Is Conventional Planning Right for You?

Do online interactive financial planning models really help people in deciding how much to save, to insure, and to invest in stocks and other asset classes? These models vary in complexity and in level of detail, according to a recent Boston University School of Management Conference on the Future of Life-Cycle Saving & Investing.

Many of these models are available for free on the Web sites of financial institutions. The simplest are "calculators" that tell the user how much to save each year at an assumed rate of return in order to accumulate a desired future sum at an assumed retirement date. They make doing sensitivity analysis quick and easy. The more ambitious ones perform Monte Carlo simulations and take into account a relatively large number of factors, including household size and composition, income, wealth, desired retirement date, expected inflation rate, expected asset returns, attitude towards risk, etc. A Monte Carlo simulation is an analytical tool for modeling future uncertainty. In layman's terms, it's a computer program that first examines thousands upon thousands of market environments and market returns and then spits out ranges of possible outcomes or success rates.

But many of these models, at least from the perspective of economic theory, are seriously deficient according Laurence J. Kotlikoff, Professor of Economics, Boston University and President, Economic Security Planning.

In his recent paper, “Is Conventional Financial Planning Good for Your Financial Health?” Kotlikoff notes that economics teaches us that we save, insure, and diversify in order to mitigate fluctuations in our living standards over time and across contingencies.

While the goals of conventional financial planning appear consonant with such consumption smoothing, the actual practice of conventional planning is anything but. Consumption smoothing is the notion that consumers will spend on average 70 to 80 percent of their pre-retirement income per year once in retirement. Conventional planning’s disconnect with economics begins with its first step, namely forcing Americans – in the absence of a financial planer - to set their own retirement spending targets. In many cases, experts say Americans are ill-equipped to establish how much they will spend in retirement.

Setting spending targets that are consistent with consumption smoothing is incredibly difficult, making large targeting mistakes almost inevitable, Kotlikoff notes.

But even small targeting mistakes, on the order of 10 percent, can lead to enormous mistakes in recommended saving and insurance levels and to major disruptions (on the order of 30 percent) in living standards in retirement or widow(er)-hood.

There are many reasons why small targeting mistakes lead to such bad saving and insurance advice and such large consumption disruptions, according to Kotlikoff. For instance, the wrong targeted spending level is being assigned to each and every year of retirement. In addition, planning to spend too much (or too little) in retirement requires spending too little (or too much) before those states are reached. This magnifies the living standard differences.

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Conventional planning's use of spending targets also distorts its portfolio advice. Given a household's spending target and its portfolio mix, standard practice entails running Monte Carlo simulations to determine the household's probability of running out of money. Most of these simulations assume that households make no adjustment whatsoever to their spending regardless of how well or how poorly they do on their investments. But consumption smoothing dictates such adjustments and, indeed, precludes running out of money; i.e., ending up with literally zero consumption. It is precisely the range of these living standard adjustments that households need to understand to assess their portfolio risk. Conventional portfolio analysis not only answers the wrong question; it may also improperly encourage risk-taking since riskier investments may entail a lower chance of financial exhaustion thanks to their higher mean return.

In addition to exposing the general and generally serious shortcomings of targeting spending, Kotlokoff says online calculators typically offer remarkably simple advice geared to speed households through the planning process in a matter of minutes.

But quick and simple doesn't necessarily spell helpful, according to Kotlikoff. In fact, many online calculators lead to dramatic oversaving thanks to retirement-spending targeting mistakes ranging from 36 to 78 percent too high.

For his part, Kotlikoff suggests: "None of us would go to a doctor for a 60-second checkup. Nor would we elect surgery by meat cleaver over surgery with a scalpel. And any doctor who provided such services would be quickly drummed out of the medical profession. Financial planning, like brain surgery, is an extraordinarily precise business. Small mistakes and the wrong tools can just as easily undermine as improve financial health."

At the end of the day, most experts suggest that using a financial planner can eliminate the need to use Web-based calculators and run the risk of saving too little for retirement or spending too much in retirement.

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