# The Only Guide You'll Ever Need for the RIGHT FINANCIAL PLAN

## Managing Your Wealth, Risk, and Investments

Larry E. Swedroe
with Kevin Grogan and Tiya Lim

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# Table of Contents

# *Additional Praise for* The Only Guide You'll Ever Need for the Right Financial Plan

"Larry Swedroe has given us an experienced and research-based treatment with examples of what should enter into the design and implementation of an investment strategy. The book includes a wide range of alternative investments and savings related plans that should prove to be beneficial to individuals and to their financial advisors."

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Mutual funds researcher and
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Columnist, Morningstar's Fiduciary Focus

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MANAGING YOUR WEALTH,
RISK, AND INVESTMENTS

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*This book is dedicated to the employees of the Buckingham Family of Financial Services and the advisers at the more than one hundred independent, fee-only registered investment adviser (RIA) firms with which we at Buckingham have strategic alliances. Each and every one of them works diligently to educate investors on how markets really work, building long-term relationships by doing the right thing.*

# Preface

Each of the prior eight books I have written reflects what I have learned in my almost forty years of managing financial risks for major corporations and advising individuals, institutions, and corporations on the management of financial risks.

Included among my books is the trilogy of “Only Guides.” The first focuses on equities, the second on bonds, and the third on alternative investments. Each presents what one might call the “science” of investing: evidence based on peer-reviewed academic studies. The “Only Guides” explore the best investment vehicles to use, the risks and rewards of major asset classes, specific types of investments, and the benefits of a globally diversified portfolio. The books even present model portfolios, but these are meant as starting points only. Each investor has a unique ability, willingness, and need to take risk.

What investors need today is a book offering more specific investment advice, one focusing on the “art” of investing and guiding investors to adapt a winning investment strategy to their own situation. That is what this book is all about.

This “Only Guide” addresses a wide range of investment issues. For example, who should consider owning more small-cap stocks, value stocks, and emerging market stocks, and who should consider owning less of them? It also addresses the often-overlooked subjects of asset location (as opposed to allocation), withdrawal strategies in retirement, and when and how to take Social Security benefits. Most importantly, it will help you integrate other financial issues into an overall financial plan. Having a well-thought-out investment plan is a *necessary* condition for success, not a *sufficient* one. The sufficient condition is integrating the investment plan into a well-thought-out estate, tax, and risk management plan. As we demonstrate in Part IV, even the best investment plans can fail if these other issues are not adequately addressed.

The goal of this book is to help both investors and professional advisers make better, more informed decisions in order to practice the winning investment strategy. Thus, the book is designed to help you understand the fundamental concepts of asset allocation, asset location, and other investing and general financial planning concepts. After reading this book, you will have learned how to:

- design an investment policy statement (IPS) and asset allocation plan, one most appropriate to your unique situation
- locate assets in the most tax-efficient manner
- maintain the portfolio's risk profile in the most efficient manner
- provide effective tax management
- integrate risk management and estate planning issues into the plan

While written to be accessible, this is not a “dummies” book. The assumption is that you know some basics about stocks and bonds.

## *How to Use this Book*

This book can be used in two ways: read cover to cover or searched for topics of interest, providing quick access to information to answer specific questions that may arise and as circumstances change. Thus, it can serve as a reference manual. Most topics are broad based. You will find a brief discussion of a subject and perhaps a reference to an appendix or one of my other books containing a more detailed discussion of the subject.

Because investing is more art than science, this guide is not meant to provide hard-and-fast rules. While a physicist can measure the speed of light to the fourth decimal place with minimal estimation error, even the most fervent finance professor knows that such precision is impossible in investment theory. Investors and advisers alike must accept that they will never know, *ex-ante*, the optimal allocation to international investments or how much an investor's portfolio should tilt toward value stocks or small-cap stocks. In most cases, all they can be sure of is that they are in the ballpark. This book is a tool to help you make prudent decisions, remembering prudence is determined not by the outcome, but by the process. Therefore, this book:

- raises questions leading you to the best answer given a particular situation
- helps identify issues that should be considered
- gives direction so you can best use your own judgment and apply it to each unique situation

As a final resource, the book contains an extensive glossary of terms.

LARRY SWEDROE

# Acknowledgments

Books are seldom the work of one person, or in this case three people. Ours represents the collective wisdom of the investment professionals at the Buckingham Family of Financial Services.

