On Being Conservative

I probably had my first taste of being conservative when I was brought up in the Great Depression. My parents had become risk adverse, mostly out of the need to preserve scarce capital after much of their savings disappeared in the stock market. I learned from them as well as my own lessons too.
Shortly after I went to work for Boeing, I contacted a stock broker to help me with investments. He got me into a number of small companies that promptly lost money after I bought their stock. I think that he used me to pawn off stock that their brokerage firm had in their name and wanted him to off-load to clients. None of his optimistic projections of growth came true.

I also found this in real estate investing. I got a group of people together to buy a significant piece of property. Then I sought one of the most successful realtors in Seattle and got him to participate with us with some of his own money. With optimism, he recommended that we buy the whole hill adjacent to the South Center Mall because the prospects of fast growth were so promising. It turned out that when we finally sold the property after about ten years, we earned about as much as we would have just by putting our money in the bank. Still, that was better than many of the partnerships my advisor pushed.

After I started the Short Range Attack Missile program at Boeing, I got another lesson on optimism vs. conservatism. It turns out that our aerodynamics organization made performance promises based on using drag values from the middle of a spread of their wind tunnel data points instead of a more conservative approach of using drag values that would cover all of the data points. Those performance promises were incorporated in the contract. During the missiles first flight, the actual drag turned out to be higher than what was predicted by the aerodynamicists. The aerodynamicists had never been told to use conservative values because they had always worked on cost-type contracts where a small shortfall in performance would likely be accepted by the government as not worth the additional money it would cost to regain the performance. With a fixed-price contract for development, the government could not overlook the smallest shortcoming from specification values. That cost us a lot of money to both reduce the drag and get some extra thrust. Ultimately it cost the government more as well, because subsequent production contracts were based on the higher cost configuration.

Boeing and the aircraft industry always used conservative calculations for loads on airframes as a standard practice, thank goodness. First we would find the particular conditions that gave the greatest load. Then we would increase that amount by 50%. We called that the ultimate load. Then we would do static tests to make sure the structure wouldn't break at anything less than the ultimate load.

When I got to be head of planning for Boeing and had to portion out the research funds, every organization would promote its case. Almost always these were optimistic projections. I can remember adding up all of the projected sales for the various military projects wanting research funds when I found that the total of their sales projections exceeded the likely military budgets for the entire industry.

When Boeing sent me to the Sloan management school, I chose to write a thesis about the uncertainty of cost projections for complex projects. I already knew that it was very unlikely that a new development program would be able to meet its initial cost projection. The only way to get a conservative cost projection was to have already done something so similar in totality that you could use your previous experience. Invention is virtually impossible to estimate costs and so requires ballpark guesses.

After I retired, I became well read on various retirement planning methods. I found that almost all of them used optimistic portfolio returns from history and left out many things that influenced retirement spending and income. Not only that, but they produced widely different projections. I helped both

Vanessa O'Connell and Tom Herman from The Wall Street Journal on two separate occasions where they wrote full page articles using my materials and research of their own to verify my findings.

My father retired in 1965. Had he retired much earlier or much later, his retirement savings would have given him an amount that would preserve his past lifestyle. But that turned out not to be the case for retirees that had to endure several market crashes and high inflation that followed the year 1965. It is NOT true that you can rely on market performance repeating itself which is the justification for using either historical averages or historical statistical distributions as in the current use of highly touted Monte Carlo analyses.

Mirriam and I offer modest help to some widows who rely only on Social Security income. Before their husbands died, they were able to live off the Social Security of two people and the savings they had accumulated. For various reasons, they consumed their savings too early and now regret that they weren't more conservative in their planning, budgeting, investing and spending. Some had fixed pensions, now worth little because of inflation that compounded over all of these years. Few people realize that they can't spend all of their fixed pensions in retirement. They have to save part of what they receive so they'll be able to supplement the pension receipts later as inflation destroys fixed pensions values.

Morningstar did an analysis that found that the average person did far worse than the averages reported for the stock market. The main reason is that the average person buys after the stocks have gone up and sells after they have gone down. But another reason is that there is a tremendous amount of overhead in the financial firms that sell and buy these products. Vanguard's John Bogle has estimated that something on the order of $600 billion each year goes to supporting the financial infrastructure including the big bonuses that we often read about. That money has to come from the difference between what we pay or get vs. what the financial firms get or pay. So there's a huge difference between results in personal portfolios and stock market indexes. Nevertheless, most planning programs still use default values of historical index values.

