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Now and in the future

Planning for retirement requires balancing savings, lifestyle

Take time to track life goals to reach an acceptable level in terms of financial performance

By **John J. Grande, CFP®**,
Traudy F. Grande, CFP®, and
John S. Grande, CFP®

Q I am saving as much as possible toward retirement.

Am I sacrificing current lifestyle by saving too much for the future? Is there a method by which I can have more certainty in my planning?

This is an excellent question because it relates to current lifestyle as well as future planning. You used the word “sacrifice” and, because this is not your practice life, why would anyone want to diminish needlessly the quality of life that he or she could currently enjoy? Your question brings up significant issues, which call into question the very premise of traditional financial planning.

Following will be several aspects of financial planning that we think will help to uncover what we consider “inconsistencies” and “contradictions” in the way most people plan for their retirement, as well as the approach they take in planning for their short and intermediate goals in life.

Average rates of return

Most retirement analyses use a set of assumptions to calculate how much someone should save for retirement. In part, these assumptions include current assets, age of retirement, inflation rate, rates of return, income tax rates, social security benefits, mortality ages, investment portfolio allocation, and projected savings.

The first flaw that we find in traditional planning is the use of average rates of return. We strongly recommend against using average rates of return in a financial planning process because, as we all know, most investments do have volatility.

Other than short-term treasury bills, CDs, and money market accounts, almost all investments have a standard deviation from their average annual rate of return over any time period. To rely on an annual fixed average rate of return is to say that the Dow Jones Industrial will return, as an example, exactly 12.1% per year for the next 50 years.

To use averages is to imply that there is no risk or standard deviation to investing. If this were true, then markets as they occurred during 1973 to 1974 and 2000 to 2002 would have no effect on your planning. Of course this is not true, because volatility in market values, especially during the withdrawal stage of the investment cycle, can have a monumental impact on someone’s financial security.

Here is an example of a married couple that consulted a financial planner. Both were 55 years of age, had \$900,000 in their 401(k) and intended to invest an addi-

tional \$16,000 per year. They desired to retire at age 61 on \$112,500 per year. They were planning for a 40-year time horizon and have decided on an asset allocation of 55% large cap stocks, 25% small cap stocks, 18% bonds, and 2% cash.

A portfolio allocated in this manner over the 10-year period ending December 31, 1999 produced a compound rate of return of 15.4%.

However, the planner who did these calculations considered that this approach was too aggressive and, to be prudent, used returns over a longer time frame of 40 years, e.g. 1960 to 2000. This reduced the “average” rate of return that the planner used in the analysis to 12.23%.

According to this traditional method of projections, this planner informed the couple that they would not only have sufficient cash flow for life, but that his projections showed that they would end up with \$23 million in invested assets at age 94, their joint age of mortality.

This investment profile is hypothetical, and the asset allocations are presented only as examples and are not intended as investment advice. Please consult your financial advisor if you have questions about these examples or how they relate to your own financial situation.

However, when using another form of analysis, one that we feel is infinitely more accurate at forecasting, and which we will discuss, we found that this couple would have run out of money at age 85. A gap like this is unacceptable, and should cause concern for any intelligent investor.



It is true that years ago it was virtually impossible to use regressive analysis, because computers and programs were not yet developed that could handle these extensive calculations. However, today's computer technology allows for the development of highly sophisticated tools that utilize actual historic market statistics, and use these statistics randomly over 1,000 hypothetical lifetimes. You may have heard of these types of analyses under the name of Monte Carlo Simulation, Stochastic Modeling, or Probability Analysis.

Regardless of the name, in our experience, these are the most reliable methods in which to test your financial plan's success probabilities. Monte Carlo Simulation helps us understand that capital markets are subject to risk, even over long periods.

As you mentioned in your question, it is extremely important to get a sense of confidence in your planning, because it not only affects your future, but has an impact on your life right now. This confidence can be achieved by discovering your odds (chances) of exceeding your goals, falling short of your goals, or being on target for your goals. This is accomplished by generating 1,000 random trials that match your investment structure (current or proposed) along with your prioritized goals.

Each planning scenario will have either an acceptable success probability, an unacceptable success probability, or a success probability that is so high that it would indicate you are either taking on too much risk in your portfolio, saving too much, retiring too late, or spending too little income in retirement, etc.

Conversely, an unacceptable probability of success would call for a different set of adjustments, which could include a compromise on savings, retiring later, living on less, or being more aggressive in your portfolio. Once on target, you should monitor that scenario on a quarterly or annual basis, making sure that your goals have remained the same, or making adjustments if new goals have been added.

Again, pertinent to your question, this more sophisticated approach to retirement planning

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would dictate just how much you would need to save now, and what concessions you might be willing to make in order to compromise between current lifestyle and future goal priorities.

One very important point, however, is that even using a Monte Carlo Simulation approach can be misleading, if the sole criteria for your calculations are based on your maximum risk tolerance level. Read discussion below.

Risk tolerance level

The second flaw we find in many retirement planning approaches is that planners are asking investors to give them their “risk tolerance” level. According to the original Nobel Prize work that uses standard deviation as a measure of investment risk, it seems logical that an efficient frontier can be established for an investment portfolio that mirrors a person’s tolerance for risk. But how is an investor supposed to find out what his or her individual tolerance for risk is?

There are many ways to measure risk: Sortino ratios, Sharpe ratios, semi-variance and downside risk measures, total draw-down risk, beta, etc. Many questionnaires are based on a Meyers Briggs type of profiling that helps investors discover their “risk attitude.” However, this is contradictory to what we have found most investors really want to discover.

What most people want to know is “how to avoid risk.” We don’t believe that anyone really would like to experience the maximum risk tolerance, just as no one would not want to experience the maximum tolerance for pain. We believe your question would more likely be: “Based on my short, intermediate, and long-term planning goals, my current assets and savings ability, what is the least amount of risk that I can take and still have an acceptable probability of success?”

