Questions from an Old Friend

[Editor’s Note: Don’t forget the deadline for submission for the WCI scholarship is August 31st. We’re giving away over $60K in cash and prizes; don’t miss out on your share.]

I occasionally jot down some thoughts about a post that I’d like to write. Sometimes, I lose that note. Sometimes I lose it for years. This post comes from a note I recently found. I have no idea when I wrote it or who the email came from that triggered it, but I titled the note “Questions from an Old Friend”, so that’s what we’ll call this post. There were apparently four questions, all of which would be helpful to discuss on the blog.

Q. Can we do an IRA? Our accountant says we can’t.

A.

Your accountant is wrong. If you have earned income, you can contribute to a tax-deferred traditional IRA. However, if you wish to DEDUCT any of that contribution, one of two things must be true:
1. You must either have a modified adjusted gross income (MAGI) of < $73,000 ($121,000 married) or
2. You do not have access to a retirement plan like a 401(k) either at work or through your self-employed work

With regards to a **tax-free Roth IRA**, you can make your full $5,500 ($6,500 if 50+) contribution under two circumstances:

1. You have a MAGI under $120,000 ($189,000 married) or
2. You do so indirectly, by contributing first to a traditional IRA and then converting it (i.e. a **Backdoor Roth IRA**).

If you are married, your spouse doesn’t actually have to have earned income, as long as you have as much earned income as was contributed to both of your IRAs. This “spousal” traditional IRA has slightly different rules for deducting contributions. If the working spouse has a retirement plan available at work and your MAGI is < $189,000, you can deduct the full contribution.

As you can see, your accountant is wrong if he really said what you think he said, but he probably didn’t. He was probably referring to your ability to deduct your traditional IRA contribution or your ability to contribute directly to a Roth IRA.
Q. Is my S corp salary too low?

A.

The real tax benefit of an S Corporation is to save on payroll taxes, since you can split your income into salary and distributions and only owe payroll taxes (theoretically Social Security and Medicare but in reality for high earners, just the 2.9%-3.8% Medicare tax). Obviously, the less of your income you designate as salary, the less you owe in Medicare tax. However, if you set that salary too low, you also may not be able to max out your individual 401(k) or other self-employed retirement account. It can also affect the amount of the new pass-through entity deduction.

The IRS doesn’t want you to set your salary too low, so it has set rules about how low you can set it. Basically, you have to pay yourself the going rate for your job. In the event of an audit, you need to be able to convince the IRS auditor that you had a good reason to use that figure. That might be a salary survey or an amount you pay an employee doc in your practice or something similar. As a general rule, The IRS rules are that the following factors should determine reasonable compensation:

- training and experience,
- duties and responsibilities,
- time and effort devoted to the business,
- dividend history,
- payments to nonshareholder employees,
- timing and manner of paying bonuses to key people,
- what comparable businesses pay for similar services,
- compensation agreements, and
- the use of a formula to determine compensation.

Sources of information on comparable compensation for services include the U.S. Department of Labor’s Bureau of Labor
Statistics, employment agencies, and a market analysis.

Bottom line, as a doc working full-time, I think you’d have a very hard time justifying a salary under the amount of income subject to Social Security ($128K in 2018), much less a five figure amount. That’s okay, because you’ll need a salary larger than both of those amounts just to max out an individual 401(k). ($55,000 – $18,500)/25% = $146K in 2018

Q. Can I employ my spouse?

A.

Yes. You can employ anybody you like, as long as they can legally work in this country. The question, however, is SHOULD you employ your spouse. Lots of docs have this idea in their head that somehow employing a spouse gives them some huge tax deduction. In many cases, it actually COSTS them money to hire their spouse. Now, if you legitimately need someone to help you, your spouse is qualified to meet that need, and your spouse actually wants to do the work, then go ahead and hire your spouse. Remember you have to treat them like all your other employees. That means you have to pay their payroll taxes, which is where most docs realize this isn’t a great idea for them. If that income was paid to the doc, it would only be subject to Medicare tax (and maybe not even that in an S Corp) but if it is paid to a previously non-earning spouse, it will be subject to Social Security tax too, which is 4 times higher than Medicare tax.

Of course, if your spouse earns money, they are able to contribute some of it to a retirement account. If things are set up properly, your spouse might even be able to put as much
as $55K in there. But that’s going to require you to pay a lot of payroll taxes, and the cost may not be worth the benefit. Run the numbers in your situation to see if it makes sense.

**Q. Can I have a SEP-IRA and a Solo 401(k) at Vanguard?**

**A.**

Again, the answer to this question is yes, but the question you should have asked is “SHOULD I have a SEP-IRA and a solo 401(k) at Vanguard?” and the answer to that is probably not. In fact, there are precious few reasons for most readers of this blog to have a SEP-IRA at all. The problem with SEP-IRAs, at least when compared to an individual (solo) 401(k), is that you may need more income to max them out since there is no employee contribution component (the $18,500 for those under 50 and $24,500 for those 50+) and they screw-up your Backdoor Roth IRA pro-rata calculation. (See line 6 of IRS Form 8606). And for what? Maybe you get a slightly lower ER (a Vanguard SEP-IRA is eligible for admiral shares but a Vanguard individual 401(k) is not) and slightly less hassle (don’t need to spend 3 minutes getting a free EIN, don’t need to fill out a few pages of paperwork, and don’t need to do a Form 5500-EZ after it hits $250K). Many docs have made this mistake, and unfortunately, the
solution to it is NOT to open a Vanguard Individual 401(k), because their 401(k) doesn’t allow IRA rollovers. You actually need to open one at eTrade or Fidelity (which do take IRA rollovers.) Then, if you really want it at Vanguard, roll it over to a Vanguard individual 401(k).

What do you think? Have you had any of these questions before? Do you have an S corp or a solo 401(k)? Have you employed your spouse? Comment below!

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The Value of an Advisor

Once more I find myself needing to chart a moderate course. I run into many do-it-yourself investors who are convinced that the financial advisory industry is hosing every one. I also run into many financial advisors who are convinced their services are so valuable they should be paid millions. In the last couple of years, advisors have taken to pointing toward two studies, one by Vanguard and one by Morningstar, that seem to argue that the services of an advisor provide an incredible amount of value. Let’s talk about each of these points of view and why they are both wrong and right.

The Hard-Core Do-It-Yourselfer
DIY investors are fond of adding up all the asset-based fees associated with advice and extrapolating them out for decades. For example, they might use 1% for the financial advisor fees, another 1% for the mutual fund expense ratios and commissions, and another 0.5% for the account fees (such as a 529 or a 401(k)). In total, 2.5%. So if a portfolio has a long-term pre-fee return of 8% per year, and you’re paying all those fees, you’re really earning 5.5% per year. The difference between 8% and 5.5% over the long run is absolutely monstrous. Consider a physician who invests $50K a year for 30 years.

At 5.5% per year, \( \text{FV}(5.5\%,30,-50000,0,1) = \$3.82 \) Million

At 8% per year, \( \text{FV}(8\%,30,-50000,0,1) = \$6.12 \) Million.

$2.3 Million, or 60% more. Think that’s huge? Run the numbers out for another 30 years during the distribution phase and you’ll really be in awe. If you can withdraw 4% a year from a portfolio safely, but 2.5% goes to the advisor, the advisor gets 63% of what your portfolio produces and you only get 37%, despite doing all the saving and taking all the investment risk. This is a compelling argument that every investor should be aware of. Fees matter, and they matter a lot. Minimizing investment-related fees are a critical aspect of successful investing.

However, this analysis ignores a couple of important concepts. Before we get into those, let’s take a look at another point
of view.

**The Vanguard Study**

Vanguard did a study a few years ago, and their conclusion is routinely trotted out by financial advisors trying to convince you to use their services. The conclusion is that an advisor adds “about 3%” to the returns of a typical client. If you’re paying 1%, and getting 3%, well obviously you’re coming out ahead.

Where does that 3% figure come from? Vanguard says three places:

- Portfolio construction (0-1.15%/year)
- Behavioral coaching (1.5%+/year)
- Wealth management (0-1.45%/year)

Those are pretty wide ranges. I mean, we’re really looking at 1.5%-4.1%, even just taking their numbers at face value. We’ll come back to how they break those numbers down later.

**The Morningstar Study**

These are trustworthy institutions doing these studies. Who doesn’t trust Vanguard? Who doesn’t trust Morningstar? But it’s important to not just take the “headline conclusion” and to actually dive into the data a bit. The Morningstar study discusses three greek letters— the well-known “alpha” (beating the market, as attempted by stock pickers and actively managed mutual fund managers with negative success on average), the equally well-known “beta” (the market return captured by an index fund), and a new, unknown letter, gamma, which they describe as the value added by an advisor.
Morningstar came up with five “Gamma Factors”, i.e. ways an advisor can add value. They include:

- Asset location and withdrawal sourcing (0.23%/year)
- Total wealth asset allocation (0.45%/year)
- Annuity allocation (0.10%/year)
- Dynamic withdrawal strategy (0.70%/year)
- Liability relative optimization (0.12%/year)

They concluded that the advisor added the equivalent of 1.59%/year of value. Which is great if you’re only paying 1%, not so great if you’re paying 2%.

Criticizing the DIY Argument

There are three main criticisms of the DIY argument. The first is that it ignores the effects of poor returns on AUM fees. For example, lots of investors think that having an advisor you pay 1% to reduces your safe withdrawal rate from 4% to 3%, or costs you about 25% of your potential retirement spending. Michael Kitces makes a convincing argument that isn’t the case. The reason why is that if a bad sequence of returns shows up, it reduces not only how much you have to spend, but also how much you pay the advisor. Kitces calculates it out that instead of losing 25% (1% of portfolio) of your potential spending, you really only lose 10% (0.4% of portfolio).

The second criticism is that it ignores taxes. That extra
return you get from not hiring an advisor should be reduced by the tax cost of that extra return. If the return is LTCG/qualified dividends in a taxable account and you’re in the top tax bracket, it should be reduced by 23.6%. So instead of a 1% extra return for the DIY investor, it’s really just 0.76% extra. In addition, advisory fees are often paid out of a tax-deferred account. Although technically only a proportion of the fee equal to the proportion of the portfolio that is in a tax-deferred account vs a tax-free or taxable account should come out of the tax-deferred account, I suspect that doesn’t always happen, to the advantage of the client and the advisor. If your marginal tax rate is 40%, it’s as if your 1% advisory fee really only cost 0.6%. In essence, you’re paying your advisory fees with pre-tax dollars. Now it’s a little more complicated than that since you lose that tax-protected and asset-protected space forever, but suffice to say you’re not losing the full 1% return.

The third criticism of the DIY argument is simply that it ignores value. As Oscar Wilde said, “a cynic is a man who knows the cost of everything and the value of nothing.” I was cynical before I ever went to medical school, and I would be an extremely unusual person if I wasn’t more cynical after 7 years of education and training and 12 years of working in an emergency department. We’ll discuss value more below, but suffice to say that a good advisor can add value for many people, even knowledgeable, sophisticated investors.

Criticizing the Vanguard Study

Vanguard says advisors can add 3% of value. But let’s break it down.

- Portfolio construction (0-1.15%/year)
- Suitable asset allocation using broadly diversified mutual funds/ETFs (> 0%/year)
Cost-effective implementation/low expense ratio funds (0.4%/year)
- Asset location (0-0.75%/year)
- Total return vs income investing (>0%/year)
- Behavioral coaching (1.5%+/year)
- Advisor guidance (1.5%/year)
- Wealth management (0-1.45%/year)
  - Rebalancing (0.35%/year)
  - Spending strategy/withdrawal order (0-1.1%/year)

Now that we’ve gotten into specifics, things don’t seem quite so rosy any more. First because their estimates are way too high for some of these things. Consider rebalancing. They claim that provides an additional return of 0.35%/year. I call B.S. In general, rebalancing LOWERS returns. It doesn’t increase them. What it does is maintain risk at the preset level. Because stocks usually outperform bonds, each time you sell stocks and buy bonds, you’re lowering your future expected return. So I have no idea where they come up with a figure like 0.35%/year. There is no rebalancing bonus when one asset class has a much lower expected return than the other.

Another factor they name is asset location. At Vanguard (like with most advisors), that usually means two things:

1. Putting higher expected return assets preferentially into tax-free (Roth) accounts, which is bogus because while it does increase expected returns, it does so at the cost of increased risk when accounts are appropriately adjusted for taxes.

2. Putting stock preferentially into taxable accounts and bonds preferentially into tax-protected accounts, which is not always optimal because it focuses on tax-efficiency only, instead of both tax-efficiency AND expected returns.

Next, the study fails to acknowledge that many of these “valuable services” could be provided with some very limited
How long does it really take to teach/learn the following:

- Use broadly diversified, low-cost index funds to build your portfolio
- **Watch your expense ratios**, keep them as low as possible
- Preferentially put high-expected return, tax-inefficient asset classes into tax-protected accounts and vice versa
- **Don’t focus on income, focus on the total return.**
- **Save 20% of your gross income** for retirement and don’t sell all your stocks in the depths of a bear market
- **Rebalance once every 1-3 years**
- **Spend taxable assets first in retirement**, then use tax-deferred assets up to the top of an appropriate tax bracket, and tax-free assets after that

I mean, I can put that on an index card. I can teach it in a one hour lecture. I just gave it to you for free in this blog post. A good fee-only, hourly rate advisor can probably convince you of it in just a year or two of quarterly meetings for the cost of a few thousand. But you want me to pay you 1% of my net worth every year for the next 60 years (easily a 7 figure amount and possibly an 8 figure amount) for teaching me that? That doesn’t pass the sniff test.
Criticizing the Morningstar Study

The precision of this study cracks me up. I mean, it’s great to estimate stuff, but reporting it to 1/100th of a decimal point given how vague the assumptions going into the study are? Give me a break. This is financial planning, not physics. Using those levels of precision misleads those reading the study into thinking this data is better than it is. If you just read through the “study” you realize how much hand-waving is going on. The only reason anybody gives this study any credence is because their conclusions are reasonable. Sure, I can believe an advisor could potentially add 1.59% per year of value. But I would have believed it just as much if the answer had been 1.25% or 2%!

Then the study starts throwing out calculations like these:

\[ II = \left( \frac{\sum_{t=0}^{\eta} q_t (1+\rho)^{-t} \cdot \frac{\eta}{\eta-1}}{\sum_{t=0}^{\eta} q_t (1+\rho)^{-t}} \right) \]

\[ \eta = \text{the level of income in year } t \]

\[ q_t = \text{the probability of surviving to at least year } t \]

\[ r = \text{the last year for which } q_r > 0 \]

\[ \rho = \text{the investor’s subjective discount rate (so that } d_t \text{ in equation [A5] is } q_t (1+\rho)^{t-1}) \]

Do you know what any of that means? No, of course you don’t. Neither do I. Neither do 99% of the financial advisors in the country. But it sure looks impressive, doesn’t it? I mean, if they use figures like that, it must be accurate.

