Know Your Enemy: Investing for Retirement

[Editor's Note: This article originally published as one of my monthly columns over at MDMagazine and is about combating the three enemies your portfolio faces – inflation, taxes, and investment expenses.]

Investing your retirement savings wisely is not all that different from fighting a battle. Unfortunately, too many investors don't actually know the enemy they're fighting.

Financial advisors often reinforce these mistaken ideas by comparing portfolio performance to an index such as the S&P 500 Index composed of the stocks of the largest companies in America. Since that comparison seems important to the advisor, the investor assumes it is important.

Even worse, many investors compare the performance of their portfolios to that of Bob down the street, or more likely, Bob's idle cocktail chatter. You see, it's unlikely that Bob mentions anything other than his best investments at the cocktail party, and highly likely that Bob actually has no idea how to calculate an investment return.

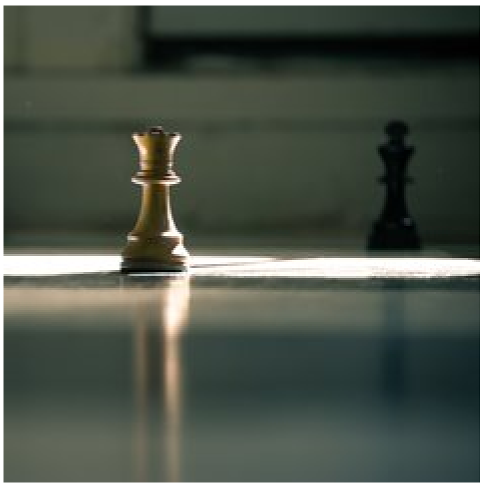
You Decide What a Win Looks Like

When it comes to retirement investing, what matters is whether or not you reach your goal. The more specific your goal, the easier it is to design and monitor a plan to reach it. A good example of a specific goal is “Have a portfolio capable of supporting an income of $100,000, indexed to inflation, that will last throughout my retirement beginning Jan. 1, 2030.”

Notice how there is no comparison to the S&P 500 or Bob’s portfolio. It’s much easier to win the battle when you get to decide what a win looks like.

Three Enemies of Every Retirement Investor

Your opponent in this battle is not Bob. Unfortunately, your enemies are far more worthy. The three enemies of every retirement investor are inflation, taxes, and investment expenses.



Consider an investor whose investments achieve a gross return of 8% for the year. He may pay as much as 25% of that return in taxes, leaving him with a 6% return. Investment expenses may run as high as 2%, decreasing the return down to 4%. If inflation is running at 3%, then the investor’s net return, after inflation, taxes, and expenses, is just 1% a year. At that rate, it will take over seven decades for compound interest to double his money. In other words, he is going to have to do almost all of the heavy lifting through brute savings, rather than allowing his portfolio to do much of the work of building his retirement nest egg through compound interest.

#1 Beating Inflation

There is precious little an individual investor can do to actually control the rate of inflation of the goods and service he will purchase over the course of his life. Keep in mind that the rate of inflation that matters is your personal rate of inflation, not necessarily what the government says the overall inflation rate is. For example, someone paying a great deal of money for health care and college tuition may have a much higher personal rate of inflation than someone who spends most of his money on technology and heating his home with natural gas.

The main error that investors make when combating inflation is worrying about the wrong risk. Too many investors think the main risk they're running is the volatility of their investments. They remember that gut-churning feeling in late 2008 when a third of their nest egg disappeared.

While volatility is a risk because many investors cannot handle it and end up selling low, a far greater risk is not outpacing inflation and falling short of your retirement goal. In order to beat inflation, a significant percentage of the portfolio must be invested in asset classes that are likely to beat inflation over the long run. At current historically low yields, nominal Treasury bonds (much less cash-like investments such as savings accounts and CDs) are unlikely to do this. Riskier investments such as stocks and real estate are much more likely to beat inflation over the long run.

Inflation-indexed bonds, such as Treasury Inflation Protected Securities (TIPS) and I-Bonds are unique in that they are relatively safe investments that hedge a portfolio against unexpected inflation. Although at current low yields they are unlikely to beat inflation by much, at least they'll keep up if inflation spikes, unlike nominal bonds.

#2 Beating Taxes

Believe it or not, Uncle Sam wants you to have a nice retirement. There are many tax breaks available to investors. Long-term capital gains and dividends are taxed at lower rates than regular income. If you lose money in a taxable investment, the IRS will share your pain through tax-loss harvesting. When you die (or receive an inheritance), the investments receive a step-up in basis as of the date of death, allowing the heir to sell them tax-free.

There are also a plethora of tax-advantaged retirement savings accounts including 401(k)s, 403(b)s, 457(b)s, profit-sharing plans, defined benefit plans, IRAs, Roth IRAs, SEP-IRAs, solo 401(k)s, SIMPLE IRAs, HSAs, etc. The tax-drag on investment growth is eliminated insomuch as you invest inside these accounts.

The tax advantage of being able to choose when you pay your taxes is also substantial. For example, a resident physician in the 15% bracket may choose to pay taxes now and invest in a Roth IRA. When he pulls that money out tax-free in retirement, he may be in the 25% bracket. A physician in his peak earning years may contribute to his retirement plan and save 40% in taxes on the contribution. The effective tax rate of his withdrawals after retirement may be closer to 15%.

Too many physicians complain about high tax bills without taking advantage of the easiest way to save on those taxes, ensure a comfortable retirement and protect the assets from creditors – contributing to retirement accounts and investing in a tax-efficient manner outside of retirement accounts.

#3 Minimizing Investment Expenses

I have seen physicians paying as much as 2% to 3% of their assets every year in investment expenses. 401(k) fees, mutual fund expense ratios, commissions, and advisory fees can add up rapidly. Many physician investors don't realize the heavy impact that fees can have on their eventual nest egg size.

Consider two doctors, each saving $50,000 per year for 25 years in an investment earning 8% per year before expenses. The first pays 2% in investment expenses and the second pays 0.2%, or one-tenth as much. After 25 years, the difference in net worth will be nearly a million dollars! Every dollar you pay in fees comes directly out of your investment return.

The retirement investing battle is definitely worth fighting, and it becomes much easier when you realize what you're fighting against. Having a plan to combat inflation, taxes, and investment expenses will give you peace of mind now and a comfortable retirement later.

What other financial enemies sabotage your retirement plans? Comment below!