Live It Up without Outliving Your Money!

10 Steps to a Perfect Retirement Portfolio

Paul Merriman

WILEY

John Wiley & Sons, Inc.

More praise for *Live It Up without Outliving Your Money*

"It's a whole new ball game: the traditional defined-benefit corporate pension, which for decades assured the average retiree of comfortable existence, is a thing of the past. Almost as an afterthought, employers are tossing workers into self-directed defined-contribution plans and forcing them into becoming their own investment managers. With *Live It Up without Outliving Your Money*, Paul Merriman has thrown struggling employees and retired folks a lifeline—an easy-to-understand survey of the investment world and blueprint for successful portfolio management. Pick it up, read it, and secure your financial future."

—William Bernstein, author, *The Birth of Plenty* and *The Four Pillars of Investing*

"Paul's insights and process to implement a financial plan to help enable our life's dreams is inspiring! He brings starry-eyed investors back to earth and teaches them how to take-off again—more safely—with an exciting financial independence flight plan. Thank you, Paul!"

—Alan Mulally, president and CEO, Boeing Commercial Airplanes Group

"Paul's wonderful book will educate you, stimulate you, and motivate you to develop the appropriate retirement plan for your personal situation. It provides both the diagnosis and prescription."

—Larry Swedroe, director of research, Buckingham Asset Management and author, *The Only Guide to a Winning Investment Strategy You'll Ever Need*

"One of the easiest to understand explanations and illustrations showing the importance of allocation diversification I have ever read."

—Bud Hebeler, www.analyzenow.com, and author, *J.K. Lasser's Your Winning Retirement Plan*

"Paul Merriman is a practical idealist whose advice should be heeded."

—Sheldon Jacobs, editor, *The No-Load Fund Investor*

"Sage advice from a Master. Merriman pulls it all together: Investment Theory, Portfolio Strategy, Investor Psychology, and a practitioner's common sense approach to solving the great retirement riddle. There is no better road map for anyone that would like to retire in style, with financial security and peace of mind. Merriman, is your experienced and friendly guide with intimate knowledge of the terrain. He navigates his familiar retirement landscape and avoids the pitfalls with the sure confidence of a veteran who has been there done that with hundreds of personal clients."

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and author, *The Informed Investor*

"Typically, it's either or! Either you live it up during retirement and outlive your money, or you deprive yourself during retirement so that you don't outlive your money. Well, Paul Merriman provides practical and easy-to-implement advice that will let help you do both—enjoy retirement without fear of running out of money."

—Robert Powell, editor, *Retirement Weekly*—
a service of MarketWatch

"I recommend *Live It Up without Outliving Your Money!* to you . . . and your parents . . . and your children . . . and anyone else whose future you care about."

—Joseph L. Shaefer, chairman, The Stanford Advisory Group

"The most important financial decisions in your life happen *after* you retire. Paul's book is a step-by-step guide to living like a king in retirement."

—Tony Sagami, editor, Weiss Publications and president,
Harvest Advisors

"*Live It Up without Outliving Your Money* should be required reading for everyone."

—Ed Fulbright, CPA, and host of *Mastering Your Money*
radio show in Durham, NC

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To five people who light up my life every day: my wife, Suzanne;
my son, Jeff; and my three delightful daughters:
Julie, Larisa, and Alexa

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No duty is more urgent than giving thanks.

—St. Ambrose

I could not have written this book—and I could not do the teaching I do—without the help of many people who have generously given their time, talent, wisdom, and encouragement.

I have the good fortune to have wonderful close working partnerships with three very talented people. Tom Cock Jr. helps me reach hundreds of thousands of readers and listeners. He is my co-host on "Sound Investing," our weekly radio show, and creator of *SoundInvesting.com,* where those broadcasts are available online. Tom, who is host of the weekly PBS series "Serious Money," also makes sure that the workshops I lead are filled and oversees *FundAdvice.com,* my company's educational web site.

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

Every part of this book reflects the writing skills of Rich Buck, managing editor of *FundAdvice.com.* Rich spent 20 years as a *Seattle Times* business reporter, and all that experience shows. Rich and I have great fun together generating and developing articles. He transforms my ideas into interesting, easy reading that has helped thousands of investors since 1993.

