

# Fat Tails, Black Swans, and Serial Crises: Planning for a Volatile World

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**F**inancial planners experienced a new awareness of uncertainty with the events of 2008. The market disruptions and collapse of prices were alarming in their impact on clients, but they also represent a major threat to some of the traditional foundations of the planning process. We always knew the future was uncertain, but wow! There is a sense that these events may only be the first of a series that could continue for years. How can we plan in this kind of world, or for this unknowable future?

The Financial Planning Association's Public Issues Advisory Committee is charged with thinking about questions that fall between the jurisdictions of other committees or have a broad-scale potential impact on the planning profession. Among other things, we have talked about various approaches to regulating financial planning and how the planning community is responding to last year's financial crisis. (In fact, the committee's conversation formed the basis for much of FPA's full-page ad on the crisis that appeared in *USA Today* in September 2008.)

As the economic problems continued to unfold, we decided to explore whether financial planners think crisis planning is

something we all need to pay more attention to. The best way to learn what people think is to ask them, so at our request, FPA conducted a survey of the 670 members of the FPA Research Group in November. Almost half of the group—313—responded, and 284 provided complete responses.

The planners were asked about five different potential crises:

1. Would there be a big financial crisis that resulted in a depression, dollar devaluation, hyperinflation, or other result more extreme than we've experienced in a long time or ever?
2. Would we experience climate change sufficient to affect the overall society and economy, including chronic water shortages or repeated major weather events?
3. Would shortages of oil or other energy resources have a major impact on our lives?
4. Would we have one or more major disruptive events such as terrorism attacks or epidemics?
5. Would the U.S. government become insolvent, including (or as a result of) a crisis in Medicare or Social Security?

If respondents thought these events were likely, we also asked about the time frame

in which they might occur: in the next three years, the next five years, or within the next decade.

## 'Game-Changing' Events in the Next Ten Years

It turns out that none of the planners expect to make it through the next ten years without any of these events occurring. About one-third of the respondents either define

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the current economic crisis as meeting the extreme standards of the first question (depression, hyperinflation, and so on) already, or that it will grow to that level, and even more expect a major economic crisis within the ten-year time frame.

Interestingly, almost all respondents—99 percent—expect one or more of the other crises to hit within the next decade, with 38 percent fearing one of those events within three years, and another 45 percent within five years. Energy shortages and government insolvency are the most likely in the survey group's opinion, but the other two possibilities received many votes as well. In addition, an open-ended question asking about other areas of concern generated many responses, with multiple mentions of health care, demographics, financial services, government ineffectiveness (or creeping socialism), and many other topics.

While this is only a sample of the planning community, the statisticians are comfortable that it is roughly representative of all of us. We collectively anticipate that one or more game-changing events are in our immediate future, events that are not really defined by standard deviations from the norm.

The paradigm that planners often follow involves more or less steady progress toward the accumulation of assets so clients can finance their personal goals (such as career growth, educating children, avocations, charity and community, retirement, and intergenerational wealth transfer), the management of cash flow once the goals are funded, and the management of risk, especially of bad health or premature death.

How do these potential crises affect that paradigm?

1. A big financial crisis threatens the value of all investments and the orderly operation of the economy. Accumulation of financial assets for a future goal becomes impossible, and the disruption created by the crisis can throw millions out of work.
2. A long-term drought could threaten the viability of both urban life and agriculture in the Southwest or other

regions, and lead to ever larger wild-fires. Increasing storm intensities disrupt life and require huge amounts of money and efforts to rebuild cities, draining resources from other priorities. Imagine Hurricane Katrina and "hundred-year floods" as annual events.