For all their support and encouragement we would like to thank the principals of our firm: Adam Birenbaum, Ernest Clark, Susan Shackelford-Davis, Steve Funk, Bob Gellman, Ed Goldberg, Ken Katzif, Mont Levy, Steve Lourie, Vladimir Masek, Bert Schweizer III, Brenda Witt, and Stuart Zimmerman.

Too many of our co-workers contributed to list them all. But we would be remiss if we did not mention the special efforts and contributions of RC Balaban, Jim Cornfield, David Ressner, John Corn (who made major contributions to the sections on retirement plans and college savings plans) and Aaron Vickar (who made major contributions to the chapter on insurance). Jared Kizer, the coauthor of *The Only Guide to Alternative Investments You'll Ever Need*, also made important contributions. The usual caveat of any errors being our own certainly applies.

We also thank our agent, Sam Fleischman, for all his efforts.

Kevin adds: My wife, Julie, makes every day a joy. I thank her for her love and patience. I thank my parents and my brother, who have always supported me and had my best interests in mind. I owe an enormous debt to all the kind people (especially Jared Kizer and Vladimir Masek) who have taken the time to teach me what I know about investment theory.

Tiya adds: Thank you to my parents, Chak and Mira. You have supported my decisions all along the way.

I especially thank my wife, Mona, the love of my life, for her tremendous encouragement and understanding during the lost weekends and many nights I sat at the computer well into the early morning hours. She has always provided whatever support was needed. And then some. Walking through life with her has truly been a gracious experience.

LARRY SWEDROE

# PART I

## INVESTMENT STRATEGY IN AN UNCERTAIN WORLD

# CHAPTER 1

## The Uncertainty of Investing

*When there's uncertainty, they always think there's another shoe to fall. There is no other shoe to fall.*

*—Kenneth Lay, former CEO of Enron*

**I**nvesting deals with both risk and uncertainty. In 1921, University of Chicago professor Frank Knight wrote (he is not the publisher) the classic book *Risk*, *Uncertainty*, *and Profit*. An article from the Library of Economics and Liberty described Knight's definitions of risk and uncertainty as follows: "Risk is present when future events occur with measurable probability. Uncertainty is present when the likelihood of future events is indefinite or incalculable."

In some cases, we know the odds of an event occurring with certainty. The classic example is that we can calculate the odds of rolling any particular number with a pair of dice. Because of demographic data, we can make a good *estimate* of the odds that a 65-year-old couple will have at least one spouse live beyond age ninety. We cannot know the odds precisely because there may be future advances in medical science extending life expectancy. Conversely, new diseases may arise shortening it. Other examples of uncertainty: the odds of an oil embargo (1973); the odds of an event such as the attacks of September 11, 2001; or the odds of an accounting scandal the size of Enron. That concept is uncertainty.

It is critical to understand the important difference between these two concepts: risk and uncertainty. Consider the following example.

An insurance company might be willing to take on a certain amount of hurricane risk in Dade and Broward counties in Florida. They would price this *risk* based on perhaps one hundred years of data, the likelihood of hurricanes occurring, and the damage they did. But only a foolish insurer would place such a large bet that the company would go bankrupt if more or worse hurricanes occurred than in the past. That would be ignoring the *uncertainty* about the odds of hurricanes occurring: The future might not look like the past. [A number of insurers made this bad bet, losing big-time when Hurricane Andrew swept through Florida in 1991.]

Just as there are foolish insurance companies, there are foolish investors. The mistake many investors make is to view equities as closer to risk where the odds can be precisely calculated. This tendency appears with great regularity when economic conditions are good. Their “ability” to estimate the odds gives investors a false sense of confidence, leading them to decide on an equity allocation exceeding their ability, willingness, and need to take risk.

During crises, the perception about equity investing shifts from one of risk to one of uncertainty. We often hear commentators use expressions like, “There is a lack of clarity or visibility.” Since investors prefer risky bets (where they can calculate the odds) to uncertain bets (where the odds cannot be calculated), when investors see markets as *uncertain*, the risk premium demanded rises. That causes severe bear markets.

