Two great Dave Ramsey myths, debunked.

Mar 23, 2015 | By Michael Markey

Personal finance guru Dave Ramsey (AP Photo/Mark Humphrey)

Last month, I wrote about the **seven steps Dave Ramsey followers really need to thrive financially.** I was astonished with the amount of interest and debate the piece sparked. To the many who support our voyage, thank you and I'm excited to walk with you down this path, holding *America's Favorite Finance Coach* accountable for his investment advice. To the critics who believe anyone disagreeing with the guru means they haven't read his books, listened to his show, or attended his FPU … you're wrong, wrong, and right. I have not attended FPU nor do I intend to. I don't need to smoke a cigarette to know they stink, cost lots of money, and are negative for my long-term health. Financial Peace University is taught by those who've mistakenly taken a myth for a truth.

This sort of mix-up is one that Dave is familiar with.

"I have heard it said that if you tell a lie often enough, loudly enough, and long enough, the myth will become a fact. Repetition, volume, and longevity will twist and turn a myth, or a lie, into a commonly accepted way of doing things." -David L. Ramsey III "The Total Money Makeover" (TTMM)

Hmm … 12 percent *annualized* rates of return, 8 percent safe withdrawal rates, no debt EVER, 7 percent mortgage rates used to debunk the tax benefits of mortgage interest, 100 percent stock-based mutual fund portfolios, asset allocation is a dupe, term insurance is better than permanent … I could keep going but I think you get the point. Many of Dave's truths are actually myths, but they're said often enough and passionately enough that their validity is accepted without challenge.

Myth No. 1: The Ramsey brand of endorsement benefits clients *and* advisors.

Let's turn our attention toward a classic Ramsey-backed idea: the endorsed local provider, or ELP. To be or not to be an ELP, that is the question.

Working with an ELP or an investing advisor (Dave's fictitious title, not mine) is recommended in **Step 4** of Dave's seven-step plan. Please note that an *investing advisor* is not the same thing as an *investment advisor representative (IAR).* They get paid to *sell* you something not *give* you advice. But that's not the real issue here. The real issue is I don't think Dave actually believes in some of the core teachings he spouts with, as he puts it, "extreme confidence."

It's important to note up-front that Dave's entire marketing plan points to the fact that his recommended advisors must be commission-based, rather than fee-based. Instead of going into his reasons, let's take a look at the facts.

Fact: Investment advisors are prohibited from using endorsement. SEC Rule 206(4)-1(a)(1) of the Investment Advisers Act of 1940 determined testimonials or endorsements are a form of misleading advertising since they only share positive experiences.

Fact: The statement found on Dave's site, "98 percent of users highly recommend using an ELP" would most likely be in violation of SEC Rule 206(4)-1(a)1.

Fact: The very term Endorsed Local Providers would also most likely violate the above rule. I suppose you could argue he could rename them Dave's Elite Squadron of Advisors. (Dave, if you're reading this, feel free to use this term. No royalties needed.)

Fact: If ELPs were IARs they would have to disclose they pay a fee for the clients referred to them by the Ramsey system.

Fact: Working in a fee-based relationship would make it nearly impossible for ELPs to take on the types of clients Dave sends their way.

Fact: Dave states he at some point held the appropriate investment, insurance, or real-estate licensing to give advice in the applicable areas. I could not find a currently registered or previously registered IAR or FA whose full name matched or was from the Tennessee area.

OK, so, if the name is no longer ELP and we remove Dave's endorsement (he could still use his name in the agency titling, or advertise the firm on his site and his workshops with much success, I'm sure) and we omitted that 98 percent of users highly recommend an ELP, then his team could work as fee-based advisors, right? Not quite. Even if the necessary changes were made to Dave's marketing approach, a fee-based advisor would very likely starve by working as an ELP.

Let's look at the math behind all of this. While it was impossible to find the exact referral fee paid to Ramsey for the endorsement, multiple Google searches revealed fees ranging from a few hundred dollars well into the thousands. For the purpose of this column, let's settle on a referral fee of $100 dollars, which seems reasonable compared to other lead sources.

Now, here's the math for an American household with an annual income of $48,000 (the average annual wage for U.S. households, as provided by Dave) that is looking to invest 15% of said annual income, per Dave's Step 4.

Average American household income: $48,000.

Example of 401k Employer Match: 3%

$48,000 x 15% = $7,200

$48,000 x 3% 401k employee contribution (to max out employer match): $1,440

$7,200- $1,440 = $5,760 left to invest with ELP per year, or $480 per month.

In scenario one, let's consider an ELP who is fee-based at 1 percent AUM. ELPs must have the heart of a teacher, not a salesperson. So we can assume they'd meet with the client a few times prior to making any recommendations. After investing 2–3 hours (roughly 1 hour per appointment) the ELP accepts a check from our client in the amount of $480. For the purposes of our example, let's assume the initial investment takes place at the beginning of a quarterly billing cycle. Over the cycle, there's $1,440 invested, but only an average balance of $960. The ELP would be entitled to one quarter's advisory fees of .25% (1% divided by 4 quarters). In other words, our ELP would make a whopping $2.40 for 3+ hours of work.

