

Live It Up Without Outliving Your Money!

**GETTING THE MOST FROM YOUR
INVESTMENTS IN RETIREMENT**

Revised and Updated Edition

Paul Merriman



WILEY

John Wiley & Sons, Inc.

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No duty is more urgent than giving thanks.

—St. Ambrose

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I could write a whole chapter on the many ways my life is enriched by my son, Jeff Merriman-Cohen. Jeff is my boss, as chief executive officer of our company, freeing me to concentrate on what I do best. Jeff is a superb financial adviser, an excellent manager, and a pleasure to work with in every way. Perhaps best of all (and very rare), my son is a full partner and a true friend. Every father should be so lucky!

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Thaddeus, professor emeritus at the University of Washington, was one of my teachers long ago and has been a friend for 40 years. He spent decades as a professor preparing students for successful careers. He's devoting his "retirement" years to the Business and Economic Development Program through which the University of

Washington Business School and Seattle Rotary put students and experienced business professionals together to help small businesses in Seattle's inner city.

Lynn, a retired physician from Children's Hospital in Seattle, started Global-HELP (global-help.org), a nonpolitical, humanitarian agency that distributes free publications to medical professionals in developing countries. I'm proud to be a founding member of this organization's board.

My highest aspiration in life is to be like Thaddeus and Lynn.

Introduction

WHY I WROTE THIS BOOK

I am not a teacher but an awakener.

—Robert Frost

This book is designed in part to help investors protect themselves from Wall Street practices that I saw firsthand many years ago. Fresh out of college in the 1960s, I became a broker for a large Wall Street firm. Training classes in New York quickly taught me the priorities that should dominate my working day.

I guess I was naive and too idealistic for Wall Street. I had looked forward to helping people with their money. It didn't take long to learn that Wall Street had only one high-priority objective: sell.

Sales, of course, required trading activity. Gradually, I realized Wall Street was infected with an attitude that didn't seem right to me: If the clients were content, they weren't doing the firm any good. No matter what the clients had done, it was the broker's job to persuade them to do something else.

Ideally, that "something else" involved buying proprietary products on which the big brokerage houses earned unusually high commissions. Sometimes brokers were offered incentives such as free trips. In most cases, the commissions and the cost of the trips were built into the price of the products. This allowed brokers to

tell clients they could buy these products without paying any commission. The clients thought they were getting a special deal. We knew otherwise: They were being exploited.

I'll admit the sophisticated world of New York City held quite an allure to a young man from Wenatchee, Washington. Wall Street made the job fun, and it seemed as if there was lots of money to be made easily. But it didn't take me long to grow weary of a job that, I came to realize, was designed essentially to separate people from their money with little thought given to whether these people were getting something valuable in return.

Before long, I left the brokerage industry to follow other business pursuits that brought me much more satisfaction. This eventually also gave me enough financial success that I could open my own investment business and begin managing money for individuals in 1983. I vowed at the time to keep my business free from all conflicts of interest, and independence has allowed me to fulfill that pledge.

In working with thousands of investors since then, I have seen the unfortunate results of what happens when people do what Wall Street tells them to do.

- Millions of people who wouldn't leave on a vacation without a road map nevertheless set aside hundreds of thousands of dollars for retirement without knowing their destination or having any plan to get there.
- Investors leave the bulk of their money in popular but lazy investments that don't historically compensate them for the risks they entail.
- Investors don't understand the effects of expenses and taxes. As a result, they let far too much of their hard-won savings leak away.
- Investors make far-reaching decisions based on whims, emotions, or superficial tips from amateurs, salespeople, and advisers whose financial interests are in conflict with those of their clients.
- In the end, too many investors wind up with too little money and too much emotional stress.

My professional life is dedicated to teaching people how to take care of themselves and their families so they won't wind up with

those unfortunate outcomes. Much of this teaching takes place in retirement workshops I lead every year. Tens of thousands of investors have found these sessions helpful and stimulating, and I thoroughly enjoy doing them. This book contains the most important material from those workshops.

In doing this work over the years, I've met a lot of great people (along with a few I'd be happy to forget), and I've had a lot of fun. I hope you will find some fun in these pages, too. I hope you'll find the book easy and enjoyable to read, something you'll want to share with somebody else.

Three serious objectives shaped this work: to educate, to stimulate, and to motivate.

Education is essential because there's simply too much data and information available to investors. Much of it is important, but much of it is a combination of noise and sales pitches. I've spent tens of thousands of hours identifying what matters to investors and what doesn't. In these pages you will learn which is which.

