Episode 157 - Basics of Investing Actual vs. Average Return

Episode Transcription

"And often times what we do is we end up looking at just average rates of return…and what you're gonna learn in our episode today is that you can miss something in the difference between average and actual."

Paul Adams: Hello and welcome to Your Business, Your Wealth. My name is Paul Adams. I'm founder and CEO of Sound Financial Group. I am joined by Cory. His shirt may be blue, but his attitude, never is shepherd. Cory, glad you could be here, as always. Today we had some internet problems. Thought we weren't gonna be able to have Cory with us.

Cory Shepherd: Or I thought you weren't gonna be able to join me. That's the way that I was thinking about it.

Paul Adams: It makes a lot of sense. You have definitely picked up some of my attributes over time.

[chuckle]

Paul Adams: We're excited about this episode today because we're gonna be introducing something we've talked about with clients but never on the show, which is the difference between average and actual returns. It's something that's gonna change the way you view investments you might consider participating in, investments you currently have and how you're gonna assess them before you participate in them. So we're so glad you could join us today. We're also gonna work to keep this episode shorter. In the past, we've done these longer form interviews or longer form topics and the trouble is, we're hearing from many of you you'd like to share these episodes but because of their link that can be a lot for a friend or a colleague to dig into. So, notice there's lots more clips up on YouTube now that are shorter so you can take a concept and email it to a friend, text it to them, show it to them on your mobile device while having lunch. Any way you wanna share the videos.

Cory Shepherd: Print it out, fax it to 'em.

Paul Adams: Yeah, whatever works. So we're gonna get that done today as well as make sure you just have this high quality content that you can absorb in a short as a commute to work. So buckle up, we're gonna go faster than usual, with just as much content. You may need to play me on three-quarter speed to catch all of it. But why don't we go to In The News, finances in the news? Jordan, if you could please go to my screen in just a moment. I'm ready. Okay, so here's the first thing I wanted to illustrate today is not about top 1% income because these articles we're gonna look at are all about what it takes to be in the top 1%. Here's what we're gonna notice today is that you need to read into the articles you read. Now, this is true whether you're reading a bit something about politics or you're reading something about money. Go ahead, Cory.

Cory Shepherd: Wait a second, Paul. You mean, I can't just read the headline and choose... Make very big decisions about how to live my life, just from the headlines of

articles in place like Investopedia, huh?

Paul Adams: Not in the world of clickbait, you can't. No. Here's the thing. Investopedia is considered quite the staple of online financial advice. People go to it all the time but we're gonna show how even something as trustworthy as Investopedia can actually lead us astray if we're not reading into the article and understanding the grounding of what it is they're talking about. So this here talks about the top 1% income and it mentions here, "Here's the earnings threshold to be in the top 1%, $718,766. Now, I read this article and I know the numbers well enough to know that that's wrong. That is not the threshold to be in the top 1%. We're gonna demonstrate that in a second, but right here, fortunately, most news outlets and information outlets still cite their sources. God, help all of us, if they stop doing that. And we're gonna talk about what happens when you dig into this. But it's not $718,000. In fact, there is, the accuracy is in this article, but you don't see it. Look how far down I'm scrolling into this article before you see this: It's the average wages of each bracket. Okay, so that's the average, $718,000 is the average of the top 1%. So let's go to another article that tackles this on CNBC.

"That volatility of the up and down can actually make our average a useless number and we have to rely on the actual."

Cory Shepherd: And while you're changing that, this got me because I love Investopedia for... If there's a little number that I don't remember, like this tax bracket or just a quick lookup to refresh, like gosh, now if I have to... You have to go three or four pages deep to find them going against or contradicting their own headline in the same article.

Paul Adams: It's true.

Cory Shepherd: Gosh, golly gee whiz. I'm glad we have a PG show or else those would have been different words.

[chuckle]

Paul Adams: Well, here's the thing, the minimum family income. So this is household income. So you can get a sense of where your rank is. You might be a sole provider for your household and it's kind of gratifying if you're in the top 1% as a sole income earner 'cause you're competing against all the dual income households in this statistic, but to break into the top 1% is $421,000. The other number that's referenced if you dig into the Economic Policy Institute, which by the way, both articles are referencing the exact same study and yet there's two different numbers. So this is the reason why, if for no other reason, you wanna make sure that you're working with a coach and an advisor because we're not working with a coaching advisor and certainly not one that's grounded in economics. So right now, if you're working with an advisor right now that you met with two or three times before you moved your money to them, you might be working with somebody who's selling their services but not advising and coaching you, because to get to this level of information where you understand it this well, it takes a lot more than just one or two meetings.