Yet when you start looking at the assumptions the study is making to get to those conclusions, you lose what respect you had for their mathematical ability. Check out this chart:
Anything there seem weird to you? These are their assumptions for future market returns. Yes, they assume that the future returns on bonds are 4%, never mind that the 10 year treasury was yielding 2% at the time of publication. How about the assumed returns for emerging markets stocks? Yup, 15.2%, 5.5% higher than their assumption for US stocks. Vanguard’s emerging markets index fund, started in 1994, has an annualized return since inception of 7.23%, but sure, if you want to use 15.2%, that’s fine. Seems reasonable. I mean, how much can you trust the conclusions of someone who makes such stupid assumptions, even if they can solve a dozen indecipherable mathematical formulas?

Making Sense of This Mess

So where does this leave you dear reader? What is the value of a financial advisor? Well, like many things in personal finance and investing, it depends. And what does it depend on? It depends on the advisor and it depends on the investor.

The Advisor

It should come as no surprise that some advisors are better than others. Not convinced of that? I encourage you to try an experiment I have undertaken over the last half decade. I’ve invited financial advisors to apply to be listed on my
The application is not particularly difficult. Most of the questions are pretty leading, such as “Do you believe you can pick stocks well enough to beat an index fund over the long term?” or “Do you believe you can time the market?” Guess what? I disqualify half the people who apply because they didn’t get these sorts of questions right. There are tons of incompetent advisors out there, and I’m not talking about the *salesmen masquerading as financial advisors* that make up the majority of people who call themselves advisors in this country. I’m talking about “real advisors”, people who are fee-only fiduciaries with designations like the CFP and no red flags on their ADV2. Incompetent. I have no doubt in my mind that a significant portion of these folks are not worth their fees. Add in the thousands of brokers and insurance salesmen masquerading as advisors and I fear the percentage of really good financial advisors could be as low as 10%. But guess what? They all think they’re in that 10%. And by the time you know enough to distinguish whether an advisor is in that 10% or not, there’s a good chance you know enough to do this yourself if you so desire. There’s entirely too much luck involved in a needy investor connecting with a competent advisor.

**The Investor**

As important as the advisor is to this equation, the investor
matters even more. You see, the value of even a good advisor depends a great deal on the investor. Consider a physician who knows nothing about personal finance or investing. An advisor who can get this doc budgeting, saving, maxing out retirement accounts, investing in a reasonable plan, buying appropriate types and amounts of insurance, and staying the course through down markets has likely provided millions of dollars in value over the course of this doc’s lifetime. Now consider a physician who is a good saver, understands the nuances of 401(k)s and Roth IRAs, already has a reasonable written investing and insurance plan and has proven her ability to stay the course by herself in a bear market? How much value is an advisor going to be able to add to this doc’s life? Maybe the advisor could tweak the asset allocation a little, but that might end up lowering future performance just as much as increasing it. The advisor could take care of some financial chores. The advisor could perhaps motivate the doc to do some estate planning and toss in a tax-efficiency pearl here and there. But is that going to be worth $10,000, $20,000, or even $30,000 a year? Probably not.

So we see that value is not only relative to the advisor and the investor, but it is also dynamic. Generally, as time goes on and the investor becomes more knowledgeable and disciplined and the plan is put into place, the value goes down. Which is odd, because under the most common payment scheme for fee-only advisors, an asset under management (AUM) fee, the fees generally go UP as time goes on.

Some Recommendations

At the risk of making this post too long to read, I’d like to throw in a few recommendations, none of which should be new to long-term readers.
# 1 It is Okay to Be a DIY Investor

I figure perhaps 20% of physicians and other high income professionals have enough interest in this topic to develop the discipline and knowledge required to be their own financial planner and investment manager. If you’ve found your way to this blog and read it regularly, that percentage is likely far higher than 20%. So if you think this stuff is interesting, or if you just can’t stand the thought of paying someone else thousands of dollars a year to do it for you, then go for it. You CAN do this. I’ve done it and so have thousands of other docs just like you. You can reduce that 3% figure Vanguard uses to less than what most advisors charge without too much time or effort. Managing your own finances is likely the best possible return on your time. It will pay a far higher hourly rate than doctoring, at least after you acquire basic financial literacy.

# 2 It is Okay To Hire an Advisor

Nevertheless, if you are not interested in this stuff, if you are worried you won’t do a good job, or if you’ve proven inadequate to the task in the past, you should not feel “money-shamed” for hiring an advisor. There are so many ways to reduce the cost of advice that if you just put a little effort into it, it shouldn’t be that hard for you to get the cost below the value provided to you. That value could be
millions of dollars.

# 3 Get Good Advice

Good advice comes from a fee-only, fiduciary, experienced advisor with an understanding of the academic literature. If the advice generally gels with what you see when you read good financial blogs or books or spend time on good forums, you’re probably fine. If in doubt, get a second opinion! It can be done from the comfort of your own home with little effort at no cost to you.

# 4 Make Sure You’re Paying a Fair Price

A fair price for financial advice is a four-figure amount each year. You’re not going to get good comprehensive advice and service for less than $1,000. But you can certainly get it for less than $10,000. Why pay $30K when you could pay $5K? No reason that I can see other than inertia. A bigger problem is that docs don’t know what they’re paying. If you think you’re getting advice for free, you’re likely getting bad advice. If you’re not sure what you’re paying, add it up. The math works like this: Percentage x assets = total fee. If the percentage is 1% and you have $2 Million in assets, the fee is $20K. If the percentage is 0.8% and you have $600K, the fee is $4,800. Now you can compare that to an advisor who charges an annual retainer or an hourly rate, or simply to the value of your own time.

# 5 Don’t Be Afraid to Negotiate

Doctors are notoriously bad negotiators. Now you don’t need to talk about fees every time you see your advisor, but it’s probably a good idea to do so every few years, especially if the amount you’re paying is a five-figure amount. Most advisors would rather see their fees cut a bit than watch the entire fee walk out the door and down the street, especially if they’ve already got your basic plan on auto-pilot and enjoy
working with you (that relationship thing goes both ways!)

# 6 Try to Minimize the Impact of Fees

Start by selecting an advisor who charges less than average. Give serious consideration to paying for your financial planning via an hourly rate and your investment management via an annual retainer. But given how many AUM advisors charge less than 1%, I see little reason to pay 1%, much less MORE than 1%. Then try to pay as much as possible from tax-deferred accounts. Might as well pay with pre-tax dollars if you can. And realize that you’re not losing quite as much as many DIYers would have you believe.

# 7 Nothing is Final

If you are like most, the value of advice likely falls as the years go by. There is absolutely nothing wrong with using fewer services as time goes by or even becoming a DIYer. The vast majority of DIYers hanging out on the WCI forum used an advisor at some point. Once a year, add up what you are paying in fees and consider the value of what you are receiving. If you don’t feel you are getting good value for the fees, either renegotiate them, change to a less expensive or less comprehensive advisor, or take over yourself.

What do you think? How would you quantify the value of a financial advisor? How can someone tell if they would benefit from hiring an advisor or not? Comment below!
How To Learn About Mutual Funds

This post will be a bit of a “back to basics” post. I’ve written about mutual funds in the past, but it has been a long time and I’ve never done a post like this one. If you want to see some of the older stuff on mutual funds, check these out:

- Mutual Fund Expenses
- Why Vanguard?
- Avoid Actively Managed Mutual Funds
- Survival Bias- Another Great Reason to Invest In Index Funds
- Mutual Funds Versus ETFs

But today, I’m not going to give you a fish. I’m going to teach you how to fish. Mutual funds make up the majority of my investment portfolio and I think that should be the case for most investors out there. There are other ways to invest successfully, but they will require significantly more time and effort.

Building a Mutual Fund-Based
Portfolio

Upsides and Downsides

Mutual funds have a number of sweet benefits you can’t get by buying individual stocks, bonds, and properties. These include:

1. Diversification – Buy thousands of securities in 10 seconds
2. Pooled Costs – Share the costs of the fund with thousands of others
3. Daily Liquidity – Buy or sell the entire investment any day the market is open
5. Automatic Reinvestment – While stocks often have DRIP programs, try doing that with a municipal bond or a duplex

Mutual funds have a few downsides as well, and in full disclosure they ought to be mentioned.

1. Diversification – It works both ways, you (or the manager’s) best ideas get diluted
2. No Capital Loss Pass Through – While capital losses in the fund can be used to reduce the capital gains passed through, those tax losses that occur on individual securities in the fund won’t find their way on to your
tax return. You can be assured you’ll get a capital gains distribution most years though, whether the fund makes money or not.

3. Management Fees – While they can be very low, they often are not
4. Loads and 12b-1 Fees- While you don’t have to buy a fund with these fees, lots of investors do
5. Manager Risk- The reason you hire a professional manager is because you recognize you’re an idiot. But what if the manager is too?

What Mutual Funds Should You Buy?

Instead of paying mutual fund loads, save your money and go heli-skiing

This is a “back to basics” post, so let’s make this real basic. If the name of your mutual fund does not have one or more of the following words in it:

- Vanguard
- DFA
- TSP
- Index

you probably shouldn’t buy it. That doesn’t mean that any fund with one of these words in it is a good fund, nor that every
fund without one of these words is a bad fund, but it’s a pretty darn good first screen.

What Are Acceptable Fees?

I’ve written before about mutual fund fees. There are a number of fees associated with mutual funds. Most of them you don’t have to pay.

**Expense Ratio:** Don’t pay one over 1% and try to keep it under 0.2%.

**Load:** Don’t pay one at all. This is supposed to compensate your “advisor” for his advice. In reality, it’s a commission for a commissioned salesman. Since the best funds don’t charge loads, why would you pay extra to get a crummier fund? You wouldn’t, unless you don’t know. Now you know, and **knowing is half the battle**. And if you need advice, go to someone who sells advice (i.e. a fee-only, not fee-based planner/investment manager) not products.

**12b-1 fee:** Just like a load, this is an unnecessary fee. Since the best mutual funds don’t have one, if the fund you’re looking at has one, then you know it’s a crummy mutual fund. It doesn’t even matter what the theory behind 12b-1 fees was/is (the theory is BS anyway.)

**Buy/Sell Fees:** Some funds, including some of those at Vanguard, have buy and sell fees. It might be structured so you get hit with a sell fee only if you don’t hold on to the fund for a period of time like 6 months or 5 years. Try to avoid these as much as possible. If you are really, really interested in the fund/asset class and are committed to it for a long time and the fee is low, then maybe it’s okay to pay.
What About ETFs

Exchange Traded Funds are just mutual funds that you can buy and sell during the day instead of at 4:00 pm. They’re not necessarily good or bad, just slightly different. They are certainly a little more complicated to use, so have a good reason (such as lower overall expenses) to use an ETF over a mutual fund.

Actively Managed Versus Index Funds

I love it when people call the frequently seen argument about active management a “debate.” It’s not a debate and if it ever was, it was over a decade or two ago. An actively managed mutual fund has a manager who tries to buy the good securities and avoid the bad ones. A passively managed mutual fund has a manager (mostly a computer) who just buys all the securities and keeps costs as low as possible. It turns out that it is very hard for a mutual fund manager to add enough value to overcome the costs of active management over the long run, especially in a taxable account. In fact, it is so hard that an individual investor even bothering to choose an active manager is probably making a mistake. The data, which I don’t have room to recount here, is pretty overwhelming. So at least until you know something, stick with passive (index) mutual funds. Chances are once you do know something that you won’t change your strategy and you’ll be glad you started with it. And you’ll probably send me a nice thank-you email in a few years and I like those.

Which Mutual Funds Should I Invest In?

Okay, you got the message and you’re looking for an appropriately risky mix of low-cost, passively-managed, broadly diversified index mutual funds mostly from Vanguard. But then you go to the Vanguard site and it’s overwhelming. I
mean “there are eight money market funds, and I don’t even know what money market funds are.” There are 37 bond funds. And dozens and dozens of index funds. Too many choices lead to paralysis by analysis. I was in a restaurant recently and I was handed a menu. There were three options on it. That was awesome. I think all menus should be like that. The happiness literature tells us that we like to have choices and feel in control, but that the fewer choices we have, the happier we’ll be. So let me try to simplify things a bit.

We’re going to work our way down the entire page listing the [Vanguard mutual funds by asset class](#). (Remember “asset class” is the type of investment the mutual fund invests in.) By the way, this is one of the most important pages of the internet for a Do-It-Yourself investor. If you don’t have an investment advisor, you should know it like the back of your hand.

### Money Market Funds

Okay, let’s walk through this. First, what’s a money market fund? Well, it’s basically a bank account. There are some subtle differences, but not enough that you really need to spend a lot of time on them. Basically money market funds make very short term loans to companies and federal, state, and local governments. In return, they are paid interest. After paying their expenses, whatever interest is left over is paid to you. They are very safe investments in that you are unlikely to lose money in them. But don’t expect to make much.
In fact, for the last 5-8 years, you’ve made less than the rate of inflation in money market funds. As you can see, there are two types of money market funds. There are “taxable” ones and “tax-exempt” ones. The tax-exempt ones are like municipal bonds. You’re loaning money to state and local governments. In order to incentivize you to do so, you get a federal tax break and maybe a state and local tax break on the interest. So as you might expect, the interest on these is generally lower than on a taxable fund, but if you’re in a high tax bracket, you may come out ahead after tax even with that lower interest payment.

