Don’t Let Greed Rule Your Investment Expectations

By Ricky Grunden, CFP™

Unhappy with your portfolio returns? Be careful. Greed for higher returns is not a good reason to change your investment manager. How your manager is paid and the return you receive for your level of risk may be.

Greed has always driven bad investing behavior, particularly when investors choose an investment or investment advisor based solely on returns. As the old saying goes, if it’s too good to be true, it probably is.

It is important to have appropriate expectations in any investment environment. Over the last 60 years, the equity markets have returned between 8% and 10% to investors after inflation and taxes each year. The bond market has returned less than 5%. But because of the length of our recent bull market (nearly eight years) and the fact that until this summer many investors had never seen minus signs on their monthly portfolio statements, some people believed that the march toward higher and higher returns on investments would never end. They lost sight of reality and put money into high-risk investments that promised high returns, confident that the investments could not fail. Then the market turned down, and so did those investments.

To keep from chasing unrealistic returns yourself, you should answer two key questions before starting a relationship with any investment advisor or manager:

1. How is the investment advisor compensated for his or her efforts? (What are all the costs associated with investing through this advisor?)

2. What performance do you expect from your investments – in terms of risk and return?

Investment advisors are compensated in three basic ways for the time they spend determining your investment needs and preparing appropriate advice. These are paid by commission only, by fee and commission, and by fee-only.

Paid by commission only: These advisors do not charge their clients for the time spent working with them and developing an investment proposal. Instead, they hope that clients will purchase financial products (such as stocks, mutual funds, annuities, and insurance) through them, from which the advisors receive a percentage commission. (The amount of commission varies across companies and financial products.)

Ask about these potential costs to you as a client: Is there a similar product to the one(s) recommended with less commission (and less cost to you)? Are there 12-b1 or similar fees? Has the advisor carefully explained what those fees are? What are the up-front costs you will incur? Are there surrender fees? If so, how do they work? Is there a quantity discount (i.e., do you get a break on the fees if you invest a certain amount of money)? What is the difference between A, B and C class shares? What will the broker make in commission with each class category? How often are stock transactions recommended? What is the percent commission on the buy and on the sell? Is this negotiable?

Paid by fee and commission: These advisors charge a nominal fee for the hours spent working with clients to develop an investment plan, but rely on commissions earned from clients’ purchase of financial products for the bulk of their income. The fee charge allows these advisors to work with clients who may be unlikely or unable to make investments, but need professional financial advice.

Ask about these potential costs to you as a client: Exactly what services are included in the fee? Are there any time limitations? What actions will incur a commission? What are the commission arrangements on each product being considered? Are there loads or fees associated with the

investments? Do you have the option of implementing the advice yourself using a discount brokerage?

Paid by fee only: These advisors charge a flat fee for their investment advice or, more commonly, a periodic fee (monthly or quarterly) for long-term oversight of client investments based on a percentage of either assets managed or client net worth. Many of these advisors have discretionary authority to direct the investment of their clients' assets, following client-approved guidelines. Others give clients advice on what to do with their investments which they must then approve or implement themselves.

Ask about these potential costs to you as a client: Exactly what services are included in the fee? Are transaction costs, account maintenance fees, and other account-related fees included? If not, how are they billed, how often, and how much do they cost? Are there any fees for accounts that fall below the minimum size?

A candid discussion of the advisor's compensation method and all costs that you might reasonably expect to incur while working with the advisor should be part of the initial educational discussion between you and your advisor. As a client, you need to know and feel comfortable about the compensation model your advisor uses.

Regardless of how an advisor is compensated, most do an excellent job and more than earn their pay. There are excellent financial and investment advisors within each compensation model. However, no matter how good an investment advisor is, he or she will never be able to satisfy a client who has unrealistic expectations.

Expectations for Risk/Reward

The quest for high returns at low risk is the most common unrealistic expectation for investments. The risk/return relationship in investment performance is a very simple concept: they increase and decrease together. To get higher returns, you have to expect more risk. If you want less risk, then you must accept lower returns. Look back to the average return of the stock market over the past 60 years: 8% to 10% (after inflation and taxes). That return correlates to average risk within the market. If you want to achieve 25% returns year after year, then you must take on significantly higher risk than the market average.

(Because the market does go up and down, 25% returns may be an average return requiring only average risk in a given time period. But over long periods – five years or more – the average return hovers around that 8% to 10% level.)

If your investment advisor does not seem willing to discuss what returns you expect to receive and what level of risk you feel comfortable taking, then you should probably look elsewhere.

Think about the risk/return relationship the next time one of your friends brags about the high returns they got from an investment. Chances are they took a lot more risk to earn that return, and their next big risk may not pay off so well. If you are satisfied with your levels of risk and return, resist the urge to compete with your friends. What's right for your neighbor or brother-in-law isn't necessarily right for you.

Greed is a difficult human emotion to admit to, but it can sabotage the security of your financial future if allowed to go unnoticed. Screen your investment advisors before working with them, to make sure that they are worthy of your trust, faith, and assets. Don't rely solely on someone else's recommendations. Ask questions until you understand the answers. If you do not understand where the promised returns will come from, ask for help in understanding the related investment concepts. If it still does not make sense to you, pass on that investment, or that advisor.

Only when you take responsibility for your decisions can you be sure that your natural human greed will stay in check and your investing future will be well handled by advisors you trust.