But Mike, you've forgot these fees add up! Why, yes, they do. One full year later the client's balance will be $6,087. (I used the conservative, widely-agreed-upon, historical S&P 500 12 percent average rate of return.) If billed at that amount, our ELP would make a meager $15.22 for the first quarter billing. I even rounded up.

First year total fee compensation: $37.48

Second year total fee compensation: $103.11

Total compensation, first two years combined $140.59

I know ELPs are supposed to have the heart of a teacher, but in a fee-based relationship they certainly wouldn't be compensated as much as one. If the ELP were to meet with the client a few times at the beginning and once a year for the first two years, then our ELP would have at least 5 hours invested with them. If we subtract $100 from the total fees paid to the advisor of $140.59 (remember, this is going to Dave for the referral), then our ELP is left with $40.59 for two years' worth of work.

Let that sink in for a moment, then we'll move on to scenario two.

This time, our ELP is commission-based and uses mutual funds with 5.75 percent upfront sales charges. Every month, the ELP will make $27.60. He or she will also have some ongoing compensation from the funds sold and kept. Yet just the commissions will equal $662.40 over the two-year span. Subtract the $100 referral fee and you're left with $562.40. That's $521.81 greater than our first scenario.

Here are a few other things to consider. Will the ELP convert every referral? Not likely. Let's say he or she converts 70 percent of referrals. Most referral services, and presumably this one as well, charge per referral sent, not per referral captured. So, 10 referrals equals seven clients.

Here's the fee-based total over two years:

> 7 x $140.59= $984.31 minus $1,000 (10 referrals at $100/ea.) = ($15.69)

Here's the commission-based total over two years:

> 7 x $662.40= $4,636.80 minus $1,000 (10 referrals at $100/ea.)= $3,636.80

Our fee-based ELP is in the red after two years. This person has worked for FREE for two years! What if they got two referrals per month rather than 10 referrals over two years? I'm not going to bore you with prorating them, let's just use the same math as above. Two referrals leads to 16 clients (yes, 70 percent of 24 is 16.8 however you can't have a partial person; we only count whole people here) which gives us a loss of $150.56.

How many 100-percent altruistic advisors do you expect are out there?

Myth No. 2: Invest Dave's way, and you can expect a 12 percent annualized rate of return.

I said earlier Dave doesn't even believe his own math. He defines long-term investing as five years or longer. He then says to pick out a "good" mutual fund. Dave says never finance a car, yet today you can finance a used car for 1–3 percent. (Dave and I agree new cars are highly depreciable and often a poor choice.) If you can make a 12 percent average on your good ole mutual funds, then why wouldn't you invest the $10,000 car fund and make payments? Oh, because if you play with snakes you will get bitten! But here's the thing: We're talking about folks who have completed Steps 1–3 and are midway through Step 4. They've got a robust emergency savings now and no debt. Couldn't they afford to do this? Haven't they proved they have the discipline to be financially responsible?

Dave clearly doesn't believe in the 12 percent returns fallacy. Why? Ask this question: What about a mortgage? You don't ever want a mortgage longer than 15 years, according to the guru. What about the tax deduction CPAs tout? "I can do the math," Dave says. Why pay $7,000 in mortgage interest (7 percent is his number, not mine) on a $100,000 mortgage to save $2,100 in taxes (he uses 30 percent). Um … I can do math, too. One hundred thousand dollars will make 12 percent. Twelve percent interest on $100,000 is $12,000. Mortgage rates are 4 percent, not 7 percent. And let's use the more typical federal bracket of 15 percent, since the 30 percent pertains to higher income individuals who are certainly NOT using his advice.

OK, so $12,000 in interest. We'll assume gains are taxed as capital gains, since I can't imagine how he'd argue for using IRA dollars to pay off the mortgage. So, here's what we have:

> $12,000 – $4,000 in mortgage interest paid + $600 tax deduction = $8,600 (capital gains tax should not be applicable)

That's right: If you believe in 12 percent long-term averages, you do not pay off your mortgage early. And you will not be bitten by snakes because you have discipline. You have proven your discipline by accumulating 3–6 months' worth of expenses in cash savings and by paying off all of your debts, according to the earlier steps in Dave's plan.

If all of this is true, Dave Ramsey doesn't believe in 12 percent returns for long-term averaging and neither should anyone else.

The big picture

There are many great advisors out there. Many of these hardworking, honest, sincere, and genuine advisors also happen to be ELPs. ELPs are not bad. Commission-based investing has its place. The collage of contradictions and inaccuracies related to Dave's "investing advisors" and his "investment" advice are what bother me.