Over the years, many people have helped me get my message out to investors. I am indebted to Craig Tolliver, who invited me to write a weekly column at *CBSMarketWatch.com*; to Ken and Daria Dolan, who invited me to be a guest on their nationally syndicated radio and television shows; to Paul Kangas of "Nightly Business Report," Humberto Cruz, a syndicated newspaper columnist, and Paul Farrell, a writer at CBSMarketWatch who shares my commitment to helping investors distinguish between what I call "investment pornography" and legitimate advice.

Bill Donoghue introduced me to thousands of investors at his Donoghue Mutual Fund Superstars conferences; Kim and Charles Githler of Intershow did the same with their wonderful Money Shows across the country. Wayne Baxmann of the American Association of Individual Investors has made it possible for me to speak at dozens of AAII chapters.

From Dan Wheeler, Bo Cornell, Eugene Fama, and Kenneth French I have learned the power of putting together world-class investments using the best mutual funds on the planet. Every reader who follows my advice in Chapters 6 through 10 is also indebted to these individuals.

Finally, I must mention two very special people in my life: Thaddeus Spratlen and Dr. Lynn Staheli. They have inspired me to realize that I don't ever want to retire, because I'm simply having too much fun and there's too much still to be done.

Thaddeus, professor emeritus at the University of Washington, was one of my teachers long ago and has been a friend for 40 years. He spent decades as a professor preparing students for successful careers. He's devoting his "retirement" years to the Business and Economic Development Program through which the University of Washington Business School and Seattle Rotary put students and experienced business professionals together to help small businesses in Seattle's inner city.

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

My highest aspiration is to be like Thaddeus and Lynn.

Contents

Introduction

Why I Wrote This Book

I am not a teacher but an awakener.

—Robert Frost

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

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

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

Ideally, that "something else" involved buying proprietary products on which the big brokerage houses earned unusually high commissions. Sometimes brokers were offered incentives such as free trips. In most cases, the commissions and the cost of the trips were built into the price of the products. This allowed brokers to tell clients they could buy these products without paying any commission. The clients thought they were getting a special deal. We knew otherwise: They were being exploited.

I'll admit the sophisticated world of New York City held quite an allure to a young man from Wenatchee, Washington. Wall Street made the job fun, and it seemed as if there was lots of money to be made easily.

But it didn't take me long to grow weary of a job that, I realized, was designed essentially to separate people from their money with little thought given to whether these people were getting something valuable in return.

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

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

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

My professional life is dedicated to teaching people how to take care of themselves and their families so they won't wind up with those unfortunate outcomes. Much of this teaching takes place in dozens of retirement workshops that I lead every year. Tens of thousands of investors have found these sessions helpful and stimulating, and I thoroughly enjoy doing every one, whether it lasts for a couple of hours or a whole day. This book contains the most important material from those workshops.

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

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

Education is essential because there's simply too much data and information available to investors. Much of it is important, but much of it is a combination of noise and sales pitches. I've spent tens of thousands of hours identifying what matters to investors and what doesn't. You'll find the results in these pages.

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

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

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

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

TEN STEPS TO A PERFECT RETIREMENT

The book title promises 10 steps to a perfect retirement, yet the chapters aren't organized quite that way. I'm about to list these 10 steps and point you to where in the book you'll find out about each one.

This list may seem daunting, filled with tasks that would take you months or even years to complete. They might seem more manageable if I share something I've noticed over the past half-dozen or so years of leading workshops for people looking ahead to retirement. Most of the people who come to these workshops can accomplish all 10 of these steps by attending a one-day workshop and then spending 90 minutes with a professional adviser. This book gives you what's in my workshop. If you can manage another 90 minutes with a good adviser (plus the time it takes to do the necessary homework), you'll have all this done.

Step 1: *Determine how much you will need to live on in retirement.* This will tell you how big your portfolio must be when you retire. And that figure will tell you what investment return you need to get there. Chapter 5 tells you how to establish your basic target for the income you'll need from your portfolio. Most investors give this step too little attention. Investors who don't have this information are too often captivated by fear and greed, taking either too much risk or too little risk, depending on what's happening in the markets. This first step is necessarily the foundation for everything that follows.

Step 2: *Determine how much you want to live on in retirement.* In Chapter 5, you'll find out how to establish your living-it-up target. This gives you a second figure for the target size of your portfolio and the return necessary to achieve it. We talk to many clients who, having neglected to take this step, invest as if they must achieve the highest possible return regardless of risk. Often, analysis will show that they can achieve all their goals with much less risk than they thought.