Again, only by back-testing almost 80 years of market volatility and testing your

individual variables and goals to 1,000 random lifetime performances do we feel that you can choose with any degree of confidence just how much risk you “need” to take. The standard deviation you may need to take may be far less than the risk you would have been willing to tolerate.

Saving and sacrificing

The third flaw we find in a traditional approach to financial planning is in how most investors and planners arrive at what investors’ maximum annual savings should be and how long they need to save. Many investors save to a point of unnecessary sacrifice to their current lifestyle. Some feel that if it doesn’t hurt, they aren’t saving enough. Others feel they can postpone saving until they get closer to retirement, which is usually unrealistic.

Without knowing the probability of success using your personal set of assumptions, how is it possible to know (guess) how much you should be saving? Or, for that matter, how much should you be saving within your qualified plan versus saving outside of your retirement plan?

When using Monte Carlo calculations properly, you get to pick, choose, and balance goals according to your priorities.

Let’s take a look at the risk tolerance flaw, examining what happens when you take more risk than you need to.

As an example, what if after calculating your success probability you find that by using your maximum risk (pain) tolerance level, you were only going to gain an additional 3% in retirement income? Would that be worth it?

Would having the added stress and anxiety of extreme volatility in your portfolios be worth the extra 3% in income you may receive 20 years from now?

What if you are leaving excess returns on the table, because your portfolio is not on the efficient frontier, or you were not systematically re-balancing asset classes

and styles?

The idea of constructing an efficient portfolio is, in theory, to reduce risk and increase expected rates of return by hiring managers with high alphas and reasonable betas and creating an efficient blend of non-correlating asset classes. Just last week we worked with an ophthalmologist whose analysis showed that his portfolio was off the efficient frontier.

His percentage of success probability rose from only 44% to 78% without increasing his risk and by increasing the efficiency of his portfolio.

Of course, this was something he could not have possibly known by looking at his portfolio as it related to his retirement goals.

This premise works the same for your savings program.

Why do most questionnaires for retirement planning only ask for the “maximum” that you can save? Why don’t they ask, “Is it possible for me to reduce my savings and still meet all of my goals?”

Shouldn’t this be a goal as well?

Take the case of a couple earning \$300,000 per year with a \$2 million portfolio.

Given their retirement goals it is most likely that by saving an additional \$10,000 per year now until retirement they would only be able to retire 1 year earlier.

What if your goal is to travel every year between now and retirement? Wouldn’t it be comforting to know the impact this travel would have on your retirement, and what compromises you could make to live your life fully now? Isn’t it a fact that not everyone even gets to retirement?

We believe there needs to be a prioritized balance between future planning and current lifestyle.

Monitor what happened

Reporting is very important because it does show you whether your money managers are in the top northwest

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quadrant of their peers, or conversely, not producing return commensurate with the risk that they are taking.

But planning your future using past performance reports is like choosing money managers using their past performance.

Herein lies what we consider to be another flaw in most financial planning approaches.

Planning the future using a rear-view mirror approach just isn't going to work. What is needed is the ongoing monitoring of your life goals based on ongoing portfolio performance.

We believe you should be tracking your life goals within three areas of probability:

- Unacceptable (less than a 75% chance of success);
- Acceptable (between 75% and 90% success); and
- Sacrificing (over 90% probability of success).

If you fall into "unacceptable" or "sacrificing," then adjustments in risk, goals, and savings should be made.

It is imperative that you revisit the goals that you are tracking to make sure that they are still appropriate and realistic goals.

This exercise forces a constant reappraisal about the choices you have so that you can adjust your priorities to fall between unacceptable and sacrifice, which would be the comfort zone.

It's okay to dream

Who doesn't want to dream? It is healthy to dream. Most of us want our children to receive the best schooling available; we want to spend as much as possible now and in retirement; we want to retire as early as possible; we want to take as little investment risk as necessary; we want to save as little as possible; we want to gift as much as possible; we want to leave behind as much as possible; and live it up now as much as possible while we still can.

And who can blame us for that?

Even though most of us have these desires, it is very infrequent that people take these goals into consideration.

However, somewhere between achieving your dreams and settling for the bare minimum that would be tolerable for you is a mathematically verifiable set of goals that fall between 75% and 90% probability.

This is a good comfort level to live with. It is true that in many cases a person's dreams are attainable and, in other cases, what would be tolerable might be a stretch to achieve.

However, it is not unusual to find that somewhere between these two extremes is a "recommended" set of goals.

Your own goals, according to your own priorities and assets, will point to the realistic goals you can achieve. ○ T

author info

John J. Grande, CFP®,
Traudy F. Grande, CFP®, and
John S. Grande, CFP®



are co-editors of *Money Matters*. John J. Grande, CFP®, and Traudy F. Grande, CFP®, are owners and principals of Grande Financial Services Inc. and registered principals of Raymond James Financial Services Inc., member NASD/SIPC.



Their son, John S. Grande, CFP®, has been in business with them for 10 years. He has a degree in finance from Lehigh University, Bethlehem, PA. He lectures at Johns Hopkins University



School of Medicine, and his work has been published in several medical journals.

The Grandes advise ophthalmologists across the country on a diverse range of investment and financial matters. Readers may submit their financial questions to them at 800/722-1258 or grande@raymondjames.com. Readers may also access the Grandes' newsletters at [www.gradenewsletters.com](http://www.grandenewsletters.com).

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REGISTERED INVESTMENT ADVISOR

257 Monmouth Road • Oakhurst, New Jersey 07755 • 1-800-722-1258

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john.grande@raymondjames.com

www.raymondjames.com/grande