Dave Ramsey's Investing Advice May Be Leading You Astray

I should start this post off by saying I really enjoy listening to Dave Ramsey. He's on the radio every weeknight for 3 hours so I often listen to him coming or going from a shift. He is far better than the other two "gurus" on local radio, one of which sells his advisory services and the other of which is selling permanent life insurance.

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I think he is a fantastic motivator at getting people out of debt and keeping them from screwing up the big things, like using credit cards for credit, spending more than you earn etc. You can do far worse than following his "baby steps" out of debt and toward financial independence.

I also like the advice he gives people about money and relationships. He does a great job advising those being hounded by creditors and facing possible bankruptcy. In fact, the worse the shape of your finances, the better Dave's advice is. His investing advice, however, leaves a lot to be

desired.

4 Ways Dave Ramsey's Investing Advice May Be Leading You Astray

1) The Cost of Debt Aversion

Many people have a problem with Dave's absolutely rabid anti-debt stances. For Ramsey, there is basically no good debt. Dave's approach leans a little too far toward the behaviorally correct thing to do, and too far away from the mathematically correct thing to do.

For instance, it's nice to have no house payment and no risk of losing your house to the bank if you lose your job. So Dave recommends paying off your mortgage as soon as possible. Behaviorally, that might be the right answer. But mathematically, it often isn't.

Consider a 3% mortgage, 2% after the mortgage interest tax break. If inflation is 3%, the bank is basically paying you to borrow money after inflation. Even if you only expect 5% out of your investment portfolio, you're still far better off (mathematically) directing new money into the portfolio than toward paying down the mortgage early.

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There are still lots of benefits to paying down the mortgage (less risk of losing home, ability to cut back at work, the feeling of being debt-free, improved cash flow etc), but you should probably calculate how much those benefits are likely to cost you before making that decision.

Consider $100K in your pocket that you can either pay down your mortgage with or put in your investment portfolio. Say the mortgage is costing you 2% after tax, and the portfolio (while riskier) returns 8% after tax and expenses. Over the next 10 years, putting that $100K toward the mortgage will save you something in the neighborhood of $94,000. I might be able to live with a little debt for a decade for $94K. You might too.

2) His Endorsed Local Provider List

Dave continually pushes his "endorsed local providers" for investing (as well as insurance, real estate etc.) Most of these, unfortunately, are commissioned salesmen who sell you loaded mutual funds. My local ELP says he discloses his fees and commissions to clients, but he doesn't do so on his website. He does, at least, recommend against permanent life insurance as an investment product.

Dave's attitude toward loads is that they don't matter over the long run. I disagree. I don't see any reason to pay a commission when commission-free products are available. Even if you view that as a way to pay for "good advice", you should realize you are introducing a serious conflict of interest for the adviser, and likely getting crappier investments, even ignoring the load.

3) Good Growth Stock Mutual Funds

Dave often recommends you go out and get yourself some "good growth stock mutual funds" that will return you 12% a year. No mention of bond funds or any other type of diversification. Apparently, 3 or 4 growth stock funds will do you. Never mind that is exactly the type of portfolio you are most likely to bail out of in the event of a market downturn. For someone who is so concerned about the behavioral aspects of debt, he seems to ignore them in investing.

12% is an extremely optimistic long-term expected return, especially after paying the high ERs and loads you're likely to get from Dave's ELPs. The long-term return of the S&P 500 (good growth stocks) is on the order of 9-10%, and the return for the ultra-low-cost Vanguard Growth Index Fund is only 8% over the last 20 years. How likely do you think 12% is going forward?

4) The 8% Safe Withdrawal Rate

Dave often mentions that you should be able to spend 8% of your portfolio a year in retirement. Never mind that all the best minds in academia recommend a safe withdrawal rate between 3 and 5%.

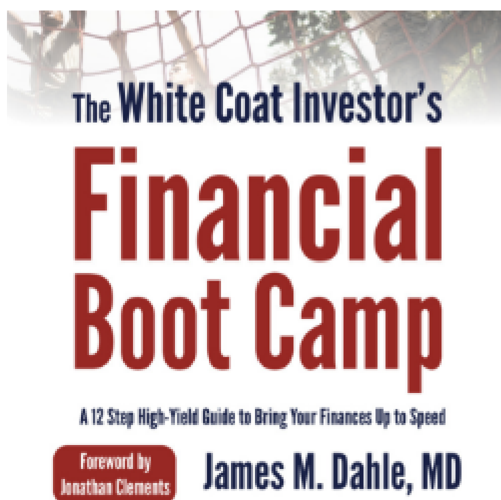
In fact, the updated Trinity Study suggests that a withdrawal rate of 8% on a 50/50 portfolio has less than a 50% chance of lasting 20 years. Even if you stick with Dave's recommended asset allocation of 100% stocks throughout your retirement, you still have a 1 in 4 chance of running out of money in 15 years. That's hardly a safe withdrawal rate.

The Real Danger of Following Dave's Investing Advice

The problem with throwing these numbers out – "12% returns" and "8% a year withdrawals" is that if you really run the numbers, you'll arrive at the wrong amount to save.

Consider someone who wants to live on $100K a year in retirement in today's dollars. If you assume a relatively standard 4% withdrawal rate, and a portfolio that returns 5% real a year (some people would argue even these numbers are optimistic), you need a portfolio worth $2.5 Million at retirement. Assuming you acquired that over 30 years, you would need to save about $36,000 per year.

If you followed Dave's advice, and assumed a return of 9% real (let's make a big leap and assume Dave's listeners can adjust for inflation) and an 8% withdrawal rate, you'd need to save $1.25 Million in today's dollars at retirement, and somehow magically do that by only putting away $8500 a year. There's an awfully big difference between $8500 and $36,000 a year.



The truth is that someone following Ramsey's advice is not only highly likely to run out of money in retirement, but to be far short of his projected nest egg at retirement time.
So, while I like how Dave recommends eating "[Rice and Beans, Beans and Rice]" until you're out of debt (similar to my

recommendation to live like a resident for a few years after graduating), I’d be very cautious taking investing advice from him or his endorsed local providers.

In what ways has Dave Ramsey’s advice helped you be a better investor? Do you agree with me that some of his investing advice is off base and detrimental to his followers? Comment below!