The Stan Clark Financial Team's

PERSPECTIVES

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Financial planning

Return Assumptions for Financial Plans Part 3: The 100-Year Stress Test

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Previously we've discussed how return assumptions have a huge impact on financial plans. And, how performance returns in the future can't be accurately forecast. For that reason, we make conservative estimates based on long-term historical results, adjusted for current valuations. By "long term" we don't mean just for the last 10 or 20 years. Rather, we use data from the last 100 years to capture all the ups and downs. In this third part of our series on return assumptions for financial plans, we discuss our *100-Year Stress Test*.

A typical financial plan could be a 30-year plan. Even though the return assumptions are based on the last 100 years, there have been some very good 30-year periods and some very bad 30-year periods. The problem is, we don't know which version we're going to get in the future – and taking that into account will have a significant impact on how your plan looks. As discussed in Part 2, it matters a lot when the up and down years occur, relative to when you are adding and withdrawing money. So, how do we put it all together?

This is where we do something different from most financial plans. We run your plan through our 100-Year Stress Test. In this case, we test the plan through every 30-year period over the last 100 years. Let's say we start in the year 1920. We test the resiliency of your plan for the subsequent 30 years, using actual returns and inflation. Then we do it again, but starting in 1921, then 1922 and so on until all the data are exhausted.

As you can see in the chart below, each of the squiggly lines represents the value of your financial assets over a 30-year period, each with a different starting year. As expected, some lines do very well and some not so well. This gives you a picture of the range of outcomes that would have occurred in the past, and shows your best- and worst-case scenarios. We then evaluate each of the tests and see if any of them came up short, i.e., ran out of money. In this example, none of the scenarios came up short, which is good. If there were many scenarios that came up short, it would indicate to us that we might need to make some adjustments to the financial plan. These could include increasing savings, reducing future spending or perhaps downsizing a home. We also show the median outcome, to give us an idea of what a normal path would have been historically.

There have been many periods of market declines in history, and inevitably there will be many more. Although market fluctuations are a normal part of investing, they can still pose challenges to investors – especially those who are near or already in retirement. This is why our 100-Year Stress Test is important. No one knows if the market is going to be strong, weak or average going forward. We have to go through all the scenarios to find out how resilient your financial plan is. We're mostly worried about the bad periods. If the test can survive all the historical scenarios, then that gives us confidence in your financial plan and will also help you stick to it. ■

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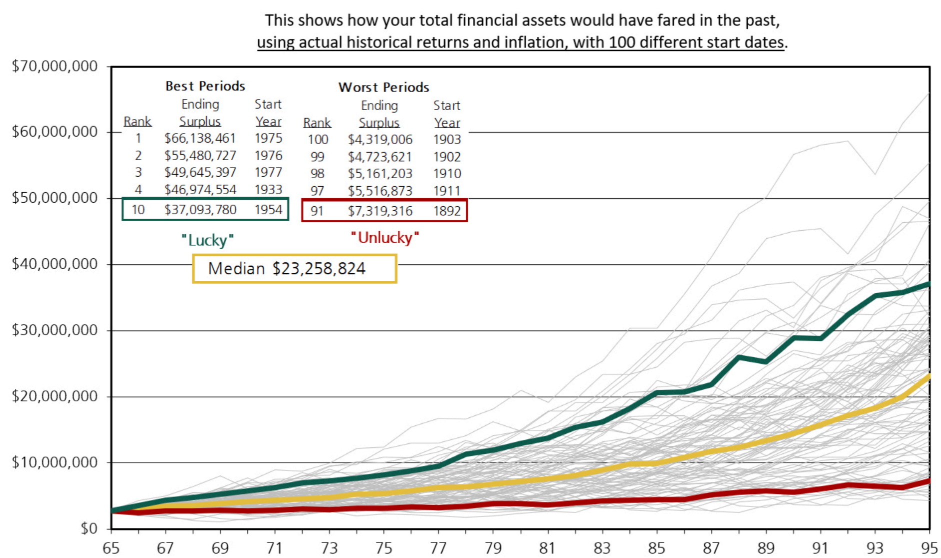

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