

THE INVESTOR CATCH

Straight talk about investments, fees, risk, and who is poised to profit more—you or your advisor.

Market Advisory Group

With Danny Goolsby, Larry Kloefkorn, Matt Goolsby,
and Jonathon McCoy

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This booklet discusses general concepts for retirement planning and is not intended to provide tax or legal advice. Individuals are urged to consult with their tax and legal professionals regarding these issues.

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THE INVESTOR CATCH

THE INVESTOR CATCH-22

As the story goes, someone once asked Jessie James, “Why do you rob banks?” His reply, “Because that’s where the money is.” Ask any investor, “Why are you invested in the stock market?” and you’ll likely hear the same thing. The market is where all the horsepower is.

While this kind of thinking sounds rational, the market is decidedly irrational. This is what economist John Maynard Keynes was trying to warn investors of when he said, “The market can stay irrational longer than you can stay solvent.”

We live during unpredictable times. Pension plans have gone the way of the dinosaur, Social Security benefits are constantly changing, and people continue to live longer thanks to advances in modern medicine. All of this only puts more pressure on the earning potential of your nest egg, yet most investors continue to place all their eggs in market investments, even during retirement, even when losing could very well mean going broke.

But this isn’t the full story.

Investors have also been told throughout their working lives to save in vehicles such as 401(k)s and IRAs—but what happens when they get ready to retire? All of this money is going to be taxable, and if you've done a good job saving and happen to be a high-income earner, then a high percentage of your Social Security might also be taxed. From a volatility standpoint, living longer also acts as a kind of risk multiplier: it magnifies the number of times you'll likely go through a market cycle and experience sudden, plunging loss. Longevity also magnifies the likelihood of having a long-term care event.

With all of this stacked up against you, the last thing in the world you need is a brokerage account that is poorly managed, with inappropriate investment classes and high fees. Yet time and time again, that's what we continue to see. People come into our office with their investment account statements, and they are concerned about what they see because it doesn't at all match their needs or expectations. Through no fault of their own, they are paying exorbitant fees for features they often don't need or even know they have, and making choices simply because they don't know that other options and strategies exist. These mistakes are not just expensive; they're

harmful to the long-term viability of your nest egg.

And here's the real gotcha: you're going to be on the hook for these fees/taxes/losses/obligations whether you know about them or not. The mistakes are there, even if you choose to keep your head in the sand and your statements sealed in a drawer. So, what can you do about it?

IS THERE AN ESCAPE?

It was the 1961 war novel by Joseph Heller that first coined the phrase "catch-22." The term refers to a kind of paradox whereby escape is impossible. The "damned if you do, damned if you don't" trap that investors face has also to do with the large number of misperceptions and misrepresentations being perpetuated by an industry that relies on their money. You, the investor, are the one who has to do all the saving; if you don't, you'll have nothing to live on during retirement. But the investments you need to generate returns come with sales charges, management fees, and confusing terminology spelled out for you in dry, boring, multipage prospectus reports that would make better doorstops than reading material. (Think about it: if a prospectus has more than

200 pages, who do you think it was written to protect? You, or the investment company?) So what does the rational investor do?

He or she seeks the help of a financial advisor, who in many cases only stands to gain when the investor pays higher fees, and an inherent conflict of interest results. Arthur Levitt, the 25th and longest-serving Chairman of the United States Securities and Exchange Commission (SEC), gave a speech in 2001 on the rights and obligations of America's investors whereby he illustrated the problem of suitability standards. In one example—and there were several—he cited a case reported by the SEC where an investor allegedly paid out more than \$168,000 in unnecessary sales charges, even losing some of their principal; meanwhile, over that same period of time, the broker earned himself commissions totaling \$210,000.¹

So many of our clients come from situations where they aren't being serviced and they haven't been taught the pros and cons of the different products they're using. Even the alternative, going it alone and following outdated advice, doggedly holding onto stock portfolios as companies like Enron go down like

¹ <https://www.sec.gov/news/speech/spch457.htm>

the Titanic, can end up costing you money. The key findings of the 22nd annual Dalbar study also report that in 2015, the average equity mutual fund investor underperformed the S&P 500 by a margin of 3.66 percent.² Investors taking a different approach might run for the banks. There, you can purchase bank CDs where you earn so little, you end up doing what we in the industry call “going broke safely.”

