Failing to plan is planning to fail

I recently spent some time with a financial advisor who practices in an affluent area of Melbourne. He's has been on a mission this year to make sure that all his clients do some kind of systematic retirement income planning.

The process has been a revelation to him, in that he found that only about five percent of the clients coming into his practice already have a written financial plan for retirement. “I had thought that the important thing was how accurate and detailed the retirement income plan was,” he says, “but it turns out that what really matters is *whether there is any plan at all.”*

That's right, of course: the threshold issue in retirement income planning isn't how well you've done it. It's whether you've done it at all. As in so many aspects of life, failing to plan financially ***for*** retirement is in reality the act of planning to fail financially ***in*** retirement.

Because when we finally step across the threshold of retirement—as a thousand of the fabled baby boomers do every day in this country—our financial lives essentially shrink down into one perfectly binary issue: **will our money outlive us, or will we outlive our money?**

The answer we get to that question will affect not just the quality of our lives in retirement, but it will directly impact the lives of our children and grandchildren. Will we be able to leave a legacy to our children, or intervene in the funding of our grandchildren's education? If we're on plan to consume less than our retirement savings in retirement, those are options. If we outlive our savings, they're not.

Whether you're thirty years away from retirement or thirty months into retirement, I can assure you—and I know your financial advisor will join me in this—that it is neither too soon nor too late to formulate a plan. The calculations themselves aren't complex. (As another advisor friend of mine recently said, in a malapropism worthy of the early Ringo Starr, “This isn't rocket surgery.”) The willingness is all: get the facts, and then face the facts.

The primary fact of retirement income planning is that it's a moving target. It isn't enough to plan to have a certain income to cover a certain cost of living on a certain retirement date (although that's a really great start). Because the cost of living is always—however slowly—increasing: in a three-decade retirement at long-term historical inflation of three percent a year, your cost of living can be expected to go up something like two and a half times.

For those of us planning for a retirement in the future, that means it won't be enough to plan to cover today's living expense. Once we figure those expenses out, we need to inflate them (at, say, three percent a year) for every year from now until our retirement date. (Get the facts; face the facts.)

Centre for Investor Behavior

Then, on the back of an envelope, you can make a halfway decent guess at the sum of retirement savings necessary to produce that (realistically inflated) cost of living: multiply the income by twenty.

The questions then become: (1) How much have you saved for retirement so far? (2) How much are you going to have to put away each month—that is, how much gratification are you going to have to defer—to bring you in range of your goal? (Remember that, at the long-term compound return of the market of about ten percent, *the last dollar a 45-year-old spends is fifteen dollars his 75-year-old self won't have*.) (3) What rate of return will you need in the interim to close the gap? And finally (4) which investment classes have (and which have not) historically produced that needed rate of return in the long run?

Again, not rocket surgery, but not a set of calculations most of us can easily do—which is why your financial advisor, who I assure you is standing by to do them for and with you, was sent into the world. The goal: ***a dollar-specific, date-specific retirement income plan***, for (as the great American philosopher Lawrence Peter Berra famously said) if you don't know where you're going, you might not get there.

Even for those of you who've crossed the threshold into retirement, one more critical planning session is in order. Again, it involves two relatively simple calculations. (1) Inflated at three percent per year, what is the trajectory of your probable living costs over the balance of you and your spouse's life expectancy? (2) Given your present portfolio, what is the historical long-term trend of your income likely to be? If you find that a reasonably projected trendline of your living expenses will one day overtake and then exceed the trendline of your expected income, *then today is the day for you and your advisor to make a new plan.* ***Get the facts; face the facts.***

Your physician will confirm to you that the five most dangerous words with respect to a person's health are "Maybe it will go away." The financial equivalent of that denial is the absence of a written retirement income plan. This isn't just the year or the month to make an appointment with your financial advisor in order to begin formulating such a plan. ***This is the day.***

Centre for Investor Behavior

Six Steps to control what you can control

Investing by its very nature—that is, putting money away for use at some future time—requires us to submit ourselves to variables we can neither predict not control. World events, government policies, interest rates, taxation, inflation and the business cycle are just some of the forces which may act upon our investments over time, for good or ill.