Step 3: *Determine your tolerance for taking risks.* You'll find important insights on this topic throughout the book. Chapter 10 focuses on risk. For every investment you make, you should understand the inherent risks involved and how this investment will affect the overall risk of your portfolio.

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

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

Step 5: *Determine the kinds of assets that will give you the returns you need to achieve your goals.* Academics have done years of mind-numbing research—and some have won Nobel Prizes for it—into this very topic. I have distilled that research into five chapters (6 through 10) that tell you what you need to know and what you should do about it. Actually, I think you'll find this is quite interesting material. You'll learn how to add eight equity asset classes to the S&P 500 Index in order to achieve an extra three percentage points of annual return without taking any more risk than that of this popular index.

Step 6: *Combine those assets in the right proportions into a portfolio that's tailored specifically for you.* I show you exactly how to do that in Chapter 12. I name names of the specific funds you should use at Fidelity, Vanguard, T. Rowe Price, and other sources.

Step 7: *Learn to recognize and control the expenses of investing.* Chapter 11 will tell you how to recognize expenses as "leaks" in your portfolio and how to plug them. There are many things about investing that you can't control, but this is one that you can. Savvy investors pay lots of attention to expenses. Sloppy investors would rather not be bothered. Over a lifetime, the difference can add up to tens—or even hundreds—of thousands of dollars.

Step 8: *Make sure you understand enough about the tax laws to avoid giving Uncle Sam a bigger-than-necessary cut of your money.* Lots of investors carelessly squander opportunities and assets because they don't pay attention to tax issues. This is a big topic, but we hit the high spots in Chapter 11. The advice you'll find there will help you turn your investments into an efficient machine that works as hard as possible for you, not the tax man.

Step 9: *Establish the right distribution plan that will give you the income you need in retirement along with the peace of mind of knowing you won't run out of money.* Of all the 10 steps, this one is taught and discussed the least when professionals and authors try to help people handle their money. Investors who bungle this by withdrawing too much too fast can wind up impoverished in their old age—or broke. Investors at the other extreme can, sometimes without realizing it, pass up fantastic opportunities to enjoy life and contribute to others during their lifetimes.

Chapter 13 tells you how to get this step right and gives you much to think about. Among many other things, you'll find a conservative strategy that, based on actual asset returns from recent history, would have multiplied a retiree's annual income by six times over a 30-year retirement; at the end of that 30 years, the portfolio would have been worth more than six times as much as its starting value.

Step 10: *Put everything you do on automatic pilot.* In 40 years of working with people and their money, I've seen again and again the value of making careful, thoughtful decisions and forming those decisions into a plan that can be executed automatically. Investors who do this are likely to achieve the highest returns among their peers at whatever level of risk is appropriate for them.

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

Invest in index funds, which by nature will automatically correct for the unexpected disasters in the market. If a big company goes into the tank unexpectedly (think of Enron), the S&P 500 Index will automatically correct for that with no action required from you. Set up your withdrawals automatically too, so you never have to worry about how much to take out or when. In other words, organize your finances so you don't have to spend a lot of time on them, so they just do what they need to do on your behalf, letting you concentrate on the things that make life worth living.

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

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

A NOTE TO THE READER

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

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

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

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

You'll find the third level throughout the book in the form of highlighted text boxes that act as sidebars to illuminate ideas you might want to come back to for reference. Some of this material does not fit conveniently into the text but is still relevant and helpful. You can skip these boxes without missing the main points of the book. But I hope you'll find them worth your while.

The fourth part of the book is most unusual because it is based on today's technology: a web site (www.wiley.com/go/paul merriman) that was created just for the readers of this book. Here you'll find more detailed versions of some of the charts and tables in the book. You'll also find reference documents that wouldn't fit into these pages as well as links to newsletter articles I published elsewhere.

You'll be able to come back to this web site in the future to see updated material that will always incorporate returns and results from the most recent calendar year. Be sure to visit this site for any updates to our suggested portfolios before you invest. In addition, the web site will give you a chance to submit a question and to read my answers to questions posed by other readers. In the book's appendix you'll learn exactly how to do that.

Finally, the appendix at the end of the book contains my suggestions for further reading and education.

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

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

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

Part I

Why Some Succeed and Many Fail