Your Financial Advisor Is Taking 75% of Your Retirement

Module 4 | Lesson 11

In our continuing series on closing the gap, I'm going to show you a simple way to maximize the Wealth Growth component of your wealth plan by controlling investment fees.

This lesson has a really catchy title, eh? I'll bet it got your attention!

And for good reason, too. Nobody likes the idea of their financial advisor taking 75% of their retirement, but the shocking truth is most people are doing exactly that, and probably worse.

Again, it's just simple math once you understand how this all fits together. I'm not saying anything revolutionary. I'm just pointing out the obvious by applying the exact same principles from the earlier lesson on compound returns where you changed the investment return by just a few percentage points, and the compounded effect on your portfolio value was enormous.

In other words, it's just taking a proven math principle and giving it a real world application that's admittedly shocking.

The key idea is your financial advisor fees and expenses are charged as a percent of your assets. That means the effect directly lowers your net return, all other things being equal. More importantly, the effect on your portfolio growth is compounded. What that means is those seemingly tiny advisory fees have an enormous impact on your equity that defies intuition.

Let me walk you through how it works step by step…

Your Financial Advisor Is Taking 75% of Your Retirement

The High Cost of Low Fees

I'm going to make a couple of assumptions just to make the math so easy and intuitive that you can follow along in your head.

Fortunately, the assumptions I'm making are actually industry standard assumptions, so I'm not stretching anything here to make the point. In fact, you'll soon see I'm actually being conservative.

Let's start by assuming you'll use the standard 4% safe withdrawal rate for pulling funds out of your investment accounts to support spending in retirement. Again, if you're not familiar with how the 4% rule works, then please refer to the linked resources at the end of this lesson for a full understanding.

I use this rule for illustration because it's not that far from reality. We can argue endlessly about details, but research shows it's close enough that we can use it as a working approximation.

The other assumption we'll make is that low cost, passive index funds and ETF's have an expense ratio around 25 basis points, or ¼ of 1 percent. Again, some are higher, and some are lower, but it's a usable approximation for fees on low cost, passive investment products.

The final assumption is an all-in fee structure of 2.25% when you invest through a financial advisor. By "all in", I mean the advisor himself charges an annual advisor fee of ¾ to 1%, and the underlying fee structure for the funds he invests you in range from 1.25% to 1.50%. These are fairly common fee structures, if not conservative, so when you put them together, you'll get an all-in fee structure that we'll round off to 2.25%.

Your Financial Advisor Is Taking 75% of Your Retirement

I chose 2.25% because it makes the math easy, but please understand I'm being super-conservative here and probably understating the real expense of working with many financial advisors. Some of the specialty investment products sold by advisors have fee structures that alone rise above that 2.25% range, and then you'd need to add in advisor's fees on top of that, which are often 1% of assets, commission, loads, and more that are charged on top of the fund expense structure. So again, I'm being very conservative with 2.25% for all-in fees.

The reason I chose the 2.25% number is because that makes the spread between using an advisor and using a low cost passive index alternative a nice round number of 2% per year, which makes the math intuitive and simple for you to follow in your head.

So now let's look at how that small, extra fee structure of 2% costs you 75% of your retirement income.

How Your Financial Advisor Reduces Your Retirement By 75%

You can think of traditional retirement planning in two phases:

- You have the wealth accumulation phase all the way until the day you retire,
- And then after you retire, you're supposed to spend down that wealth until you die.

So that gives you an accumulation phase before retirement, and a spending phase after retirement. Let's start the analysis by looking at the first phase where you're trying to compound your assets to accumulate a nest egg for retirement.

Your Financial Advisor Is Taking 75% of Your Retirement

We know from the Rule of 72, explained in an earlier lesson, that a 2% reduction in net investment return resulting from the higher fee structure will eliminate one doubling period roughly every 35 to 36 years. The reason is because expected return is reduced by fees because the only thing you see in your account is returns net of fees. Those are the returns you can eat, so to speak.

Putting real numbers into the compound return calculator to test our intuitive analysis, let's assume $100,000 invested at 8% for 35 years. Your future account value would be $1,629,254.99. However, that same $100,000 earning 6% (because remember, 2% was absorbed by high fees), only grew to $812,355.15, or a little less than half as much.

That means you'll have half as much assets after 35 years using a high-cost personal financial advisor as you would using low-cost alternatives, all other things being equal. Bam!! 50% of your retirement is gone because of that little 2% fee differential. Shocking, but true.