There is no reason you should have to suffer the indignity of a retirement portfolio that is subpar, earning less than what it could, with balances at a fraction of what you deserve. You do have other options.

PLAN FOR YOUR FUTURE, LIVE YOUR LIFE NOW

As Benjamin Franklin once said, “Beware of little expenses; a small leak will sink a great ship.” We’re writing this book to help right the ship that is your retirement plan. We’re not broker-dealers or financial salesmen or even politicians; we are a group of like-minded fiduciary professionals with over 100 years of combined experience in the financial industry. We believe that putting our clients’ best

² <https://www.qidllc.com/wp-content/uploads/2016/02/2016-Dalbar-QAIB-Report.pdf>

interests before our own means operating with the utmost transparency and honesty. To that end, we are presenting you with the facts—the inside story, so to speak—so that you can see for yourself how investment products really work and how *not* to be caught unaware. We'll also tell you stories about real-life individuals such as yourself, people who have made mistakes through no fault of their own—mistakes that we want to help you avoid.

Every advisor out there no doubt has opinions on which investments are best, and which ones have the potential to earn the highest returns. You also no doubt have your own. We're not here to present you with our opinions (although at times we might, in which case we'll let you know). Rather, we consider it our duty as fiduciaries to lay out the facts, not opinions. The more facts you know, the better equipped you'll be to form opinions of your own. This is important, because regardless of how much your broker stands to make in commissions from your investments, nobody cares more about your money than you do.

If you have worked multiple decades to get to where you're at now, if you have arrived and are wondering how to best proceed, we're here to

offer you some straight talk about the multiple options that are available to you.

What's the catch?

The only thing that we want you to catch is a retirement, or maybe a fish from the bow of your craft as you sail away into a peaceful sunset.

Here's to a great escape,

~ Market Advisory Group

A little note about how to use this book: Investors come in all shapes and sizes, with different levels of experience. We have tried to make this book welcoming, without it being a dozer for those of you who are savvier savers. **Investment terms** that are in bold are defined in the lower left-hand corner of the page. We've also included an Investor Q&A for quick insights and Gotcha warnings that deliver potentially bad news now so that you can take action before it affects your accounts.

THE INVESTOR CATCH

CHAPTER ONE: MARKET-BASED INVESTMENTS

KNOW WHAT YOU OWN

“Rule No.1: Never lose money.

Rule No.2: Never forget rule No.1.”

~ Warren Buffett

Jerry worked for over 30 years as a high-ranking accountant with Boeing. As someone who was good with shocked numbers, he also handled all his own stock and mutual fund purchasing. He bought into a fund in the technology sector that did well in the 1990s, and so he held onto it, believing in the fund and in the long-term viability of the buy-and-hold strategy.

From 1999 to 2004, the fund lost 73 percent of its value, and Jerry’s retirement account plummeted from just over \$3 million to just under \$810,000. This happened the year before Jerry planned to retire. He was shocked. It was the first devastating loss he’d ever experienced, yet he didn’t adjust his strategy or change his approach. Jerry retired and started taking money out of these investment

accounts for his income. His advisor told him to stick with the market, and this reassurance only confirmed Jerry's own belief that the technology sector would continue to advance. But then again in 2008 it fell, and by 2009, his account value was at the bare minimum of what he needed to live on. At that point, he felt he had no other choice but to bail. Jerry cashed out his savings, took his money out of the market, and cobbled together his retirement after losing over \$2 million.

