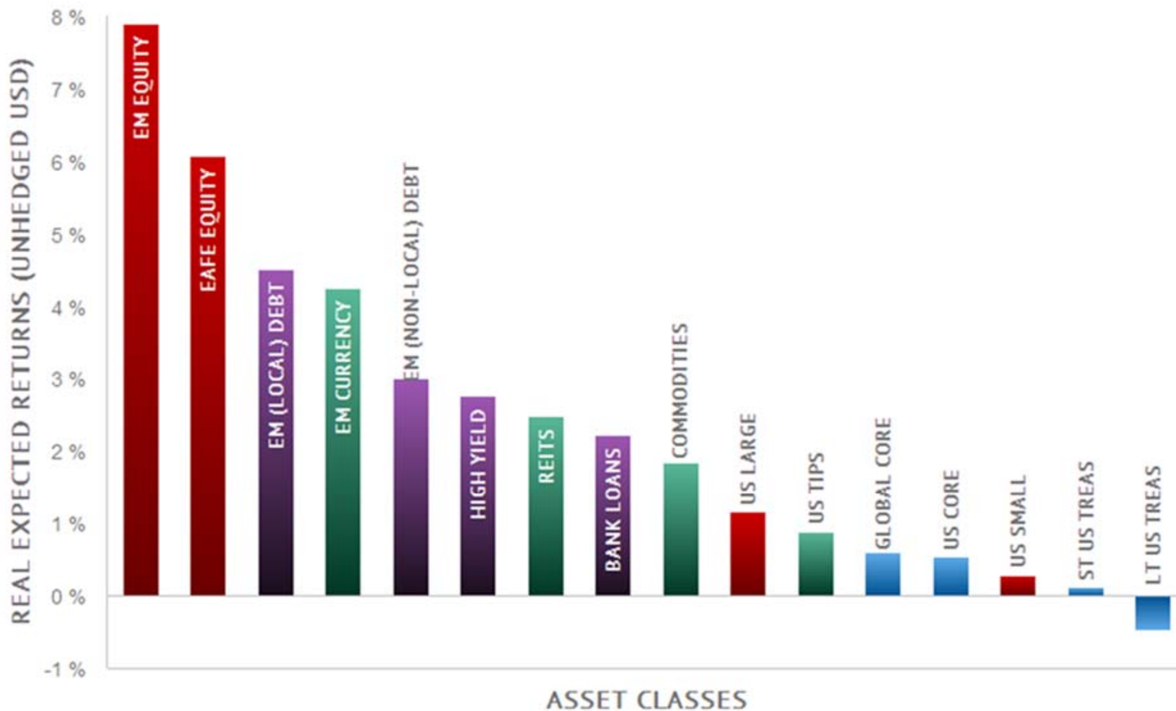
June 2016 Financial Planning Bulletin

FRONTIER

<u>Rates of Return for Financial Planning – What are Reasonable Assumptions?</u>

Anxiety is high among recent retirees and for good reason. Interest rates remain near historic lows, the global stock market (measured by Vanguard ETF ticker VT) is flat going back to January 2014 (nearly 2 ½ years of no growth) and the cost of healthcare and insurance are at all-time highs. Not exactly a recipe for retirement success going forward. Further, many clients have conceded that due to some emotional decisions during the financial collapse of 2008 -'09 their retirement accounts were rebalanced to conservative allocations at inopportune times, leading to a slower recovery of asset values. The combination of these events has cast a doubt over how long one's assets will last compared to what was illustrated only a decade ago in the days of roaring stock markets, healthy interest rates and high projected future returns.

Now a dose of reality. Ensuring that you will have enough money to last throughout retirement starts with a financial plan built on realistic inputs, namely expected portfolio returns, inflation and income tax erosion. Not long ago, retirees and their advisors would have said that getting an 8-10% pre-tax return was a fair assumption. This is highly unlikely over the next decade -- see the following chart from data source ResearchAffiliates as of April 2016 that illustrates their estimate of future expected real returns (gross return less inflation)…



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Rates of Return for Financial Planning – What are Reasonable Assumptions?

So what is a realistic rate of return when running financial projections? It obviously depends on your precise asset allocation. For instance, even a 100% fixed income portfolio will have a range of returns depending on type and maturity of bonds. Stock returns, on the other hand, will vary based on geographical breakdown and dividend yield offered. For diversified portfolios with a balance of stocks and bonds (50/50 allocation), a reasonable expected range over the **next 10 years would be between 2.5 – 5%**.

With interest rates still hovering just above all-time lows of 2012, the fixed-income portion of a balanced portfolio is going to drag down the portfolio for years to come. Consider that a standard bond or bond fund (government, municipal or investment grade corporate) is currently yielding anywhere between 0.5% and 5.0% depending on maturity dates. Future US stock returns are generally pegged from 4 - 7% (dividends plus growth). There is danger for the "do it yourself" contingent of retirees since most online calculators and default financial planning software assumptions typically use returns based on 75 - 100 year historical averages (7% or 8% is routine). Even if interest rates were to rise dramatically in the next few years based on Federal Reserve actions or other market influences, the total return of bonds would be muted or possibly even negative as the 2013 rate increases resulted in negative performance in nearly all fixed income categories (recall the inverse relationship between yield moves to performance).

Some clients are inclined to allocate more of their dollars to equities or high yielding instruments (junk bonds, utilities, energy/MLP holdings, etc.) to attempt to increase their portfolio returns, but this comes with a whole new set of risks. Increasing equity exposure while in the distribution phase can permanently reduce account values since you'll need to withdraw funds for living expenses during possible downturns. Further, the risks of "chasing yield" are well documented and recently highlighted by the energy industry's collapse of over 50% -- a bad trade to gain an 8% yield. Avoid the temptation to stray from traditional asset allocation discipline in hopes of increasing short-term returns. While you can't control the markets, you can adjust your spending or savings limits now in order to provide surplus assets down the road. These future account values will come in handy for unanticipated health expenses in your advanced years.

Specific action items required

1) If your written financial plan is more than two years old, request a plan update using current values and assumptions. Plan updates are recommended every 2 - 3 years.
2) Request that the calculations be "stress tested" for the possibility of prolonged lower than average returns.
3) Discuss with your investment advisor whether any asset allocation changes are required to match your current income needs or future legacy goals.
4) Take this opportunity to review beneficiary designations on all applicable retirement accounts.

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