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Can You Do It Yourself?

Last week, when offering to help my granddaughter tie the laces on her sneakers, she said, "I can do it myself." While it's nice to see her evolving self-confidence, I hope she'll learn that a do-it-yourself attitude isn't appropriate for all tasks. It's fine for gas stations and salad bars but none of us would be foolish enough to look in the mirror with a dental drill in one hand and one of those suction tubes in the other.

Like it or not, most of us have the responsibility of designing and managing a portfolio that will finance a 30-year retirement. In today's complex and ever-changing world of finances, "I can do it myself" financial planning is an option. The internet provides do-it-yourself investors with access to research and the opportunity to purchase almost any type of security at little or no cost. Books, advertisements and articles in the financial media encourage do-it-yourself investing. Unfortunately, the emphasis is usually on individual investments or funds instead of how to create a financial plan that incorporates your goals, time horizon and willingness to take financial risk.

The Employee Benefit Research Institute's *2017 Retirement Confidence Survey* of workers and retirees reveals that only one in ten have prepared a financial plan for retirement. Only one in four say they have spoken with a professional advisor about retirement planning. In other words, three out of four are do-it-yourself investors. Yet most don't possess the expertise or knowledge to answer these important financial planning questions –

- How much money will I need to live my desired lifestyle in retirement? Do I even know how to calculate the answer?
- Is my current savings rate sufficient to reach my financial goals?
- What asset classes should I have in my portfolio and how should they be allocated?
- What, if any, is the employer match to my 401(k) or 403(b) contributions?
- Should I invest in a 401(k) or is a Roth IRA a better option?
- How often should I rebalance my portfolio?
- Do commodities deserve a place in my portfolio? If so, in what percentage?
- What portfolio withdrawal strategy am I going to use in retirement and what is a safe annual withdrawal percentage?
- In what order should I take money from my taxable, tax-deferred and tax-free accounts in retirement?
- When should I take Social Security?
- What is meant by "asset location" and how can it enhance my portfolio's long-term rate of return?
- Do I need long term care insurance? If so, how much?
- Do I need disability insurance? If so, how much?
- Do I need life insurance? If so, how much and for how long?
- Should I change my portfolio allocation when I retire?
- Should I annuitize part or all my 401(k) upon retirement?
- How will my employee benefits change once I retire?
- Does the plan I have to guide my finances in retirement make accommodation for several bear markets during my retirement years?

These are just a few of the questions that are addressed by good financial planning. A small percentage of investors have the knowledge and temperament to manage their portfolio on their own but this group is smaller than most people realize. I've never met a do-it-yourself investor who I would trust to manage my wife's financial affairs should I shake off my mortal coil sooner than later. Most are "fund collectors". Their research leads them to invest in a fund that seems like a good bet (usually based on recent performance) without considering how it fits into their portfolio. If future performance fails to live up to expectations, they sell the fund and repeat the process. This inevitably leads to portfolios that contain both gaps and redundancies and are over-weighted in currently popular market sectors.

Much has been written about mutual fund managers lagging their benchmark indexes but less attention has been paid to the fact that most investors underperform the mutual funds that they own. Each year, Morningstar looks at the monthly asset flows in and out of mutual funds to calculate the dollar-weighted return of a fund over time. This calculation approximates the return of the average dollar invested in the fund. The dollar-weighted return is compared to a fund's time weighted return, which is the standard measurement of fund performance over time. Any difference between the two returns is called the "investor gap". It reveals how well investors timed their way in and out of a fund. Morningstar reported that for the ten years ending in December 2016, the average annualized time-weighted return of all domestic stock funds was 5.2%. Yet the average investor in these funds managed to receive only a 4.4% return. This 0.8% investor gap may not seem like much but it's a 15% performance shortfall. Here are ten reasons why do-it-yourself investing is a major cause of the investor gap --

