SIGMA
Investment Management Company
Knowledge plus Discipline

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Financial Planning Follies

The bull market of the past 15 years has led to an explosion in the number of financial planners and finance related magazines. A staple of the magazines (and the software used by financial planners) is the calculation of how much you should save each year for your retirement, based upon your current wealth, standard of living and assumed rates of return. Your supposed future wealth is often plotted year by year into the future, much as an insurance agent will tell you what your whole life policy will be worth when you are age 97. At the risk of committing professional heresy (both of Sigma's principals are Certified Financial Planners), we humbly suggest that this fundamental exercise is at best nonsense and at worst seriously misleading.

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One flaw in the exercise is that you are asked to assess your future income needs. The tendency is to project a fairly lavish retirement, which leads to the conclusion that you need to save an unrealistic amount. If you do the retirement needs calculation and the answer is that you need to save 120 percent of your income, of what use is the information? You may get discouraged and save even less than you otherwise would, figuring that you are lost already. Trust us, a realistic assessment (e.g., including taxes and inflation) of the gap between how much you will have in the future versus what you may think you "need" is likely to be depressing, especially if you forget that you are more likely to enjoy *Matlock* re-runs when you are 85 than exploring the source of the Nile River.

A second problem with the standard retirement calculation is that you are assumed to die on the date projected by actuarial tables. But what if you "win" and live longer? Somebody projected to die at age 70 could easily wind up living to age 100. A potential 30 year swing in needed living expenses calls into question the importance of some of the more subtle assumptions you make as part of the calculation by the quiz or software program.

A third problem with retirement savings projections is the uncertainty of investment returns. The calculation methods usually use historical asset class returns. According to Ibbotson Associates' *Stocks, Bonds, Bills and Inflation 1997 Yearbook*, the return on the Standard & Poor's 500 stock average over the past 71 years has averaged 10.7 percent. Over the past 15 years, the index averaged a 16.79 percent return. Most retirement plan calculators use either the long term average or a recent average. The lowest 20 year average return, however, has been 3.11 percent. While these differences sound small, they result in huge changes in dollar outcomes when compounded over several years. Let's say you have $100,000 to invest in the S&P 500 and will retire in 20 years. At the

long term average return, you will have $764,000 (ignoring taxes, inflation, fees and costs). If you extrapolate recent bull market returns, you will have $2.2 million, but if your returns are equal to the lowest 20 year period, you will have only $184,500. Your standard of living in retirement obviously is critically affected by whether you achieve average or low returns on your investments.

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Once you retire, long term average investment returns cease to be of any importance to you -- all that matters is the actual performance you will experience during the period of your retirement. It will be of little consolation to you as a retiree that your poverty will be offset by some future generation who will enjoy above-average investment returns. Given the big changes in results from small changes in assumptions, it is not surprising that different leading retirement calculation programs can suggest radically different needed annual savings amounts, even using the same inputs. This is where the retirement calculation quizzes or software are most dangerous -- they can lead to a false sense of security in the face of uncertainty.

There is an asymmetry involved in all retirement calculations -- the downside of saving too little is more bad than the opportunity cost of saving too much, but the software or magazine quizzes treat upside and downside variances the same. In your old age, you are much more likely to be wishing you had saved more money than you are to be wishing that you had spent more money in your youth. Unless you are now lucky enough to be wealthy beyond your needs, we believe the appropriate course is to build a *margin of safety* in your retirement plan so that living longer or enduring a couple of decades of below average investment returns is not a disaster. You do not want to be looking for work at age 90 because your retirement plan assumptions were too optimistic.

The fourth and perhaps largest problem with retirement plan calculations is that they assume you will actually achieve the assumed returns. As we have written in past months, there is a large gap between theory and reality when people, influenced by emotions, invest their money. If you like the idea of retirement planning with a margin of safety and help in "staying the course," contact us.