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FORECASTS AND OTHER FOLLIES

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Prediction is very difficult, especially about the future.
Niels Bohr, Danish physicist (1885 - 1962)

When planning one's future, projections of future needs are critical to obtaining goals and dreams. Assumptions about life expectancy, inflation, lifestyle income needs, and rates of return all interact to create an amalgam to give us some assurance about what our future will look like. When you change one assumption; the needs and resource needs can change dramatically. So getting them right is critical to success. Of course, it's not likely to get them all right. The one thing guaranteed with each projection is that it's not precise. It is constructs using assumptions that reflect highly probable events, not anomalies or recent personal experiences.

While making long-term projections defy absolute precision, reasonable assumptions can and should be made. Just like predicting the weather precision is an objective, but often difficult, if not impossible, to achieve. At the same time most people do not plan an outdoor picnic in Minnesota in January. It is not impossible to imagine such an event since there have been days of abnormally warm temperatures in January. But, if you want to be wearing shorts and a tank top in January it is not the "highest probability" time of year to be holding an outdoor picnic without a snowmobile suit.

Below are some examples regarding White Oaks Wealth Advisor's thoughts on how we think about assumptions.

Life Expectancies: My career in Financial Planning and Wealth Management spans four decades starting in the mid 1970's. Planning for life expectancy has probably been the most significant shift in planning. When I first started, life expectancies for a male would be 71 or 72 and retirement at age 65 was the norm. On the social security website (http://www.ssa.gov/planners/lifeexpectancy.htm) it shows that a male, age 65, is ***expected*** to live to age 83 and a female to age 85. Due to medical advances there is little reason to not expect the number of years to continue to increase.

Lifestyle Needs

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Lifestyle Needs

There is an abundance of clients who believe that living in retirement will be much cheaper than before they retired. It is true that many work related expenses go away, but they are soon replaced by recreational pursuits or potentially additional healthcare costs. The initial few years are often at the same spending level as before, if not more. Unrealistic spending expectations can easily cause a portfolio's life expectancy to be less than the retiree's and that is truly sad. One of the causes for failing to recognize true spending patterns is focusing on "one time expenses". You know...the kitchen remodel, the wedding or the big trip. While it may be true that they will not happen again, if one examines data of a few years it's common to observe "serial" one-time events. We recommend clients track spending over three to five years and create a moving average of the numbers to ascertain a more reasonable goal. Tracking in the traditional way causes most people to stop before a number becomes apparent. For that reason we have turned the model upside down. The formula works liked this. Take your total income, minus the federal income taxes, FICA and state income taxes. From that amount subtract any savings/investments you added and/or add the amount you withdrew from savings/investments. The remaining amount is what you spent for the year and should be used as a baseline for a retirement need.

Investment Returns

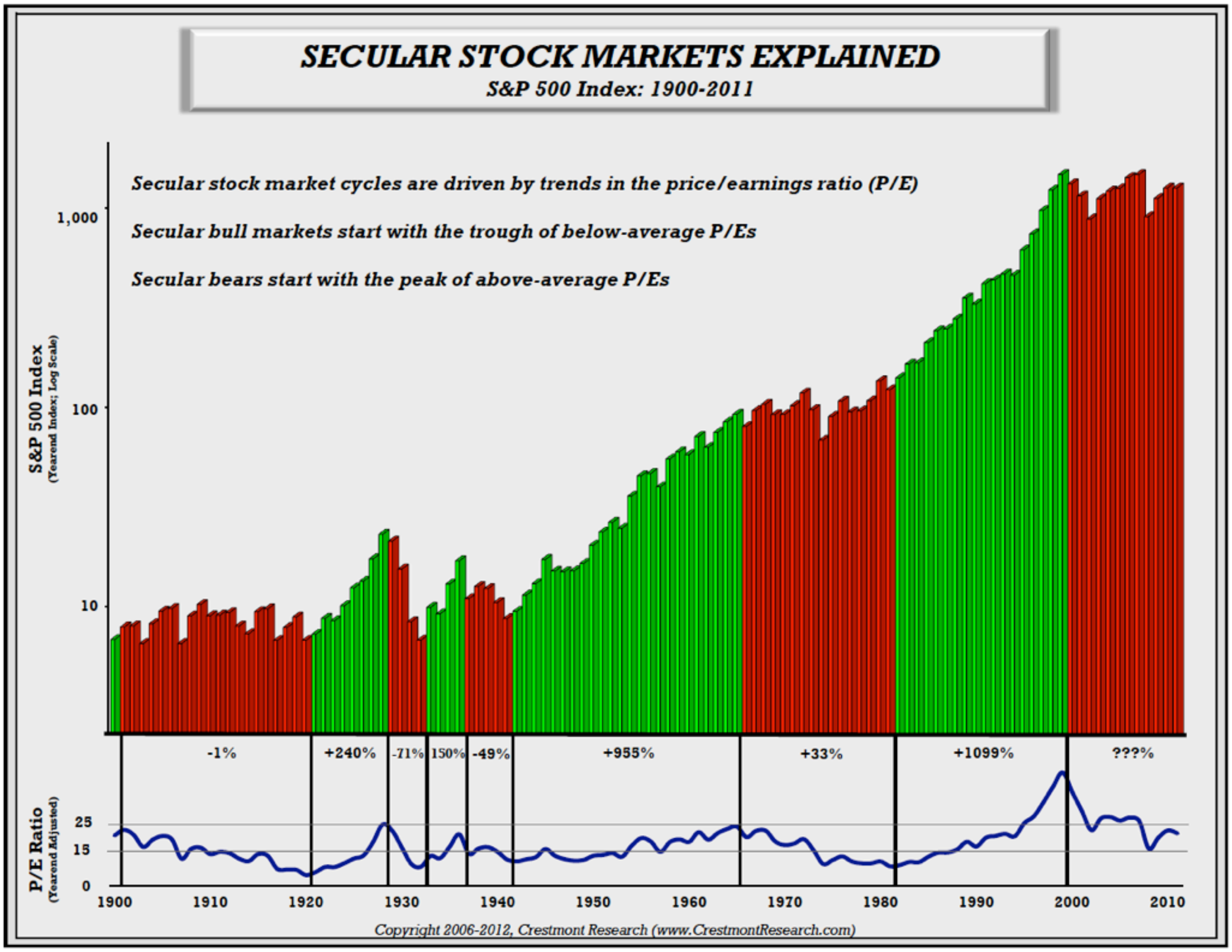
With the latest Secular Bear Market starting in the year 2000, equity market returns have been flat to non-existent. Recent movements to the upside in 2012 and early 2013 notwithstanding reasonable people have had doubts of whether or not the assumptions used were sound to begin with.