The mistake that Jerry made wasn't investing in the market; it was how he was invested in the market. Not everyone has \$2 million to lose, but regardless of the account balances in your retirement portfolio, no one who is near the time of retirement wants to see a 73-percent loss. Investors like Jerry in our story above who experienced loss during what has become known as the Lost Decade are only just now recovering. For those folks who retired during that time, their accounts may never recover.

Jerry retired with a fraction of the benefits he deserved not because he didn't save enough or work hard enough, but because he didn't have the right kind of professional support and



guidance. It was misdirected confidence that kept Jerry improperly invested—that and an investment plan that wasn't in his best interests. This chapter will help identify why.

THE RACECARS OF THE INVESTMENT WORLD

Racecars are designed for aerodynamics. They can hug a curve and go from 0 to 100 miles per hour in 4 seconds flat, while claiming speeds on the racetrack upwards of 200 miles per hour.³ They are designed specifically to be driven hard and fast for short periods of time, with lots of maintenance in between. Street cars, on the other hand, are designed with completely different goals in mind. Their owners expect comfort and safety, and they rarely if ever exceed 150 miles per hour. These

³ <https://www.express.co.uk/sport/f1-autosport/809783/Indy-500-how-fast-top-speed-500-mile-race-200-laps>

cars need to run for much longer time periods, and ideally with much less maintenance.

Investments are also designed with different goals in mind. Market-based investments are designed for accumulation. They have the potential for higher rewards, but that also comes with a greater potential for risk. This is one thing that market investments have in common with stock car racing: the potential for cash prizes and spectacular crashes.

To avoid that, investors want to be savvy about the types of investment vehicles they choose and how they are allocated for risk. When making these choices, most people look under the hood of their investments and ask, “How fast can it run?” This is the equivalent of asking, “What is the rate of return?”

There’s nothing wrong with assessing the earning potential of your investments, but if that’s all you look at, you’ll likely not get the vehicle you need. Let’s take a tour of the showroom and meet the investments that can provide the horsepower for your portfolio.

Our first stop: stocks.

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Irene was an 82-year-old widow in a wheelchair, living off her Social Security income. One day she received a small inheritance from her aunt and wanted to know what she could do with this money to best improve her situation. Her husband had always handled their investments in the past, and so she found an investment advisor willing to make house calls.

The advisor was sitting at her kitchen table when he noticed an entire wall devoted to what looked like several framed stock certificates, displayed rather prominently.

“What’s that?” he asked, curious.

“Oh,” said Irene, “that’s my hubby’s pension.”

Irene wasn’t joking. The stock was for Enron, and it was the only stock they ever owned. All during her working years, Irene was told by her husband, “Look how much our stocks are earning. We’re going to receive a stream of income from these dividends, and if we ever need more money, all we have to do is sell.” All those years raising three kids and going to work every morning, and he told her they would have it easy someday when they sold off their stock.

Then they retired, Enron went bankrupt, and their stocks became worthless.

STOCKS: Both traditional and dividend-paying stocks can have a place in a well-designed portfolio and may supply the horsepower for growth during the 20 to 30 years that can make up a retirement. When you purchase stock, you are given a piece of ownership in the company—be it a large, small, or medium-size company—and you become a shareholder. In that sense, stocks are a lot like buying a house, in that you hold equity in something tangible (and stocks are sometimes also called equities). As the value of the house/company goes up, the value of your equity/stock goes up. Investors like stocks because they can appreciate, or increase in value. When a company performs well, the price of the company stock rises in value and the investor can make money. When a company depreciates in value due to market volatility, the investor may lose money, which is why stocks are said to have **risk**.

