Financial Abundance
EDUCATION · CLARITY · CONFIDENCE
Registered Investment Advisor

The Rule of 72 Can Be Revealing to You

Have you ever noticed that the published, 5-year, and 10-year annualized returns on your mutual funds and investments often show 10%+? I've always found this interesting because that is not what I see when I review most people's account values. The balance of their actual account does not seem to be in line with the published returns, especially when you apply the Rule of 72.

The Rule of 72 is mental math for quick financial calculations. This formula is useful for financial estimates and understanding the nature of compound interest. But for our purposes, the Rule of 72 is simply the rule for doubling your money. Here is the formula: Years to double your money = 72 divided by your rate of return. With a 6% interest rate, your money roughly takes 12 years to double, or 72/6.

I rarely see many accounts we analyze doubling every seven to 10 years; that would require a 10-12% yield, but in actuality it takes roughly 12-15 years for their accounts to double. This tells me that most people may be getting a return of 10% before fees, but 5-6% after fees. Most people are shocked to find that their total fees are not 1-2%, but more like 3-5%. How else could you explain published returns not jiving with actual account yields? In other words, if you were receiving returns of 10% net, your money would double roughly every seven years. If your money is actually taking 12-15 years to double, you aren't getting anywhere near a return of 10%. Why? Fees!

Let's review how fees work in this industry. There are basically three fees that are involved when investing in the market: the advisor fee, the annual expense ratio (mutual funds), and the statement of additional information (SAI) charges.

The first fee is what the advisor would receive for recommending the portfolio. This is known as an asset-management fee; it is generally expressed as a percentage of assets. For example, if your management fee was 1%, the account would be debited quarterly on .25% of your managed assets. The other way this fee could work is if you're dealing with a Registered Representative versus a Registered Investment Advisor it would be in the form of some type of commission or "load," depending on the share type they recommend.

But the asset-management fee is not the only cost you will incur. In addition to paying for the advisor, you also must pay for the fund used in your portfolio. This is where you'll find the other two costs: fixed expenses and variable expenses. Fixed expenses are included in the annual expense ratio. Every mutual fund and ETF charges this fee, even so called "no-load" funds. The fee is mainly for administrative costs. According to Morningstar, the average expense ratio is 1.35%, although it is not uncommon to see many over 2%. Even though this is expressed as an annual figure, it is debited daily.

You will find the last fee in the SAI — we refer to this as the "Bid-Ask Spread" — and some advisors are not familiar with how draining this fee can be on your returns. Unfortunately, it can equal or even exceed the other fees depending on the amount of turnover or trading the fund manager does.

For those of you who do not know what your total fees are, we have access to the largest independent and objective database that contains annualized returns dating back to 1926. This proprietary program is located at the Center for Research in Securities Prices (CRSP), and it allows us to dissect a portfolio and compare it to historical returns. The only way to find out what your "total fees" are is to conduct a portfolio analysis that is objective and independent. Unless you pay for an analysis, it would not be objective … right? ■

www.FinancialAbundanceInc.com