"Looking at the actual, this is this eighty-three year history where we've got an average rate of return of the S&P 500 of 11.395% but an actual, for your money, of 10.45%."

Paul Adams: So I just wanna encourage all of you that as you look, you wanna be in a position actually know whether or not the information you're getting is accurate. And are those people willing to bring the indisputable math and independent scholarship to your plate so you can make your decisions? Now, one more that I think you'll get a kick out of is this graph. Now, we're putting all of these in the show notes, so if you're listening, you can go to these three links read the articles for yourself. But there's a really neat graph with a slider bar to show you where you rank against all other income earning households in the United States. I thought you guys might enjoy that, we just threw it in the show notes as an extra little gift.

Paul Adams: Alright, that's it for this week in the financial media, in the financial news because even the stuff that we bring up on the show, we're vetting before we bring it to you, because the information, it's not that it's inaccurate, it's just often incomplete and it can be incomplete, it can be out there totally incomplete, but when it comes to making decisions for your finances, for your life, you want to be able to dig in whether that's the way you vote or the way you plan for your money, or your thoughts about a social issue or a real estate performance. We've shown those several times on the show, where the little bits of that buzz headline, the clickbait-ey headline all the way down to the article could be information that's incomplete. Alright, let's get back to it. Cory.

Cory Shepherd: Yeah. Well, and I think this is the reason why it's important to like these things, subscribe, leave us a review so that you can help all of your friends, family, people you care about, sort through things that are really hard to sort through 'cause it's not like it's... Most things are grossly inaccurate. If they had said 20 billion, everyone would have known. Like, "Wait, no," but it's close enough to the truth but far enough from reality to make it a problem for planning, which is why we're gonna keep talking about actual versus average. It's a nice marrying of the two topics today, this week and planning.

Paul Adams: Absolutely.

Cory Shepherd: And our main topic today. So, Paul, I think you're going back to your screen.

Paul Adams: Indeed. So let's start with why we're doing this up so today. All of you wanna be able to have enough wealth to be able to retire. And oftentimes what we do is we end up looking at just average rates of return and we look at something like Standards and Poor's 500. "Oh, it's done 10% or 11% since the beginning of time. That's what I'm gonna use for my retirement plan projections." And what you're gonna learn in our episode today is that you can miss something in the difference between average and actual. So Cory, why don't you walk us through one of the first examples of this?

Cory Shepherd: Yeah, this is one of my favorite stories 'cause I draw this out on paper for

clients a lot around the screen 'cause it's really easy illustration for folks to get the difference between actual and average. So picture someone comes to you with an idea for an amazing investment that they say is just gonna hit it out of the park. And you say that, "Yeah, sounds great. We're gonna do this, let's put $100,000 in." And they come back a year later and say, "Congrats, you are right to put your faith in us, we just got you a 100% rate of return on this investment." This is amazing, everyone's happy. But another year later, year two, kind of bad news, we're down 50%. So it wasn't as good as... It was not a good year by any means, but we had a great year last year, I think we're gonna have a great another year, just hold on, stay the course." Year three, "Hey, we turned it around. 100% rate of return again. We're doing amazing." And then everyone's happy. And then year four, negative 50% return. That's the bad news. But the good news is, over the last four years remember that we are still averaging 25% a year in rate of return.

"Your average vs. actual also changes as a result of you adding money over time."

Cory Shepherd: Now if you're holding the math in your mind or if you're seeing the screen show up here, you notice that $100,000 balance went up to 200 down to 100, up to 200 down to 100. So even though the mathematical average of those four returns is 25%, your actual experience is zero over that time period. And so that is a stark an example we can give of what's possible. It's not always gonna be this big of a difference, but when you see an investment company talk about, "Here's the returns that we got. This is your chance to say, 'Well, wait a second, let me look deeper.'" And I think that's the key here, is you've gotta do your investigation, scroll through the article a little bit more.

Paul Adams: And Cory, while your house is burning down there, let me just gotta illustrate that this doesn't even count, the fact that there's $100,000 upswing would have likely had a tax liability with it. Each one of those would have caused us to maybe lose money, we would have been performing not only a zero, but perhaps negative because of the tax liability of those up years that that volatility of the up and down can actually make our average a useless number and we have to rely on the actual.

Cory Shepherd: Well, and most investments have some kind of fee for the pleasure of being a part of that investment, especially if someone's bringing it to you, there's some other costs, so even a zero-percent rate of return doesn't mean you didn't lose money at the end of the day.