In my own studies in my book, *J. K. Lasser's Your Winning Retirement Plan*, I found that retirees often get hit from reverse-dollar-cost-averaging. Most people have heard that savers benefit from making regular deposits because they buy more shares for their deposits when stock prices are low and buy fewer shares when they are high. That reinforces the concept that you should buy when prices are low and sell when they are high. It stands to reason that retirees making regular withdrawals (instead of regular deposits) sell more shares when the prices are low and less when prices are high. That's just the opposite of what they should do to get the most out of their investments. In fact, this is a zero sum game where for every winner there is a loser—and the retiree is most often is the loser.

There are lots of financial books purporting methods that will quickly make you a millionaire. Most are contrived instances from economic boom periods, and the authors' main incomes come from sales of books and seminars, not from the methods they describe. Many of these push various schemes with real estate, but real estate investments are almost always highly leveraged, and leverage implies great risk. Few actually succeed in bringing great wealth. That said, I believe that it's a good idea to have some part of your investments in real estate just as in stocks, but preferably in widely diversified real estate sources. Publically traded Real Estate Investment Trusts (REITs) make this easy. Most of those I know who have done well with real estate have really gotten their hands dirty from lots of physical participation—something that's not mentioned in the get-rich books.

Another reason to be conservative in financial planning is what we used to call Unk-Unks in the defense industry. This stood for unknown-unknowns, a term used to emphasize the point that they were really unlikely to be considered in advance. Unk-Unks can not only be emergencies in your own household, but events in the lives of your adult children or elderly parents. One time I surveyed my retired friends to find out about events that upset their retirement plans the most. The most common problem was the divorce of a daughter with children and next was the need to supplement the incomes of impoverished elderly parents.

Then there are the things that you could have planned on had you thought enough. In the construction industry we used to call these OSIFs. OSIF is short for "Oh, shoot, I forgot," except we had a stronger word than "shoot." If you forgot something that should have been included when you estimated the costs for a bid, it was often very painful. Every forgotten item results in a dollar-for-dollar loss in profit. In the more comprehensive planning programs on www.analyzenow.com I include a special event worksheet that encourages people to think about such things as what it might cost to replace a roof, automobiles, etc. If you don't plan on large items that are almost inevitable, you end up taking out a loan to pay for them—which can almost double the cost. Retirees (and older working people) have to learn to save the money for a future purchase, not buy the item and then pay for it over time.

I have gained a reputation for being a Social Security expert when I'm not. But I do have the capability to compare alternatives and, more often than not, be able to put enough numbers to a financial decision to understand what may be best in a given situation. In the case of Social Security, years ago I disputed the common professional financial planner's claim that early retirees would be better off if they started taking Social Security at 62. For this to be true, you had to earn outlandish returns, be single and save, not spend, your early Social Security income. I found that Jonathan Clements, a popular financial journalist for The Wall Street Journal, agreed with me. Together with his writing capability and my system analysis skills, we got lots of attention to this subject. Now most financial planners agree that delaying the start of Social Security is often the best thing to do. It is conservative because it provides a much better standard of living for those who live beyond the life-expectancy they had when they first retired. Life expectancy is the average age of death for a particular group of people, but because it's an average, 50% of the people will live longer. So if they end up in the 50% that lives longer than a life-expectancy used in a financial plan, they could live in poverty because they exhausted their savings prematurely.

Sometimes being conservative means that you have to look at the data very carefully, just as the aerodynamicists using the average drag from the wind tunnel. There are a group of planners that claim that statistics show that the very elderly spend less as they age. Of course the statistics show that. As people get older they look at their remaining savings and figure the savings will have to stretch out longer. The only way to stretch it longer is to spend less. It's not conservative to base a plan on a diminishing need for money as you age. I have numerous elderly friends who spend far more now that they did early in retirement because they can afford to--as do we. Even those that are inactive and have sufficient savings spend more late in life because they can afford expensive assisted care instead of being a burden on their children. Besides, it's the elderly that need the most medical care, and the cost of a unit of medical care has been growing faster than inflation. It's a double whammy for the elderly.

I was very successful in managing projects and organizations in my working years starting with engineering and ultimately becoming president of The Boeing Aerospace Company. I feel this was because I was conservative. Now after over twenty years of retirement I believe I can say the same thing about my retirement years. Being conservative can really pay. Never base your future on "averages" from the past or the hope that you will be able to "get by" or that something good will pop up to save you. You might as well buy a lottery ticket to get the money for your elderly years.

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