Financial Planners Have a Lot of Crow to Eat, or
After the feast comes the reckoning!

Henry K. Hebeler, 8-18-01

The vast majority of retirement plan methods have the mantra that retirees will make 7% return, average 3% inflation, and will live to age 90. Using the conventional financial equations or standard payment tables, this translates to a 6.4% withdrawal at age 65. Thereafter, the withdrawals are supposed to increase at the inflation rate. This has been very bad advice as the last few years have proved.

Old fashioned planners, after a little dance about risk tolerance, may recommend a portfolio with about 60% stocks and 40% fixed income securities like bond funds and money markets. The new fashion is to recommend 80% to 100% stock allocations and express great confidence in high statistical success rates. Incredibly, this latter group is still talking this way in spite of the terrible outcome for those whose nest eggs have fallen at least 30% and some as much as 70% over the past two years.

Let's take a look at what would have happened to the person who retired two years ago at age 65 with a nice round $1 million investment balance. The popular magazine, Web sites, and many financial planners recommended all of the standard things: 7% return, 3% inflation, and 25 years life expectancy. After the analysis, the retiree plans on withdrawing $63,000 per year that will increase by 3% per year to offset inflation. The investments are projected to be exhausted in 25 years. That $63,000 corresponds to an initial draw rate of 6.3%. I've seen so-called sophisticated professionals recommend 7.5% based on a million Monte Carlo runs, so, by comparison, the 6.3% would be conservative.

But now, two years later, let's suppose security prices are down only 30% and not those huge losses from the dot-com and high tech chasers. After withdrawing $63,000 in the first year and $65,000 in the second year, the retiree's nest egg is down to $600,000, or 40% from the original $1 million. But things are really even worse because the plan showed the retiree would have $1,008,000 at this time.

So this retiree, like so many people today are faced with several decisions. Should retirees stick with the planed withdrawals or go back and get a new recommendation from a different magazine, Web site, or financial planner? Should they go to a more conservative allocation of investments and reduce their exposure? Certainly this drop was a lot more risk than they envisioned from any warnings.

If they decide to stick with the plan, and IF future returns are 7%, they will be broke in only ELEVEN more years, far short of the plan to exhaust their savings in 23 more years.

But suppose the planner says, "Don't worry, the market will rebound, and you'll be on your way again." Then let's see what kind of future returns would be required. It turns out that the future returns would have to be 14% every future year, or TWICE the assumed return used for the plan. That would be extraordinarily unlikely and require NO future severe drops in values.

On the other hand, the planner is more likely to say, "Let's do another analysis. Now we only have to plan on a 23 year life expectancy and 7% should be easy starting from this market point." (But, unless the planner came from some other planet, he should know that retiree's returns didn't even beat inflation over 20 year life spans for those retiring in any of the years from 1964 to 1974.) After a pause to add a little drama and help justify the fee, the planner says, "Ah, I see. You should reduce your budget to $39,600 each year, but you can increase it by 3% each year for future inflation."

You wonder if the planner knows what's going on. Just two years ago, you had assurance that you could take out $63,000 plus 3% inflation. That would be a budget of $69,000 this coming year, and now you are being told you can spend only $39,600 of your savings. That's a 43% reduction. And then the planner tells you that you will be able to spend even less if you go to a more conservative allocation.

The Pennsylvania Dutch say, "Too soon oldt. Too late Schmardt." The problem is that the financial planning community assumes that the future will be like the past, whether it's an average of the past or the current fad to use some kind of trumped up statistical definition of the past. What is more likely is that the future may contain elements of the past, but not the whole of it. Therefore, what planners have to learn to do is to present a set of plans so that the clients have an image of what can happen in bad times as well as "average." If a different allocation, contingency reserves, and lower spending will make the bad-times scenario more acceptable, then go with a more conservative plan. Be skeptical of plans that purport to give you very high success rates when they do any of the following: Leave out reserves, recommend risky allocations, fail to account for fees and costs, and/or let you choose your own returns or inflation. Keep in mind that retirees are subject to REVERSE dollar-cost-averaging that reduces returns for even moderate portfolios by 1% on the average or 3% for higher success rates. A more conservative plan will more likely be able to survive another 30% market drop in the future. These principles are all illustrated in *J. K. Lasser's Your Winning Retirement Plan.*