The 12% Reality *?*

The following is taken word-for-word from an article on Dave Ramsey's web site titled *"The 12% Reality—Can you really get a 12% return on your mutual fund investments?"*, located at http://www.daveramsey.com/article/the-12-reality/lifeandmoney_investing dated March 4, 2011.

The black type below is the text from Ramsey's original article, and the red type is our responses.

Twelve percent—whether you first heard Dave mention it in the *Financial Peace University* lesson *Of Mice And Mutual Funds* or you read it on Dave Ramsey's web site, it was undoubtedly followed by questions.

But most of those questions boil down to two important ones: **"Can I really get a 12% return on my mutual fund investments, even in today's market?"** and **"If I can, what mutual funds should I choose?"**

Where Does It Come From?

When Dave says you can expect to make 12% on your investments, he's using a real number that's based on the historical average annual return of the S&P 500. First mistake: gauging future *expectations* solely based on PAST performance.

The S&P 500 gauges the performance of the stocks of the 500 largest, most stable companies in the Stock Exchange. It is often considered the most accurate measure of the stock market as a whole. This is true but there is an important note to tag onto this. Mutual Funds are simply a compilation of stocks and often the managing brokers will select stocks from the S&P 500; however, how often does the S&P 500 refresh the 500 companies? In 2007 it changed 47 times, so what constitutes the stocks contained in the index itself is a moving target. Ramsey would say, "that's why you should have a good money manager" but it's important to understand the tax consequences when stocks are sold. If your account is constantly refreshing (selling and buying stock) to truly reflect the companies represented in the S&P 500 then additional fees, taxes and lost opportunity costs MUST be calculated into the overall return…which Ramsey does not do. Also, the S&P 500 does not determine your portfolio's performance; your mutual funds within your portfolio do that for you—and studies have shown that the vast majority of mutual funds fail to match the S&P 500's returns, while the very few that have matched or beaten the index at times, fail to do so consistently year after year.

The current average annual return from 1926, the year of the S&P's inception through 2010 is 11.84%. This isn't completely accurate but the data doesn't really change. Standard & Poor's introduced its first stock index in 1923. Before 1957, its primary daily stock market index was the "S&P 90," a value weighted index based on 90 stocks. The S&P 500 index in its present form began on March 4, 1957. Most historical “look backs” for the S&P 500 go back to 1936 not 1926 but the “average” doesn’t really change…so it is somewhat trivial, but typical of Ramsey to gloss over his points without thorough analysis (which is understandable, given radio and TV time limitations). That’s a long look back, and most people aren’t interested in what happened in the market 80 years ago. He say’s later that we can ONLY base our investment expectations based upon the past, so why are most people “not interested in what happened” 80 years ago?

So let’s look at some numbers that are closer to home. From 1991–2010, the S&P’s average is 10.66% (true). From 1986–2010, it’s 11.28% (true). In 2009, the market’s annual return was 26.46% (true for the S&P 500 index but he fails to specify what he means by “the market”—this particular index?). In 2010, it was 8%.

So you can see, 12% is not a magic number. This one literally makes me chuckle because it’s about as accurate as he gets. 12% is in fact *not* a magical number it’s simply an average. But based on the history of the market, it’s a reasonable expectation for your long-term investments. ***Now*** we start separating the truth behind the discussion about “average vs. actual”. It is NOT a reasonable expectation to believe our account balance will reflect the Index’s average rate of return. This will be shown shortly. It’s simply a part of the conversation about investing.

But What About The ‘Lost Decade’?