Another reason people like stocks are because of the dividend payments. A company may distribute some of its earnings to its stockholders, but generally speaking, dividend-paying stocks tend to have less of a growth aspect. These are typically large-cap stocks

Risk is the danger or probability of loss.

that grow steadily, albeit at a slower rate. Investors often misunderstand how the yields on dividends work, and they get excited when the price of their stock goes up. Unlike yields, however, *dividends are declared*. **While it's public perception that these dividends typically don't fluctuate and the value of these stocks is a specified monetary amount, there are times when the company may lower or suspend the dividend payout.**

And during bankruptcy, stockholders will stop receiving dividends altogether.⁴

Problems can arise if you have too many of your eggs—or investments—in the basket of one company's stock. We see this often with investors like Irene and her husband in our story above, who participate in their company's profit sharing. Because these investments are done automatically, investors continue buying shares of one company's stock, steadily growing their retirement fund; meanwhile, retirement gets closer and no one asks the question, "How are we positioned for risk?" No matter the stock, you might not want its value to be directly tied to the quality of your future life.

⁴ <https://www.sec.gov/reportspubs/investor-publications/investor-pubsbankrupthtm.html>

Investor Q&A: *My stock just split! Should I buy a Ferrari?* Sadly, no. Just because your stock split doesn't mean that it has doubled in value. One benefit may be that more people are able to invest in your stock, but typically its value will not be worth more.

BONDS: Compared to stocks, bonds are traditionally thought of as the safer part of your typical 60/40 stock-and-bond portfolio. When you buy a bond, you are basically loaning money to a company or state municipality in exchange for periodic interest payments, plus the return of the bond's face amount on the date that bond matures. They typically offer a lower rate of return than stocks, but the **principal** on most bonds is thought to be guaranteed.

If interest rates rise, however, you may be forced to sell your bond at a discount. The Federal Reserve has been talking for some time now about the need to normalize interest rates, which for bonds are typically in the neighborhood of 3 to 4 percent. As of the writing of this book, rates continue to remain low, but we may have turned a corner.

Your principal is the base amount of money that you put into an investment.

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If interest rates rise as predicted, and you go to sell your lower-rated bonds, you may have to sell at a discount, and it's possible that you won't get all your money back. **In a rising-rate environment, bonds can be as volatile as stocks.** Even though they are perceived as safer and more conservative than stocks, when the interest rates rise, bonds can subject your portfolio to the same type of volatility as stocks.

GOTCHA: Investor alert for callable bonds: corporate bonds are often callable. The best way to explain this is to think about your mortgage. When interest rates go down, the homeowner might like to refinance. With callable bonds, when interest rates change, the corporation is the homeowner, so all the power is in their hands. They can call in the bond, sell it, and refund your money. This gives the company more favorable terms, not you. The investor is left without that income stream, in a position where they have to go back into the market for a new investment while trying not to jeopardize their principal.

INVESTMENT FUNDS: Pooled investments allow investors with similar goals to combine their savings in hopes of benefiting from more diverse purchases and lower individual risk. One of the most common types of investment funds are mutual funds. A mutual fund is an investment company that pools money from many investors and invests it, usually offering built-in diversification and professional management based on specific investment goals. What do mutual funds invest in? Mutual funds are an equity investment just like individual stocks, and you'll recognize the four main fund categories:

- Stock funds
- Bond funds
- Balanced funds (a combination of stocks and bonds)
- Money market funds: short-term investments that are sometimes described as cash equivalents

If you own an IRA with a brokerage company and/or invest in your company's 401(k), then chances are pretty good that you're invested in mutual funds. *Most people invest under the misguided belief that their advisor charges them a small fee of around 1 percent for the privilege of investing in mutual funds.*

Here's the catch, folks: there are many other fees! How many fees? We need a full chapter to understand all the different ways you can be charged fees inside of mutual funds, so stay tuned for what's ahead in Chapter Two.

Investor Q&A: Is there a low-cost option for pooled investments other than mutual funds? Yes!

Exchange-traded funds (ETFs) are pooled investments like mutual funds, but they typically have lower operating expenses, no loads (or sales charges), and no 12b-1 fees.