Stimulation is valuable because it gets people to think. If you go through this book chapter by chapter, I guarantee that you will think in new ways about investing, about psychology, about your money, and about your future.

Motivation is the most important goal, and at the same time the most elusive. If I have only convinced you that there is a better way, yet my words haven't persuaded you to take some action, then I have failed to motivate you. What you do or don't do, of course, is outside my control, as it should be. I don't know how to directly motivate you except to use words to paint pictures of what is possible and how your life could be. You'll find two direct examples of this in Chapter 2.

If at the end of this book you understand investing in ways that are brand-new to you, then I've done my job of education. If you can see the world around you in new ways and think about what you see in new ways, and if some of the stories from this book help you to notice things that you didn't notice before, then I have done my job of stimulation. And if you take action to improve the way you put your financial resources to work for you, then I have done my job of motivation.

If these things happen, then the many hours spent writing this book will have been worthwhile for me. I'm confident that the time you spend with this material will be no less worthwhile for you.

Ten Steps to an Ideal Retirement Portfolio

Some people organize their thoughts best with a step-by-step list. This book isn't organized along those lines, but your mind may work best if it's following a list. So right here I'll give you my list of 10 steps to creating the retirement portfolio that's ideal for you. And I'll tell you where in the book to find out about each one.

This list may seem daunting, filled with tasks that would take you months or even years to complete. But here is something I've learned from leading workshops for people who are looking ahead to retirement: Most of these people can accomplish all 10 of these steps by attending a workshop and then spending 90 minutes with a professional adviser. This book gives you what's in my workshop. If you can manage another 90 minutes with a good adviser (plus the time it takes to do the necessary homework), you'll have all this done.

1. *Determine how much you will need to live on in retirement.* This will tell you how big your portfolio must be when you retire. And that in turn will tell you how much you need to save and what investment return you need. Chapter 5 tells you how to establish your basic target for the income you'll need from your portfolio. Most investors give this step too little attention. Investors who don't have this information are too often captivated by fear and greed, taking either too much risk or too little risk, depending on what's happening in the markets. This first step is necessarily the foundation for everything that follows.
2. *Determine how much you want to live on in retirement.* In Chapter 5, you'll find out how to establish your live-it-up retirement income target. This gives you a second figure for the target size of your portfolio and the return necessary to achieve it. We talk to many people who, having neglected to take this step, have invested as if they must achieve the highest possible return regardless of risk. Often, analysis will show that they can achieve all their goals with much less risk than they thought.
3. *Determine your tolerance for taking risks.* You'll find important insights on this topic throughout the book. Chapter 10 focuses on risk. For every investment you make, you

should understand the inherent risks involved and how this investment will affect the overall risk of your portfolio.

4. *Make all your decisions based on what's probable, not what's possible.* From 1995 through 1999, the Standard & Poor's 500 Index compounded at a rate of 28.5 percent a year, leading many people (including plenty who should have known better) to conclude that successful investing was easy. Some investors scoffed at me in 1999 when I refused to give serious consideration to questions like "What's a fund I can count on to make 75 percent a year?" I was dismissed as hopelessly old-fashioned when I suggested investors should aspire to long-term annual growth of 12 percent.

The brief bull market bubble in 1999 showed us that returns of 75 percent were possible. But the bear market of 2000–2003 showed us that 75 percent losses were equally possible. As it turns out, we have more than three quarters of a century of history to show us what's probable. This, not the flash-in-the-pan excitement of a bull market, should be the basis for your planning.

5. *Determine the kinds of assets that will give you the returns you need to achieve your goals.* Academics have done years of mind-numbing research on this very topic—and some have even won Nobel Prizes for it. I have distilled that research into five chapters (6 through 10) that tell you what you need to know and what you should do about it. Actually, I think you may find this is quite interesting material. You'll learn how to add nine equity asset classes to the S&P 500 Index in order to achieve extra return without taking any more risk than that of this popular index.
6. *Combine those assets in the right proportions into a portfolio that's tailored specifically for you.* I show you exactly how to do that in Chapter 12. I name names of the specific funds you should use at Fidelity, Vanguard, T. Rowe Price, and other sources.
7. *Learn to recognize and control the expenses of investing.* Chapter 11 tells you how to recognize expenses as leaks in your portfolio and how to plug them. There are many things about investing that you can't control, but this is one that you can. Savvy investors pay lots of attention to expenses. Sloppy investors would rather not be bothered. Over a lifetime, the difference can add up to hundreds of thousands of extra dollars.