1. ***Lack of Education.*** The US education system has failed to educate students about finances and investing. Unless they studied financial planning and economics in college, most university graduates are close to illiterate in financial matters. Few do-it-yourself investors possess even a basic understanding of the subjects required to create a viable financial plan. A conflict of interest exists when Wall Street institutions and the financial media "educate" do-it-yourself investors. The strategies they promote always involve some sort of active management, strategies that are likely to enrich Wall Street at the expense of naïve investors. Inevitably, self-serving recommendations and useless forecasts become substitutes for real financial education. This is unlikely to change anytime soon because few adults have the interest, time or energy to become students of investing.
2. ***Taxes.*** Few investors understand the impact that poor tax planning can have on their portfolio's long-term return. For example, gains taken in an asset you've owned for less than a year are taxed as ordinary income, not at the lower, long-term capital gains rate. If you own an actively managed mutual fund in a taxable account, be aware that the fund manager's primary concern is performance; not on the higher taxes that short-term trading might generate for shareholders. The capital gains rate for taxpayers in the 15% marginal tax bracket (less than $75,900 taxable income for married filing jointly and $37,950 for single filers) is 0%. Consequently, by failing to "fill up" the 15% marginal tax bracket with long-term capital gains, many investors miss the opportunity to capture tax-free gains.
3. ***An inordinate love for cash.*** Conservative investors tend to hold too much cash – because it feels "safe". They suffer from what is known as the "money illusion"; focusing on the dollar value of their portfolio and ignoring the ongoing loss of purchasing power due to inflation. The biggest risk that investors face over the long term isn't stock market volatility, it's the risk of not earning an adequate inflation adjusted return on their capital.
4. ***The Wall Street Promise Machine.*** Billions of dollars are spent on advertising to get you to do something, anything. Buy this, sell that -- hurry up before it's too late. The financial media is Wall Street's willing accomplice, presenting a daily parade of talking heads obsessing over every market movement. Most do-it-yourself investors don't realize that none of these "experts" know what the future holds. The financial media promotes a financial world view designed to enhance the economic health of its advertisers, not its audience and has become a prime contributor to the investor gap.
5. ***Having No Plan.*** A written plan that encompasses your risk tolerance, financial goals and the steps to achieve them is the foundation of lifetime financial planning. If you don't have a written plan, you don't have a plan. A portfolio containing assets accumulated over the years is not a suitable substitute for a financial plan. Let's be honest, few investors know how to create a financial plan on their own. Once a plan is in place, most investors will need ongoing perspective and advice, behavioral modification, encouragement and a voice that says "no" when silly financial ideas make their way into the conversation. Getting started on your financial plan is a two-step process. The first step is easy - make the intellectual decision that you've got to get going. The second step is harder - make the emotional decision to acquire or hire the expertise to do it properly.
6. ***Emotions.*** There's no such thing as emotion-free investing and your emotions and financial goals are rarely going to find much to agree about. Emotions are more powerful than intellect and a high IQ gives no guarantee of investment success. The average investor is market focused and performance driven; likely to fail because investing decisions are more likely to be reactive than proactive. A written financial plan helps anchor your emotions. The investor gap provides clear evidence that, after portfolio allocation, an investor's behavior is the most critical factor that will determine their portfolio's long-term return. The best portfolio and financial plan are of no value to someone who makes investment decisions in response to the media's Apocalypse of the Week.
7. ***Chasing Past Performance.*** "Past performance is no guarantee of future returns". This should also be the first filter that investors use when being pitched the latest hot fund or stock. History shows that recent winners are not likely to repeat. Just as in professional sports, last year's victories don't count towards this year's championship. In investing, reversion to long term averages usually produces underperformance after a year or two of stellar returns. Yet, it seems that every mutual fund advertisement proudly proclaims past performance. Caveat emptor.
8. ***Owning Individual Stocks.*** There is no good reason to own shares of individual stocks. If you can own everything (in an index fund) for almost nothing, why own any one thing? If your favorite stock has been mispriced by the market (and only you realize it), it might be an outperformer. But don't count on it. Stocks expose your portfolio to individual company risk. The market might be going up while your favorite stock declines. Owning individual stocks will limit your ability to diversify if insufficient funds remain to own other important asset classes. In my experience, portfolios of do it yourself investors are rarely well diversified and usually contain shares of a few well known, S&P 500 companies.
9. ***Mismanaging Risk.*** Managing risk isn't easy. To do it successfully over the long term, investors must focus on the risks that apply to them and have the highest probability of occurring. I suppose it's possible that the United States

