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Chasing Rates of Return - Take a Look in Unexpected Places

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Fifty years ago, the landscape of personal finance was a much different place. Common retirement and investment plans with funny sounding, alphanumeric names such as the 401(k), IRA, 403(b), RRSP, HSA, Roth, and RESP, among others, did not exist. The average worker generally expected to work for one or two companies throughout their entire working life. And this company was going to reward such loyalty with a company pension. You worked for a few decades and upon retirement, you could count on a monthly income for the rest of your life.

Most people felt that a comfortable and safe retirement was assured through a combination of a “promised” corporate pension and government retirement benefits. Any additional savings or investments became “icing on the cake” and helped to increase retirement income over and above the guarantees of the pension.

Fast forward a few decades and in the mid to late 1970’s, the burden for securing a sound retirement began to shift from corporations and the government to being squarely upon the shoulders of employees. The corporate pension was about to go the way of the dinosaur- or at least that of a very endangered species.

Workers today are now used to actively saving for their own retirement. Most do it through a payroll-deducted plan and may supplement it with some self-directed savings. Whether you’ve worked with a financial adviser or are a DIY kind of person, you’ve undoubtedly made savings and investment decisions based on the expected rate of return that a product or service has to offer. Simply put, a rate of return is the gain or loss of an investment, over time, in relation to the value of the investment at a starting point.

You commonly hear phrases like "*average rates of return*," "*historical long-term returns of the stock market are around 10%,*" and "*high risk/high reward, low risk/low reward*." The prevalence of *goal-based planning* has also put a tremendous amount of emphasis on an investment or portfolio's *rate of return* due to the planning needing a specific rate of return for success. Because of this, people have been conditioned to think of *rates of return* as being generally synonymous with success in planning. Yet, it's not that simple.

Obviously, *investment risk* is a consideration when trying to earn the highest *rate of return* that you can. Let's look at the very interesting realities of *average rates of return* and identify a "place" that you might not think of looking when trying to increase *rates of return*.

There's a problem with how *rates of return* are typically expressed. When you see published *rates of return*, you're usually given an average rates of return, of an investment over a specific period of time. It might be expressed over six months, a year, 5 years, ten years or even longer. But this can be very misleading. Here's a simple exercise to understand why:

Starting Balance:	$10,000
Year 1 Rate of Return:	10%
Year 2 Rate of Return:	-10%
Balance End of Year 2:	$9,900
Average Rate of Return:	0%
Actual Rate of Return:	-0.50%

In this example, the $10,000 you started with is worth $9,900 after two years. At the end of year one, the $10,000 grew to $11,000 after earning a 10% *rate of return*. But after year two, and a loss of 10%, the $11,000 loses $1,100 of value and thus you end up with $9,900. Mathematically, the average *rate of return* after two years is 0% (up 10%, down 10%, divided by two years = 0%). But the actual rate of return that you realized in the account was *negative*: -0.50%

So, chasing rates of return is fraught with numerous challenges such as past performance not being an indicator of future results, and that the reported r*ate of return* may not accurately reflect how you would have done if you invested in the account.

An easy way to increase "*rates of return*" is not to focus on the investment side of your financial life. Instead, focus on the costs that you are incurring. The effect can be dramatic. Here’s a *simple* analogy to understand the profound effect that reducing or recapturing financial costs can have.

Let’s say you analyzed your entire “financial engine” and determined that is has a growth potential of 8%. But it also has financial costs of -3%. So, in very simplistic terms, you conclude that your “financial engine” is performing at a rate of 5%. In order to increase the “engine’s” output, most people first think of adding more “fuel” to their engine. That is, they are searching for different products or advice that will help them get better performance from their “engine.” In most cases, seeking increases in *rates of return*, based on investment selection, demands that more risk be taken. So, it’s not guaranteed that you’ll out-perform your current investments and you’ll likely be taking more risk to do so. What if instead of focusing on trying to increase the “engine’s” 8% growth potential, the focus was on reducing the 3% financial costs and inefficiencies that are slowing the “engine” down? Imagine being able to reduce these costs by half so that instead of -3%, they were -1.5%. The effect would be that the “engine” would now be operating at a performance rate of 6.5%. This is a 30% increase in the “financial engine’s” efficiency.

Even more importantly, this was accomplished without taking any additional risk and by using the dollars already within the engine!

Some examples of financial costs that drive down the efficiency of people’s “financial engines” are:

- Income taxes
- Increasing taxes
- Excess or duplicate expenses
- Interest on loans and debt
- Planning & advice fees
- Investment fees & charges
- Loss of wealth in market corrections
- Overpaying for certain types of insurance
- Being under-insured when claims arise
- Lack of coordination between various financial products

So, when it comes to seeking better performance from your “financial engine” the best place to look may not be at which shiny, new investment product or idea might offer a better return in the future. Rather, pop open the “hood” and see if you can make your “financial engine” work harder by eliminating unnecessary costs which are driving down performance today.

Remember, a “clean financial engine” is one that’s poised to perform at its peak for years to come. Financial professionals who use the Leap® process are trained to help their clients improve their financial life by reducing and eliminating current and future financial costs *first*. It is only then, that one’s true financial potential has the opportunity to be realized.