Acorn Financial Advisory Services

Don't Let Small Numbers Distract You From the Big Picture

Even though it's all about dollars and cents, the financial industry runs on percentages; dollar signs are few and far between. The use of percentages is an understandable, and helpful, convention when communicating financial information. After all, a headline saying "Company A's Net Jumps by 16%" is more helpful than one that reads "Company A's Net Jumps to $1.02 billion." Providing percentages rather than dollars also allows investors to compare apples to apples: You can readily discern that an investment that has gained 8% during the past 10 years has been a better bet than one that has gained half as much.

Yet dealing in percentages, especially relatively small ones like inflation rates, expense ratios, and long-term annualized returns, can also distract from important information that factors into your financial plan. Those small and innocuous-looking percentage figures, when translated into dollar terms and compounded over many years, can make a huge difference between success and failure.

How Small Numbers Can Make Your Investment Plan…:Say, for example, that you stick with the 3% 401(k) contribution rate that your company uses as the default, contributing $1,500 of your $50,000 salary for 40 years and earning 5% on your money. You'd have about $190,000 at the end of the period; not too shabby. But bumping up your percentage contribution just 2 percentage points (to 5%) would have a meaningful impact on your bottom line, increasing your nest egg to nearly $320,000.

In a similar vein, you might choose to keep your child's college fund in cash. Assuming cash yields stay as low as they are now (which is, admittedly, a big assumption), a $50,000 investment that earns just 1% for the next 10 years will amount to just $55,000 at the end of the period. But by maintaining a 60% stock/40% bond portfolio and assuming a not unreasonable 4% return, you'd be able to grow your $50,000 investment to $74,000. Neither return rate will allow you to keep up with college inflation, sadly, but at least it's better than putting the money under your mattress. However, keep in mind that the 60/40 portfolio entails market risk.

…or Break It: Just as seemingly small percentage changes (either in contributions or return rates) can provide investors with an enormous helping hand, they can also work in reverse, and this is where many investors run into trouble. They blow off small percentage amounts like expense ratios and inflation rates when making investment decisions.

For example, let's say an index fund has a fairly low expense ratio of just 0.63%. It's certainly cheaper than most actively managed funds, and it doesn't appear to be that much more expensive than most other S&P 500 index funds, some of which charge as little as 0.06%. If you opted for the expensive fund rather than a cheaper alternative and you held it for a long time, you'd be shortchanging yourself. Assuming a 10% annualized return and a $100,000 initial investment, you'd be leaving a lot of money on the table during a 25-year period by opting for the more expensive fund: nearly $170,000, to be exact. All because your fund charged 0.57% per year more than a comparable option.

Inflation is another factor that investors tend to underestimate, because the average historical inflation rate of roughly 3% looks pretty benign when viewed without any context. Should the fact that bananas that are $0.59 a pound today but might be $0.79 a pound 10 years from now cause a major rethinking of your financial plan? Yes, actually. When you extrapolate inflation across all of the items in your shopping cart and compound it over many years, it can have a hugely corrosive effect on the purchasing power of your savings, meaning you need to save a lot more than you thought you did.