But unknowability is not the same thing as chaos. We can identify patterns—in history as well as in human behaviour—which have usually served the investor well over time. And as Lyndon Johnson's biographer Robert Caro said not long ago, "The power of history is in the end the greatest power." Thus, we may perceive both historical trends and behavioural qualities which have often led to significantly enhanced investment outcomes in the long run. Behaving in harmony with these trends and qualities, we may practice ***rationality under uncertainty.***

The converse is also true—and it is the converse which explains the blighted investment outcomes suffered by many or perhaps even most people. That is, the ultimate irrationality is for investors to waste great quantities of time and energy studying variables which we have every reason to know are random, and which cause people to underperform not just the markets but their own investments. The three main avenues of this failure are economic forecasting, market timing, and the handicapping of the future relative performance of similar investments based on their recent past performance.

The tragedy is not simply that these are fool's errands, though they surely are. The tragedy is that they are historically all but irrelevant to lifetime investment outcomes. They are the tail, trying (and failing) to wag the dog.

But there are, in my experience, six variables which, practiced together, will often cause the long-term, goal-focused investor to achieve investment outcomes that are supportive of his financial plan. Three of these are temperamental qualities—beliefs, if you prefer—and are therefore much more important than the other three, which are behaviours, or essential portfolio strategies.

Warren Buffett recently opined that "Temperament is more important than IQ" in successful investing. And the pioneering computer scientist Alan Kay went so far as to aver that "Point of view is worth 80 IQ points." The successful investor's governing temperamental quality—and the first of my six variables—is **faith in the future.**

Though I don't know how I'd set about proving this to you, I'm convinced that it is impossible for anyone who is fundamentally fearful of the future to achieve long-term investment success. The investor who perceives the world as chaotic, fragile and forever on the brink of some ultimate catastrophe will always get scared out of the markets again and again near panic low points, not merely wiping out his return but inexorably decimating his capital.

Optimism is historically the only realism—the only worldview that squares with the facts, and with the historical record. Surely we see this in every aspect of our lives, and the longer we live, the more obvious it becomes. It isn't just technology—although the iPhone 6 I carry

Centre for Investor Behavior

contains more computing power than existed in the earth when my father started kindergarten in 1950.

My grandfather's life expectancy at birth in 1909 was 47 years; his great-granddaughter's, at birth in 2015, was 84. My father was only one generation away from the influenza pandemic that carried off 50 to 100 million people worldwide—including my father's older sister. My mother was born in 1948; on her mother's side she had two aunts and two uncles. One aunt and one uncle died of tuberculosis before Joan was six. Deaths from TB and flu in this country this year will be all but nonexistent.

As I write, a hundred people have died violently in the Syria over the last week, and this is surely a terrible thing. But just seventy years ago—that is, in my father's lifetime—World War II killed 180,000 people in an average week. Also within the past few days, a man whose family emigrated to this country from the Ukraine when he was 16, and who lived on food stamps until they could get on their feet, sold his company to Facebook for $19 billion.

In the summer of my father's 21st year, three young men were brutally murdered for helping African Americans register to vote. Eight years ago, an African American was elected President of the United States by a large majority; four years later, he was re-elected by an even larger one. One can go on like this for a very long time, but perhaps just one more juxtaposition may serve to focus the point:

The joint life expectancy of a nonsmoking couple of average retirement age (62) is thirty years. Thirty years ago, the Standard & Poor's 500-Stock Index was around 160. Its earnings were running at about $17, and its dividend around $7.50. As I write, the Index is 2,100. The consensus earnings estimate for 2016 is in the neighborhood of $130, and I'm guessing the dividend will end the year either side of $38. Can you even count—much less recall the details of—all the disasters that have befallen this country and the world, just in those thirty years? Thus you may see that **faith in the future** is not optimism in spite of the facts but because of them.

The second temperamental quality which seems to me to increase the chances of long-term investment success is **patience**. We live not in an age of enduring truth but of late-breaking news. Hewing to the long-term plans and portfolios which we and our financial advisors created to fund our most important multi-decade goals becomes ever more difficult, as the 24/7 financial news cycle, and the endless blather of numberless talking heads, pressure us to *do something smart and timely right now*.