When Joe was 58, he went to his advisor and told him, "I'm going to be retiring in the next few years. What can you get me in the way of guarantees? I don't want to lose any of my income to the stock market."

Because Joe was working with a stockbroker, the advisor recommended a kind of annuity called a variable annuity. With the purchase of something called an income rider, Joe could get a guaranteed growth rate of 7 percent, but he didn't quite understand the fee structure or limitations of the investment he was in. All he understood was

that he was getting a guaranteed growth rate of 7 percent. What's not to like about that?

Several years went by, and then Joe retired. He had met his goal of saving \$1 million and felt pretty good about his prospects. Then he started noticing that the actual account balance on his variable annuity was starting to drop. At first, he thought it was due to his income payout, but the numbers weren't quite adding up. After a while, Joe started to get concerned. If he had a guaranteed 7-percent growth rate, why wasn't his account balance higher?

He went in to see a fiduciary professional who took the time to explain to him how variable annuities worked. When the professional was done peeling back all the layers of the onion, Joe got a very bad feeling. He realized that in exchange for his 7-percent guaranteed growth rate, he had paid out more money in fees during the last 10 years than what the investment was able to earn.

VARIABLE ANNUITIES: Of all the popular types of market-based investments, variable annuities continue to be among the most vexing. In our experience, most people get into these vehicles under the misguided belief that they are protecting their nest egg and preserving their

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retirement, without realizing that they are still in a market-based investment. If there is only one thing you learn about variable annuities, it should be this: *they CAN lose money, even if you pay extra for the guarantees.* And by lose money, we mean to the stock market. That's why they have the word variable in their name.

If you can't wait to learn "All About Annuities," check out Chapter Four. Not all annuities are market-based. The variable annuity is special in this respect. It is one type of annuity that attempts to give you the horsepower of mutual funds packaged under the durable hood of a minivan, so to speak. If you're looking for growth and safety, a variable annuity is a kind of one-size-fits-all answer that comes with a rather expensive price tag. They are much more complex than mutual funds because they are trying to give you a layer of protection and access to dependable income. They are also, generally speaking, the most expensive kind of annuity that you can own.

Just how expensive? A Morningstar 2012 report found the average fees for a variable annuity to total 2.35 percent, but if you add the living benefit rider, which is what Joe in our story above got in order to get his guaranteed

7 percent, then the average cost becomes 3.4 percent.⁵ Your fees might be higher due to the individual subaccounts charged by the mutual funds inside the annuity. There are several costs associated with variable annuities:

A possible upfront sales charge, which can be similar to the front-load fees charged by Class A mutual funds

- A sliding-scale surrender charge that generally ranges anywhere from 0 to 10 percent, and which may decrease the longer you own the annuity
- Insurance charges known as the **mortality and expense risk (M&E)**, in addition to administrative costs and possible distribution charges
- Management and/or administration fees
- Underlying fund expense ratios, similar to those charged by mutual funds
- The additional expense of the rider if you want to get a guarantee
- An annual contract or maintenance charge assessed by the company that sells the annuity

⁵ http://corporate.morningstar.com/us/documents/NASDCompliance/ADV_AIR_SubmittedReport_SideBySideComparison.pdf

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With all these fees, you might wonder why anybody ever buys them. In most cases, we find that people who purchased them did so because they thought they were getting a shiny racecar that could give them a guaranteed rate of return somewhere in the neighborhood of 6 or 7 percent, like Joe in our story above. They don't realize that: 1) this type of investment can lose money during a stock market downturn even with the guaranteed protection in place, 2) the fees really add up, and 3) you have very limited access to your money. And here's the real gotcha: you still have to pay those fees even if your account takes a hit and is losing money.