As we move left to right here, we see the name of the fund, the ticker symbol (ignore this), the expense ratio (never ignore these, but if you’re on the Vanguard site, they’re all pretty low), and then we come to the price of the shares. In a money market fund, the price is always $1.00. The next two columns give you the change in the share price yesterday, both in dollar terms and percentage terms. Since the price of a money market fund is zero, that should also always be zero. The next column is important. This shows you the yield on the mutual fund. Remember that yield is not return for most mutual funds, but for a money market fund (and a bank account) they are essentially interchangeable. Finally, we come to the “return” figures. Remember that it is not wise to choose a mutual fund primarily based on past returns, but it is a good idea to have some idea of what you can expect from this mutual fund in a given economic environment. The first column is the year to date return (interesting, but not very useful) and then Vanguard publishes the 1 year, 5 year, 10 year, and “since inception” return. As you can see, the last decade has not been kind to money market funds but the “since inception” numbers and dates tell you that things were not always like this.
Okay, let’s move on to bonds. Remember a bond is a loan to someone, but it’s a longer loan than the ones that go in a money market fund. Because of this, bond funds can’t keep the share price at $1.00. As Jack Bogle has said, you can have stable principal or you can have stable yield, but you can’t have both. With a bond, you get a stable yield and a variable principal (unless held to term). With a money market fund, you get a stable principle, but a variable yield. However, when you throw a bunch of bonds into a bond fund, the yield is only kind of stable, especially with economic fluctuations.
Let’s go down the left-hand column first. Luckily, at Vanguard the names of the funds actually tell you what they’re invested in. At other mutual fund companies, you might actually have to read the prospectus to get that information. No wonder everyone is pulling their assets from other mutual fund companies and sending them to Vanguard. At any rate, the first fund is GNMA. Ginnie Mae is a semi-government agency that does mortgages. So the bonds in this fund are loans to homeowners. You’re buying mortgages. Where does the money go when you pay your mortgage? It doesn’t go to the bank. They sold your mortgage to someone like this fund two weeks after you got it. So when people pay on the mortgages you own through this mutual fund, you make money. When they don’t pay, well, you don’t make money. The next fund is “Inflation Protected Securities.” That means Treasury Inflation Protected Securities, or TIPS. These are bonds whose value is indexed to inflation. This is one of my favorite funds and one I’ve owned for years. The next fund is Intermediate Term Bond Index Admiral Shares. That means it invests in all types of bonds that are of an intermediate duration and uses an index fund strategy. It buys both corporate (loans to Ford and Apple) bonds and government bonds (treasuries.) This fund doesn’t hold GNMA bonds. The “admiral” means you have to put at least $10K into it. If you don’t have $10K, you have to buy the “investor” shares, which have a slightly higher expense ratio and usually a $3K minimum. I also like this fund and use it in my parent’s portfolio. The next fund is just like it, except no corporates. The fifth fund down doesn’t have the word “index” in it. It is actively managed and invests only in treasury bonds. Luckily, even the actively managed bond funds at Vanguard act like index funds so there isn’t a bad fund on this list.

Moving left to right, we see some various expense ratio, prices that aren’t stable (but really don’t move much, I mean, you can handle swings of 0.27% per day, which are actually pretty big for a bond fund,) and higher yields and returns than you see from money market funds. Be aware the TIPS fund yield is a “real” (i.e. after-inflation) yield. If it was a nominal yield, you would be better off putting money in your mattress than investing in that.
As you scroll down the page you will also notice there are corporate bonds funds (guess what they invest in) and tax-exempt bonds funds (just like the tax-exempt money market funds.) In the interest of time, we’ll skip through all that and get to the Balanced Fund Section.

### Balanced Funds

What is a balanced fund? It invests in both stocks and bonds at varying ratios depending on the strategy. Why might you want to use one? Mostly to keep things simple. You only have...
to own one fund and you get to own all kinds of assets all over the world without any hassle. I use them (okay, one of them) for things like my kids’ Roth IRAs. Vanguard has a number of different types of balanced funds. The Target Retirement funds are supposed to be chosen by your retirement date. The further you are out from retirement, the more aggressive the fund is (i.e. more stocks, fewer bonds.) Then the fund gradually becomes less aggressive as the years go by. The Target Risk funds are also contain a reasonable mix of stocks and bonds, but they don’t become less aggressive as time goes by. They just stay the same. Then there are more traditional balanced funds, including both index funds and some of Vanguard’s most successful actively managed funds. Finally, there is the managed payout fund, which tries to keep a constant “pay-out” despite wildly fluctuating asset values. That’s kind of fun to watch to see if Vanguard can do it, but I wouldn’t actually invest in it.

### Stock Funds

Now let’s move on to a more exciting part of the portfolio—the stocks! Remember when you own a stock you own a tiny piece of a real, live company with real, live customers. When they make money, you make money. When they lose money, you lose money. In the short run, there is also an impressive speculative component, but in the long run, you’re just buying a piece of a (hopefully) profitable enterprise. First we see US Large Cap Stock (or Equity) Mutual Funds. Dave Ramsey (and
other people who were investing in the 90s) calls these Growth and Income funds. You’ll notice Vanguard has a couple dozen of these. Which one should you invest in? This one.

<table>
<thead>
<tr>
<th>Fund Type</th>
<th>Date</th>
<th>Percent Change</th>
<th>Return</th>
<th>Expense Ratio</th>
<th>Rating</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total Stock Market</td>
<td>0.05%</td>
<td>$57.16</td>
<td>0.04%</td>
<td>1.96% B</td>
<td>1.93%</td>
</tr>
<tr>
<td>Stock - Large-Cap Blend</td>
<td>1.93%</td>
<td>21.71%</td>
<td>13.92%</td>
<td>7.23%</td>
<td>5.95%</td>
</tr>
</tbody>
</table>

That was easy, wasn’t it? It is also a good example of why you shouldn’t choose a fund based on performance since inception. As you scan down that list, you’ll see funds with very different inception dates, and the date has more to do with the return since inception than anything the mutual fund actually does or has control over. But moving left to right, you’ll see slight changes in the asset class column. Some funds invest in Large Cap Growth stocks, some invest in Large Cap Value stocks, and most invest in Large Cap Blend (growth and value) stocks. You can also see the difference in expenses between an index fund and an actively managed fund. Even at Vanguard, you can see an 8-fold difference in expense ratio. That is not easy for a manager to overcome. Stock funds have yield too, although instead of coming from a bond coupon, they come from stock dividends, and thus aren’t nearly as stable. You’ll also notice that returns, particularly for the last few years, are dramatically higher for stock funds than balanced, bond, and money market funds.

As you scroll down, you’ll come to Mid Cap stock funds (Dave Ramsey calls these “Growth” funds) and Small Cap stock funds (“Aggressive Growth.”) “Cap” means market capitalization, or the size of the stock. Large caps are companies you’ve heard of (Amazon, Exxon) and small caps are companies you’ve never heard of. Then you move into international funds.
International Funds

Remember this section includes both stock funds and mutual funds, but again, the names are descriptive. Developed Markets include mostly Europe, Australia, and Japan. Emerging markets are places like Brazil, Russia, India, China, most of the Pacific Rim, and most of Central and South America. The best thing for most investors to do is scroll to the bottom of this section and look at the two “Total International” funds. The first buys all the bonds in the world outside of the US and the other buys all the stocks in the world outside the US. I’ve been using the Total International Stock Index fund for more than a decade in my portfolio.
Global Funds

The next section down is for “Global” stock funds. There is an important bit of terminology here. When it comes to investing, “International” means outside the US and “Global” means the entire world including the US. These funds are all a bit small and a bit expensive. I’ve never invested in any of them. The Total World Stock Index has potential, but still hasn’t caught on much after almost a decade. You can buy its components cheaper separately.

Finally, we get to the bottom. If you want to invest at Vanguard, but still want some excitement in your life, this is your place. Why buy a diversified portfolio of stocks when you can get a concentrated one? If you learned something in the previous 3000 words of this post, you have no business buying any of these funds. That said, I’ve owned all of them at one point or another and they’re a lot of fun. I mean, look at Energy, 33% last year alone! And Precious Metals, 76% last year! Whoohoo! (And I owned both of them last year- bragging rights for cocktail parties.) Guess what? They go down just as fast. In fact, precious metals still has a markedly negative return over the last 10 years. Health Care is one of Vanguard’s long-term successes in active management. But they had a pretty rough year last year, underperforming the overall market by 10%. Lots of people hold a little slice of REITs in their portfolio in hopes that they will act differently from
other stocks due to the slightly different structure. I lost 78% of my money in that fund in the 2008 bear market. Use extreme caution with any of these four funds, even if they do have the word Vanguard in their name. You should not have a large portion of your portfolio in any of them.

**Prospectus**

As you can see, this page alone gives you a lot of information about a mutual fund once you know how to read it. You can get even more information from the Prospectus and Annual Report, which I also recommend you at least skim. In fact, let’s look at one now. Just click on a mutual fund link. Let’s do the REIT Index Admiral Fund for convenience. It’ll take you here:

This is the fund page. It gives you even more information about the fund including what it invests in, what the fees are, what the past performance is etc. If you want even more
information, click on “View Prospectus and Reports.” Then read the prospectus. There’s a short version (8 pages) and a long version (53 pages.) The short version is probably good enough. I would concentrate on these sections:

**Investment Objective**
The Fund seeks to provide a high level of income and moderate long-term capital appreciation by tracking the performance of a benchmark index that measures the performance of publicly traded equity REITs.

**Fees and Expenses**
The following table describes the fees and expenses you may pay if you buy and hold Investor Shares or Admiral Shares of the Fund.

<table>
<thead>
<tr>
<th>Shareholder Fees</th>
<th>Investor Shares</th>
<th>Admiral Shares</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sales Charge (Load) Imposed on Purchases</td>
<td>None</td>
<td>None</td>
</tr>
<tr>
<td>Purchase Fee</td>
<td>None</td>
<td>None</td>
</tr>
<tr>
<td>Sales Charge (Load) Imposed on Reinvested Dividends</td>
<td>None</td>
<td>None</td>
</tr>
<tr>
<td>Redemption Fee</td>
<td>None</td>
<td>None</td>
</tr>
<tr>
<td>Account Service Fee (for certain fund account balances below $10,000)</td>
<td>$20/year</td>
<td>$20/year</td>
</tr>
</tbody>
</table>

**Annual Fund Operating Expenses**
(Expenses that you pay each year as a percentage of the value of your investment)

<table>
<thead>
<tr>
<th></th>
<th>Investor Shares</th>
<th>Admiral Shares</th>
</tr>
</thead>
<tbody>
<tr>
<td>Management Fees</td>
<td>0.23%</td>
<td>0.11%</td>
</tr>
<tr>
<td>12b-1 Distribution Fee</td>
<td>None</td>
<td>None</td>
</tr>
<tr>
<td>Other Expenses</td>
<td>0.03%</td>
<td>0.01%</td>
</tr>
<tr>
<td><strong>Total Annual Fund Operating Expenses</strong></td>
<td>0.26%</td>
<td>0.12%</td>
</tr>
</tbody>
</table>

Tons of interesting information on the 2nd page. First, you learn what it invests in. Unsurprisingly, it invests the entire fund in Real Estate Investment Trusts. You also learn the strategy- it tries to track the performance of an index. In other words, it just buys all the publicly traded REITs.
The fee section is also interesting. Well, maybe not for Vanguard funds, but when you compare it to another fund. You see there are no loads, purchase fees, sales fees, redemption fees, account services fees (I know, it says $20 but that gets waived if you opt for electronic communications or if you have more than $10K in the fund), or 12b-1 fees. The expense ratio is a low, low 0.12%. Just for fun, let’s look at a similar page from the prospectus of another mutual fund. How about the Alger Capital Appreciation Fund Class A. It’s page looks like this:

Investment Objective
Alger Capital Appreciation Fund seeks long-term capital appreciation.

Fund Fees and Expenses
This table describes the fees and expenses that you may pay if you buy and hold shares of the Fund. While the investment minimum is lower, you may qualify for sales charge discounts if you and your family invest, or agree to invest in the future, at least $25,000 in Class A Shares of the Alger Family of Funds, including the Fund. More information about these and other discounts is available from your financial professional and in "Purchasing and Redeeming Fund Shares" beginning on page A-2 of the Fund's Prospectus and the sections "Right of Accumulation (Class A Shares)" and "Letter of Intent (Class A Shares)" on page 25 of the Fund's Statement of Additional Information.

<table>
<thead>
<tr>
<th>Class</th>
<th>Alger Capital Appreciation Fund</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>A</td>
</tr>
<tr>
<td>Shareholder Fees (less paid directly from your investment)</td>
<td></td>
</tr>
<tr>
<td>Maximum sales charge (load) imposed on purchases as a % of offering price</td>
<td>5.25%</td>
</tr>
<tr>
<td>Maximum deferred sales charge (load) as a % of purchase price or redemption proceeds, whichever is lower</td>
<td>1.00%*</td>
</tr>
<tr>
<td>Annual Fund Operating Expenses (expressed as a percentage of the value of your investment)</td>
<td></td>
</tr>
<tr>
<td>Management Fees**</td>
<td>.79%**</td>
</tr>
<tr>
<td>Distribution and Service (12b-1) Fees</td>
<td>2.5%</td>
</tr>
<tr>
<td>Other Expenses</td>
<td>19%</td>
</tr>
<tr>
<td>Total Annual Fund Operating Expenses</td>
<td>1.23%</td>
</tr>
</tbody>
</table>

* Purchase of $1 million or more of Class A Shares at net asset value may be subject to a contingent deferred sales charge of 1.00% on redemptions made within 12 months of purchase.

** The Fund and First Alger Management, Inc. have adopted fee breakpoints for Alger Capital Appreciation Fund. The management fee for assets up to $2 billion is .83%. The management fee for assets between $2 billion and $3 billion is .85%, for assets between $3 billion and $4 billion is .80%, for assets between $4 billion and $5 billion is .75%, and for assets in excess of $5 billion is .45%. The actual rate paid as a percentage of average daily net assets for the period ended October 31, 2015 was .79%.
They have an investment objective too. But it’s so friggin’ vague you have no idea what they’re doing. And check out those fees. Wow! Let’s start with the 5.25% load. Yup, that’s money right out of your pocket. Give your commissioned salesman $1000 to invest, and he takes $52.50, puts it in his pocket and invests $947.50. That’s going to take a little while to recover from. Oh wait, there’s more. Not only do you get to pay a “front-load” but you also get to pay a 1% back-load. I love the little extra kicker there- if the share value goes down, you pay a back load off what it used to be, not what it actually is at the time of sale. The ER is 0.79%, or approximately 16 times as high as a Vanguard Index Fund. But wait, there’s more. You can also pay a 12b-1 fee of 0.25-1%. And “other expenses” of 0.19%, whatever the heck those are. All in, you’re looking at 1.23% for the front-loaded shares. But wait, there’s more. Look at all those asterisks and fine print at the bottom! I’m not saying this fund sucks and you should avoid it….actually, that is what I’m saying. Given those high fees, you won’t be surprised to learn its recent performance was kind of crummy too. Last year, while the US stock market generated returns of 12.94%, this fund LOST MONEY. A LOT OF MONEY. -4.94%. That sucks and it certainly doesn’t sound like “capital appreciation” to me. Why are people still investing with those chumps? Because they’ve never read a blog post like this one.

Okay, let’s go back to the Vanguard prospectus.
This section is pretty important. It talks about the risks you’re running in this fund. Let’s just say it is a risky fund, but you should read and understand all of these before buying the fund. There is a reason the government requires them to tell you this.
This is also a really useful page. It may give you some idea of what to expect in the fund. You’ll notice it has had some huge losses, such as in 2007 and 2008. -37.05% doesn’t sound too bad, right? But wait. Didn’t I say I lost 78% of my money in this fund in that bear market? Yes I did. Bear in mind that performance data reported for the calendar years will down play what you will feel as an investor. You feel the peak to trough drop (and trough to peak rise), not the calendar year drop. Notice how few years there are with returns of 5-10%, which is what you expect the long-term return to be. Most years are big losses or big gains. That tells you it’s a risky fund.

