The Stan Clark Financial Team's

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Financial planning

Return assumptions for financial plans – Part 1: Life is like a box of chocolates

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When we make a financial plan, we need to make assumptions about the future returns for the life of the plan. This isn't easy. As the eminent philosopher Forrest Gump would say, "My mama always said, life is like a box of chocolates. You never know what you're gonna get."

Future return assumptions, especially those used over a long period of time, have a huge impact on the results of a financial plan. They can mean the difference between projecting a significant estate – or having to reduce expenditures.

The first issue with future return assumptions is that, well, they're for the future! We know that future returns cannot be accurately forecasted. So, what we do is base them on long-term historical results. To be conservative, we reduce these by 2-3%. And by long term we don't mean just the past 10 or 20 years, as most plans would. We mean the past 100 years. This way we capture all the ups and downs, as well as the long-term trends. The average return for stocks over the past 100 years was 10.8%. For most of our plans we use 7-8% as an average, maybe 5% above inflation.

It sounds easy enough. Just plug in these forecasts, and see where we're at! Indeed, this is probably the most common approach to financial planning. Come up with a long-term return assumption – assuming it was reasonably determined – and then use that in the plan.

Let's say we're doing a plan for someone aged 60. We're projecting until they are 95, in other words, a 35-year plan. Over such a long period, minor differences in the return assumptions, even 1 or 2%, can have a significant impact on the final results. It's like we're boating and our navigation is off by two degrees. On a small lake, it won't make much difference where we end up. But if we're going a long distance, say, over an ocean, then that same two-degree difference could mean arriving in the wrong country! That's the first issue with return assumptions: small differences in returns can make huge differences in results – especially since they're being used over such a long time.

This raises another issue, one that most people don't consider. The past 100 years have been wildly volatile: inflation, deflation, a deep depression, explosive growth, two World Wars, embargoes, assassinations and pandemics. There were some very good 35-year periods, some very bad 35-year periods, and many in-between periods.

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As we look to the future, the world remains uncertain. No one really knows what the next 35 years will bring. Maybe they will be average; maybe they will be really good. But what if it's one of the very bad 35-year periods?

History does tend to repeat itself. The problem is, you don't know what specific part of history is going to be repeated next! It makes a big difference when the up and down years occur, relative to when we are adding or withdrawing money.

In the next of this three-part series, we'll discuss how – even if the average returns are the same – the path or order of returns can make a big difference in financial projections. ■

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