The Analytical Disconnect

by Jonathan Guyton, CFP®

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Earlier this fall, the *Journal's* editorial staff asked me to offer my take on the results of their annual retirement income planning study. Not surprisingly, several results caught my eye as comment-worthy. However, nothing grabbed my attention more than this: responding planners reported that, on average, 24 percent of their retired clients had experienced "a significant change in their lifestyle" from last year to this.

That's right, in just the last 12 months.

Planners typically complete this survey in late July or early August each year, and there's no way to know whether all these changes really did occur since the summer of 2010. Significant change was defined for retirees as going back to work or significantly reducing their lifestyle expenses. And the 24 percent figure applies to the actions clients took as viewed by their planners and not the percentage of clients actually advised to make such a change.

Are Such Drastic Changes Necessary?

But all said, that's still a lot of significant lifestyle changes! Before going further, think for just a moment about what a "significant change" might be like. Fears are stoked, relationships with family or friends are affected, meaningful life experiences could be shifted to the back burner to await a hopefully brighter day, comforting routines may be interrupted, even a little thing like a relaxing dinner out can involve stress over "whether we should have wine."

That's not to say such lifestyle changes are unwarranted; changes may well be warranted. Certainly, they are a big deal.

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In my experience working with our clients and in talking with colleagues around the country, I have come to believe that when clients trust their adviser they place a very high value on the adviser's interpretation of how economic and market conditions relate to their personal financial well-being. In other words, if we tell them they should be worried or make a significant change in how they are living, it's quite likely that they will. And similarly, if we have sound reasons why such (undesirable) changes are unnecessary, they are rather unlikely to do something so "significant."

And so I conclude that a primary reason roughly one in four retiree clients made so significant a lifestyle change in the last year is that—more or less—their planners said they should. To me this raises the question not of judgment (the recommendation itself), but rather of process (how such a recommendation is reached). For beyond the matter of trust itself, there is perhaps no question more at the heart of the matter to a client than, "Am I (still) going to be all right?"

This question is obviously as complex and "gray" to answer as it is simple and black and white to ask! To answer it calls on our profession's science as well as its art. We require well-developed right and left sides of our brains—high levels of both IQ and EQ—if we are to be competent, trustworthy agents of either "change" or "don't need to change," as the case may be. Fellow practitioner Guy Cumbie has written thoughtfully on this. Doug Lennick and his colleagues at Lennick Aberman considered the influence of our involuntary brain chemistry and our acquired emotional intelligence on the rendering of sound judgment and advice. I commend their writings. We always benefit from looking in the mirror reflectively even if it is not always pleasant to see our vulnerabilities and Achilles' heels. Alas, the only thing worse for ourselves—and our clients—is when we don't!

However, the analytical tools and resources that inform our advice on this matter are what I want to explore. In short I suggest that at present, many tools are much less helpful than either we or our clients need them to be.

Realizing the Flaws in Our Methodology

Whenever we run a retirement projection or simulation, we take what we know about the client's current situation and combine it with a set of assumptions about the future—whether sophisticated or simplistic—to calculate what the situation (or series of situations) will be at some point far down the road. Unfortunately, these conclusions are almost universally based on a methodology that precludes any mid-course adjustments, intervention, or recalibration along the way. It's an analytical autopilot akin to taking a road trip in a car with no brakes or mirrors. What's the point in having them if the simulator of this financial journey doesn't allow for corrective action based on the conditions that may have arisen? Tap the brakes or turn the wheel all you want; it won't make any difference in what is simulated to happen next.

Of course, this simulated autopilot is not how you or I or any other financial planner worth his or her salt provides ongoing advice to retired clients about the sustainability of their lifestyle. In fact, it is in the very ways such simulations assume our hands are tied that we provide advice most valued by clients. But notice the awkward or even dangerous question such an analytical framework requires us to answer: how big a probability of failure can be mitigated by skillfully applied mid-course adjustments? Five percent? Fifteen percent? And even were we to know, questions remain about the timing and size of such dynamic adjustments. Projections that leave such questions unanswered are unhelpful to planners and their clients.

Not even a diligent annual recalibration of such projections throughout a client's retirement years overcomes this if its method implicitly assumes there would never be any other adjustments going forward. Moreover, the outcome of such analytical updates that occur when markets are either overvalued or undervalued is highly influenced by the returns assumed in the ensuing three to five years. (Note that the S&P 500 has gained over 14 percent annually in the three years since November 2008 despite prognosticators' assertions back then that future returns would be much lower; Scott Leonard's October 2009 *Journal of Financial Planning* article provides an excellent historical perspective on this subject.) Sadly for clients, basing advice on such an underlying analysis could easily heighten the chance of the advice "crying wolf."

Practitioners appear to be recognizing this. When giving a talk to colleagues, I routinely poll the audience on a handful of items including, "How many of you use financial planning software that models the impact of the mid-course adjustments you would advise clients to make?" I am still waiting for the first hand to go up.

Unfortunately, the flip side—relying predominantly on our perceptions—can lead to the same advice, and current conditions are ripe for this to occur. In this year's study, more than 75 percent of planners who lowered their recommended maximum safe withdrawal rate from a year ago cited a subjective view of current or future conditions rather than an analytical basis as their primary reason. (Planners expressing such a view numbered 19 percent of respondents; they were also about twice as likely to have more than 20 percent of their retired clients significantly change their lifestyle as planners who did not change their view on this.)

When planners lack the analytical tools to effectively model the dynamic policy-based advisory approach they provide their clients, they may be left to their own wits to determine whether changes are warranted because "this time, it's different." Those concluding that it is may in fact be right; however, it is also easy to see paths to overconfidence or wolf-crying from such a place … and to recommendations that significant lifestyle changes are called for.

Perhaps the disconnect between the capabilities of many analytical tools and the dynamic approaches actually utilized by planners will soon not matter as much. Fewer than 10 years after such systematic policy-based frameworks were first presented in empirical research, they are already being employed by about one-third of practitioners, according to the FPA study. Because such an approach also serves as a real-time diagnostic tool, these planners have no need to run yet another projection when clients ask, "Am I still okay?"