On the one hand, if one uses too low an assumption the sacrifice called for currently may be excessive relative to the benefit off into the future. On the other hand, if the assumptions are too high the sacrifice later comes in the form of a sharply reduced standard of living at a later, and always, inconvenient time.

One often looks to long-term results as a way to ascertain a "reasonable" number. While reasonable on the surface these numbers need to be put through a reasonableness filter. For example, Ibbotson data is widely used to demonstrate the long-term results of asset classes. While accurate to the decimal points this data has its own form or variability. As an observer of this data since the mid 1970's the averages have moved around depending on recent performance. For example, "in my early days" I remember the long-term average (starting in 1926) to be in the 9% range. By the end of the 1990's, the average was in the 12% range. Since that time, during a secular bear market, the average dropped back to the 8-9% range.

Recognition of the nature of the markets we are in, both with regards to equities and fixed income, is important to assess the assumptions being used. From today's perspective using a double-digit rate of return as an assumption is truly misguided. That being said, having a successful outcome using a 3% return assumption, with a 3% inflation rate, will work for the Warren Buffet's of the world but not for a majority of the affluent.

As members of the human species one of our great advantages is pattern recognition. We are able to see, assimilate images and dates, and process this information. While a huge advantage most of the time, it is also a source of weakness to see a pattern where in fact there is none and, sometimes it's because the data being observed is too short relative to the total experience. Daniel Kahneman's recent book "Thinking Fast and Slow" provides a much deeper dive into the mistakes we make. From this writer's perspective the cliff notes, as it relates to investing, is that we overweight recent events causing either over-confidence or lack of confidence.



The chart above from Crestmont Research shows the impact of secular (long-term) bear and bull markets. Long sideways up and down volatility is typical of secular bear markets, as well as, flat returns much like the period of 2000 through 2013. The contrast is the secular bull markets exhibit significant upside movements averaging 12% per year over long periods of time.

We have searched for decades for the Guru who can tell us with CERTAINTY the precise time to be in and out of the market. One would think this is a simple thing to do but, when one thinks of GREAT investors no market timers come to mind other than long-term investors like Benjamin Graham and Warren Buffett who are certain to make the list.

The choice of assumptions for a long-term financial plan is clearly an individual's choice.

When our opinion is sought we strive for the middle ground that will provide the highest probability of success, taking neither the high nor the low number. Clearly one can be successful with the low number that is ideal and the middle ground can provide a high probability of being correct. As a firm we tend to use age 99 for longevity. Some scoff at this feeling there is little chance that will happen for them. Yet, with medical advances it still could fall short.

Lifestyle and expenses are the two things that individuals ultimately have the most control over. Matching resources to desires and needs are a balancing act of bringing data together in the most realistic way and shaping an expectation that has a high probability, but not certainty, of success. Moderation is good for most everything in life and sharing assumptions is no different.

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