or manager cannot beat the market picking individual stocks with timing strategy over the long term. There are a few anomalies, as there are a few that win Powerball lotteries. That said, ethical and knowledgeable investment advisers adhere to the five percent rule: *It's OK to speculate five percent of one's investment portfolio. But keep it to five percent!*

AAII not only provides interesting and ethical articles, but also avails great educational materials on fundamental and technical analysis, options trading, hedging strategies, futures and other financial oddities. Stock Investor Pro, the most widely used professional stock screening and research program, is available for only $200 per year.

Join AAII. The people are totally fun geeks; most are engineers with more than $1 million saved. You can brag and bemoan your triumphs and screw-ups to your heart's content. I'm a member and love the camaraderie. But keep your speculation to five percent! ■

Author's Bio



Dr. Douglas Carlsen has delivered independent financial education to dentists since retiring from his practice in 2004 at age 53. For Dentists' Financial Newsletter, visit www.golichcarlsen.com and find the "newsletter" button at the bottom of the home page.

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