

# Winning the Battle Against Investment Fees and Biases

Arm yourself with the tools you need in the fight to keep as large a share as possible of your investment returns.

by Paul Merriman | May 2024



*Paul Merriman leads a class in AAI's new Essential Investing Video Course. Go to <https://www.aai.com/ves> for more information and to subscribe.*

- Investors face two foes that work against their wealth-building efforts: their own emotions and Wall Street
- Understanding personal biases and Wall Street's interests helps investors navigate toward better returns

- Incremental increases in your returns and keeping costs as low as possible can significantly impact your long-term wealth

When investors hopefully set out to make their fortunes, very few spend much time thinking about the forces that might be allied against them. But they should.

As an investor, you have two major foes: yourself and Wall Street. These aren't necessarily your "enemies," but I can make a case that they are allied—and not always on your side.

In a nutshell, here's what I mean:

- Your own emotions, biases and the way your brain is pre-wired all make it hard to do the right things as an investor.
- Wall Street would like you to be successful, but that's secondary. It is much more important to the investment industry that it gets a piece—many pieces—of the action, in the form of commissions, fees, charges and all manner of expenses.

There's a sort of conspiracy between these forces. Your brain wants to believe that Wall Street is really on your side. Your brain wants to believe your broker or adviser will lead you to an easy and pain-free way to build wealth.

For its part, Wall Street, of course, knows very well how your brain is wired. The industry spends a lot of time and money figuring out how to take advantage of that knowledge.

The good news is that you can overcome these foes if you educate yourself to understand and declare a sort of war on unnecessary costs as well as the complexities of your own "bad behavior."

## The Math of Successful Investing

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Let's start with some simple math. Over a lifetime of investing, a seemingly small increase in your return can make a really big difference in your ultimate results.

Table 1 shows that an increase of only 0.5% per year can be worth more than \$1.5 million to you and your heirs. The calculations assume you invest \$6,000 when you're 25 and keep adding the same amount each year for 40 years. You retire at 65, then take 4% annual distributions for 30 more years.

**TABLE 1**

**Long-Term Impact of Boosting Returns by 0.5%**

	Scenario 1	Scenario 2
Investor Age at First Investment	25	25
Annual Investment	\$6,000	\$6,000
Total Amount Saved	\$240,000	\$240,000
Annualized Return Ages 25–65	8.0%	8.5%
Portfolio Value at Age 65	\$1,678,686	\$1,924,893
Annualized Return Ages 65–95	6.0%	6.5%
Age at Final Withdrawal	94	94
Total Withdrawals Ages 65–94	\$2,623,973	\$3,243,727
Residual Value of Portfolio at Age 95	\$2,833,234	\$3,741,381
Withdrawals Plus Residual Value	\$5,457,207	\$6,985,108

*Source: The Merriman Financial Education Foundation.*

Using conservative assumptions for your long-term returns, the table shows results of two scenarios. The only difference is that scenario 2 is based on returns that are 0.5% higher than those of scenario 1.

Three interesting things in this table jump out at me:

- First, the bottom row's very large numbers resulted from "only" \$240,000 in investments over the years.
- Second, in each scenario, 30 years of withdrawals at a conservative 4% rate yielded significantly more than the whole portfolio was worth at age 65.
- Third, after 30 years of withdrawals, the remaining portfolios were each worth more than when those withdrawals began.

In this hypothetical scenario, an additional 0.5% in return was ultimately worth an extra \$1,527,901.

An extra 0.5% isn't hard to achieve. In fact, it's often easy to get twice that much: an extra 1.0% compound annual return. Over a lifetime, the results can be mighty impressive, as shown in [Table 2](#).

**TABLE 2**

**Long-Term Impact of Boosting Returns by 1.0%**

	Scenario 1	Scenario 3
Investor Age at First Investment	25	25
Annual Investment	\$6,000	\$6,000
Total Amount Saved	\$240,000	\$240,000
Annualized Return Ages 25–65	8.0%	9.0%
Portfolio Value at Age 65	\$1,678,686	\$2,209,751
Annualized Return Ages 65–95	6.0%	7.0%
Age at Final Withdrawal	94	94
Total Withdrawals Ages 65–94	\$2,623,973	\$4,019,535
Residual Value of Portfolio at Age 95	\$2,833,234	\$4,943,035
Withdrawals Plus Residual Value	\$5,457,207	\$8,962,570

Source: *The Merriman Financial Education Foundation.*

The bottom line is that an extra 1.0% was worth an extra \$3,505,363. This is more than twice as much as the extra \$1,527,901 from adding 0.5% in return ([Table 1](#)). That's a result of the "magic" of compounding.

These impressive results are based on assumed returns well below those of the S&P 500 index, which over the past 94 years has compounded at a rate of roughly 10%.