3. The U.S. economy requires steady supplies of electricity and petroleum. If these become unreliable or scarce, our food system, our suburbs, and our urban cores all are affected, and the overall economy suffers badly.
4. Terrorism, epidemics, and comparable events threaten the open nature of our society, disrupt trade and transportation, and raise fear levels so that economic growth—and sometimes economic life—cannot continue. Restoration of prior stability can take years.
5. If the government's finances fail, there are immediate impacts on the people

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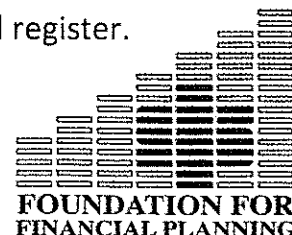
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who rely on the payments, but the wider challenge to economic stability and government legitimacy would be serious.

The events of 2008 illustrate one more lesson. Even those people who predicted that the housing bubble and all that followed would have a bad end did not predict the magnitude of the global credit and banking crisis, which has led to the first major simultaneous global recession. How a situation unfolds will always be a surprise in the specifics and the timing.

### Not Enough Crisis Planning

When the survey respondents were asked if they had incorporated the chance of one of these events in their planning recommendations, 59 percent said they had done so for a major financial crisis, 48 percent said they had done some planning for government insolvency, with smaller percentages

Many planners recognize the threat of more crises, but relatively few have included crisis planning in their work with clients. What help are these planners seeking from FPA on how to add macro-level risk management into their planning?

Three things stand out:

1. Almost 80 percent want information on planning techniques, and 70 percent include research on historical approaches and successes in their list of desired resources.
2. Seventy percent want information on the possible impacts of these events, with 53 percent interested in content predicting the likelihood the events may occur.
3. Seventy percent want help in how to communicate these issues—both threats and responses—to their clients.

Further, planners want this information in a number of formats, including articles, presentations at chapter and national meetings, and networks with fellow planners.

One of my favorite sayings is that “even the past is not inevitable.” Up until the last months of 2008, we believed investment returns were reliably positive over extended periods of time. Yet U.S. stock prices, as measured by the S&P 500, suffered one of the worst ten-year returns in history in the decade ending in 2008. Retirement savings accounts seemed to be working fairly well, but now people

speak of their 401(k) turning into a “201(k).” This article is being written in mid-January, and the range of forecasts for the markets and the overall economy is wider than I can remember in my quarter-century as a planner. And we haven’t clearly reached one of the five crises we asked about in the survey.

How do we plan—how do we even think about planning—for a world that seems to be much more uncertain than we expected? Of course, the uncertainty has always been there, but it was not widely acknowledged until recently. The lower-right corner of a spreadsheet has always been a lie, but now we realize it more than ever. Our clients come to us seeking security (including everybody’s favorite client objective, high growth with low risk)—but we cannot provide that security, and it turns out, we never could.

What we can do is help improve the chances for prosperity, and help them add to their store of resiliency to cope with surprises. We can add to our understanding, and to our toolboxes, to minimize the impact of external disasters.

This planning can help in the real world. For decades, flight attendants have instructed passengers on what to do in the event of a water landing, gliding over the fact that there had never been a successful water landing of an American commercial passenger jet aircraft. Never, that is, until January 15, 2009, when US Airways flight 1549 was successfully ditched in the Hudson River. The disastrous event turned out to be a serious inconvenience—a plane crashed, after all, and people faced personal terror and property loss—but without the expected loss of life. Proper preparation cannot eliminate bad events, but can help turn those events into serious inconveniences rather than personal disasters.

This topic will be explored further in a panel discussion at the FPA Retreat in Palm Springs, California, in April. We hope many planners will attend the Retreat and join in a conversation about “Fat Tails, Black Swans, and Serial Crises: Planning for a Volatile World.” Meanwhile, the Public Issues Advisory Committee welcomes your views, and your local chapters are encouraged to help us all think about what to do in the face of a challenging decade.



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(16–37 percent) planning for the other three problems. Because part of the planner’s role is to anticipate and prepare for risks, these numbers are pretty low. The survey did not ask—there’s a limit to the number of questions people will answer, after all—what kind of recommendations were being included in these plans.