Paul Adams: Indeed. Now, Cory, the other thing that I think about here is that, that doesn't count the tax impact of every single time. You had this 100% return, you likely would have had a tax impact meaning you may not have done zero, you might be less than zero after paying taxes on all those years you had the gains.

Cory Shepherd: Well, never mind that most investments aren't free, like you have some kind of fee for the pleasure of being a part of the investment. So, zero percent rate of return doesn't even mean that you didn't lose money between taxes and fees that might have happened along the way.

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"What we want to be able to do is we want to be above average. We don't need to be wildly above average but we need to be above the averages that most people teach."

Paul Adams: Well said as always Mr. Shepherd. And with that, should we let people hear a little bit about Sound Financial Group?

Cory Shepherd: That's a great idea. So we've talked about your income, your investments, average versus actual and the giant difference that that might make, who knows where we'll go from here after this brief break.

[music]

Paul Adams: Hey, everybody I had to interrupt our show for just a moment to share with you something new. We've designed a new white paper that we think is gonna add new value in the way that you think about money. It's three of the biggest mistakes we see people make and six ways to fix them. Now, for some of you, you might not want the white paper, you might be ready to have a conversation with us and that is okay. You can email us at info@sfgwa.com, that's info@sfgwa.com. Find us on the web at yourbusinessyourwealth.com, and any time on any of our social media platform, send us a message and we can get you this white paper. But in the meanwhile, if you want to just skip over the white paper, have a philosophy conversation with us, we're happy to do that with you. Just let us know philosophy conversation in the subject line, and if you want this white paper, just put white paper in there and we'll immediately get out to you this white paper on the three biggest mistakes that we see people make and the six things that you can do to fix them. And now back to our show.

Cory Shepherd: And welcome back. So now we're going to take a walk down memory lane to the history of the S&P 500, and what you're seeing on the screen here goes all the way back to 1936, the actual rates of return of the stock market back as far as we have really good records for that, and I wanna point out a couple of pieces. We're gonna deal with this actual versus limited in a second as we change some things. But just looking at the actual... This is this 83-year history, where we've got an average rate of return of the S&P 500 of 11.95, but an actual for your money of 10.45. See, even if you had all your money there at the beginning, you don't get the average because the average ups and downs are weighted equally if we just average them together arithmetically, but to look at what's happening with your money, you've gotta look at something called the geometric average. So, if you wanna go deeper into the weeds of the math, look up arithmetic versus geometric average, that's what's happening here in the average versus actual.

Cory Shepherd: But now, Paul, there are some kinds of products and funds that don't always give you the dividends that are invested in the stocks that you have 'cause you don't actually own the S&P 500, you own the fund, which then owns the S&P 500. So, if you click that box that says dividends, we're gonna take out the dividends that were paid by the S&P 500. And now, if you're in something that mirrors the S&P 500 but doesn't actually own it, doesn't actually pay you the dividends, your average return goes down to

7.9, your actual is only 6.5%. Huge, huge difference.

Paul Adams: In the [14:48] ____ Over this period of time, $1 invested would either be worth $3800 or $186; 3800 versus 186. Huge, huge difference. And something people just don't talk about. In a later episode, we'll go deeper into some of these products, invest in the point-to-point movement of an index where you don't actually own them because when they are sold to people they sound a lot like equity rates of return when in fact they're not equity like rates of return. Now, speaking of our equity like rates of return, Cory, as we look at not just average versus actual investing over time, let's talk about an actual investment some people are in, in this case, the Standard and Poor's 500 index. Now, if you look at its performance over time, now granted we're doing a point-to-point on this one, not with dividends we're missing up point a half to 2% a year out of the S&P 500 because this is not counting full dividends, and we just add $20,000 a year because your average versus actual also changes as a result of you adding money over time. The average investment of say, the big mountain chart somebody shows you when they're marketing a mutual fund to you versus your actual returns because you're adding money over time are different.

Paul Adams: So this is the S&P 500. You can see the pre-tax yearly rate of return. Highlighted in yellow are all of the negative years, and as we scroll through you can see something simple like the tech bubble where we had three down years in the Standard and Poor's 500. Your investment would have been up to $800,000, then it would have fallen to $521,000, struggled its way back to 944,000 before the 2008 financial crisis hit. And this, that period of time from 1999 to 2010 is what they talk about is the lost decade. But if you're invested in the Standard and Poor's 500, it took you 10 years to have zero rate of return over that period of time. This is the reason why we teach people to own academically allocated globally-diversified portfolios because you would have had tremendous returns over that decade if every year consistent, systematic, rebalancing and holding strategy would have taken effect.