The historical evidence is clear that dramatic falls in prices lead to panicked selling as investors eventually reach their “GMO” point. The stomach screams “Don’t just sit there. Do something: Get me out!” Investors have demonstrated the unfortunate tendency to sell well *after* market declines have already occurred and to buy well *after* rallies have long begun. The result is they dramatically underperform the very mutual funds in which they invest. That is why it is so important to understand that investing is always about uncertainty and about never choosing an allocation exceeding your risk tolerance. Avoiding that mistake provides investors the greatest chance of letting their heads, not their stomachs, make investment decisions. Stomachs rarely make good decisions.

## Efficient Frontier Models

To assist in the development of investment plans some investors and many advisers use what are called efficient frontier models.

Harry Markowitz first coined the term “efficient frontier” almost forty years ago. He used it to describe a set of portfolios with the highest expected return for each level of risk. Today, many efficient frontier programs are available. They begin with individual investors answering questions about their risk profiles. The program then generates a portfolio consisting of various asset classes delivering the greatest expected return given the individual’s risk tolerance. Sounds like a wonderful idea. The problem is understanding the nature of an efficient frontier model and the assumptions on which it relies. As with a sophisticated racing car, a powerful tool in the wrong hands can be a very dangerous thing.

Efficient frontier models attempt to turn investing into an exact science, which it is not. For example, it is logical to believe that in the future, stocks will outperform fixed income investments. The reason is stocks are riskier than risk-free Treasury bills. Investors will demand an “equity risk premium” to compensate them for this risk. While the past may be a guide to the size of the equity risk premium, the bull market of the 1990s and bear markets of 2000-02 and 2008 demonstrate that it is no guarantee.

The equity risk premium is not constant. From 1927 through 1999, the equity risk premium was 6.8 percent. By the end of 2002, it had fallen to 5.7 percent. By the end of 2007, it was back up to 6.1 percent. And by the end of 2008, it had fallen to 5.4 percent. We shall see that even relatively small changes to the inputs are very important when it comes to efficient frontier models.

Efficient frontier models rely on inputs of expected returns, correlations, and standard deviations (measure of volatility) for each asset class that could be used in the portfolio. Let’s begin with a simple portfolio that can potentially invest in just five asset classes: S & P 500 (U.S. large-cap); U.S. small-cap; one-year fixed income; Europe, Australasia, and the Far East index (EAFE) (international large-cap); and international small-cap. Table 1.1 shows our assumptions for returns, correlations, and standard deviations. Using standard deviation as the measure of risk, let us also assume we have designated a 12 percent standard deviation as the level of portfolio risk we are willing to accept. An efficient frontier model will generate the optimal asset allocation.

**Table 1.1 Capital Market Expectations**

| | S & P 500 | U.S. Small | One-Year Fixed Income | EAFE Index | Int'l Small |
|---|---|---|---|---|---|
| S & P 500 Index | 1.0 | | | | |
| U.S. small | 0.8 | 1.0 | | | |
| One-year fixed income | 0.0 | 0.0 | 1.0 | | |
| EAFE Index | 0.6 | 0.4 | 0.0 | 1.0 | |
| Int'l small | 0.4 | 0.4* | 0.0 | 0.8 | 1.0 |
| Expected return (%) | 12* | 14 | 6 | 12 | 14 |
| Standard deviation (%) | 20 | 30 | 4 | 20* | 30 |

*Assumptions changed in different case scenarios, below.

The following is the recommended allocation generated by the efficient frontier model.

| **Case A** | |
|---|---|
| S&P 500 Index | 22% |
| U.S. Small | 9% |
| One-year fixed income | 38% |
| EAFE Index | 22% |
| International Small | 9% |

We now make a series of minor changes to expected returns, standard deviations, and correlations to see how sensitive the efficient frontier models are to assumptions. Each change, indicated by an asterisk in Table 1.1, will be a minor one from our original base case. In Case B, we reduce the expected return of the S & P 500 from 12 percent to 11. In Case C, we increase the standard deviation of the EAFE index from 20 percent to 22 percent. In Case D, we reduce the correlation between U.S. small-caps and international small-caps from 0.4 to 0.2. In each case, the efficient frontier model generated a dramatically different asset allocation, sometimes entirely eliminating an asset class from the portfolio. This implies a precision nonexistent in the field of financial economics.

| | Case A | Case B | Case C | Case D |
|---|---|---|---|---|
| S & P 500 Index | 22% | 0% | 36% | 15% |
| U.S. small | 9% | 20% | 4% | 15% |
| One-year fixed income | 38% | 40% | 40% | 40% |
| EAFE Index | 22% | 36% | 0% | 15% |
| International small | 9% | 4% | 20% | 15% |