Dave often points out that every 10-year period in the market’s history has made money, and that was true until the latest market drop in 2008. From 2000–2009, the market endured a major terrorist attack *and* a recession. S&P 500 reflected those tough times with an average annual return of 1% and a period of negative returns after that, leading the media to call it the “lost decade.” (true)

But that is only part of the picture. In the 10-year period right before that, 1990–1999, the S&P averaged 19% annually. Put the two decades together, and you get a respectable 10% average annual return. Now Ramsey begins the critical error of teaching that the average rate of return is what you should expect in obtaining your account balance. According to Ramsey, the first 10-year period earned a 19% return and the second 10-year period earned a 1% return. To get the average we simply add both decades together and divide by two, which equals 10%. Ramsey then tells us that over the 20-year period of time our account would reflect an average 10% rate of return. Let’s look at this closer: $100,000 at a 10% actual rate of return for 20 years would give us a balance of $672,750. That’s excellent! Unfortunately, when your statement shows up you would NOT see $672,750…not even close. Let’s take a look at what would have happened if your money was on the roller-coaster, year-by-year returns of the S&P 500 during that same time frame. If you invested $100,000 at the beginning of 1990 and kept it “in the S&P 500” until the end of 2009 you’d actually have $473,000. That’s a rate of return of 8.08%. That’s still good but reflects a $200,000 difference from what Ramsey said you would get with that “respectable 10% average annual return”. However, it still gets worse than that. What are the three items missing from this calculation? (1) Taxes, (2) fees, and (3) the lost opportunity costs of both. Now ***this*** is where it gets really bad for Ramsey.

Take a look at this video we did for the remainder of this analysis, showing all of the ups and downs, the taxes, and the fees, and the documentation to back up the calculations:

http://www.screencast.com/t/fJ9CwUcQbQg2

The rest of this document should not be read without first watching that video. The results are shocking, to say the very least. After all the market fluctuations, taxes, and fund fees are accounted for, the end result is anemic. The student of Ramsey's advice would be terribly disappointed to be left with less than 1/3 of the total Ramsey suggested they would arrive at.

There exists a fallacy that few people take into account when they speak (often authoritatively, as Ramsey does) about averages. I have been known to point out that if you get a +50% return one year, followed by a -50% loss the next, you have averaged a 0% annual return—and that is mathematically correct. But the reality is your *actual* annual return was -13.4%. Had you started with $100,000, you would have only $75,000 left at the end of that exercise—a loss of -$25,000. How's that for a 0% average annual return?

The SEC contributes to this "Myth of Averages" by allowing the mutual fund industry to quote their average returns while failing to disclose their *actual* returns, resulting in a false belief in higher return expectations than are shown by reality—and greater risk-taking by individual investors in the belief that a higher return justifies that risk. Risks they may not be willing to take if the truth of the lower *actual* return were known.

An April 19, 2011 article on the Forbes web site by John Girouard (http://blogs.forbes.com/advisor/2011/04/19/average-annual-returns-spy-dow) illustrates this concept well. Girouard writes, "*Average annual return is as irrelevant to investing as average annual temperature is to weather. Minneapolis's average is 45 degrees, but that won't help you pick the right clothes to wear in January. By the same token, knowing the average annual return of stocks in the past won't help an investor with financial planning.*"

But that's the past, right? You want to know what to expect in the future. **In investing, we can only base our expectations on how the market has behaved in the past.** Nonsense. Show me a financial advisor that only looks at the past performance of a stock and I'll show you an advisor that is closed for business. Stocks do well based upon what the company is expected to deliver *in the future*! Can GM stand up and tell everyone to invest in them because of how good they *<u>used</u>* to be? Of course not! This statement is naïve…he even put it in **bold**. And the past shows us that each 10-year period of low returns has been followed by a 10-year period of excellent returns, ranging from 13% to 18%! Again, averages are misleading, so this statement is irrelevant. Does Ramsey get to claim to be a fortune teller predicting the future now? For one thing, he fails to account for the pending demographic shift of baby boomers leaving the workforce and the downward pressure they will put on markets as they withdraw money from their 401k's to live on in retirement—the same population segment that drove markets up in the 80's and 90's as they put money *in* to those 401k's. We're not fortune-telling here, these are facts about our aging population. We have videos on this subject at http://www.screencast.com/t/8n1X8EtPvJi2 .