Cory Shepherd: Well, you know, you bring up a good point which is that the media has hammered into us the lost decade. People just take it as a given that no one made any money in the market for those 10 years, which is absolutely not true. It's true, in a limited sense, if you were only in the S&P 500 for certain conditions, but most people aren't. You had a diversified portfolio, you had positive returns and I think it's back to our theme of scroll down in that article, click all the way through, look deeper. The headline is never enough to tell you what you need to do to make decisions around your money.

Paul Adams: Know what you're reading, get help, have a coach. Yes. And now, as we get all the way down, your total investment balance would have been 2,071,000. Now, well, the return was approximately 9%, 9.16, if you average the annual returns that would have given you 3.3 million, but you don't have 3.3 million. What you have is 2, 071,000 because your actual rate of return is because your money was not there the entire time, and this

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person was disciplined, adding $20,000 every single year to their portfolio and they don't get the average. In fact, the difference between average and actual is about $1.3 million, that's a lot of money. In fact, that's more money than what most families are gonna have for their entire retirement savings and we got tricked by the average versus the actual and what we thought that investment might be worth. So what can you do about this? What can you do differently?

Paul Adams: You know, when we look at our investments, when we look at a potential investment somebody's bringing to us, we often aren't thinking about the average versus the actual. Somebody says we anticipate, we're gonna do X amount return. You want to be able to be working with a coach or an advisor who can actually look at those outside investments and help you assess them because you might have a return in say, a piece of real estate and it looks like a really good rate of return on a year to year basis or immediate cash flow based upon rents minus mortgage. But there's a lot of other factors that go into it. And you want an advisor who has the ability to assess those with you, come alongside you and allow you to see through the hype, through the averages to the actual. What is my family actually gonna have as an outcome as a result of this? You wanna make sure you're doing that assessment on any of the funds that you have because even if you look at your 401k, you're gonna see one-year, three-year, five-year averages from those returns, which are not the actuals of what people got in those investments and it leaves people chasing. We've talked about chasing returns before, but in this case, you end up chasing average. Chasing average.

Paul Adams: That is not what any of us wanna work toward in life. What we wanna be able to do is wanna be above average. We don't need to be wildly above average, but we need to be above the averages that most people teach. Nobody strives to have average children, nobody wants to have an average marriage, nobody wants to have an average vacation and yet what are we marketed to with all the time average rates of return? Don't let average bring you down, don't make mediocrity your target, dig in, read through the article, ask through the initial sales pitch and find out if those things work for you. As always, we love hearing from all of you. If what you'd like to do is make sure we talk about some of the things have been proposed to you or maybe the things you've already gotten into, then reach out to us. Cory, why don't you just take us from here?

Cory Shepherd: Yeah, so we've got a great featured review this week and as a reminder, if you just could help us help get the word out and leave an honest review, whatever comments you wanna give, feedback you wanna give, and send us a screen shot of that to info at sfgwa.com, we'd love to send you a book either Paul's book, my book, or Clockwork by Michael Michalowicz. And so just let us know what kind of book that you want. Here's an example of what that future review looks like just to get a sense, 'cause this one is one of the shorter ones. So Golf and Guns... [chuckle] which I think that's great. That's a great name.

Paul Adams: Great screen name.

Cory Shepherd: Yeah, he said, "Really enjoy the Scott Adams podcast, very interesting information and much broader than just Dilbert." So, when we get the email from Golf and Guns, that's good for a book, very short, succinct, you don't have to write a novel, but what you will do is contribute to someone else being able to get access to this material, be exposed to some of these messages because, as you've seen, some of the headlines that people see very easily on financial articles don't tell in the whole story, and that's just what we wanna do for them.

Paul Adams: And Cory, I saw one of our clients that called in from the podcast, they reached out, we did a review of everything to have, give it just easy, great example of the difference you can make. These folks were paying fees that they thought they knew and didn't realize there was another point and a half built into their investments, like they could have hired a whole extra investment advisor and paid them on the same portfolio and be at the same cost structure is what they had inside their current investment. So we talked about expense on investments before, it's a great example of the difference all of you listeners have made to allow somebody to hear about this information and get engaged with us that never would have otherwise.

Cory Shepherd: That's so great. So, yeah, take a look at the links or the clips that we have online, share those, do a review and help us get that word out because as always, we hope that this has contributed to helping you design and build a good life.

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