We reiterate: Investing is not an exact science. It is foolish to pretend we know in advance exact levels for returns, correlations, and standard deviations. Yet that is the underlying assumption of every efficient frontier model. Experienced practitioners know that to come up with something intelligent, they must generally impose constraints on efficient frontier models. Examples of constraints might be that no asset class can either exceed 30 percent or be less than 10 percent of a portfolio. Another might be that international assets in aggregate cannot exceed 40 percent of the portfolio. The impact of imposing constraints is similar to what we would end up with using a simple common-sense approach (without the need for modeling)—a relatively balanced, globally diversified portfolio with exposure to all the major asset classes. Simply put: Don’t waste your time with efficient frontier models.

# CHAPTER 2

## The Investment Policy Statement

> *Have a plan. Follow the plan, and you'll be surprised how successful you can be. Most people don't have a plan. That's why it's easy to beat most folks.*
>
> *—Paul "Bear" Bryant*

**N**o rational traveler would ever take a trip to a place he has never been without a road map and directions. Similarly, no rational businessperson would start a business without spending lots of time and energy thoroughly researching that business and then developing a well-thought-out plan. Investing is no different. It is not possible to make a rational decision about any investment without considering how the addition of that investment would impact the risk and return of the entire portfolio, and thus the odds of achieving the plan's objectives.

There is an old and wise saying that those who fail to plan, plan to fail. Yet, many investors begin their investment journey without a plan, an investment policy statement (IPS) laying out the plan's objectives and the road map to achieving them. The IPS includes a formal asset allocation identifying both the target allocation for each asset class in the portfolio and the rebalancing targets in the form of minimum and maximum tolerance ranges. A written IPS serves as a guidepost and helps provide the discipline needed to adhere to a strategy over time.

Just as a business plan must be reviewed regularly to adapt to changing market conditions, an IPS must be a living document. If any of the plan's underlying assumptions change, the IPS should be altered to adapt to the change. Life-altering events (a death in the family, a divorce, a large inheritance, or the loss of a job) can impact the asset allocation decision in dramatic ways. Thus, the IPS and resulting asset allocation decisions should be reviewed whenever a major life event occurs.

Even market movements can lead to a change in the assumptions behind the IPS and portfolio's asset allocations. For example, a major bull market, like the one we experienced in the 1990s, lowered the need to take risk for those investors who began the decade with a significant accumulation of capital. At the same time, the rise in prices lowered future expected returns, having the opposite effect on those with minimal amounts of capital (who were perhaps just beginning their investment careers). The lowering of expected returns to equities meant that to achieve the same expected return investors would have to allocate more capital to equities than would have been the case had returns been lower in the past. The reverse is true of bear markets. They raise the need to take risk for those with significant capital accumulation, while lowering it for those with little. A good policy is to review the IPS and its assumptions at least annually.

## The Foundation of the Investment Plan

Because it outlines and prescribes a prudent and individualized investment strategy, the IPS is the foundation of the investment plan. Meir Statman, a behavioral finance professor at Santa Clara University, notes the importance of psyches in investment behavior, likening the situation to antilock brakes. “When at high speed, the car in front of us stops quickly, we instinctively hit the brake pedal hard and lock ’em up. It doesn’t matter that all the studies show that when the brakes lock, we lose control.” Statman suggests investors need antilock brakes for their investment portfolios as well.

> Instinctively we react to investment situations in ways that might have saved our lives fighting on distant battlefields long ago. But, today they are counterproductive, like locking up our brakes. When the market drops, our instinctive fear to flight is so strong, even the most rational investors find themselves caving in, to their own demise. And market tops can often be called soon after the staunchest of bears throws in the towel and turns bullish.[1]

An IPS can act as an investor’s antilock braking system. Your own IPS will provide you the discipline to stick with your plan and reduce the risk of emotions (greed and envy in bull markets or fear and panic in bear markets) from impacting the decision-making process.

Before writing an IPS, you should thoroughly review your financial and personal status. Financial situation, job stability, investment horizon, tolerance for risk, and need for emergency reserves vary from investor to investor and change over time for each individual. The IPS should not be developed in isolation. It should be integrated into an overall financial plan, one addressing investments and the entire spectrum of risk-management issues (creditor