Check out the tax data too. These are also mandatory disclosures. Notice the difference between the 10 year pre-tax return of 7.44% and the post-tax return (assuming maximum tax brackets) of 5.40%. That’s a fairly tax-inefficient fund to
lose 27% of its return to taxes. Compare those numbers to a more tax-efficient fund, like the Vanguard Total Stock Market Index Fund

<table>
<thead>
<tr>
<th>Vanguard Total Stock Market Index Fund Investor Shares</th>
<th>1 Year</th>
<th>5 Years</th>
<th>10 Years</th>
</tr>
</thead>
<tbody>
<tr>
<td>Return Before Taxes</td>
<td>0.29%</td>
<td>12.03%</td>
<td>7.39%</td>
</tr>
<tr>
<td>Return After Taxes on Distributions</td>
<td>-0.15%</td>
<td>11.61%</td>
<td>7.04%</td>
</tr>
<tr>
<td>Return After Taxes on Distributions and Sale of Fund Shares</td>
<td>0.53%</td>
<td>9.60%</td>
<td>5.99%</td>
</tr>
</tbody>
</table>

which lost just 19% to taxes or a really tax-efficient fund like the Vanguard Intermediate Term Tax Exempt Bond Fund

<table>
<thead>
<tr>
<th>Vanguard Intermediate-Term Tax-Exempt Fund Investor Shares</th>
<th>1 Year</th>
<th>5 Years</th>
<th>10 Years</th>
</tr>
</thead>
<tbody>
<tr>
<td>Return Before Taxes</td>
<td>2.86%</td>
<td>4.70%</td>
<td>4.33%</td>
</tr>
<tr>
<td>Return After Taxes on Distributions</td>
<td>2.66%</td>
<td>4.70%</td>
<td>4.33%</td>
</tr>
<tr>
<td>Return After Taxes on Distributions and Sale of Fund Shares</td>
<td>2.88%</td>
<td>4.39%</td>
<td>4.18%</td>
</tr>
</tbody>
</table>

which only lost 3% to taxes.

**Morningstar**

Vanguard is pretty good at putting lots of very useful information on their website and in their prospectuses and reports. Probably because they don’t have much to be ashamed of. But if you’re looking up a mutual fund somewhere else, you may find it a little tougher to get the information you seek. Or you might just want more detail. In those cases, you can go to Morningstar, which provides all kinds of mutual fund information. There is some information behind a paywall, but everything you really want is in front of it. Let’s take a look at that Vanguard REIT Index fund there.
Most of the good stuff is under the “Performance,” “Portfolio,” and “Expense” tabs and is summarized at the bottom of the front page.

This tells you what it is invested in (100% stocks, remember REITS are a type of stock) and mostly small to medium slightly growthy stocks.
At the bottom, you can see all of the money is invested in the real estate sector (no surprise there) and that their top holdings are all big real estate companies, some of which you might have even heard of. It is a fairly concentrated fund, with over 20% invested in just the top five holdings. The comparative performance data is also pretty useful. Look at the long-term % rank in category near the bottom. Over 5-10 years, this fund has outperformed 80-83% of the other funds in its category. That’s pretty typical for an index fund. Despite whooping up on 4 out of 5 funds for a decade, Morningstar only gives it 3 out of 5 stars. That’s another good point- when you go to Morningstar, you’re looking for 3-4 star funds. 1-2 star
funds tend to stay 1-2 star funds, but 5 star ratings do not predict future performance. Steady eddies are what you want.

This post is way too long already, but I hope it has been educational. You can learn a lot about mutual funds without ever reading an investment book if you just know where to look on the internet and what you’re looking for.

What do you think? How did you learn about mutual funds? What do you think a beginning investor needs to know? Do you invest in mutual funds? Why or why not? Comment below!

Why I Won’t Be Your Financial Advisor

I receive multiple requests a month to be somebody’s financial advisor. I routinely turn those requests down for a number of reasons that I thought might make for an interesting post. I’m
going to combine this list of reasons with a description of a financial advisory firm I hope to see appear in the next decade.

I’m Not Licensed

The easiest reason to turn people wanting to hire me as their advisor down is because I’m not licensed to be a financial advisor. I only have two licenses, one to practice medicine and one to drive, neither of which I do on this site. And they’re both specific only to a single state. That’s why this site is purely for entertainment and informational purposes, rather than constituting actual formal financial advice.

Lack of Formal Credentials

When I write about financial advisors, I generally recommend they have one of the highest credentials available in the field such as CFA, CFP, ChFC, or CPA/PFS. While there are good advisors that don’t have these, and bad advisors that do, for me a designation like this represents a commitment to your profession as well as a minimum level of education. I don’t have any of these, so if I really wanted to be a financial advisor, it would be pretty hypocritical of me not to go and get them.
I Already Have Two Jobs…and Plenty of Income

Frankly, I barely have time to do both of my jobs now and consider cutting back on shifts and/or hiring additional help for WCI every month. I certainly don’t need to add on another job. In fact, I would really like some more time with family and my non-professional pursuits. One of my jobs offers me the ability to trade my time for money at a very high hourly rate and to really make a difference in the lives of others. The other I enjoy so much I would do it for free (and basically did so for two years.) Is it possible I could make a slightly higher hourly rate providing financial advice than practicing medicine? Sure. But at this point in life, I’m more interested in doing something I enjoy than in making slightly more money.

I Really Enjoy Aiding the DIYer

Generally, those who come to this site, read my book, send me emails, and post comments are people who wish to be heavily involved in the management of their personal financial lives and their own portfolios. All they really need is a little more information to be able to accomplish much of their needed financial tasks. So I function more as a teacher, enabling them to become independent learners, and I really enjoy that. On the other hand, the type of doc who typically wants to hire a full-service advisory firm, and who gets the most value out of it, just wants “a money guy to take care of everything.” While that job certainly provides value, and pays well, I’m not really interested in it.

Scalability is Critical For Me

Dave Ramsey (appropriately) gets lots of criticism from
financial advisors. One of his favorite responses is “I helped more people in the last hour than you will in your entire life.” He’s right. While I’m nowhere near as well-known as Dave, keep in mind an individual financial advisor typically only has 20-100 clients. Yet I have over 4 million page views per year on this site. Thousands of people bought (and presumably read) my book. I can see financial education for medical students, residents, physicians, and other high-income professionals moving forward by leaps and bounds and am confident that I am a large part of that movement. I think that’s pretty awesome.

A second reason for the existence of this website is to feed my entrepreneurial spirit (i.e. make some money.) As I mentioned above, if I want to trade time for money I have a very good way to do that. Emergency physicians (particularly partners in a democratic group like I am) may enjoy the highest hourly pay of any physician specialty, and if not, it’s close. What my day (?) night) job does not provide me, however, is a way to make money while I’m sleeping. This blog works 24/7/365 and is completely scalable. There is no reason it can’t have 40 million or even 400 million page views per year or pay me ten times or even 100 times what it does now.
Internal Conflict Between What Docs Need and The Best Way To Run A Business

Most of the really successful (meaning richest) financial advisors have learned one of the greatest truths in the financial advisory world- that what is best for the advisor is not best for the client. As one advisor remarked to me, “AUM fees are the best kind of passive income there is.” The best way to make a lot of money advising physicians is to find doctors who have a lot of money, don’t have a lot of debt, have a high income, and who are not fee-sensitive and charge them high AUM fees. I have great respect, as an entrepreneur, for advisors running their firm that way. If they are skilled and work hard, they are often financially independent at an age younger than their clients were upon earning their first attending paycheck.

But the phrase “Where are the customers’ yachts?” seems appropriate. The docs who need the most advice are those with high student loan burdens, negative net worths, and low incomes. The advisors would argue that if they weren’t providing more value than their fees, the clients wouldn’t pay those fees. But I think it is patently obvious that when doctors realize just how much they’re paying, many of them become very interested in doing more of those tasks themselves, or at least hiring a less expensive advisor. I find paying an hourly rate, even a high one, is a far better method of paying for financial planning. The main reason is that the client keeps more money and the advisor takes less of it. I prefer a flat annual fee for investment management, for the same reason. Advisors may argue that since the best advisors want to also be the richest, you get better advice by paying more money, but I find that a fairly self-serving, hollow argument. The bigger issue is that those types of fees, aside from generally being lower overall, are not scalable (i.e. more money each year for the same, or even less, work). And that takes away a decent chunk of my motivation to do that
type of work. I like helping people, but there are limits to my sainthood.

In fact, the more I think about those issues, the more respect I have for Jack Bogle, aka Saint Jack. While the real story is slightly more complicated, when faced with the choice of building a business that would make him rich or one that was best for his investors, Mr. Bogle chose to give “his” company away to his clients. I think it would be awesome to see, and even assist in, the appearance of the “Vanguard” of physician financial advisory firms. Said firm would pay fair, and probably very high, salaries to its administrators and advisors. But they would be salaried, rather than having a scalable income. The firm would be owned by the physicians and run at cost. This would prevent the high fees and, most importantly, most of the financial conflicts of interest that advisors face.

Word would travel quickly among physicians and it would grow so quickly that it would rapidly become the largest firm of its type in the country. It might even put many advisors out of business, and certainly prevent a bunch of them from ever
opening their doors. Its biggest challenge is likely to be dealing with its rapid rate of growth and maintaining a sufficient number of highly qualified individual advisors, no matter how high the salary. But in the end, it would be far better for the clients than our current hodge-podge of for-profit advisory firms fighting amongst each other to get to a critical mass of clients and assets under management. Critics may call it “socialist” but those same criticisms can be (and were) leveled at mutually owned insurance companies and mutual fund company, most of which are now among the strongest financial institutions in the country.

The hardest part would be finding talented people willing to put in all that work knowing that the financial reward for doing so would be limited by design. I certainly don’t have the time nor motivation at this stage of my life to bring this sort of company into existence, not to mention I have a financial conflict of interest against doing so (advisory firms pay me money_to_advertise_here.) But if you are interested in starting a firm like this, you can count on a lot of support from me!

What do you think? Would you rather be a financial advisor than a doc? Why or why not? Would you hire a mutually-owned advisory firm to manage your money? Why or why not? Comment below!

 Winning The Loser’s Game – A Review
I had the opportunity recently to read Charley Ellis’s *Winning The Loser’s Game*. This is an investment classic and should be required reading for anyone who is either picking their own stocks or trying to pick a winning actively managed mutual fund manager. If you’re already convinced that using index funds is a better idea than either of those, you’re not going to get much out of this book, other than some reinforcement of your views, a better ability to stay the course in a downturn, and a lot of great quotes. However, this book is Bill McNabb’s (CEO of Vanguard) favorite investment book for a reason and is often referred to by other Boglehead authors. It was first published in 1998, but the sixth edition, published in 2013, reads like it was just written, and includes lots of references to the Global Financial Crisis and events that have occurred since.

**The Loser’s Game**

The basic premise of the book is that 50 or 60 years ago investing in the stock market was a winner’s game. 90% of the participants were individual investors and someone who was willing to take the time and effort to really study what they were doing could earn market-beating returns. However, since that time professional investors have become so numerous, so skilled, and so tech savvy that they now make up 90% of the market. Now when you trade stocks, mutual funds, or ETFs, you are almost surely trading with a professional who spends 60-80 hours a week doing
something you may do once a month. It isn’t that active mutual fund managers suck at what they do at. It’s that they’re entirely too good at it and there are too many of them for any of them to win. It has changed from a winner’s game to a loser’s game. A loser’s game is like amateur tennis, where the winner is the one who makes the fewest mistakes. If you can just volley the ball back to your opponent, eventually your opponent will hit it out of bounds or into the net. On the other hand, if you try to smash a shot and crush your opponent (like the pros do), you’re much more likely to hit the ball into the net yourself. The way you win a loser’s game is to not play. The way you avoid playing the stock market game (trying to beat the market) is to simply avoid going into “the casino” and just own the entire market at the lowest possible cost. You do that by purchasing index funds and spending your life energy on something else.

**Some Great Quotes**

Charles D. Ellis

Here are some quotes from the book to give you a flavor for it:

*Sensible investors rely on themselves. A strategy of professing ignorance and handing assets to a trained professional invites failure....Ironically, upon acquiring sufficient information to assess the skill of an investment*
service provider, individuals end up empowered to take control of their portfolios and make their own decisions.

Over the past decade index funds beat the results of 80 percent of mutual funds....After adjusting the comparison of index funds to actively managed funds for survivorship bias, taxes, and loads, the dominance of index funds reaches insurmountable proportions.

For all its amazing complexity, the field of investment management really has only two major parts. One is the profession—doing what is best for investment clients—and the other is the business—doing what is best for investment managers. As in other professions, such as law, medicine, architecture, and management consulting, there is a continuing struggle between the values of the profession and the economics of the business. Investment firms much be successful at both to retain the trust of clients and to maintain a viable business, and in the long run, the latter depends on the former. Investment management differs from many other professions in one most unfortunate way: it is losing the struggle to put professional values and responsibilities first and business objectives second.

Over the past 20 years, more than four out of five of the pros got beaten by the market averages. For individuals, the grim reality is far worse.

Of course, most professional investment managers would have good performance—comfortably better than the market averages—if they could eliminate a few “disappointing” investments or a few “difficult” periods in the market. (And most teenagers would have fine driving records if they could expunge a few “surprises.”)

Investing is not entertainment—it’s a responsibility—and investing is not supposed to be fun or “interesting.”

Benign neglect is, for most investors, the secret of long-
The hardest work in investing is not intellectual; it’s emotional. The hardest work is not figuring out the optimal investment policy; it’s sustaining a long-term focus—particularly at market highs or market lows—and staying committed to your optimal investment policy.

A small boat sailor can do little to change the wind or tide but can do a lot by selecting the right course, keeping sales well trimmed and by knowing what he and his boat can do in heavy weather and watching for the signs to avoid serious storms. Similarly, the investor can work with the markets to achieve his or her realistic objectives, but must not take on more risk of heavy weather or possible market movements beyond his capacity to sustain commitments until the market storms have passed.

If you don’t know who you are, the stock market is an expensive place to find out.

While investment counseling is more important to long-term success than managing investment portfolios—and could make far more of an economic difference over the long term—most investors will neither do the disciplined work of formulating sound long-term investment policies for themselves nor pay the modest fees for investment counseling—the more important service.