## Keeping the Return That You Earn

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Serious investors know they will be rewarded for taking risks. The return you get is (in a very general way) proportional to how much risk you take.

That reward should belong to you. But Wall Street—which does not share any of the risk you have taken—has myriad ways to nibble away at your return. These nibbles may seem tiny and insignificant but they can really add up.

If an underlying asset like the S&P 500 has a return of 10%, that's all that is available to split between you and Wall Street. Whatever Wall Street takes, you don't get.

Look at those tables again, but imagine you are running a business on Wall Street. If your company can find a few investors who will let you have a mere 0.5% of their returns, it's good for you. Find 10,000 investors who are willing to pay you 0.5% of their returns and your business can really thrive.

The investors take the risk, while you rake in the dough. I know this sounds cynical. I assure you that Wall Street has many ethical, honest managers, brokers and advisers who don't consciously try to cheat their clients and customers. The tension I have just described is still very real,

and it's why I believe investors are engaged in a "battle for investment returns."

Much has been written about Wall Street's investment fees and expenses. I want to touch on a few of the biggies—along with my quick-and-dirty advice on how to avoid or minimize them.

Among the worst offenders is the mutual fund sales commission, called a load. If you invest \$10,000 in a load fund that charges a 5.75% up-front commission, you immediately lose \$575. Only \$9,425 is invested in your account.

That \$575 is money that won't ever work for you. Instead, it will work for a brokerage company and a salesperson who persuaded you to buy the fund.

If \$575 seems like a small price to pay for the help of a salesperson, think about it this way: You not only give up 5.75% of your initial principal but also 5.75% of every dollar you would otherwise earn in that fund.

Fortunately, the solution is simple: Just say no to any fund that involves a sales commission. For any load fund that a salesperson recommends, there is undoubtedly a comparable no-load fund that won't gobble up a chunk of your money on the first day.

Another biggie is active management. A few actively managed funds outperform their benchmarks. But most of them don't. Why? They pay a lot more for managers than is the case with index funds. They have higher portfolio turnover (which costs money, and the shareholders are the ones who pay). Active funds also often pay substantially more for marketing than index funds. Moreover, they rely on fallible human beings and their guesses about what the market has in store.

For investors in taxable accounts, the buying and selling within a fund can incur taxes. These taxes can easily take away as much as 1% of the compound return.

## The Solution

There is a simple solution: index funds. There is a low-cost index fund for virtually any asset class with a favorable long-term record of returns.

A lot of the aforementioned nibbles are wrapped up in a fund's recurring operating expenses, which are unavoidable. Some funds—even index funds—charge much more for just keeping the doors open than others.

I think it's reasonable to pay expenses of perhaps up to 0.20%. But if you own funds that are charging annual expenses above 0.50%, you may be paying too much. In some cases, way too much. Fidelity, for example, offers a few index funds with annual expense ratios of 0.00%.

Although I'm mentioning mutual funds, this discussion also applies to exchange-traded funds (ETFs).

## Doing Something Wall Street Can't Take Away

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Now I want to switch gears for a moment and tell you something simple you can do to improve your lot. It's not magic, but Wall Street can't take it away from you.

In Table 2, we saw the result of adding 1.0% to your long-term return. Table 3 goes one step further by increasing your annual investment every year by 3%.

**TABLE 3**

## Long-Term Impact of Increasing Savings Contributions by 3% Each Year

	Scenario 3	Scenario 4
Investor Age at First Investment	25	25
Initial Annual Investment	\$6,000	\$6,000
Total Amount Saved	\$240,000	\$452,408
Annualized Return Ages 25–65	9.0%	9.0%
Portfolio Value at Age 65	\$2,209,751	\$3,068,065
Annualized Return age 65–95	7.0%	7.0%
Age at Final Withdrawal	94	94
Total Withdrawals Ages 65–94	\$4,019,535	\$5,580,807
Residual Value of Portfolio at Age 95	\$4,943,035	\$6,862,013
Withdrawals Plus Residual Value	\$8,962,570	\$12,443,820

Source: The Merriman Financial Education Foundation.

When you're 25, you invest \$6,000. When you're 26, you increase that to \$6,180, and so forth. Each increment is relatively painless (an extra \$15 per month when you're 26, for example). But over time, these increments add up as [Table 3](#) shows.

Scenario 4 was funded with \$212,408 in additional investments. The payoff? More than \$1.5 million added to your retirement withdrawals, plus \$1.9 million more available for you to leave to your heirs.

## Back to the Battle

Even if you successfully fend off Wall Street's desire to pick your pocket, your second foe in the battle for investment returns is right there in your mirror. I wish this weren't true, but even more than Wall Street, YOU can be your worst enemy.

# Our Behavioral Biases Versus Our Portfolio

Some biases are built into our brains. Researchers have come up with fancy names like confirmation bias, recency bias, frequency bias and the Dunning-Kruger effect. But you don't have to know those terms to know that you might be heading for trouble.