8. *Make sure you understand enough about the tax laws to avoid giving Uncle Sam more of your money than you are obligated to.* Lots of investors carelessly squander part of their assets because they don't pay attention to tax issues. This is a big topic, but we hit the high spots in Chapter 11. The advice you'll find there will help you turn your investments into an efficient machine that works as hard as possible for you, not for the tax man.
9. *Establish the right distribution plan that will give you the income you need in retirement along with the peace of mind of knowing you won't run out of money.* Of all the 10 steps, this one is taught and discussed the least when professionals and authors try to help people handle their money. Investors who bungle this by withdrawing too much too fast can wind up impoverished or broke in their old age. Investors at the other extreme can, sometimes without realizing it, pass up fantastic opportunities to enjoy life and contribute to others during their lifetimes. Chapter 13 tells you how to get this step right and gives you much to think about.
10. *Put everything you do on automatic pilot.* In more than 40 years of working with people and their money, I've seen again and again the value of making careful, thoughtful decisions and forming those decisions into a plan that can be executed automatically. Investors who do this are likely to achieve the highest returns among their peers at whatever level of risk is appropriate for them.

There are many good ways to accomplish this last step. Accumulate savings through dollar cost averaging. Invest in funds through automatic investment plans that take money out of your bank account regularly or through payroll deduction. Set up your portfolio for automatic rebalancing at the same time every year, using your electronic calendar to remind you if necessary. Fund your IRA in the first week of every year. If you can, do the same with your 401(k) or similar plan at work.

Invest in index funds, which by nature will automatically correct for the unexpected disasters in the market. If a big company goes into the tank unexpectedly (think of Enron or Bear Stearns), the S&P 500 Index will automatically correct for that with no action required from you. Set up your withdrawals automatically too, so you never have to worry about how much to take out or when.

In summary, organize your finances so that instead of taking up your time they simply support you while you do what makes your life worth living.

If you want what my schoolteachers used to call “extra credit,” here’s an 11th step: *Very carefully, choose and hire a financial adviser.* This is such a valuable move that I’ve devoted Chapter 14 to it.

If you apply yourself seriously to these 10 steps (and taking the 11th will make the others much easier and more likely to be successful), you will have the best possible chance for that ideal retirement.

A Note to the Reader

Even a casual reader is likely to notice quickly that this book is unusual. This reflects the fact that not everybody learns the same way. It also reflects my personal commitment to make the material in this book as useful as possible and to keep it up to date for you, the reader.

This book is designed to be read at three levels. The simplest level makes it about a 30-page book. Every chapter begins with a brief introductory essay that presents the main points in the chapter, without the supporting evidence or a full discussion. If you want a general overview of what’s in this book, you can get it by reading only those essays. Of course, I hope you will want to know more and will take the time to delve into the contents.

The second level is the main text, including graphs, charts, and tables. This is the heart of the book, the stuff that makes it worth your money and your time. The concepts presented here are not complex. If you enjoy reading the business sections of daily newspapers, you should have no trouble following my arguments and the evidence that backs them up.

Along the way you will see some graphs and tables unlike any that you’re likely to be familiar with. If you have a little patience, understanding these illustrations won’t be hard. They will help you to see information in new ways so that the important points become obvious at a glance.

You’ll find the third level throughout the book in the form of highlighted text boxes that act as sidebars to illuminate ideas you might want to come back to for reference. You can skip these boxes without missing the main points of the book. But I hope you’ll find them worth your while.

Inevitably, the numbers and the specific fund recommendations in this book will become outdated. The good news is that you'll always be able to find our current recommendations, along with updated versions of many of the tables in this book, online. You'll find this at my company's educational web site, FundAdvice.com. Be sure to visit this site for any updates to our suggested portfolios before you invest.

Finally, the Appendixes at the end of the book contain my suggestions for further reading and education.

Here's a final important note. I am the founder of a company in Seattle that provides investment education, advice, and management. We are in the business of managing money for clients.

My many years as a hands-on money manager have given me an enormous amount of practical experience with real people in real situations. This book is filled with stories and insights based on decades of being in the trenches, helping investors who, in many ways, may be like you.

