



THE AUDACITY OF HOPE IN RETIREMENT PLANNING

While we should never give up hope, hope is no substitute for careful and realistic planning.

Just as dangerous as not planning at all, planning based on unrealistic assumptions can spell disaster for workers saving for retirement. It seems that too many people, even financial professionals, base their future assumptions on the best possible future scenarios, rather than considering the possibility for errors.

In "Hope Is Not a Strategy," John West and Rob Arnott at Research Affiliates show how the assumptions used by most pension fund and 401(k) calculators do a disservice to the people who rely on them to predict their financial futures. If we don't question those assumptions and allow for the possibility that the markets may do much worse, we set ourselves up for stress down the road.

PLANNING FOR THE BEST IS NOT THE BEST PLANNING

We don't rely on hope alone when we make our travel plans. While we hope that we will not encounter traffic on route to the airport, that we will not be stuck in a long security checkpoint line, that our flight will not be delayed, and that our luggage will be the first to pop out at the baggage claim, we don't expect these things to happen every time. It would be foolish to make our travel plans based on the best possible scenarios.

The authors propose another analogy—suppose you had a very important trip, one that will determine your financial well-being not just for the next few years, but the next few *decades* ahead. How might your travel plans be different? We would probably spend the night at the airport, fly out—at least—the day before, research directions

→ A QUICK LOOK

- Most pension funds and 401(k) calculators assume total returns in the 7-8% range.
- Stocks and bonds are actually expected to return 5.2% and 2.5% respectively.
- The real growth in stock earnings and dividends has been just under 1% over the past 100 years.
- Meanwhile, inflation in stocks is forecasted to be 2.0%.

map out our route, call ahead to confirm, reconfirm and have a contingency plan for every possible snag we could imagine.

Planning for retirement *will* determine your financial well-being for the next few decades, yet how cavalierly do we assume that, because we put forth a little effort, everything will go our way? In a time of an aging U.S. population and a government debt of \$13.6 trillion and rising, expecting a worry-free passage into retirement is like "counting on the plane getting to the gate an hour early, followed by a road-clearing motorcade."

ARE THE ASSUMPTIONS WRONG?

The recent rally in the stock and bond markets has breathed hope into investors everywhere. Even pension fund managers are relieved that the worst seems to be behind us. Many big pension funds are now expecting 7% to 8% returns a year from here on out, and retirement planners use those assumptions to calculate their future earnings. But how carefully planned is that assumption? Could it be wrong?

YMCA Retirement Fund's RESOURCE TOOLKIT

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Right now the dividend yield on U.S. stocks is about 2.2%. However, in real, inflation-adjusted terms, earnings and dividends have only grown by 1% a year. Since 1900, the average is only about 1.2%, and in the second half of the 20th century, just 2%.

With an expected inflation rate of 2% (below historical average), the authors forecast a long-term return of just 5.2% on stocks.

There is the possibility that valuation may help out earnings. Valuation is the process of estimating the potential market value, in other words, the change in the value that the market is willing to pay for a dollar of earnings and dividends. Valuation has had a huge impact on long-term returns when invested at the right time. In the 1930s and again in the 1970s, investors found cheap shares which they would later cash out during the market booms of the 1960s and 1990s.

Could we hope for a repeat of those decades now? Unfortunately, it is not very likely. This latest rally has lifted shares already to pretty high levels in relation to average cyclically-adjusted earnings. The 10-year cynically adjusted price/earnings ratio (Shiller P/E) is at about 22, while its historic average is 16. The only time the market has boomed from these levels was the bubble in the late 1990s, a highly unusual event and definitely not one we should rely on for retirement planning purposes.

Only when planners assume that their stocks will consistently perform in the top quartile will their projected returns be closer to the 8% they hope for.

What about bonds? The good news here is that bonds involve much less room for hope, since bond coupons and the repayment of principal are fixed. The bad news is that the return on bonds is low, based on the yields of prices across all investment grade bonds, the authors calculate likely long-term bond returns of about 2.5%.

“Prediction is very difficult, especially if it's about the future.”

—Niels Bohr, Physicist

So, taking hope out of the equation, an investor with a standard, conservative portfolio of 60% in stocks and 40% in bonds can expect a weighted average annual return of only about 4.1%, according to the authors' viewpoint.

MORAL OF THE STORY: SAVE MORE

It's a bad sign when even the financial planners and pension fund sponsors don't see past the present market rally to spot potential long-term disaster ahead. Returns will very likely be much lower than most people expect.

The best way to prepare for retirement is to save, save, save. Hope for the best, but don't let hope become the bedrock of your financial planning. As Benjamin Franklin once wrote, “He that lives upon hope will die fasting.”

The study, titled “Hope Is Not a Strategy,” was written by John West and Rob Arnott at Research Affiliates, an investment management firm in Newport Beach, CA. It was published in October 2010 in Fundamentals, the Fundamental Index® Newsletter.