Most investors don't think much of a little 1% advisor fee and mutual funds with high expense ratios, but the whole situation takes on another perspective when you imagine delivering a briefcase filled with, let's say $20,000, every year per million in your account, for your advisor's services. Few people would be willing to pay directly, but they don't think twice about a percentage fee dedication when it's the exact same thing. It's totally irrational.

But that's not all, folks, because it actually gets worse…

We also agreed you'd use the industry standard 4% rule which means you can only spend 4% of your assets in retirement. The only problem is all the research supporting the validity of the 4% rule uses that same assumption that you're invested in a low-cost passive index portfolio.

Your Financial Advisor Is Taking 75% of Your Retirement

If you're using a high-cost provider with 2% higher fees, that means that advisor is sucking out half of your spendable retirement income in his high fees.

In other words, you can still spend the 4%, but 2% goes to your advisor in fees and 2% goes to you as spendable money. Bam!! You never get to spend 50% of your portfolio income because it's paid directly to your advisor in fees.

So again, you may not think 1% here or there is a big deal, but would you be willing to take all the income from your retirement portfolio and split it 50/50 with your financial advisor for the privilege of his investment insights? Of course not, but that's exactly what many investors do.

Putting both expense burdens together, the high fees compound out to 50% less money accumulated, and the high fees also mean you can spend 50% less of what's left in the account. A little high school algebra tells you that you only get 50% of 50%, which is 25% of the income you would have had if you had watched your investment expenses more closely.

That means that small 2% fee differential cost you 75% of your spendable income in retirement.

I don't know about you, but the first time I figured that out it blew my mind. That's a life changing result!

Your Financial Advisor Is Taking 75% of Your Retirement

But It's Actually Worse!!

But remember, I was being conservative.

It's not uncommon at all to see financial advisor clients with an all-in fee structure closer to 3.25% instead of my more conservative 2.25%. In your homework with this lesson, I'll have you run the calculations on a 3% fee differential so you can see what happens to your retirement income. Just please make sure you're sitting down first and there are no sharp knives or scissors nearby because it's *ugly*.

Another reason this 75% estimate is conservative is because we only assumed 35 years of compound growth. Most people have longer investment time spans than 35 years, so if you compounded the impact of the fee differential for 45 or 50 years, like many investors in this course will do, then you've made the impact geometrically worse.

And there's one final assumption in here that makes this estimate conservative. Remember how I kept saying "all other things being equal"? That was just to minimize the variables to keep the analysis simple so you could follow along and intuitively get the obvious logic.

Some advisors might argue all other things *aren't* equal. I've heard the argument put forth by advisors that their fees are justified because their advice keeps clients from making dumb mistakes. However, the test for justifying advisor fees is simple – do they put more money in your pocket, or do they take money out of your pocket? That's the only issue that matters here.

And while there are certainly exceptional advisors out there who do actually deliver value, the research shows that, on average, the opposite occurs:

Your Financial Advisor Is Taking 75% of Your Retirement

- The research shows that high-cost funds selected by advisors, on balance, underperform their low-cost competitors in study after study.
- In addition, most brokerage firm investor portfolios underperform low-cost passive indexes by a significant margin according to research by Dalbar.

Summing it up then, it might be true that an advisor could defend his fees if he added value in excess of costs. It really would invalidate this entire analysis. But the research shows the exact opposite conclusion – advisors on balance are taking value in addition to layering on excessive costs. In other words, they are adding insult to injury by making things worse than I'm showing here.

When you put all these facts together, you can see that my stunning headline that your advisor is costing you 75% of your retirement income is actually conservative.

Sorry to break the news to you, but it's better now than never.

Bottom Line

The conclusion is simple – investment fees matter to the wealth growth component of your equation… a lot.

The reason investment fees are critically important is because they're charged as a percent of assets, giving them a negative compound effect on portfolio growth. What appears to be a small difference, an investment fee mole hill if you will, compounds over time into a Mount Everest portfolio difference.

Your Financial Advisor Is Taking 75% of Your Retirement

The rule is you should only pay fees that add more value than they cost. They must put more money in your portfolio than they take out.

Because few investment fees actually do that, as proven by multiple research studies, it means investment expenses are a simple, powerful, and dramatic way to improve the Wealth Growth part of your equation so you can close the gap between what a traditional wealth plan says you'll accumulate in wealth, and what your goals from the earlier lesson say you need.