Our business is carefully organized so that we have no conflict of interest with our clients. I have done my best to avoid anything self-serving in this book, and I have asked my editors to hold my feet to the fire in that regard. Still, I definitely have a point of view and some strong beliefs about what serves investors best. I am happy to let you be the final judge. Don't take what I say on blind faith. If you find my views credible, then please use them however you wish.

CHAPTER 1

Why Investors Fail

If you don't know where you're going, you might wind up somewhere else.

—Yogi Berra

Investing isn't terribly difficult, but it's a specialized area that requires careful navigation. A huge industry has evolved to use a multitude of clever ways to separate people from part of their retirement savings without necessarily providing much benefit in return. In simple terms, this means that neither your broker nor any of the array of experts on Wall Street is necessarily your friend or even on your side.

Think of investing as a journey. You start at one place and head for another. If you want to drive from California to Michigan quickly and painlessly, there are relatively few choices that make sense. Most will probably draw heavily on the interstate highways. But imagine how hard it would be to plan such a trip if sales forces for several hundred competing highways were giving you tantalizing promises, saying they could get you there better and faster if you would just choose their routes.

Investing is a little bit like that: The best route may be efficient though boring. Yet along the way there are hundreds of distractions and opportunities to get you off the track. Most people have a tough time making good investment decisions. They don't have the necessary

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training or the knowledge. The difficulty of understanding all the options sometimes appears greater than the benefits of doing so. As a result, somewhere along the way almost every investor makes at least one serious mistake. Some never seem to stop making mistakes.

In this chapter we look at some of the more serious ways that typical investors work against their own interests. Investors procrastinate or remain passive when the circumstances call for action. They ignore the effects of taxes and expenses. They don't think about their long-term and short-term goals in a clear, organized way. They don't have a written plan for how to get from where they are to where they're going. (Think of it as a road map. If you leave it at home, it's no help.)

Most investors occasionally take way too much risk. Sometimes they don't take nearly as much risk as they should. Investors pay too much of their hard-earned savings to other people who are not necessarily on their side. Too many investors act as if they think smiling salespeople are their friends. They put too much faith in institutions, as if they believe big companies are organized for their customers' benefit. They put too much faith in what they see on financial television, what they hear on the radio, and what they read in financial publications. In doing this, they fail to distinguish between facts (which can be very useful) and interpretation, persuasion, and marketing.

Without getting any particular benefit in return, too many investors give up liquidity, making it costly and inconvenient to get their money back when they need it. They have unrealistic expectations. They often treat investing as a competitive sport. They take investment advice or tips from strangers or amateurs. They invest in ways that fill their emotional needs instead of their financial ones. Thus, they give in to fear and greed, arguably the two most powerful forces on Wall Street. They put their money into investments they don't understand, leading to grief, loss, and disillusionment that sometimes prompt them to give up altogether.

Collectively, that's the bad news. Whew!

The good news is that investing does not have to be that hard. This book shows you precisely how to overcome all those hurdles and how to draw up a road map that's right for you. You'll learn how to implement that plan so that good investment decisions become automatic—instead of random events that seem to happen only by luck.

Investing is about taking risks. When you risk your capital, you are entitled to expect a fair return commensurate with the level of risk you take. But if you're not careful, your own mistakes can prevent you from achieving the return that should be yours.

When I meet with a new client, one of the first things we talk about is risk. It's a topic that most of the industry (and most investors) would be happy to avoid altogether. But investors who don't understand risk cannot understand the choices they must make as investors. You'll find numerous references to risks in this book, because it is a critical topic.

Imagine you are in a bank applying for a loan. Suddenly you realize that right at the next desk, Bill Gates is also applying for a loan. Who do you think the bank would rather lend money to? Bill, of course! Don't take it personally, but the bank would always rather lend its money to Bill than to you, because there is simply no question about his ability to pay the money back. He's as close to a risk-free, perfect borrower as the bank could wish for.

But it's not quite that simple. Bill Gates is not the sort of person who would hesitate to take advantage of his position. If he told the bank he wouldn't pay more than 5 percent interest, and if you were willing to pay 10 percent interest, what do you think the bank would do?

The bank can lend money to Bill and earn 5 percent in a risk-free transaction. Or it can lend money to you and collect twice as much. Obviously the bank would like the extra interest, but how reliable are you? Here's the rub, because the bank can't ever know for sure.

Therefore, the bank must decide if that extra return is worth the extra risk. And that is exactly the challenge that investors face. If you were the banker and you could make only one of those two loans, you'd have to tell your boss either "I turned down