ASSUMPTIONS, PART II

In part one, I talked about one method for arriving at assumptions for inflation, medical expenses, housing expenses, and educational expenses that I thought provided reasonable assumptions and could be defended in court if necessary.

In part two, I want to talk about how to create an investment return assumption that makes sense in relation to the inflation assumption used. I will also discuss how we at Keats, Connelly & Associates disclose our assumptions in the financial planning document. The objective of the both of these articles is to stimulate some much needed thinking and discussion on the subject.

I have seen many plans list assumptions for inflation and returns without any thought as to the relationship between the two. While no one knows exactly what that relationship should be going forward, it seems to me that some answers are better than others. For example, a long-term inflation rate assumption of 2% and a long-term equity return assumption of 20% does not seem reasonable to me. By the same token, a 4% inflation rate and a long-term equity return of 6% does not seem reasonable. Even looking at the five year period between 1980 and 1984 where the average rate of inflation was 7.5%, the S&P average return was 15.5%, for an average annual difference of 8%.

From 1945 to 2004, the average rate of inflation was 4.1% while the average return for the S&P 500 was 13.3% or 325% the rate of inflation. If we assume a 2.5% rate of inflation, the expected return on domestic equity in this example should be 8.125%.

You continue this approach for each asset class, providing appropriate weighting, to arrive at an approximate portfolio return. For a balanced portfolio, you would arrive at an expected return somewhere around 6.5 to 7%.

The last thing I would like to talk about as it relates to assumptions is documentation. I typically see plans that list only a hand full of assumptions. I believe that to adequately list all of the assumptions in a plan you would need to list assumptions in each. Our typical plan has two to three dozen assumptions in the plan.

Below is an example of the assumptions we use in our financial plans.

ASSUMPTIONS

The following assumptions have been used in your analysis:

GENERAL

1. Long-term average annual inflation is 2.35%.

2. Income and expenses were projected to age 100.

3. Continued Arizona residency.

4. US tax rate schedules are based on the Economic Growth and Tax Relief Reconciliation Act of 2001, rates; i.e., marginal tax rates in 2011 revert to 2001 levels. It also incorporates the Jobs and Growth Tax Relief Reconciliation Act of 2003.

ASSETS

5. Savings and checking accounts are valued at approximately $ 150,000. These have an annual return rate of .5% for the checking accounts and 1.2% for the savings/money market accounts. Account values are from statements dated May 12, 2005 and June 15, 2005.

6. Qualified investment accounts and IRA assets are valued at approximately $248,000. These grow at 6.7% tax-deferred. Account values for TIAA CREF and Fidelity are from statements dated June 30, 2005 and March 31, 2005. Accounts held at Schwab reflect values as of September 12, 2005.

7. Consolidated investment portfolio value is approximately $132,000 and grows at 6.7% annually. (3.5% growth, 1% capital gain distributions, 1.2% tax-free income, and 1% dividend income).

8. Cash value of Western Reserve Life Insurance policy is $14,872 as of January 20, 2005. Death benefit is $700,000. The policy is variable life, joint – 1st to die, with a rider of $300,000 for John; $100,000 for Mary. Annual premiums are $1,400.

9. Cash value of Mass Mutual Life Insurance policy is $6,278 as of December 3, 2004. Death benefit is $10,000.

10. Arizona home has an estimated fair market value (FMV) of $180,000. There is no mortgage on this home. Personal-use real estate assets grow at a rate of 2.9% per year.

11. Arizona rental condo has a FMV of $100,000 and an original cost basis of $80,000. There is a 30-year mortgage at 6.5% for $40,000 on this property.

12. West Phoenix land parcel has a FMV of $3,000,000 and a cost basis of $100,000. This asset grows at 2.9% per year.

13. West Virginia acreage has a FMV of $9,200 and grows at 2.9% per year.

14. Value of 2002 Honda Accord is estimated at $13,000; 2002 Toyota 4 Runner is estimated at $15,000. Estimates are from Kelly Blue Book website. Automobiles depreciate at 10% annually.

15. Other personal use assets (furniture, artwork, etc) are estimated at $80,000. These assets grow at 2.35%.

LIABILITIES

16. Currently have no liabilities and do not expect to incur liabilities in the future.

INCOME

17. John's annual salary is $135,000; this is indexed to inflation until retirement in 2008.

18. Mary's annual salary is $16,500; until retirement in December 2005.

19. John will receive a monthly Arizona State Retirement Benefit of $3,956 beginning at retirement in 2008. This benefit is not indexed to inflation.

20. John will receive $1,820 monthly in Social Security Benefits at age 64; Mary will receive $916 monthly at age 65. Social Security benefits are indexed to inflation.

21. Monthly income from rental condo is $700.

22. Beginning in 2017, the John and Mary Doe CRUT will begin paying 7% of its value for the remainder of your joint lives. We assumed $70,000 per year, every year for simplicity.

EXPENSES

23. Lifestyle expenses are approximately $44,900 annually per the Life Planning Profile and grow at the rate of inflation.

24. Other potentially tax deductible expenses (property taxes, charitable deductions, professional fees) total $26,500 annually and grow at the rate of inflation.

25. Medical expenses total $9,800 annually and grow at an average of 5% per year.

26. Annual expenses associated with the rental condo total $1,500.

27. Two new vehicles are purchased every six years (beginning in 2006) at a net cost of $20,000 each.

NOTE: Any changes in these assumptions or differences between these assumptions and actual results may have dramatic effects on your financial plan. Assumptions are not guarantees of future investment returns.

In summary, this two part article I have attempted to explain why I believe that advisors are not giving enough thought to the area of financial planning assumptions. I suggested that assumptions should have a logical relationship to each other and gave suggestions for a number of assumptions. I also presented you with the format we use for presenting assumptions in our plans.

My hope is that these articles creates some critical thinking on the subject and that you found something you can use in your practice.