Here are a few of those dangerous pathways.

As humans, we are wired to prefer answers, even if they are the wrong answers, instead of being left with nagging questions. We want our answers to be simple and easy. We want these answers to be foolproof. And we want results to be quick.

You can see this everywhere. A basic formula for a marketing campaign can be summed up in a three-letter acronym PEN: standing for "perfect, easy, now."

Our fuzzy thinking leads us to believe and trust the wrong people. If our neighbor (or perhaps someone we met on a plane) tells us they have made great money in a particular stock or fund, we're likely to give that information a lot of importance.

Likewise, we may assign extra trust to an adviser whom we've met socially or who is willing to visit us in our home. Emotionally, we are likely to feel more comfortable opening up to this person rather than to someone in an office that feels impersonal.

Determining who to trust can be like a tug of war between comfort and competence.

When we are about to share our private information with somebody, we know we can recognize comfort when we encounter it. But trying to recognize competence can make us feel in over our heads.

To avoid overloading our brains with tough decisions, we adopt mental shortcuts. Sometimes we describe this as having a gut feeling, intuition or instinct. Or “I had a hunch.” This lets us put our minds on autopilot so we can quickly detect patterns, even patterns that aren’t actually there.

Hundreds of thousands—maybe even millions—of individual investors fall into this trap when they try to time the markets, selling before prices go down and buying before they go up.

Oh, if it were only that simple!

Many academic studies have shown that most non-professional market timers do themselves more harm than good. Often a timing decision will be based on only one or two things, even though the markets are constantly under the influence of hundreds of forces that tug one way and then the other.

When you’re in the market and it starts to go down, you may panic and cut your losses only to discover that prices are suddenly going up again. Your neighbor, on the other hand, may hang on. And hang on. Until the pain of losing money is too great, and he sells everything to stop the bleeding. By then, much of the damage has likely been done.

On the other hand, you might be waiting on the sidelines until you have a clear picture of when it’s “safe” to invest. That time may come only after the market has gained substantially—and the prices you must pay to get back in are much higher.

In either case, it’s what I call the “I can’t stand it anymore” timing system.

Just 16 years ago, in the spring of 2008, the stock market was suddenly tanking. Tens of thousands of investors bailed out. Many of them are still on the sidelines, afraid of another 50% decline like the ones that came in 2000 and 2008. I don’t think it’s an exaggeration to say that even one awful timing decision can cut a retirement portfolio by half.

The solution is simple (though not always emotionally easy): Buy and hold, trusting the long-term upward trend of the market.

Then there's what psychologists call repetition bias. If we hear something once, we might or might not pay much attention. If we hear it a dozen times, we start believing it. If we hear it 100 times, we become sure that it's true. Again, look at advertising.

Here's a bias you can probably recognize in someone you know, even if you're sure it doesn't apply to you. We believe—in fact, we are certain—that we know and understand more than we actually do.

Beginners usually know they are ignorant. Once they start learning, they begin to see patterns that seem to explain all sorts of things.

In his book "Think Again: The Power of Knowing What You Don't Know," Wharton professor Adam Grant described this trap: The better you think you are, the greater the risk that you're overestimating yourself—and the greater the odds you will stop improving. True experts, on the other hand, are painfully aware of how much they don't know.

## The Importance of Patience

Finally, there's the topic of patience. If you wonder why the phrase "long-term" keeps popping up here, it's because successful investing takes lots of time and patience.

When I was an investment adviser, I once opened an account for a woman after having a long conversation with her on this very point. I told her she was guaranteed to lose money in the stock market, at least in the short term. She assured me she understood, and she vowed to stay the course.

One month later the market had gone down a little, and I learned she had closed her account. I called her and reminded her of our conversation

and her promise that she would stick with it. “I know,” she said. “I just thought I’d make some money first.”

When I looked at the numbers, I saw her account was down by 1%. If she had lost 25% in one month, her fear would be more understandable. But in the stock market, a gain or loss of 1% is just meaningless noise.

Human psychology is extremely important if you’re going to win the battle for investment returns. I have two books to suggest for further reading:

- “Thinking, Fast and Slow” by Nobel laureate Daniel Kahneman (Farrar, Straus and Giroux, 2011).
- “The Mere Mortals’ Financial Guide to Spending Your Way to Wealth(s)” by my friend Paul Heys (Investorship Publishing, 2022).

The back of Heys’ book includes a 16-page synopsis of Kahneman’s 500-page book—which is nonetheless well worth reading in its entirety.

## The Battle Continues

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I began this discussion using the metaphor of a battle between investors and Wall Street, each side fighting for as large a share as possible of investment returns. You can win that battle through your decisions, your choices and your behavior. But to prevail, you will need to use all the tools (weapons, if you prefer) available to you.