But when the pattern of history reasserts itself as it always has, we discover to our chagrin that the best policy would have been the dictum *"If your goals haven't changed, don't change your plan; if your plan isn't changing, don't change the portfolio."* Never mind what's working now; try to stay focused on what's always worked in the long run.

The third and last temperamental quality is **discipline**. This may not at first glance appear much different from patience, but wait until the next time the market goes down 30%, with every talking head you hear in the media extrapolating the current "crisis" right over the cliff. Patience, to me, is the ability to keep doing the right thing, but discipline is more about forbearance, or the capacity not to react—not to do the wrong thing, most notably panicking out of the markets at a moment of maximum pessimism. As the late Louis Rukeyser always said during apparent "crises:" Don't just do something; *stand there*.

Centre for Investor Behavior

We proceed now to the three behaviours or portfolio strategies that I believe will carry us into the higher echelons of lifetime investors. Note once more that these practices are simply ways of carrying out the temperamental qualities enumerated above: *the principles dictate the practices, in the sense that beliefs always dictate behaviours.*

The first practice (and fourth of these six steps) is **asset allocation**, which simply refers to the percentage of equities versus bonds in your portfolio, on average, over your investing lifetime. This raw number—more than any other portfolio variable, and perhaps more than all of the others combined—will likely dictate your lifetime investment return. It would almost have to.

The long-term compound return of large-company stocks over the last roughly nine decades—that is, with dividends reinvested—is close to ten percent annually. For small company stocks, it's approaching twelve percent, because of their obviously greater risk (more small companies will fail) and volatility. The compound return of long-term, high quality corporate bonds (interest reinvested) is just under six percent.

Net out from these nominal returns long-term inflation during this period of three percent, and you discover the following: at seven and nine percent respectively, large and small company stocks have historically compounded at two to three times the three percent real return of quality bonds. In a nutshell, this tells you why the percentage of your portfolio allocated to equities versus bonds has historically been decisive. (Of course, then you face for the rest of your life the consuming impulse to panic out of declining equities; now you see why temperament is critical.) The issue of which equities—that is, the pernicious illusion of superior selection as the key variable—may thus be seen to be a dead end.

The second practice is **diversification**, which to me is perhaps the ultimate expression of rationality under uncertainty. Within the equity asset class, ought we to own large company or small company equities? Domestic/developed world equities or emerging markets? Actively managed funds or indexed funds/ETFs? Speaking only for myself, my answer is unequivocally yes—to all of the above. (The only thing I wouldn't own is individual stocks. Why? Because I'm nowhere near smart enough.)

Adequate diversification is quite comprehensively expressed, to me, in the following formulation: *I'll never own enough of any one thing to make a killing in it; I'll never own enough of any one thing to get killed by it*. I hold this formula to be beyond rationality under uncertainty: to me, it is uncertainty worn as a badge of honor. This is a badge I expect to wear for the rest of my life.

And the third practice, and last of my six steps, is **rebalancing**. Let's hypothesize that your plan leads you to invest equally in, say, five different equity sectors/disciplines: twenty percent of your capital in each. A year later, you'll almost surely find that this mix has slipped out of whack: some of your portfolios will have outperformed others, such that they now contain more than twenty percent of your portfolio, whereas the relative laggards contain less than your twenty percent plan.

What most Americans will do, if anything, is to sell the laggards and put the money in the hot trends, thereby simultaneously selling low and buying high. There may be a more reliable formula for consistent underperformance, but if there is I've yet to discover it. Rebalancing (on the same day every year) causes us to sell off some of our positions in things that have

Centre for Investor Behavior

had a successful run and to redeploy the capital into things which are relatively out of favor. There is a term for this. It's ***investing***—as opposed to speculating on the continuance of recent price trends.

•••

I cannot say with any precision what percentage of your lifetime investment return will be driven by these three principles and three practices. In the next breath, I can't doubt that for myself, they have accounted for the vast preponderance of my investment outcome to date. They have been the dog; timing and selection were the tail. And I've long since had the dog's tail docked.

Centre for Investor Behavior