If You're Still Unsure…

Will your investments make that much? Maybe. Maybe more. But the idea here is that you *invest* and invest for the long haul. He's right. The long haul should be the focus. Unfortunately for Ramsey, it's the long-haul that completely destroys his recommendations. Don't let your opinion over whether or not you think a 12% return is possible keep you from investing.

In fact, if you'd rather project your mutual funds to grow at 10% or 8%—that's cool with us. Just set a goal and invest whatever you need to in order to meet that goal. "Project" is the operative word. I can project any figure I want (indeed some planners use unrealistic figures to make their projections look better. At issue here is whether the "commonly accepted" figures of 10 or 12% are likewise unrealistic.). But doing so would not change the facts. Wouldn't it be prudent to plan based upon the reality that includes a real recognition of market fluctuations, taxes, and fees? And projections alone should not be the only goal, given that the results of any projection can be so fragile. Guarantees, predictability, liquidity, use, and control with the power of leverage are key.

How To Find Your Funds

It's not difficult to find several mutual funds that average or exceed 12% long-term growth even in today's market Hindsight is 20/20. Its always easy to find a fund that performed well *after* the fact. I find it humorous when the popular magazines name the "10 best funds" each year. I cannot help but note that the 10 best in one year are not the 10 best in the next. In the 90's, the Janus Global Technology Fund returned 254% in a single year. After seeing that, loads of investors piled-in to reap the rewards, only to have the fund drop -54% the very next year. How many people ploughed their hard-earned money after seeing that excellent year only to subsequently lose half of what they put in? Mutual funds are notoriously sporadic, doing well from time to time, then striking out afterward. Ramsey says its not difficult to find the good ones, but the trick is you have to know which ones are going to be good that year *before* they actually perform—and then you have to find the next one all over again the following year. Do you have a crystal ball? You're going to need one because you have to choose the top 10 out of more than 30,000 funds available a full year before the financial magazines do it with the benefit of hindsight. **An experienced investing professional can help you find good mutual funds in each of the four categories Dave recommends.** (This is purely a subjective opinion. The Harvard Business School and Morningstar did a study - http://trendfollowing.com/whitepaper/The%20Study%20of%20the%20Decade.pdf – between 1996 and 2002. The first four years were astronomical for the S&P 500 but the last three years were losers. They studied over 4,000 mutual funds and the results were pretty humorous in regards to the value of a professional advisor. The individual investor earned a return of 6.626% working on their own and a 2.924% for funds provided by advisors. In other words, *the public working on its own did more than 100% better than financial advisors.* The average Ramsey would claim during this period of time was 8.99%. He would of course use that number to tell you how much you'd have in your account, but as heretofore illustrated, it is just not reality.)

But the value of a professional advisor doesn't end there. The stock market will have its ups and downs, and the downs are scary times for investors. They react by pulling their money out of their investments—that's exactly what millions of investors did as the market plunged in 2008. But that only made their losses permanent. If they'd stuck with their investments like Dave advises, their value would have risen along with the stock market over the next two years…only to bring them back to where they started—if they were lucky. Losses devastate and avoiding them is utterly critical. The "Lost Decade" was roughly a break-even proposition overall. But individual investors still lost something critical—Time. Time they can never recapture. 10 years is enough time that, even at a modest 5% net return (which can be safely achieved without risk) would result in a 63% increase. What Ramsey fails to acknowledge is that most individual investors cannot afford to lose 10 years of their lives making little or nothing after all the ups and downs of the rollercoaster market. And if history can be used as a guide at all, we have seen 12 to 18 year periods of time where stock market investments netted little gain at all, but still provided a wild ride in-between.

An investing pro will keep you from making that mistake and show you how the down times can actually make you money. Dave's Endorsed Local Providers (ELPs) understand long-term investing and will give you the same advice Dave would. Contact your ELP today to discuss your investing concerns and goals.

Want to find high-performing mutual funds on your own? Love to personally research your investment options? Find 12% mutual funds right from home with Morningstar Principia – Mutual Funds software.