For most investment managers, portfolio management is neither an art nor a science. It is instead an unusual problem in engineering, determining the most reliable and efficient way to reach a specified goal, given a set of policy constraints, and working within a remarkably uncertain, probabilistic, and always changing world of partial information and misinformation, all filtered through the inexact screen of human interpretation.

Investing in stocks helps keep us young.

If you must play the market to satisfy an emotional itch,
recognize that you are gambling on your ability to beat the pros. So limit the amounts you play with to the same amounts you would gamble with the pros at Las Vegas. (keep accurate records of your results and you’ll soon persuade yourself to quit.)

Don’t get confused about stockbrokers and mutual fund salespeople. They are usually very nice people, but their job is not to make money for you. Their job is to make money from you.

Two Great Insights

There were a couple of particularly profound insights in the book. The first is a list of errors investors make. These include:

1. Trying too hard (trying to beat the market)
2. Not trying hard enough (not taking on enough risk)
3. Being impatient (good investing is boring investing)
4. Changing the mutual funds you own in less than 10 years
5. Borrowing too much
6. Being naively optimistic
7. Being proud
8. Being emotional

The second was a chart in Chapter 20 entitled “What it will take to get to there from here.” This chart has your current savings on the Y axis, your age and nest egg goal across X axis, and the values in the chart are “How much you need to save annually.” I thought it was a particularly good
presentation of the benefits of starting early. Although he uses a rather optimistic 10% return for the chart, he points out that if you’re 45, expect to need $1.4 Million to retire, and already have $250,000, you’re done saving for retirement. Likewise if you’re 25 and have $100K and expect to need $3 Million in retirement, you’re also done. On the other hand, if you’re 55 and expect to need $940,000 to retire, you need to save $59,000 per year to get there. Perhaps I’ll recreate the chart using 5% real returns and use it for a post some time.

The One Thing I Learned

Given that I’ve read dozens and dozens of similar books, it is very rare that I truly learn more than one or two new things about personal finance or investing while reading them. The law of diminishing returns and all that. The thing I never really knew before reading this book was an additional benefit of donating tax-deferred accounts to charity at your death. Not only do you get to avoid the income taxes (Uncle Sam’s portion) and the estate taxes due on that money, but you get the additional decrease in the size of your estate by donating Uncle Sam’s portion of that account. I had never really considered that before. So if you have an estate tax problem, give the heirs the Roth and the taxable account, and give the tax-deferred accounts to charity. I’ll probably never have that issue, but some of you will.

A Criticism

Charley Ellis is a big fan of the 100% stock portfolio. While it is most likely that a 100% stock portfolio will be the highest performing portfolio, behavioral issues prevent that from being the highest performing portfolio for most individuals. I think he could have spent a little more time discussing the merits of bonds in the book. It reads a little too much like Stocks For The Long Run in that respect.
All that said, it’s a fantastic book. If you haven’t already read a half dozen books on the same subject, I highly recommend it. Buy your copy of *Winning The Loser’s Game* today!

Have you read it? What did you think? Comment below!

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**Where to Open Your Solo 401K**

I’m a huge fan of [Solo 401Ks](#) for self-employed physicians. You can max it out ($52K in 2014) on less income than a SEP-IRA, you can get a Roth option in it, and you can still have [Backdoor Roth IRAs](#) on the side. If you’re an S Corp, the ability to max out the Solo 401K on less income allows you to declare more of your income a dividend (and thus less as salary) saving you even more in Medicare tax. (I wouldn’t recommend trying to get your income low enough as a physician that you’re going to save any Social Security tax.) The paperwork for establishing and maintaining a Solo 401K is slightly more difficult than a SEP-IRA, but still no big deal.
Solo 401Ks also sometimes offer a loan option, like other 401Ks, but which you cannot get in an IRA, SEP or otherwise.

However, the question of where to open a Solo 401K isn’t nearly as straightforward. My normal default in questions like these is to go to Vanguard (and I did). However, this decision isn’t the “no-brainer” that going to Vanguard usually is. Like the Vanguard brokerage, the Vanguard Solo 401K has some issues.

Which Brokerage is Best For Opening a Solo 401K?

Vanguard

The Vanguard Individual 401K offers the Roth 401K option and all of the Vanguard mutual funds. However, there is no brokerage option, so buying ETFs, even Vanguard ETFs, and mutual funds from other fund companies isn’t an option. You cannot even get Vanguard’s less expensive Admiral shares, just the admittedly slightly more expensive investor shares. The Vanguard Individual 401K also doesn’t accept incoming IRA rollovers, an important issue if you have a large traditional IRA you would like to rollover to a Solo 401K in order to allow Roth IRA contributions through the backdoor. There is also no loan option if that is important to you.

Fidelity

The Fidelity Self-Employed 401K Plan has a brokerage option (through which you can buy Vanguard and other ETFs) and its low-cost Spartan index funds. However, I have been told it has no Roth option, although the plan document doesn’t say that. [Update: Fidelity has confirmed to me that they do not have a Roth option for their individual 401(k).] It does, however, accept incoming rollover IRAs, so this is a great
option if you need to do that in order to start doing Backdoor Roth IRAs. Fidelity also offers 401K loans [Update: A reader has assured me that Fidelity most certainly DOES NOT offer 401(k) loans.]

**Schwab**

The _Schwab Individual 401K Plan_ allows you to buy Schwab funds/ETFs for free and Vanguard ETFs for $8.95 per trade. They do not allow loans, but the plan document does state that a Roth option is available. To add to the confusion, the plan document states you CAN take out loans. [Update: A reader called Schwab- the Roth option is not available despite what the plan document says.] It seems to accept 401K/403B/457 rollovers, but not IRA rollovers. [Update 2/2017: I’m told by readers that Schwab now takes rollovers.]

**ETrade**

The _Etrade Individual 401K Plan_ allows Roth contributions and obviously has a brokerage option with $9.99 trades for any ETF. They accept IRA rollovers and allow for loans. They also will pay you if you transfer your current Solo 401K to them, $200 for $25K-$99K, $300 for $100K-$249K, and $600 for a $250K+ plus plan.

**TD Ameritrade**

The _TD Ameritrade Individual 401K Plan_ offers full brokerage services including a number of commission-free ETFs from Vanguard and Ishares. They have less information on the website than the other providers, so I am unsure as to the availability of loans, a Roth option, or whether or not they accept IRA rollovers.

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There are at least 13 other Solo 401K providers, but I’d recommend choosing one of these 5. Head to head, Etrade seems like the best overall option to me. Perhaps when my plan hits $25K I’ll roll it over and collect that $200.

If you are looking for more of a self directed 401(k) one option for you could be Rocket Dollar. They administer self-directed Solo 401(k)s and IRAs. Because it’s self-directed, you can buy real estate properties on your own or leverage RE crowdfunding platforms like Equity Multiple, RealtyMogul, Fundrise, Roofstock, CrowdStreet, etc.

What do you think? Where is your Solo 401K? Why did you choose that one? Comment below!

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**Your Small Practice 401K May Be Ripping You Off – Friday Q&A Series**

**Q.**

I’m a solo physician with several employees. We have a 401K/profit-sharing plan filled with expensive, actively managed mutual funds. We pay an adviser’s fee of 1% in addition to mutual fund expense ratios of 1-2%. I would like to reduce the fees by investing in something like Vanguard Target Retirement Funds, while still being able to max out ($51K) the account each year. I’m concerned the adviser, who is also our accountant, may be biased about this. What do you
First of all, your accountant/advisor is not only biased but is not acting as your fiduciary either. He is either ignorant of things he should be an expert about (i.e. that’s it’s not a good idea to invest in high expense actively managed mutual funds) or he is willfully milking you like a cash cow. If he exhibits a similar level of incompetence with regards to your accounting, you probably need a new accountant in addition to a new advisor.

Limited Options for 401(k)/Profit-Sharing Plans

Your options are limited because of your business set-up. If you were an independent contractor or didn’t have any employees aside from a spouse, you could use a low-cost Solo 401K or SEP-IRA from Vanguard. If you didn’t want to max out the account, you could use a SIMPLE IRA, again through a company like Vanguard. But since neither of those apply to you, you still need a 401K/Profit-sharing plan.
Top-Heavy Rules

Any time you have employees, you have to be very careful about the top-heavy rules. The government has these in place so you can’t have a retirement plan for the owners without providing one for the employees. A defined contribution plan is defined as “top-heavy” when key employees have more than 60% of the assets in the plan. A key employee owns more than 5% of the company, owns more than 1% and makes more than $150K per year, or is a key officer and makes more than $165K per year. In a typical practice, the docs are “key employees” and everyone else is not. Given your very small number of employees, typical employee retirement contributions, and your desire to maximize your own contributions, your plan will almost surely be considered “top-heavy.”

If you are top-heavy, you have to provide a minimum contribution to your employees as an employer match. In your case, that amount is probably going to be 3% of their total compensation. You may be able to exclude part-time employees and those who have been with you for less than a year from the plan, depending on how your plan is drawn up.
Better 401K Provider

What you need (aside from a new advisor and possibly a new accountant) is a new 401K provider. Perhaps the best one out there right now for a small business like yours is provided by a firm called Employee Fiduciary. This company has been written about by Allan Roth, one of the good guys in the business. He also refers to an article by another good guy, Daniel Solin, calling for 401K reform. Basically, Employee Fiduciary charges low fees and provides good investments. They’re not mutually owned like Vanguard, but they’re nearly as cheap, and besides, Vanguard won’t work with a tiny business like yours.

Employee Fiduciary has very low fees, $500 to start a new plan or for you, $1000 to convert an old plan. You would then pay $1500 a year (plus $30 a year for each employee above and beyond the 30 employees that the $1500 covers) plus 0.08% of assets under management. You wouldn’t get the advice you’re getting now from your advisor, but as near as I can tell, you can’t pay too little for bad advice anyway. You have access to pretty much any investment you desire to put into the plan, including funds from 377 fund families (including Vanguard), all the ETFs on the market, or even a brokerage window run through TD Ameritrade (the same one used by HSA Bank). So all in, it’ll cost you $1000 to change plans, then $1500 a year. Beyond that, you’ll pay 8 basis points to Employee Fiduciary and less than 20 basis points to Vanguard each year. That’s about as cheap as 401K plans get. You can use your current advisor, hire a new one, or not use one at all if you prefer, but any advisory fees you choose to pay will be above and beyond these fees.

Readers, what do you think? Have you reformed your 401K? Have you used Employee Fiduciary? What’d you think? Any other low-cost 401K providers you can recommend? Comment below!
The At-Cost Cafe’

Regular readers know I’m a huge Vanguard fan boy. No organization is perfect, but Vanguard stands alone as a mutually owned mutual fund company that essentially operates at cost for the benefit of the shareholders. They’ve come up with a new way of taking this message to the masses recently with their “At-Cost Cafe’.”

The Cafe’ is a big van driving around the country selling premium coffee for $0.26 a cup, which, coincidentally is 1/5th of the average cost of that cup of coffee across the country ($1.45 a cup). The message is that just as they’re selling coffee at ridiculously cheap rates, they are selling mutual fund management at ridiculously cheap rates.

Vanguard states their average mutual fund expense ratio is 0.19% a year (pick the right funds and yours can easily be half that.) The average mutual fund expense ratio across the industry is 1.11% (which is probably far lower than it would be without Vanguard in the industry keeping the rest of them honest.) I thought this might be a good opportunity to talk about how costs matter in investing.
The Lower The ER, The Higher The Return

If you invest $30,000 a year for 30 years into investments that make 8% a year before expenses, the different between an ER of 0.19% and an ER of 1.11% is a difference of $569K ($3.54 Million vs $2.97 Million).

The Latte’ Factor

If you also choose to buy your 2 cups of coffee a day at the At-Cost Cafe for $0.26 each, that means you’ll save $2.38 a day, or $869 a year. If you also invested that in low-cost Vanguard funds, you’d have an extra $103K.

Lower Costs Predicts Future Out-Performance

There have been many studies that have tried to figure out how to choose mutual funds that are likely to outperform their peers in the future. The most persistent finding in these studies is that the single best predictive factor is a low expense ratio. Asebedo and Grable found that:

“Below average expense ratios led to top 30% results. This finding has significant implications for investors and financial planners. Funds that outperformed in the sample were consistently those with lower than average expense ratios. This persistence in returns held true during the stock market pre-bubble stage (1995 through 1998), the irrational exuberance stage (1999 through 2000, the cyclical bear market stage (2000 through 2002), and the significant market upturn of 2003. The finding related to expense ratios supports the conclusion of Dellva and Olson (1998) who stated, “Funds with superior performance, on average, also have lower expense ratios” (p. 100). Although past performance is no guarantee of future returns, it is reasonable to assume that this trend may continue into the future (Carpenter & Lynch, 1999)….Until further research is conducted on this topic, investors should remember the advice
of Phelps and Detzel (1997) who declared “it does not appear that there is a reliable strategy for selecting funds expected to have superior future performance, other than to avoid funds with high expense ratios.”

It’s easy to avoid funds with high expense ratios when shopping at Vanguard. They don’t offer any. Keeping costs low is one of the key principles of investing success. Vanguard can help you do that.

What do you think? Do you invest using Vanguard mutual funds and ETFs? Why or why not?

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**DFA Vs Vanguard**

I’ve been getting a lot of questions lately about the passive mutual funds available through an advisor from Dimensional Fund Advisors (DFA), especially in comparison to the index funds available through Vanguard. There aren’t a lot of “good guys” out there amongst the dozens of mutual funds companies on the planet. Bridgeway donates half of it’s profits to charity. Charles Schwab, Fidelity, and Ishares offer a number of very low cost index funds and ETFs, although critics argue only because of the pressure from mutually-owned Vanguard. But two firms stand out amongst the others for their real commitment to passive investing, Vanguard and DFA. Most of you are familiar with Vanguard, a long-time champion for the do-it-yourself individual investor. You may not be as familiar with DFA, which although not as low-cost as Vanguard, and offered only through investment advisors, also offers a lot of great investment options which in many cases are better than Vanguard’s offering.
What Does DFA Do That Vanguard Doesn’t?

Index funds are great. Actually, they’re not great, but they’re so much better than actively managed funds due to their low costs and lack of underperformance that they look great in comparison. Like democracy and capitalism, they’re the worst possible system, except everything else that’s ever been tried. Indexing has its issues, and DFA has made a concerted effort to improve upon index funds without abandoning their most important aspects.

I had the opportunity to interview Weston Wellington, a vice president with DFA about the “DFA advantage.” Weston is a very reasonable and intelligent guy as evidenced by his careful phrasing and humility about what DFA does, and does not do. They do a lot of things very similarly to the indexers at Vanguard- i.e. invest passively (although he hates that phrase because it implies he isn’t doing anything, preferring instead the word “equilibrium”) and keep costs low. But I’m going to focus on the differences.

