Does Dave Ramsey's 12 percent growth stock fund exist?

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Dave Ramsey, the nationally-syndicated radio talk show host, has done a great deal of good for a great number of people. His core message – that the only reliable way to obtain financial peace is to consistently live within your means so that you can pay off your debts and accumulate savings – makes perfect sense.

I cringe, however, whenever he mentions that people should put their savings into — in his words — a good growth stock mutual fund because it will earn 12 percent annually.

Whether it is on his radio show, his website, his books or his educational programs, Dave Ramsey quotes that 12 percent figure again and again. He uses the 12 percent figure to tout the superiority of stock mutual funds over nearly every possible alternative, such as annuities and cash value life insurance products.

I investigated whether the 12 percent return that he quotes is realistic, and I found some surprising facts.

I started my research with Dave's explanation, which is found on his website. He says, "The current average annual return from 1926, the year of the S&P's inception, through 2010 is 11.84 percent. From 1986–2010, it's 11.28 percent."

These return figures include the value of reinvested dividends.

You think that would settle the issue, but let's look deeper at three questions.

a) Is that truly the S&P 500's average return?
b) Has the average person actually achieved that return?
c) Is the past return a good indication of the future expected return?

Shockingly, the answer to each of these three questions is a resounding no.

Is that truly the S&P 500's average return? No

Let's suppose that you own a fund that drops in value by 50 percent in year one and gains in value by 100 percent in year two. What was your average rate of return?

Some people might say 25 percent, because the 100 percent gain less the 50 percent loss is a 50 percent gain, and divided by two years, that equals a 25 percent average gain.

But a far more correct answer would be 0 percent. That's because if you put in $1,000 at the start, your balance would drop to $500 after the 50 percent loss and merely recover to the original balance of $1,000 after the 100 percent gain. You had $1,000 at the start, and two years later you had $1,000, so the average rate of return was 0 percent.

Guess which method Dave Ramsey's 11.84 percent and 11.28 percent number use? The first method.

Under the more correct second method, the average figures are much lower, 9.87 percent and 9.59 percent respectively. Moreover, an individual can't invest directly in the S&P 500, but only through financial products that add a layer of expenses, further lowering these numbers.

So, the market didn't return 12 percent. It returned 9 percent.

Has the average person actually achieved that return? No

Under the more correct second method, the S&P 500's annual return over the last 20 years has been 9.14 percent. However, according to the 2011 DALBAR Quantitative Analysis of Investor Behavior, the actual return achieved by the average mutual fund investor has fallen far short of the 9.14 percent. In fact, it has been only 3.83 percent.

The DALBAR study has been conducted annually for the past 17 years, and this year's study noted that every year, they find that "mutual fund investors consistently underperform the relevant index" and that "most of this loss in performance is due to psychological factors that translate into poor timing of their buys and sells."

So, the average investor didn't earn 9 percent. He earned less than 4 percent.

Is the past return a good indication of the future expected return? No

By law, every securities advertisement must include a statement similar to "past performance is not a guarantee of future results." Interestingly, in the explanation of the 12 percent figure on Dave Ramsey's website, it states — in bold print — "In investing, we can only base our expectations on how the market has behaved in the past."

Well, which is it? Is the past a reliable indicator or not?

To answer, let's take a look at the Japanese stock market. From 1915 – 1989, Japan was a rising economic power, and its Nikkei stock market index rose at an average annual rate 10.55 percent, excluding dividends. However, since 1989, the Nikkei index has not risen at all, but has in fact fallen at an average annual rate of 6.16 percent. In Japan in 1989, the past was a horrible indicator of the future. Interestingly, the Japanese scenario since 1989 has involved the retirement of a large segment of its population, much like what will happen with our baby boomer generation in the next 20 years. Thus, that dismal scenario is one that prominent economist Harry S. Dent warns is possible for the United States in his best-selling book, "The Great Depression Ahead." He may be right or wrong, but the repercussion is clear:

There is no guarantee that the average investor will even earn 4 percent in the future.

Implications

The market didn't return 12 percent; it returned 9 percent. The average investor didn't earn 9 percent; he earned less than 4 percent. And, there is no guarantee that the average investor will even earn 4 percent in the future.

What does it all mean? It means that when it comes to long-term wealth-building products such as annuities and cash value life insurance products, Dave Ramsey's criticisms that their returns are inferior don't hold up.

It means that criticisms made by many in the financial press that are based on his same assumptions don't hold up, either. Their criticisms are based on wrong assumptions regarding stock market returns.

If someone is basing their financial plans on realizing a 12 percent average rate of return over the rest of their life, their financial plan is not solid. If they shun annuities and cash value life insurance products because of their 12 percent expectation, they are making a mistake.