Rat-proofing Your Portfolio

When early human beings lived as hunter-gatherers, they were unable to store much of the surplus from their productive labor. Most of what they produced was consumed or carried around on their backs. Everything changed once people started settling down and farming. Now they could produce so much food that a good portion of it could be set aside for the winter months. The big challenge, however, was storing it so that it could be protected from an ubiquitous and relentless enemy—the rat. Fortunately, our ancestors developed an amazing technology that solved this problem—pottery. As long as the food remained sealed up inside of hard, earthenware containers, the rats couldn't get to it.

We've come a long way since those early days. If the rats get into our pantry we just buy some new food and call Orkin. Yet, as with many aspects of our history, some things change and other things stay the same. There are still plenty of rats around that can get into our surpluses. If you live in a modern, industrialized nation you don't typically store all the bounty from your labor in the form of a big hoard of grain. Prudent people who don't consume all of their earnings in living expenses typically set aside their surpluses in the form of financial instruments—savings accounts, bonds, or stocks. And once again, the problem arises of how to protect these instruments from an ubiquitous and relentless enemy—the rats of the financial world.

The most brazen among them will simply try to steal your savings by luring you into some type of Ponzi scheme or other financial scam. Yet others are much more subtle. They will simply feed off of your funds by charging management fees that will stifle your portfolio's growth and gradually erode its value. Even large, respected financial institutions are infested with such rats, who typically work under the direction of a "big cheese" at the top who gets a large cut of everyone's take. In a surprising reversal of roles, the rats now bait the traps for the people, convincing them to bring in all of their savings and put it into the hands of "professionals" who will do a better job managing it for them. This idea has been so relentlessly promoted by the financial industry that they have succeeded in convincing large numbers of smart, successful people that trying to make investment decisions on their own is pure foolhardiness.

One of the industry's most effective tactics has been to confuse people by constantly spinning out an ever-changing array of complex financial products. Since people are busy earning their livelihoods, they don't have time to delve into the prospectuses of these offerings and decipher all of the arcane jargon. Many can be convinced that they need a professional to do this work for them. Little do they know that it is all a lot of crap and that even the professionals they deal with don't understand it either. They spend their days schmoozing clients on the phone, or in lunch appointments and golf games with the really rich ones in order to solidify the relationship. Supposedly, the analysts in the back room have a handle on things.

If clients have made bad investment decisions in the past, financial professionals can play on their insecurity, making them feel like they are not competent to manage their own money. Like children, they must hand it over to their parents so they won't lose it all. Surprisingly, many people are willing to let the experts demean them in this way.

More confident clients will not so easily acknowledge that the financial professionals are smarter than they are. They may start asking a lot of questions in their quest to understand the logic behind the complex financial products being pitched to them. These individuals must be gently steered away from the big secret in the back room—the big pile of rat @#%$. A very effective ploy is to stroke their egos, telling them that they are highly successful people and that they should spend their time doing what they do best while allowing others to take care of the tedious grunt work of managing finances. The appeal to a client's sense of self-importance is often powerful enough to cause him to abandon the quest for understanding and move on to greater things, leaving the management of finances to the "little people" that work for him. If all else fails, the rats can appeal to peoples' greed. Baiting the trap with promises of high returns is often overpowering, especially when a client is told that others are cashing in on this wonderful bounty while he is missing out because he is overly conservative.

Sadly, it appears that the rats will always be with us, evolving and adapting to our sophisticated economy where surpluses are stored in the form of intangible financial instruments rather than food supplies. Nevertheless, we can still protect ourselves using measures that are almost as simple and straightforward as putting grain in earthenware jars: *Keep your surpluses close at hand (not out in the barn), and seal them off from from financial professionals.* In other words, never, never relinquish the management of your portfolio to a professional at some hedge fund or financial institution. Even if you know nothing about investments and simply put everything into a savings account or bank CD to begin with, that's OK. Sure, you can do much better, and yes, inflation will be gradually decreasing the value of your savings with the low interest rates that banks offer. But you are not foolish to start out here. If you don't feel competent to buy stocks or bonds on your own, how could you possibly feel competent to properly judge the honesty and skill of someone who claims he can do it for you? Will you base your decision on his or her nice personality or recommendations from others who based their decision on his or her nice personality? Why not keep everything in the savings account at first and then do some reading and Internet research. Once you are confident, you can move everything over to an index fund or bond fund at a large, well-established investment firm.