The most significant thing that DFA and its network of authorized advisors do is to tilt portfolios toward small and value stocks. These higher risk stocks have higher expected returns. You can tilt a portfolio of non-DFA index funds to small and value easily enough, but many do-it-yourself indexers don’t whereas very few users of DFA funds don’t have a significant tilt to these risk factors. The research cited by DFA is that 96% of equity returns are explained by market, value, and small factors. The new “profitability” factor added on top of that is likely to add a small amount of additional value, although Mr. Wellington didn’t want to be quoted about how big he thought that was likely to be. I asked him whether he felt the additional expected return with small, value, and profitable stocks was a “risk story” (i.e. small, value, and profitable stocks are riskier and thus carry higher expected returns) or a “free lunch” (i.e. diversification to additional
risk factors actually makes the portfolio less risky). Weston was decidedly in the “risk” camp emphasizing that the future may very well not resemble the past and the risks of small, value, and profitable stocks may very well show up in the future and provide lower than market returns over a long time period.

Aside from tilting toward additional risk factors, DFA also does a number of “little things” that give their funds a bit of an edge over a comparable Vanguard fund. They like to divide these up into management, engineering, and trading. The management refers to designing an “equilibrium” (i.e. passive) portfolio so it is appropriately tilted to compensated risk factors. Engineering refers to applying their eligibility rules for a given fund. For example, they exclude REITs from their small cap value fund, arguing that they are essentially different beasts and a different asset class. Another eligibility rule they use is that they don’t buy stocks unless that stock has at least 4 market makers. They also do not let an outside provider (such as a commercial index) dictate what stocks they should hold. Tracking error against an index doesn’t bother these guys. Rather than reconstituting quarterly or yearly as many indexes and the funds that follow them do, they do it each day as stocks increase or decrease in value. DFA uses its “core funds” to further decrease turnover costs. Trading refers to their patient trading philosophy. They use buffer zones to so that they can trade smartly, minimizing trading costs. They try to be providers of liquidity rather than paying a liquidity premium. Along those same lines, they do security lending (lending securities to short sellers) to further boost returns.

DFA also tries to minimize turnover within the fund by forcing their investors to use some of the most highly-educated advisors out there. Many of them are CFAs, essentially the highest designation for an asset manager, and they have
attended a number of seminars so they understand the academic research and exactly what DFA is trying to do. Their theory is that an investor guided by an advisor is less likely to be trying to time the market by jumping in and out of the funds and less likely to bail in a down market, minimizing costs and boosting performance for the fund. DFA actually started out investing only institutional money, but started bringing on individual investors only because of the guarantee from advisors that they wouldn’t get “hot money.”

**So How Does DFA Do?**

A number of smart individual investors have wondered whether it is worth it to hire a DFA authorized advisor just to get access to DFA funds. They’ve tried to do their best to compare apples to apples using a similar collection of non-DFA funds to DFA funds and tried to determine just how big the DFA advantage is, especially AFTER the cost of the advisor. Obviously for an investor who values the other services of the advisor, that may not be a fair comparison. I’m convinced that for some investors, they’d be better off paying an advisor 5% a year than doing it on their own. But for the intelligent investor with a reasonable demeanor, is it worth hiring an advisor JUST for access to the DFA funds? This question becomes more and more relevant as advisory fees drop, sometimes as low as $1000 a year from a firm like FPL Capital (one of my advertisers) or Rick Ferri’s Portfolio Solutions (as low as 0.37% a year with a minimum of $3700 per year). More traditional firms tend to charge around 1% a year for assets under management.

For some asset classes, such as large US Stocks, DFA doesn’t seem to make much of a difference. DFA’s large company fund (DFUSX) is very similar to Vanguard’s 500 fund (VFIAX), although it charges a slightly higher expense ratio (10 basis points vs 5 for the Vanguard fund). The performance difference? According to Morningstar, DFUSX has had an average annual return (arithmetic) of 7.96% per year for the
last ten years, compared to 7.94% per year for the Vanguard fund. Am I going to pay 0.37%, much less 1% to get DFA access to that fund? No way. For other asset classes, however, the difference is larger.

Some of the Bogleheads and a number of DFA authorized advisors have tried to make comparisons between the two, but in the quest to compare apples to apples, the results tend to differ enough due to different methodology that it’s hard to get an exact answer. Altruist Financial Advisors has a discussion of DFA vs Vanguard (and some recommendations for each asset class) on their site. FPL Advisors, one of my advertisers, has something similar on their site. Rick Ferri and Larry Swedroe, other well-known authors and DFA authorized advisors use both DFA funds and funds from other companies like Vanguard and Bridgeway in their portfolios. Tom Martin, at Larson Financial Advisors, gives clients a comparison sheet which can give you some idea of the size of the “DFA advantage”. This is my attempt at a comparison.

**DFA Vs Vanguard**

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<td>DFUSX</td>
<td>0.10%</td>
<td>VFIAX</td>
<td>0.05%</td>
<td>7.96%</td>
<td>6.96%</td>
<td>7.94%</td>
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<tr>
<td>US Small Stocks</td>
<td>CRSP US Small Cap</td>
<td>DFSTX</td>
<td>0.37%</td>
<td>VSMAX</td>
<td>0.10%</td>
<td>11.42%</td>
<td>10.42%</td>
<td>11.73%</td>
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<td>US SCV Stocks</td>
<td>CRSP US SCV</td>
<td>DFSVX</td>
<td>0.52%</td>
<td>VSIAX</td>
<td>0.10%</td>
<td>12.16%</td>
<td>11.16%</td>
<td>10.87%</td>
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<td>Microcap Stocks</td>
<td>CRSP 9-10</td>
<td>DFSCX</td>
<td>0.52%</td>
<td>BRSIX</td>
<td>0.87%</td>
<td>10.87%</td>
<td>9.87%</td>
<td>9.59%</td>
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<td>Intl Developed LC</td>
<td>FTSE Dev Ex-NA</td>
<td>DFALX</td>
<td>0.30%</td>
<td>VDMAX</td>
<td>0.10%</td>
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<td>7.94%</td>
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<td>Intl Small</td>
<td>FTSE Global SC Ex-US</td>
<td>DFISX</td>
<td>0.56%</td>
<td>VFSVX</td>
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<td>10.12%</td>
<td>9.42%</td>
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<tr>
<td>Asset Class</td>
<td>Index/Fund Details</td>
<td>DFA Fund</td>
<td>Vanguard Fund</td>
<td>10 Year Avg Return</td>
<td>10 Year Avg Return</td>
<td>10 Year Avg Return</td>
<td></td>
<td></td>
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<tr>
<td>---------------------------</td>
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<td>Emerging Markets</td>
<td>FTSE Emerging Index</td>
<td>DFEMX</td>
<td>VEMAX</td>
<td>0.61%</td>
<td>0.18%</td>
<td>15.99%</td>
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<td>US Real Estate</td>
<td>MSCI US REIT</td>
<td>DFREX</td>
<td>VGSLX</td>
<td>0.18%</td>
<td>0.10%</td>
<td>12.14%</td>
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<tr>
<td>TIPS</td>
<td>Barclays Series L TIPS</td>
<td>DIPSX</td>
<td>VAIPX</td>
<td>0.13%</td>
<td>0.10%</td>
<td>6.17%</td>
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<tr>
<td>Corporate Bonds</td>
<td>Barclays 5-10Y Credit</td>
<td>DFAPX</td>
<td>VFICX</td>
<td>0.22%</td>
<td>0.20%</td>
<td>2.92%</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>ST Federal</td>
<td>Barclays 1-5Y Gov</td>
<td>DFFGX</td>
<td>VSGDX</td>
<td>0.20%</td>
<td>0.10%</td>
<td>3.14%</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

I tried to be as fair as I could with the data and compare apples to apples as much as possible. Ten year average annualized returns as reported on Morningstar on 5/15/13 were used wherever possible (Intl small used 3 years, corporates used 1 year). When looking at the asset classes where the DFA and non-DFA portfolios are very similar (US Large, Intl Small, EM, Real Estate, and TIPS), DFA won 2, non-DFA won 2, and we’ll call US Large a tie. Subtract a 1% management fee, and the non-DFA funds handily win 4 out of 5.

**Apples and Oranges?**

Some of the portfolios are fairly different, for example the average stock in the DFA Small Cap fund is half the size of the one in the Vanguard fund. Likewise, the average stock in the DFA Micro Cap fund is over 3 times the size of the one in the Bridgeway fund and the Bridgeway fund is far more valuey. Vanguard’s SCV fund is nearly as valuey as the DFA fund, but not nearly as small. The DFA international developed fund includes Canada, but the Vanguard one does not. This makes the comparison difficult.

I asked Mr. Wellington about quantifying the DFA advantage. He points out that over the last 31 years DFA’s small cap fund has outperformed the Russell 2000 by 165 basis points (1.65%).
a year but he is careful to note that may not persist. He admits the advantage may be much lower in other asset classes. As noted above, much of that 1.65% may be explained simply by the fact that the DFA fund holds much smaller stocks than the Russell 2000.

**Entire Portfolio**

What about the entire portfolio? If I made two portfolios using these asset classes, one composed of the DFA funds and one composed of the non-DFA funds, I could figure out what the “DFA advantage” really would be. A priori (just like I chose the asset classes above), I decided my asset allocation would be 15% US Large, 5% US Small, 5% US Small cap value, 5% microcap, 10% international developed, 5% international small, 7.5% emerging markets, 7.5% real estate, 15% TIPS, 10% corporates, and 15% Federal bonds, for a 60/40 portfolio where 37.5% of the equity is international. I then calculated the DFA advantage. I calculated it out to be a MINUS 0.04%, or essentially a tie. That was before any advisory fee, but any advisory fee you add on is going to make the DFA portfolio look even worse.

**There’s No DFA Advantage?**

Well there could be. If your portfolio was more heavily tilted toward those asset classes where DFA seems to do very well, like small cap value, international small, EM, and TIPS, then there would be. Your advisor may also choose to use non-DFA funds where they appear to be superior. But certainly any reasonable interpretation of the data would not justify a statement that DFA funds were dramatically better than the alternatives, and certainly not sufficiently superior to justify the hiring of an otherwise unvalued investment advisor. However, if I were going to hire an investment advisor anyway (I’m not of course), I would definitely make sure said advisor had access to DFA funds. Not only would
that give me access to those funds, but it would also ensure my advisor was reasonably well-educated with regards to the academic investing literature and knew the importance of developing a good plan and staying the course with it.

I asked Mr. Wellington directly whether a disciplined, educated do-it-yourself investor should hire a DFA-authorized advisor just to get access to the funds and his answer was an emphatic no. He based his argument on philosophical factors, however. He felt that if the only reason you were hiring an advisor was to boost performance by access to better funds, and didn’t value the other things the advisor brought to the table, like portfolio design, maintenance, and what diehard do-it-yourselfers like to refer to as handholding, then every time you met the focus would be on “performance, performance, performance” and that the relationship wouldn’t be very satisfying to either of you, especially when the inevitable, hopefully temporary, underperformance versus a do-it-yourself portfolio occurs.

I also asked if they’d ever consider allowing individual investors direct access to the funds. He noted they weren’t staffed to service individual investors directly and also that he felt the number of individual investors out there who had the knowledge and temperament to manage their own portfolio were so few that it wasn’t worth it, pointing out that “even Tiger Woods has a golf coach. Most investors just can’t sit still and get market returns.”

So in the end, if you are an educated and disciplined investor, don’t go out and hire an advisor just to get DFA funds. There is probably an advantage there, especially in certain asset classes, but it isn’t large enough to pay for the advisory fees by itself. But before you decide to do it on your own, you’d better be sure you’re sufficiently educated and disciplined to implement and maintain an intelligent portfolio over the long run.
What do you think? If DFA funds were available without any advisory relationship which ones would you use? Have you considered hiring an advisor to get access to DFA funds? Comment below!

Could There Be A “Good” VUL Policy?

Long-time readers will probably notice I’ve become less dogmatic in some of my writing over the last two years and softened my tone considerably on several subjects. For example, although I still think the vast majority of self-styled “financial advisors” are thinly-veiled salesmen, I’ve gotten to know a few that offer good advice at a fair price. Although I think few people should ever use a whole life insurance policy, I’ve run into a few people who actually understand the product AND are still happy they purchased it for various reasons. I can even seen a place for reverse mortgages, despite widespread abuse among those selling them. However, one product I thought I would NEVER see a use for is variable universal life (VUL) insurance. Over the last couple of months, however, I’ve had a number of readers contact me with questions about a VUL being sold by Larson Financial Advisors. It seems this particular product addresses many of the concerns with VUL that I’ve outlined before. It is enough to make me wonder if VUL really might have a place in a retirement “quiver” for at least some physicians.

Any Financial Product Can Be Bad

The truth is that just about any financial product can be made terrible through design features that benefit the product
designer and salesman rather than the consumer. Consider the investment that makes up most of my retirement portfolio—mutual funds. If the only mutual funds available had an 8% load, a 2% ER, 12B-1 fees, surrender charges, horrible active management, and a high turnover rate, then it would be easy to argue that investors should avoid mutual funds altogether. However, thanks to Jack Bogle and others, an investor can now buy every stock in the world in seconds with essentially zero turnover, no fees, and an expense ratio less than 10 basis points.

What is Variable Universal Life Insurance?

VULs came out in the 1980s and 1990s when whole life insurance buyers and sellers realized that the relatively low returns available in whole life were getting creamed by stock market investors. Like with whole life insurance, it has a permanent death benefit along with a cash value component. The money grows inside the cash value account tax-free, and then in retirement the money is borrowed from the policy so it can be spent. Upon death, the death benefit pays off all the loans taken (and still provides a bit of money tax-free to the heirs.) Depending on your state, there may also be significant asset protection benefits for this money, and depending on estate tax laws in place at your death (and the liquidity of your estate) there may be estate tax benefits as well. Unlike whole life insurance where the cash value never goes down and is credited yearly with a dividend by the insurance company, with a VUL the investment component is invested in mutual fund-like subaccounts, and the value rises and falls with the market. The theory is that the long-term returns will be higher but you’ll still get the tax-free growth, asset protection, and death benefit. Stock market returns with life insurance benefits, what’s not to like?

So Why Doesn’t Everyone Have One?

The problems with investing in a VUL are basically three-fold-
the investments suck, the insurance is too expensive, and insurance policies aren’t designed to be retirement savings accounts. Imagine the worst possible mutual fund, and that’s typically what you’ll find in a VUL sub-account—poor performance, high fees, and maybe even loads. The worst part is you have nowhere else to go. Instead of having thousands of funds to choose from, you may be stuck with only 5-10, although most newer policies over 50 or even 100+.