Commodities: A commodity is a physical good such as oil or gold or coffee that is used in commerce and can be interchangeable with other commodities of the same kind. There are many ways to invest in commodities, but there are only four categories:

- Agriculture (corn, sugar, wheat)
- Livestock (live cattle)
- Metals (silver, gold, copper)
- Energy (crude oil, gasoline, heating oil)

The catch: you want to be aware that just because you can sell a commodity doesn't mean that you will be able to capture your just

rewards at the going market price. It's helpful to think of it as similar to the buying and selling of cars. There's usually a salesman involved who offers to buy the car/gold for the *least* amount possible in hopes of marking up the car/gold and selling at a *bigger* profit for themselves, not you.

GOTCHA: While **real estate investment trusts (REITs)** are becoming more prevalent, most people are surprised to find out how **illiquid** they are, with a high potential for volatility. Many of them also include internal fees and expenses that should be understood by the investor. If you have REITs in your portfolio, mark these with a red flag in your mind and have them evaluated by a fiduciary professional.

Digital Currency: This is one investment that didn't even exist during the days our grandparents were investing, and some would even argue that it doesn't really exist now. Also known as cryptocurrency or electronic currency,

Liquidity is the ability of an investment to convert easily to cash.

with names such as Bitcoin (BTC), Litecoin (LTC), and Ethereum (ETH), digital currency is highly volatile, all the rage, and worth only what other people are willing to pay for it. It exists purely in electronic form as a money balance recorded on a stored-value card or other device. For all of human history, our currency has held or stored some sort of inherent value that consumers could use for trade. According to the Internal Revenue Service, virtual currency is a digital representation of value that functions as a medium of exchange, and so in 2014, it announced that it would treat Bitcoin as *property* rather than *currency* for tax purposes.⁶ In that sense, digital currency functions more like a commodity than an actual currency. While these currencies are already trading on the futures market and likely here to stay, it's uncertain how the government will regulate them. This is a speculative and dangerous investment, in our opinion—one that is still a work in-progress, and should therefore be approached like you might the craps table at the casinos in Vegas, particularly for those investors at or nearing the time of retirement.

⁶ <https://www.irs.gov/pub/irs-drop/n-14-21.pdf>

KNOW YOUR RISK NUMBER

We find that when it comes to investments, there are generally two types of investors. Both types can best be explained by thinking in terms of a clock: some people only need to know how to tell the time; other people need to know exactly how the clock works. For the engineers among you, we're going to take a deeper dive into the subject of risk and asset allocation later on in Chapter Five, when we talk about the differences between active, passive, and tactical management. But for the rest of you, here's a simplified way to think about risk:

You know those mattress commercials where one spouse is sleeping comfortably and the other one is rustling around, miserable? Consumers are encouraged to “know your sleep number” so that everyone can get a restful night's sleep. It can also be helpful to think of risk in terms of what would allow you to sleep best at night. To that end, we advise investors to “know your risk number,” so to speak.

One way to identify your risk number is a rule of thumb known as the Rule of 100. The rule states that your current age subtracted from 100 should equal the percentage of your portfolio that you have allocated to market-

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based investments. For example, if you are 62 years old, then you should have 38 percent of your portfolio allocated to market-based investments.

100 - YOUR AGE = YOUR RISK NUMBER

Now this is by no means a hard-and-fast rule; it's just a starting point to help you understand your risk tolerance. Had Jerry in our story at the beginning of the chapter identified his risk number before retiring, he might have moved a percentage of his portfolio to safety and kept more of his money. You might also ask yourself this: if you woke up tomorrow and the balance of your investment portfolio had dropped by 73 percent, how would you feel? If the feeling isn't good, use the Rule of 100, find your risk number, and ask the question again. Using our earlier example, if only 38 percent of your portfolio (rather than 100 percent) dropped by 73 percent, how would you feel then? If you know that the remaining 62 percent is safe and enough to cover your income expenses, then maybe you're comfortable with that. If you still feel bad about it, adjust the numbers and fiddle with the dial until you can sleep at night.

Investor Checklist

Do these three things:

- ✓ Understand what you own.
- ✓ Know the goal of each investment.
- ✓ Identify your risk number.