Unless you have a brain injury or a severe mental illness, you can manage your own investments. And it's OK to move up the learning curve slowly, missing out on the higher returns that will come later once you are more proficient. Imagine if everyone had the attitude that driving an automobile was very complicated (which it is) and decided to pay a chauffeur to drive them around! You will certainly become a much better driver after doing it for many years, but not if you refuse to get behind the wheel in the first place.

Most of us will probably opt for the services of an accountant to prepare our tax returns every year. Unless they are employed by the Mob or Enron, most accountants do honorable work and can be relied upon to help us with tax planning and preparing our tax returns. In recent years, financial planners have become more popular, offering a more comprehensive service that includes such things as retirement planning, insurance, etc. If you choose to utilize their services, watch out! You'll need to know how to smell a rat. There are certainly some honest financial planners out there who will do a good job, but there are others who would love to get their greedy little paws on your portfolio and "manage" it for you for an annual percentage of the total value of the assets.

This sort of fee arrangement, though commonly accepted in the industry, makes no sense. Some may want to charge as much as 2%. This means that a retiree with a $100,000 portfolio will pay $2000 per year. Assuming that the manager successfully generates a 5% return on the assets (extremely difficult in today's market), and assuming a 3% inflation rate (extremely optimistic), you will effectively have earned 0% on your money. But that doesn't include taxes, so in effect you will be paying someone every year to lose money for you. If you are wealthy and hand over $10 million for the person to manage, you will pay $200,000 every year for the service. The average salary for a full professor at Harvard University is $192,600.[1] So, if you had $10 million to invest, for the amount of money you would pay a money manager, you could hire a Harvard finance professor to work full-time doing nothing but managing your (and only your) investment portfolio. He would be at your beckon and call every day whenever you wanted a snapshot of the latest economic news and academic research and how it pertained to your particular investments. This would certainly be a better value than the periodic lunch or golf game and schmoozing over the

[1] Scott Jaschik. "Murky Picture For Faculty Salaries." *Inside Higher Ed*. 13 April 2009. 10 June 2013. <http://www.insidehighered.com/news/2009/04/13/aaup>.

telephone. Since no money manager ever gives his clients such personalized attention, why should it cost so much more to manage a larger portfolio. One logical answer might be that for the higher fee you get to invest in the good stuff, whereas the small-time investor has to invest in the crap. But it doesn't work like airline seats or concert tickets, where the drastically-improved experience may justify the much higher price. The quality and diversity of the investments should be the same—you can just buy more of them with more money.

So what, pray tell, is the difference? Perhaps it is the added complexity involved with a larger portfolio. What complexity? As already mentioned, the investment mix and quality should be the same. Maybe it's the added burden of responsibility. Losing the millions entrusted by a wealthy person would be far more tragic than losing some small-time retiree's $100,000 portfolio. Would it?

If a financial planner is being compensated for the hours he or she must spend applying knowledge and skill to solving certain problems, it makes sense to compensate such a person based upon the time that is spent. Those with more extensive knowledge and skill would certainly be justified in charging a higher hourly rate. Nevertheless, the rate should be the same for everyone. Is it fair for a plumber to charge $200 per hour to fix a pipe in a large, expensive home and $60 per hour to fix the same pipe in a more humble dwelling? No, but of course, plumbers and and other home repair professionals are notorious for this sort of thing. Rating services such as Angie's List have now made it easier to avoid getting ripped off.

In the financial planning world, organizations such as The National Association of Personal Financial Advisors (NAPFA) have made an important effort to weed out advisors who receive kickbacks and bonuses by promoting certain products to their clients. This is an important step, but it is not enough. Those with larger portfolios will still end up paying exorbitantly high fees if they get suckered into some type of percentage based compensation arrangement. Prudent savers will steer clear of financial advisors who offer anything but a strict hourly fee-based compensation model.