The insurance is also too expensive, mostly due to fees. These suckers are typically loaded up with so many fees it’s almost impossible to have a positive return. Aside from the ongoing fees, there is usually a surrender charge for the first few years (sometimes for as long as a decade.) The insurance company doesn’t want to lose money even if you surrender the policy, and since it’s already paid the commission to the salesman, it has to get that money back somewhere. To make matters worse, since every policy is different, it isn’t a particularly efficient market, and the insurance itself simply isn’t sold at a competitive price.

In order for a VUL to qualify for the tax-free growth and tax-free loans, it has to at least masquerade as life insurance. That means you can’t cash it out without paying taxes on the gains. There has to be a death benefit. There are limits as to how much you can contribute for any given death benefit. You must pay interest on any loans you take out etc. Insurance isn’t free, and money used for the insurance portion can’t be invested on your behalf.

When you consider all of these issues with a VUL policy, the tax, insurance, asset protection, and estate planning benefits just can’t make up for all the costs and you end up with a severely under-performing investment that becomes even worse if you want to get rid of it.

What If There Were A “Vanguard” of VULs?
Just because the typical VUL sucks, doesn’t mean it isn’t possible to have one that might be worth buying for some people. What would that VUL look like? Is it possible for the costs to be kept low enough that the tax benefits would outweigh them? I don’t know but I’d love to see the equivalent of the constant lowering of total market ETF expense ratios we’ve seen over the last 5 years from the mutual fund industry.

12 Requirements To Buy A VUL

Here are twelve requirements I’d have before considering a VUL:

1) Excellent investment options – Remember you’re stuck with these options for decades. If something better comes along in the investment world, you’re just out of luck. So you’d better hope that the investment options are at least the best available options at the time of purchase. That means low-cost passive investments such as those offered by Vanguard, DFA, and similar companies. It would be even better if there were a brokerage option where I could purchase investments in the future that aren’t even available today.

2) Low cost investments – No loads, no additional fees, low turnover, and a low expense ratio.

3) Competitively-priced insurance – Permanent insurance is naturally going to cost a lot more than term insurance, but is it too much to ask that the insurance be as cheap as actuarially possible? This is probably easiest for a mutual insurance company to offer, since like Vanguard, their owners are their policy holders.

4) No surrender charges – Something like 80% of people cash out of their permanent life insurance policies in the first decade, guaranteeing a loss. There is certainly no point in investing in a cash value life insurance policy if you’re not planning on holding the policy until death. If you cash out
early, you’ll lose money. If you cash out late, your gains will be taxable and you’ll lose the death benefit. But if you’re truly offering an excellent product to well-informed, appropriate consumers, very few people ought to be surrendering their policies in that first decade. You shouldn’t have to stick them with a surrender charge in order to guarantee your ability to pay commissions.

5) Low (no?) commissions – Speaking of commissions, if we can have no-load mutual funds, why not no-load insurance policies. Agents like to point out that the consumer doesn’t pay them, the insurance company does, but who are we really kidding here? All expenses including company profits are paid by the consumer in some way or another.

6) Zero percent interest – Since the point of this policy is to act as an investment, and you know that to access your money eventually you’re going to have to take out a loan, why can’t that loan be offered at 0%? It would be direct recognition (I don’t think this term is even used with VULs) so the money you’re borrowing is no longer invested in the policy, but why should you have to pay the company interest to borrow your own money? Even if 0% interest is impossible, let’s see how close we can get to it shall we?

7) Overfunded policy, paid annually – Again, the point of the policy is to act as an investment. You want to be able to contribute as much as possible to the investment component while spending as little as possible on the insurance component. That means funding it up to the “MEC line” and paying annually, or at least not penalizing the policyholder with higher premiums for paying it monthly.

These last 5 requirements have more to do with the purchaser than the policy, but they would still be requirements for me to recommend one for someone.

8) Insurable at a reasonable price – I’m probably never going
to invest in a life insurance policy because the costs of insuring climbers are just too high. The same issue exists for those with health problems. Mixing investing and insurance usually doesn’t make sense for most people, but for some people, it NEVER makes sense.

9) Maxed out retirement plans – Remember that a very low cost VUL MIGHT make sense when compared against a taxable account, but when you’re comparing it against a solid 401K or Roth IRA, it just isn’t going to hold up. If you haven’t maxed those out, it’s frankly pretty stupid to even look at a VUL.

10) High dividend/capital gains tax rate – Dave Ramsey likes to call cash value insurance the “payday lender of the middle class.” The tax benefits are just dramatically less if you’re not paying much in tax anyway. If you’re in the 10% or 15% bracket, your capital gains rate is 0%. If you’re under $200K, your rate is only 15%. That goes as high as 23.8% for an individual with a taxable income over $400K. If you’re investing in something that is highly tax-inefficient, like corporate bonds or REITs, your marginal tax rate could approach 50%. That’s when the tax benefits of a VUL might make up for the costs of the insurance.

11) High value placed on asset protection, estate planning, or the death benefit – Life insurance can offer many benefits, but the fewer of these you care about the less benefit you are likely to get from investing in life insurance. If your state has a low (or no) exemption for life insurance cash value from your creditors, that aspect is useless. If you have no liquidity issues, or are nowhere near the $5M ($10M married) estate tax exemption, the estate planning aspects don’t do you any good. Likewise, if you don’t really care about the death benefit, why pay for it?

12) The alternative is paying an AUM fee – If you’re working with an asset manager to whom you are paying an AUM fee, then a VUL becomes more attractive. The advisor would get paid by
the commission you’re paying anyway (at least until someone comes out with no-load insurance) and you’d save the AUM fee you’d otherwise pay on those assets.

Not For Me

I’m not going to invest in even a perfect VUL. Between my 401K/profit-sharing plan, defined benefit plan, backdoor Roth IRAs, stealth IRA, individual 401K (for the blog) and other investments I want to make in 529s, UGMAs, and a taxable account (like real estate) I just don’t have the money to put in to anything else. The insurance component of any product would be too expensive due to my bad habits. I also don’t place much value on the asset protection, estate planning, and death benefit of permanent insurance and dislike the lack of flexibility inherent in an investment that must be held for decades. I also find a taxable account an exceedingly attractive alternative. Thus far in my life, a taxable account has LOWERED my tax bill rather than raised it, thanks to tax-loss-harvesting and donating appreciated shares to charity. I’m in a relatively low tax bracket (actually got down into the 25% bracket last year, last time I’ll see that for a while) and I don’t pay an asset manager. It just doesn’t make sense for me.

But I’ve met enough doctors in real life and on the internet whose financial lives are sufficiently different from mine that they could possibly benefit from a really good VUL. Check the example below to see how it might benefit some people.

The Math

How does this work? Let’s use a hypothetical example. Let’s assume you put $30K a year into a perfect VUL policy over 30 years, and $3K of that goes toward insurance costs. It provides the same investments available to you in a taxable account (let’s say they gain 8% a year) and you’re in the top
tax bracket now and in retirement, let’s say dividend and long-term capital gains rate of 23.8%. You then borrow the money out at 0% in retirement. After 30 years, the cash value in the policy would be $3.06M. Now, let’s compare that to a taxable account. We’ll assume the investments are fairly tax efficient, perhaps a yield of 2% taxed at 23.8%, lowering your rate of return to 7.52% per year. After 30 years, you pull all the money out and pay capital gains taxes at 23.8% on it. You end up with 2.37M, $690K less. You also don’t get the asset protection and estate planning benefits (if any), and the death benefit.

This whole post has been mostly hypothetical to show that a really good VUL could be a good idea for certain investors. Whether the policy being marketed by Larson Financial is really good or not remains to be seen. I’ve sent a draft of this post to Tom Martin, their main investment guy, and asked him to submit a guest post about it. Then we can see how close it comes to an “ideal” policy and readers can decide if something like that makes sense for a portion of their retirement money. For the rest of us, we’ll continue to not mix insurance and investing.

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Vanguard ETFs Vs Mutual Funds- Friday Q&A Series

Q.

In terms of Vanguard, are the ETFs really any cheaper than an admiral share mutual fund? I’m not sure the ER could really get any lower than 0.1%. I’d like to get in a pattern where my monthly contributions are being directed into funds on a
routine basis. Is a mutual fund better in this regard? I haven’t used ETFs before. When using Vanguard funds, should I be using the ETFs or traditional mutual funds?

A.

The quick answer is that it doesn’t matter. Many novice investors who learn a little more about the importance of keeping costs low are shocked to find out they’re paying 2-3% or more per year to invest. Advisor fees, high mutual fund expense ratios, and poorly disclosed 401K fees can add up quickly. But once you’re getting expenses down below 0.25%, the law of diminishing returns quickly kicks in. Since most Vanguard index funds have expense ratios in this range, it just doesn’t matter much whether you use an exchange-traded fund (ETF) or a mutual fund. I actually use both, depending on the situation.

**Where I Use ETFs**

I use ETFs in my 401K, which is basically a Charles Schwab brokerage account with an extra $200/year fee. At Schwab, the Schwab ETFs are traded commission-free, and Vanguard ETFs are subject to a low $8.95/trade fee. If I used Vanguard mutual funds, I would have to pay $76 each time I bought ($0 to sell). So for $58 less per round trip, I’m willing to put up with the hassle of using the ETF.

**Where I use Mutual Funds**

With my personal and spousal Vanguard Roth IRAs, I prefer using the mutual funds. My account balances qualify for admiral funds, so there’s no difference in expense ratios, and using the funds allows me to buy, sell, and rebalance when markets aren’t open, which is much more convenient for me.

**Comparing expenses**
Let’s take a look at the actual expense ratio difference between the commonly-used share classes at Vanguard.

<table>
<thead>
<tr>
<th>Fund</th>
<th>Investor</th>
<th>Admiral</th>
<th>ETF</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total Stock Market</td>
<td>0.18%</td>
<td>0.06%</td>
<td>0.06%</td>
</tr>
<tr>
<td>Total International Stock Market</td>
<td>0.22%</td>
<td>0.18%</td>
<td>0.18%</td>
</tr>
<tr>
<td>Total Bond Market</td>
<td>0.22%</td>
<td>0.10%</td>
<td>0.10%</td>
</tr>
<tr>
<td>REIT Index</td>
<td>0.24%</td>
<td>0.10%</td>
<td>0.10%</td>
</tr>
<tr>
<td>Small Cap International Index</td>
<td>0.50%</td>
<td>None</td>
<td>0.28%</td>
</tr>
</tbody>
</table>

As you can see, Vanguard sets the admiral and ETF expense ratios at exactly the same level. The ETFs, however, must be bought and sold on the open market, so there are some bid-ask spreads you are also paying when you buy and sell. You may also find yourself buying at a higher or lower price during the day than you’d get just putting in a mutual fund buy order which always transacts at the close of day prices. ETFs give you more control, but also more hassle.

A special case can be made for newer Vanguard funds that don’t have an admiral class yet, or those funds which have a buy/sell fee. The Small Cap International Index fund, for instance, has no admiral shares AND is subject to a 0.50% buy/sell fee. For this reason, I’ve moved that fund to my 401K and buy it as an ETF share. I’d rather pay $8.95 to buy/sell and have half the ongoing expense ratio than pay 0.50% to buy and sell along with an ER of 0.50% each year.

For someone with enough money to get the admiral shares (generally $10K per fund) that wants to minimize hassle, there’s absolutely nothing wrong with using the traditional mutual funds at Vanguard. It is much easier to automate mutual fund buying than ETF buying so the investor looking to minimize hassle should usually choose the traditional mutual fund.
Short Term Savings – Friday Q&A Series

Welcome to the first installment of the Friday Q&A series which I hope to make a regular feature. I often get specific questions by email or on internet forums that I know other people out there have. I’ll try to use them (obscuring personal information obviously) for your education.

Question:

I have about 100k sitting in a savings account for a down payment on a house for when I do eventually move. I don’t know when a spot will open up [in this group I’m hoping to join.] I imagine it could be anywhere from 6 months to 3 years. I know I should at least put the money into an online savings account, but is there something that would be better, like some type of short term bond fund at Vanguard? I know I obviously don’t want it near the stock market.

Answer:

It’s all about the risk/reward ratio. You can’t expect more than about 1% risk-free. I think my Ally Bank savings account is paying 0.95%. That’s where I keep my emergency fund, but I might need that tomorrow. You could buy Ally’s CD that has no penalty for early withdrawal, but it only yields 0.92%. They’ll give you a 2 year “raise your rate” CD at 1.14%.
You might consider taking some risk with the money in hopes of a higher yield. Perhaps you could put 1/3 of it into an Ally Savings account, 1/3 into a lower risk bond fund such as Vanguard’s Short Term Investment Grade (corporate bonds) Fund which has a current taxable yield of 1.47%, and 1/3 into a riskier bond fund such as intermediate term bond index (yields 1.88%) or even a stock fund like Total Stock Market.

Obviously, once you get out of the guaranteed investments you not only have to worry about the return on your principal, but the return of your principal too. Your choice, but risk and (possible) return are linked. It’s possible (although fairly unlikely) that you could need the money at a time when bonds have lost 10% of their value and stocks have lost 50% of theirs.

Good luck with your decision. There’s nothing wrong with just leaving it in your checking account too. I mean, think about it. 0.95% of $100K is only $950 over a year. You’re not exactly leaving a ton of money on the table.

Agree? Disagree? Post your thoughts on how much risk to take with your short term savings in the comments section below.

Image Credit: Kalan, via Wikimedia, CC-BY-SA

What About Cheap Variable Annuities?
Paul, a frequent poster on the Bogleheads Forum, recently asked my opinion about Vanguard variable annuities (VA) for doctors and other highly paid professionals. As regular readers know, I generally recommend against mixing investing and insurance, as you usually end up with the worst of both. But the main argument against VAs is not that they are without advantages, but that the advantages cost way too much. By buying variable annuities through Vanguard, you can get them much cheaper. Perhaps then the advantages would be worthwhile enough to consider them in comparison to a mutual fund (MF) in a taxable account. Well, let’s analyze this a bit.

There are two main advantages to consider with a VA. First, they grow in a tax-deferred manner. You pay no taxes on them at all until you pull the money out of the annuity. Second, in many states they are an asset that receives protection from creditors, unlike your taxable brokerage account in which you might hold a more traditional MF.

There are really three factors to consider in comparing low-cost mutual funds and a low-cost VA.

**# 1 Cost of the VA versus the MF**

While most VAs will cost you 2-3%, or even more, Vanguard offers annuities for a total expense of around 0.5%. That’s still quite a bit more than most of its index funds with an ER of around 0.1% for the admiral versions, but at least they’re able to get close.
# 2 Tax-inefficiency of the Asset Class Held in the VA

The more tax-inefficient an asset class, such as nominal bonds, TIPS, or REITS, the more valuable the tax deferral available in the VA. Of course, when you pull the money out of a VA, all the gains are taxed as ordinary income, not at the more favorable capital gains rate. You also lose advantages of a taxable account such as a step-up in basis at death and the ability to tax-loss harvest.

