How Physicians Are Unlike Most US Investors


A look at how the difference in the tax situations of physicians and average retail investors, and why these differences matter.

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>> One important success factor for physicians when it comes to investing is understanding how they are unlike most US retail investors and how they are similar. In this article, we will focus on the differences.

PHYSICIANS VS MOST INVESTORS

1. Financial Circumstances

Americans on average earn nowhere near the income that physicians do. The median household income in the US in 2019 was around $50,000,[1] while the average physician's income in 2019 was $313,000.[2] The average income of physicians in the top five medical specialties was $452,000.[3] This income difference is enormous and has implications in all disciplines of wealth management. Nowhere is this truer than in tax planning.

The average retail investor cares little about tax planning, because they do not have a significant tax problem. Did you know that approximately 44 percent of Americans paid zero federal income tax in 2018?[4] Or that the average US taxpayer has an effective federal income tax rate of 12.1 percent?

Compare an effective rate of 12.1 percent with the top marginal income tax rate of a physician. The top federal rate is 37 percent. Add the 3.8 percent Medicare surtax on modified adjusted gross income over $250,000 (for married couples, or $200,000 for individuals) and state and local taxes, and it becomes clear that most physicians face a marginal tax rate of 40 to 50 percent or more, depending on their state of residence.

This difference in the tax situations of physicians and average retail investors has significant consequences for investing. Consider just three points:

- Outside of the week before April 15, the financial media generally ignore the subject of taxes completely, yet it is top-of-mind for most physicians throughout the year.
- Almost all reporting on how an investment fund has performed shows pre-tax returns rather than post-tax returns, when post-tax returns are all that really matter to a heavily taxed investor like a doctor.
- Mutual funds have, over decades, been able to avoid disclosing their internal holdings' built-in unrealized taxable gains, so new investors cannot understand the tax hit when they buy into the portfolio. Many physicians do not realize this.

The bottom line: many financial products are designed for investors who are subject to a lower amount of taxes than physicians are.

2. For Most Physicians: The Amount of Free Time

Ask almost any physician what their scarcest resource is and the answer is likely to be "time." The data back this up, as an October 2019 Bureau of Labor Statistics report reveals the average non-farm work week in the US was 34.4 hours. For "private-sector production and nonsupervisory employees," it was 33.6 hours.[5] Conversely, in 2015 the AMA reported that fewer than 15 percent of physicians worked less than 40 hours per week.[6]

Because of this lack of time, focusing on the financial, tax, legal, risk, and insurance issues that must be understood in order to adequately manage a family's finances in general, and investments in particular, is a significant challenge. Add to this the consequences of managing a physician's higher-than-average income and net worth in less-than-ideal circumstances and the issue becomes even more important.

We are not saying that physicians cannot or should not take an active role in their wealth planning and investing. However, compared to the average investor, physicians have much less time to do so and there is more at stake.

3. Highest and Best Use: For the Few Physicians with Spare Time

For the relatively few physicians who have the spare time to actively invest on a continuing basis, the question becomes, does it make economic sense to do so?

Certainly, most physicians are able to research investments if they have the time. Thus, the most important question is not whether a physician can do-it-yourself (DIY) invest. The important question is whether they should. In other words, would a physician be better off putting his or her time to its highest and best use—treating patients and being paid well to do so—to earn income and then spending a portion of that income to hire investment and wealth management expertise?

This highest-and-best-use analysis could just as easily be applied to other services, like preparing tax returns, repairing a leaky sink, and mowing the lawn. Each physician must balance his or her interest in doing these and numerous other tasks with the opportunity cost of spending time on endeavors that they can pay other people to do for less than their own effective hourly earnings. Some physicians are natural DIYers and will gravitate to performing such tasks themselves rather than delegating, especially when the tasks are low-risk and failure or suboptimal outcomes can easily be seen and remedied (the sink doesn't stop leaking, the lawn isn't well-mowed). But consider tasks where it is more difficult to determine if the job was done well: How can one know if the tax return one files or the portfolio one designs is optimal? Basic economics may dictate that, for these types of tasks, delegation makes financial sense.

At a high level, let's examine a few numbers. Most (though not all) physicians work around 200 to 250 days a year and their income ranges from $250,000 to $1 million annually, so they earn between $1,000 to $5,000 per day.

If we estimate that the work involved in actively managing a portfolio, including researching public and private investments, assessing portfolio risk, trading and rebalancing, harvesting tax loss, locating tax-efficient assets, and implementing a spending strategy to manage sequence-of-withdrawal risk, would take one to three days per month, this equates to a time cost of between $12,000 and $180,000 annually.

Obviously, this range is extremely large, with the highest-income physicians incurring the greatest opportunity cost because they are paid so well for the highest and best use of their time. Not surprisingly, though, even for the lowest-income physicians (who still are earning much more than the average US household), their time cost almost always exceeds what they would pay a professional to handle these tasks—because they are likely to generate lower professional fees, at least in an asset-based fee model.

This analysis is much like the one that dictates why physicians should not answer their own phones, book patient appointments, do the coding and billing themselves, or even perform medical tasks that a nurse or physician's assistant can do well. Doctors do not do these tasks at their practices because of the "highest and best use" concept.

To avoid the time cost of doing their own financial planning and investment management, most physicians elect to outsource these services. If you make the decision to hire an advisor, however, that does not mean you can completely ignore your finances and become disengaged. Ask difficult questions, check for conflicts of interest, demand transparency, and expect regular communication. ■

SPECIAL OFFERS: The authors have recently completed Wealth Planning for the Modern Physician, their first book for physicians in five years. To receive free print copies or ebook downloads of this book or Wealth Management Made Simple, text PRDERM to 47177, or visit www.ojmbookstore.com and enter promotional code PRDERM at checkout.

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