will soon exchange nuclear ICBMs with North Korea but creating a portfolio based on that unlikely scenario would be foolhardy. After all, we've been at war with North Korea for more than 60 years. It's just the latest example of how we waste time focusing on factors beyond our control and that change from day to day. Closer to home risks that should attract our attention include inflation, taxes, longevity, lack of longevity, disability and a myriad of other events that happen to people every day. All too often the things that we need to worry about, and can deal with, get lost in the ongoing noise of unlikely scary events that soon disappear from the headlines.

10. ***Ignoring these warning signs***. Here is a quick checklist that will help determine if you've got what it takes to succeed as a do-it-yourself investor.

    - Do you check your portfolio balance on a regular basis?
    - Do you believe that it's possible to beat the market over the long term?
    - Every time the market goes down, do you think of 2008 and start getting anxious?
    - Every time the market goes down, do you wonder if you have too much of your portfolio in stocks?
    - Every time the market goes up, do you wonder if you don't have enough of your portfolio in stocks?
    - Do you make short-term allocation changes to your long-term investments?
    - Do you believe that your long-term financial success depends primarily on what the stock market does rather than on how much you save and invest each year?
    - When looking at the geopolitical, economic and domestic landscape, do you think that things have never been this bad?
    - Do you seek investing advice from amateurs who are unlikely to know any more than you do? In other words, your friends, relatives, neighbors and coworkers.
    - Do you seek investing advice from professionals who pretend to know what the future holds?
    - Do you have a favorite among the well-known (self-serving) media pundits?
    - Do you believe that working harder and having more information leads to better investment decisions?
    - Do you believe that finding great fund managers with superior track records will lead to investment success?
    - Would you be tempted by an investment that offers a guaranteed return that is a multiple of what safe money currently yields? For example, would you be tempted by a "safe" investment currently yielding 6%? If you answered "yes" because it's being offered by someone you trust, someone who would never cheat you, you are automatically disqualified from managing your own money.
    - Do you believe that charts and graphs of past performance provide clues to future performance?
    - Do you believe that forecasts in the financial media contain value?
    - Do you believe that after paying more than 3% in annual fees in a variable annuity or 2% annually plus 20% of any gain to a hedge fund manager that you'll come out ahead in the long run?

Any of these mistakes can do serious harm to your portfolio. If you answered "yes" to more than a few questions and there's someone else who'll suffer from your financial mistakes, you probably shouldn't attempt do-it-yourself investing.

I'm a financial planner, so it's no surprise that I believe in the value that competent financial planners provide. The function of financial planning is to get your financial house in order and keep it there. Let's be honest, most do-it-yourself investors are just trying to save money. They may be familiar with the vocabulary of investing but that's a far cry from having the ability to effectively manage their portfolios or deal with the behavioral aspects of wealth accumulation. Few know how to evaluate their portfolio's performance or calculate their personal investor gap. As Morningstar's data reveals, the problem isn't that most investors don't beat the market, it's that they don't even receive the return that the market freely offers. This is a lost opportunity cost that, over the long haul, is likely to be a multiple of any advisor fee that they may be saving. Sadly, many do-it-yourself investors are easy marks for scoundrels who are eager to profit from their overconfidence, take their money and steal their future. Finally, hiring a professional frees you up to do the things you'd rather do and eliminates the stress that inevitably accompanies do-it-yourself investing. Good luck to you if you try this without an ally on your side.

Now, it's time for my pet peeve of the month. Let's face it, the average American investor is not only financially illiterate but most are mathematically illiterate. Otherwise how do you explain why I keep reading (I'm talking to you, *Wall Street Journal*) or hearing that, for example, item A costs ten times less than item B. This drives me nuts. Times is multiplication; more, not less! In this example, item A is one-tenth the cost of Item B. Or, if you wish, item B costs ten times more than item A. Aargh! Enough already!