# 3 Asset Protection Benefits of a VA

Every state is different, but in some states, (not mine), a VA is a retirement account and protected from creditors like an IRA or 401K. You never want the tax “tail” or the asset protection “tail” to wag the investment “dog”, but there is a real value to asset protection for most lawsuit-weary physicians.

Making the Comparison

Let’s first consider a tax-inefficient asset class, such as REITs. Let’s make a few assumptions. Let’s assume an 8% pre-expense and pre-tax return, which is composed 100% of fully taxable dividends. The Vanguard mutual fund (admiral shares) has an expense ratio (ER) of 0.1%. The Vanguard REIT VA has an expense ratio of 0.58%. Let’s assume this physician investor is in the 28% federal bracket and the 5% state bracket and invests $10,000 per year and liquidates the investment without penalty at the end of the period specified.

**After 1 year**

Mutual Fund $10,529  
Variable Annuity $10,497

**After 10 years**

Mutual Fund $134,239
Variable Annuity $134,434

After 30 years
Mutual Fund $794,698
Variable Annuity $832,448

This overstates the case for a REIT fund by a small amount, as some of those gains would be capital gains and taxed at a slightly lower rate in the mutual fund. It also ignores the benefits of more liquidity, tax-loss harvesting, and the step-up in basis at death. But as you can see, the benefit of the tax-deferral starts making up for the higher expenses and the higher tax rate at withdrawal of the VA after about 10 years. At 30 years, there is a clear advantage for this highly-tax-inefficient asset class, especially if you are benefiting from additional asset protection. (This all assumes, of course, that the decision is between a VA and a taxable account, NOT a 401K, IRA or other tax-protected account.)

What About A Tax Efficient Asset Class, like Stocks?

Next, let’s consider a very tax-efficient asset class held in a VA, such as the Vanguard Total Stock Market Fund. Again, we’ll make a few assumptions: An 8% pre-expense and pre-tax return, of which 2% comes from dividends taxed at 15% and 6% comes in the form of long-term capital gains, the same 33% marginal tax rate and the same $10,000 per year investment.

After 1 year
Mutual Fund $10,649
Variable Annuity $10,504

After 10 years
Mutual Fund $145,299
Variable Annuity $135,010
After 30 years
Mutual Fund $1,015,453
Variable Annuity $846,585

As you may notice, with a tax-efficient asset class, the VA never catches the MF. In fact, after 30 years, you’ve basically paid $169K for nothing but some asset protection. That seems pretty expensive to me.

Conclusion

Most investors, including high tax bracket investors like physicians, probably shouldn’t invest in even the low-cost Vanguard variable annuities over a taxable account. However, an exception can be made if you value the asset protection benefits highly, don’t have any room in your tax-protected accounts for a highly tax-inefficient asset class that you feel you really want to hold in your portfolio, don’t mind the loss of liquidity, don’t mind the loss of tax-loss harvesting ability, don’t mind the loss of the step-up in basis at death, and you have a long investment horizon. Since most doctors aren’t even maxing out their available retirement accounts, there’s little reason for them to consider even inexpensive VAs.

Why Vanguard?
If you’ve been around this blog for very long at all, you’ve probably noticed that I spend a lot of time discussing Vanguard, to the exclusion of other mutual fund and brokerage companies. If you don’t know why Vanguard is so special, this post is for you.

**Vanguard** was founded in 1975 by John C. (Jack) Bogle, being named after Admiral Horatio Nelson’s Flagship at the Battle of the Nile in 1798. It was founded after a dispute arose between Bogle and the members of the board of Wellington Management Company. He was on the board of the Wellington Management Company, but after irreconcilable differences arose between him and other members, he was forced to resign. He then went to the boards of directors of the funds administered by the management company, and by convincing them of the merits of a mutual mutual fund company, they gradually chose to move under the Vanguard umbrella. Since then, Vanguard has internalized the management functions, lowered costs and become the largest mutual fund company in the world.

**Mutual Ownership**

As the only mutually-owned mutual fund company in the world,
Vanguard has eliminated many of the conflicts of interest inherent in the structure of other mutual fund companies. At some companies, such as Fidelity, the fund management company is owned by private owners (the Ned Johnson family). The fund management company then administers the mutual funds, which are owned by the shareholders (you and me.) Obviously, the owners of the fund management company want to make some money. Guess where that profit comes from? Yup, you and me. At other companies, such as T. Rowe Price, the fund management company is owned by public investors, and its shares are traded on the stock market. Those investors also want to earn dividends and want their share values to go up. Guess where the money to do that comes from? You’re right again—from the owners of the mutual fund shares, you and me. So there is a significant conflict inherent in the structures of most mutual fund companies.

At Vanguard, the management company is owned by the mutual funds, which in turn, are owned by you and me. There are no profits or dividends that need to go to the mutual fund company’s owners. What does that mean? It means we get to keep them and it increases our returns over time.

**Low Costs**

The means by which Vanguard sends these profits on to you is by lower expenses. In 1990, the average Vanguard expense ratio was 0.35%. The average of the rest of the industry was 1.09%, an advantage of 0.74% a year. Since then, things have gotten even worse (? better.) Vanguard’s average expense ratio is now 0.25%. and the industry has increased to 1.38%, a difference of 1.13% a year. You don’t need to know much about [compound interest](#) to know that 1.13% a year compounded over 2 or 3 decades is a huge amount of money.

**Performance**
As you would expect, these lower expenses allow Vanguard funds to outperform its peers, especially in the fixed income categories. Time after time, over any reasonable, Vanguard funds outperform the majority of their peers.

**Index Funds**

Although there was an indexed account for institutional investors at Wells Fargo in 1971, the first real index fund, the First Index Investment Trust was founded by Jack Bogle in 1976. Known today as the Vanguard S&P 500 Index Fund, it is still the largest index fund in the world, with over $111 Billion in assets, more than the GDP of Vietnam. Since then Vanguard has established dozens of other index funds. A good index fund not only uses ultra-low costs to its advantage, but it also eliminates manager risk. It is well-known that most mutual fund managers don’t add value once the cost of the management is added in. Index funds essentially trade the possibility of outperformance for the guaranteed elimination of market underperformance.

So when choosing a mutual fund company to open an account with, Vanguard should be your default option. Instead of taking the profits for himself, St. Jack (Bogle) opted to change the mutual fund industry forever and allow the investors to keep the change. Over your investing career, this will probably be hundreds of thousands of dollars you get to keep in your pocket.

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**Privately Traded REITs**
There is a category of investments out there I like to call “Investments that are sold, not bought.” In general, these investments require a commissioned salesman to get anyone to buy it. This includes cash-value life insurance, most types of annuities, many limited partnerships, and most privately traded (AKA unlisted) REITs. If you don’t read any further, just remember that you shouldn’t buy a privately traded REIT. If you want more details, keep reading.

What is a REIT?

Just as mutual funds allow an investor to diversify among the stocks of many different companies, so a Real Estate Investment Trust allows an investor to diversify into many different real estate investments. Both structures pass their taxes through to the investors, not paying any themselves. Because of this unique tax structure, a REIT is required to pass 90% of its income each year onto the investors, so their yields tend to be high relative to other investments. There are many types of REITs, but most of them borrow a lot of money, buy up commercial and/or residential properties, and manage them, reaping the rents as rewards and passing them along to investors. Their reliance on leverage (borrowed money), makes them more sensitive to interest rates than most stocks, and as a result, they tend to be fairly volatile, especially over the last few years. During the financial crisis in late 2008, it was not unusual for publicly traded
REITs to go up or down in value over 10% a day. In fact, the price of Vanguard’s REIT Index Fund dropped from $28.93 in February of 2007 to $7.01 in March of 2009. (It has since rebounded as high as $20.65 by April of 2011.) 75% drops and 200% gains are not for the faint of heart. REITs are considered by many investment authorities to be a different asset class and thus provide some diversification benefits when combined with stocks, bonds, and other investments. Unfortunately, their high yields tend to attract conservative investors looking to live off just the income of their investments, who mistakenly confuse the high yields with safer investments such as bonds.

What is the Difference Between a Traded and an Unlisted REIT?

Just as some companies are publicly owned (McDonald’s) and some are privately owned (In-N-Out Burger), some REITs are publicly owned and traded on the stock market every day, and some are not. In general, when an investment authority recommends adding some REITs to your portfolio, they are talking about the publicly traded version, and generally, a mutual fund that invests in many REITs at a time, providing further diversification.

What Are the Benefits of an Unlisted REIT?

Unfortunately, there aren’t really any at all. But that doesn’t keep them from being sold. Let’s go through the schpiel that a salesman would use. First, he would invite you out to a steak and lobster dinner, that he would pay for. Anytime this happens, you should consider that the salesman probably isn’t doing this out of the goodness of his heart. But that is neither here nor there. Once you get a few bites
of steak in your mouth, the presentation begins. He will list the following as benefits of the unlisted REIT:

1. The share price will remain stable at some arbitrary price, such as $10.00 a share.
2. Part of the income each year won’t be taxable.
3. It has a high yield. In fact, it may guarantee a yield of 8% a year or so. He may even show you that in the past, the REITs from this particular company have never not paid out 8% a year.
4. At some time very near in the future, the REIT will “go public” and you will be able to sell your shares for more than you paid for them, perhaps even $20 or $30 a share.
5. If you ever want out of the investment, you can just sell your shares back to the REIT itself.

What Are the Downsides of Investing in an Unlisted REIT?

Well, let’s take on the benefits one by one and dissect them.

1. The share price might be listed at $10.00 a share, but like anything else in life, it is worth more or less than that on any given day. The truth is you simply don’t know what the shares are worth. One popular unlisted REIT, Inland Western was marketed (to me, among others) as never dropping below $10.00 a share. The management now values it at $6.85 a share. To make matters worse, independent analysis in February 2010 suggests it is worth no more than $2.72 a share. It is just as foolish to think the share price stays at $10.00 as to think the value of your home doesn’t go up and down regularly. Just because you don’t look at what the value is doing doesn’t mean it isn’t changing.
2. The reason part of the income isn’t taxable each year is that part of the income is your original investment being returned to you, rather than earnings from the investment. I don’t need a fund to do that for me. I can do that with my mattress.

3. “Past performance is no guarantee of future results” is such a truism in investments, that the SEC requires most investments to display that fact in their prospectus. Just like with the share price in REITs, the yield in REITs has plummeted far below levels the original investors anticipated. Many of these REITs have now dropped yields to 7%, 6%, 5%...even to 0%. Remember Inland Western? 1.3%. So not only have you lost 75% of the value of your investment, your dividend has been cut by 84%. Many previous dividends were paid out of new investor’s money, essentially a Ponzi scheme. So when the REIT “closed” (no more shares sold to investors) and that income stream was turned off, they were no longer able to continue the high yields. You might think I’m joking, but their actual filings with regulatory authorities state explicitly that they have paid and will pay dividends to current investors from the investments of new investors. Legal? Maybe, maybe not. We’ll see what happens in ten years when all the lawsuits shake out.

4. If shares are worth less than $10, why would someone pay more than that when/if they go public? In general, businesses go public for two reasons—to raise cash to further expand, and because they think the business will be worth more to others than it is to the current owners. Neither of these is likely to occur with a privately traded REIT.

5. Unfortunately, buy-back programs are at the discretion of the fund management. If they don’t want to, they don’t have to. Guess what? They don’t want to. That leaves you the secondary market. Illiquid investments have huge bid-ask spreads. That means when you buy
something you pay a lot more for it than when you sell it. It turns out that when you go to sell these investments, you’ll get 20% less than their book value (what they’re actually worth), which, of course, has zero relation to what the management says the share price is. The management might say the share price is $10.00. The book value might be $8.00. And you might get $6.50. Even when management does buy back shares, there is often a penalty (10% is typical) and a limit to how much they will buy back in any given year (3% of outstanding shares is typical).

Why Do Unlisted REITs Suck So Badly?

Several reasons, but the main one is fees, fees, fees. Remember that steak dinner? Someone has to pay for that. It turns out these investments have a hefty front load, as much as 15%. That means that for every dollar you pay, only 85 cents gets invested. That 15 cents go to pay for the dinner and other “expenses” of marketing the fund. (The financial “adviser” wants to get paid, right? He’s got a family too. What about the managers? Shouldn’t they make a lot of money for running this great investment for you?) The ongoing expenses further siphon investor’s dollars into management’s
pocket. The fact that the REIT isn’t listed means that required disclosures to shareholders are much fewer. In fact, it was only in 2009 that it became required for REITs to tell their shareholders how much their investment was worth on a regular basis. The set-up is ripe for abuse by enterprising “businessmen.”

Okay, Okay. I Won’t Buy an Unlisted REIT. What Should Those Who Already Own Them Do?

Earlier this month John Wasik at Morningstar said to get an attorney. A quick google search reveals several offering to file suit on your behalf. If you’re not interested in that, you can hold the investment, cross your fingers and hope for the best, or cut your losses and sell it on a place such as Reit Secondary Exchange. You can learn more about unlisted REITs and chat with others in your situation at the REITWrecks forums. And remember in the future, that if the value of an investment isn’t listed each day in the Wall Street Journal, you probably shouldn’t be buying it. The ability of investors to desert the investment in a rapid manner has a strange way of influencing management to behave better.

So Are Publicly Traded REITs Any Better?

Vanguard offers an index fund that invests in most REITs for an expense ratio as low as 0.13%. It is highly a diversified and low-expense way to access the asset class. There is no load, and you can sell it any day the markets are open for the same price you can buy it for. Best of all, returns have been about 11% a year since inception of the fund in 1996. More importantly, correlations with the overall stock market can be quite low, allowing for an important diversification benefit.
The careful investor should note, however, that correlations were quite high during the 2008-2009 financial crisis. Given the volatility of REITs, they should be considered part of the stock or risky part of the portfolio, and since they are a narrow sector of the market and economy, it would be prudent to limit REIT investments to no more than 5-15% of your portfolio. But be aware, the current yield is quite a bit lower than the average historic yield, making it a less likely that future returns will look like past ones. Buying them might help your portfolio over the years, or they might hurt them. But you should always give careful thought prior to deviating from The Default Portfolio.

Disclosure: 7.5% of my portfolio is invested in the Vanguard REIT Index Fund. Personally, I don’t care if you buy it or not. There are several other actively managed and index REIT funds out there with a reasonable expense ratio such as the REIT ETF or the T. Rowe Price Real Estate Fund.