Gene lottery

Why you might not leave as much money to your heirs as you hope

›BY ARTHUR SALZER

SHIRTSLEEVES-TO-SHIRTSLEEVES in three generations is a common enough saying around the world, but it's a bit more involved than you might believe. The numbers play out as follows: there is a 70% chance that financial wealth does not transfer from one generation to the next, which also means that there is roughly a 90% chance that wealth does not transfer to the third generation and a 97% chance it does not make it to the fourth.

These figures seem depressing at the outset. Why is it so difficult to stay wealthy?

Let's say that at the age of 20 you receive an inheritance from your grandfather in the amount of $10 million. Can't complain about that. You approach your local bank and speak with an advisor who shows the returns of various asset classes. But what stands out is the long-term return of U.S. (S&P 500) stocks at 10.6%. If you just compound the money at this rate over the next 50 years, you would have $1.5 billion to provide to your family's next generation of your family. Right? No. There are several things not accounted for.

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For one thing, we used a straight-line annual return of 10.6%. But even if you averaged that over 50 years, some years would have been great, others much less so. Unfortunately, the variability of the return series significantly reduces the end net wealth. The variability of returns leads to what is called variance drain or volatility drag. Based on stock-market volatility over the past 20 years, the drag on a portfolio can average more than 1.5% per year. This reduces the future inheritance to $778 million. Still great, but roughly half the original figure.

But wait, the rate of inflation has averaged a little more than 3% over the past 50 years. Therefore, the real rate of return for stocks has been 6.1%. The value of your lifelong treasure based upon today's buying power is only $193 million. Throw in advisor and investing fees, even those for low-cost exchange-traded funds, of let's say 0.5% because you are a shrewd negotiator, and the inheritance is now $152 million. Finally, taxes — the legendary John Bogle, founder of the Vanguard Group has estimated taxes cost a typical investor 2% per year — and typical spending patterns of about 4% of your portfolio annually leave you with $10.5 million.

To fatten that amount up, you need to develop a portfolio strategy that maximizes return *and* minimizes risk. In other words, create a portfolio that reduces the volatility of your investment returns. This is what sophisticated institutional investors such as Canada Pension Plan do in order to generate the necessary returns.

Secondly, although you cannot escape the saying attributed to Benjamin Franklin — "In this world nothing can be said to be certain, except death and taxes" — you can pay close attention to asset location issues and employ vehicles such as TFSAs, RSPs and trusts as well as strategies like tax loss harvesting to minimize taxes paid. A fee-only Chartered Financial Planner can make a significant difference in making an investment portfolio tax-efficient.

Reducing investment costs is also very important, but a successful investor is not penny-wise and pound-foolish. The key is to optimize and not minimize total investment costs. In other words, allocate investment fees to asset classes and managers who have a chance to add value, while using low-cost strategies where the chance of outperformance is unlikely. Most investors now know that 80% of active stock managers do not outperform their benchmark after fees. However, many don't know that the top-performing alternative asset managers who specialize in asset classes, such as private equity, real estate, private debt and select hedge funds, tend to outperform their peers by wide margins. Accessing these elite managers can be worth paying for.

Finally, most people who receive a large sum of money believe there will be no end to the wealth and so they splurge on a new car, travel or house. Rest assured there is no amount of money that cannot be decimated by excessive spending. Spending money wisely and reducing the portfolio withdrawal rate by 1% can increase your portfolio's terminal value to $17.2 million — a substantial difference and a protection buffer for life's unforeseen events.

There are, of course, other issues such as family dynamics, economic disruptions, market collapses and wars. Managing an investment portfolio in any environment is a difficult intellectual and psychological challenge for a family to face. It takes an understanding of how money actually compounds in the real world to achieve success and have the wealth pass to future generations. **FPM**

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