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Big Money Mistakes

The wealthy are prone to three financial errors that you can avoid.

Wealth Management
Trusts & Estates
A Practice Focus

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As a financial adviser, I have enjoyed working with many wealthy individuals—a group that has accomplished much in life, yet often makes certain preventable financial mistakes.

As a group, wealthy individuals are exceptionally bright, hard-working, good people. They have accumulated fortunes because they have done so many right things over their lifetime. They typically earn great incomes, live on less than they make, invest the difference in equities and bonds over a long period, wisely manage inheritances, and let their investments grow with the economy.

Yet they are also subject to human frailty, and they sometimes make big mistakes in their personal finances. And I have found that the wealthy often feel uneasy and lack financial peace of mind. This is because some basic mistakes cause unnecessary risk and thus can create an intuitive and justifiable sense of uneasiness.

The following are the three most common mistakes I see the wealthy make:

- Chasing returns based on past performance
- Trying to diversify wealth by having many different brokers instead of many different types of investments
- Spending too much money from their portfolio in retirement

Avoid Chasing Returns

At the peak of the tech-stock bubble in February 2000, I knew a wealthy family who demanded that their financial adviser put all of their $5 million of financial investments into tech stocks. Although a portion of their (balanced) portfolio had already been invested in tech stocks, they now wanted their entire portfolio to have the higher returns that tech stocks had provided in 1998 and 1999.

Fortunately for this family, the tech bubble started to break shortly after their request, and they stayed with a balanced portfolio with reasonable returns and risks. But I have met with many other wealthy families who were not so fortunate and lost substantial wealth by chasing tech stocks in the late 1990s. Those who chased the Nasdaq, a representative of the tech bubble, had recovered only about half of its value in early 2000.

I also saw another wealthy individual retire with a sizable stock position in his former company. In his case, the company was the seventh largest in the world. It had treated him well in his career with good salaries, promotions, and the constantly growing value of its stock. His past experience with this stock was so positive that he could not be convinced to diversify his concentrated holdings in it.

In his case, the former employer was Enron, and within a few days after the disclosures of Enron's real financial condition, his stock was worthless. The stock's past positive performance was not indicative of its future.

In the late 1990s, a different wealthy family had placed most of their investments in junk bonds in hopes of higher returns. In the stable growth years of the 1990s, junk bonds provided reasonably high returns, but when the economy went into recession in 2000, many of their junk bonds defaulted. Again, their earlier experience with junk bonds was not a predictor of their future performance.

Past performance is not indicative of future performance. As much as we love to read the stories in the financial press about "hot" stocks and "hot" mutual funds, their past is not a good predictor of their future. Investments can run up in price, but they tend, over time, to return to historical return levels.

The best long-term course is to have a balanced portfolio of different types of stock and bond investments, a portfolio that provides a reasonable return and that reflects someone's ability to bear risk.

Investments, Not Brokers

The wealthy know that diversification is essential to achieving a secure financial future. So they will often place their wealth with six or more brokers to feel comfortable that their investments are really diversified. They often choose different brokers based on having their money parceled out to "aggressive" brokers, "conservative" brokers, their long-time family brokers, trusted friends' brokers, their insurance brokers, and so forth.

On the surface, this seems reasonable because each broker seems to be doing something different. But the problem is that no one, including the wealthy clients and each of the individual brokers, knows how everything fits together. No one is looking to see how the total package meets the clients' long-term investment objectives and their willingness and ability to bear investments risks.

In this approach, each broker independently assesses the client's needs for the small portion of investments that the broker is buying. The brokers rarely know anything about the other investments, so they act without regard for the entire portfolio.

As a result, the wealthy often do not have a clue about how much is allocated between stocks and bonds for the overall portfolio, the return objective for the overall portfolio, or most important, how much risk they have for the entire portfolio. From not knowing how they are invested overall, they often feel uneasiness with their wealth because they do not know how—or if—it all fits together.

And when I examine all of the investments and allocations with software, the wealthy are typically concentrated almost exclusively in large-cap U.S. stocks with very few bonds.

That isn't a balanced portfolio. Large-cap U.S. stocks (that is, those of the largest U.S. companies) are a good investment, but there needs to be appropriate allocations to other types of investments such as specific allocations to value and growth stocks, small-cap stocks, real estate investments, international investments, short-term bonds, intermediate-term bonds, and inflation-protected securities. An appropriately diversified portfolio will provide better returns with less downside risk.

At least one adviser needs to examine how all of the money is being invested and determine if the asset allocation reflects the family's objectives and tolerance for risk.

Spending Too Much

The wealthy have typically worked long hours for many years in demanding careers to accumulate their wealth. So, in the retirement years, they commonly feel that now they deserve to live like never before.

They now have time to spend money, they want to do things that they always dreamed about doing but were too busy to do, and they are still young and healthy enough to do them. This time is sometimes called the "go-go" years of retirement, where living expenses often increase from the working years when people were too busy to spend too much.

I have seen wealthy families go into retirement with dreams like taking their entire extended family to a European villa for the summer, building a larger and better dream home, buying an overseas home in addition to their current home, and enjoying extensive travel for themselves, their children, and grandchildren. Unfortunately, sometimes this can cause enormous stress on their future financial security.

What is the problem with taking advantage of our built-up demands in early retirement? The risk is in taking so much money from the portfolio that it cannot reasonably sustain us over time. That is, we need our portfolio to take care of us through our entire life, and particularly after an early retirement, our lives can easily extend 20 or more years into the future. That means that our portfolio not only needs to be preserved, but it also must grow so as to protect us from the long-term effects of inflation.

This challenge can best be understood by an example from Ibbotson Associates of withdrawals from an investment portfolio. This illustration assumes that 5 percent to 9 percent withdrawals, adjusted annually for inflation, are taken from a balanced portfolio of 50 percent stocks (represented by the S&P 500) and 50 percent bonds (represented by five-year U.S. government bonds), starting in the year 1972 and continuing until the investments are depleted.

The 5 percent withdrawal rate lasted 22 years (from 1972 to 1994), and the 9 percent withdrawal rate lasted only nine years (from 1972 to just 1981).

Studies have determined that a 3 or 4 percent withdrawal rate (with annual inflation adjustments) taken from a balanced portfolio of diversified stocks and bonds has been historically sustainable.

So, the challenge in retirement is to maintain a withdrawal rate that will both (1) preserve the investments and (2) let the investments grow to cover the increased future costs from inflation. Thus, the wealthy need to spend only as much as can provide a sustainable inflation-adjusted withdrawal during their whole retirement.

In sum, although the wealthy have greatly succeeded in accumulating investments, they must be sensitive to the perils of chasing returns, of diversifying with different brokers instead of with different types of investments, and of spending too much money in retirement.

Nevertheless, an appropriately balanced portfolio of different types of stock and bond investments, with reasonable withdrawal rates in retirement, can provide increased financial security. By adopting this type of portfolio and avoiding major mistakes, the wealthy can enjoy their retirement with peace of mind.

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