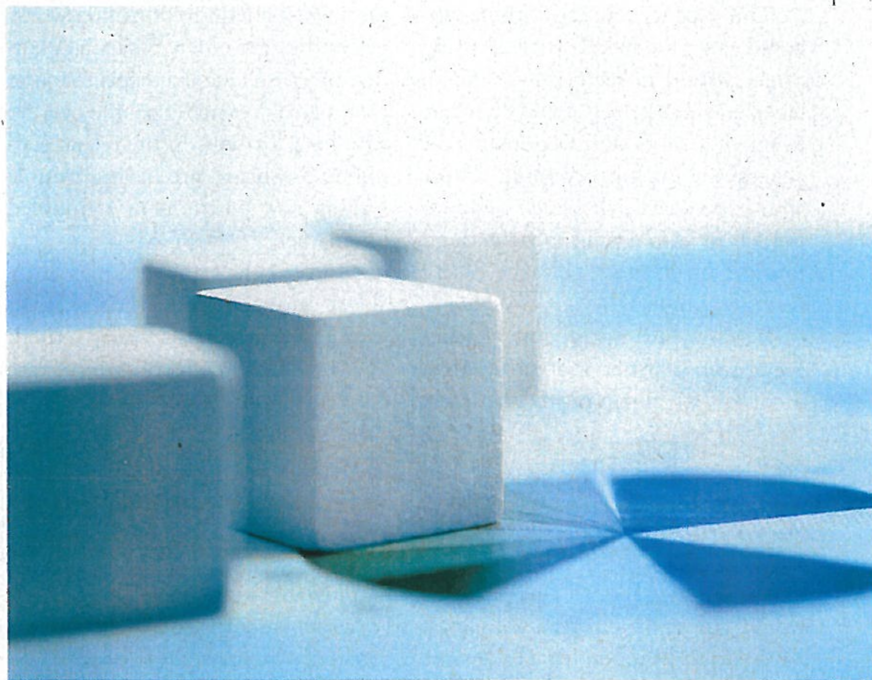
The Ditmas Test

Planners need to look at the numbers in their most basic assumptions and ask, "Does it make sense?" By Richard Vodra

HERE ARE A FEW ASSUMPTIONS THAT you may have heard during your many years in the trenches as a financial planner:

- Assume the U.S. economy is going to average 3%-4% growth for the next 30 years. Assume the Chinese economy will grow by 7% per year during that time.
- Assume that one of your clients without adequate savings can continue to work until at least age 75. Assume that your client will live until age 110.
- Assume that the total return on stocks in a portfolio will average 8% per year. Assume that the expected return on a pension plan's assets will be 7.5% for the life of the plan.
- Assume that the basic structure of the U.S. tax system and economy is not going to change. Assume that the debt loads throughout the economy will be resolved without any real change to business as usual.



You're probably making those assumptions, or something like them, each and every day in your advisory business. Most financial planners do, and they don't even realize it. Every time planners make retirement projections or asset allocations, or run a Monte Carlo simulation, the calculations are based on a view of how the world works, and this view tells us what it is reasonable to expect in the future. The problem is, we rarely think through the implications of those beliefs.

Specifically, most financial planners don't examine the numbers in their assumptions and scenarios to see how they would work in the real world. Without this kind of analysis, initially sound projections can spin out of control.

GROWTH SCENARIOS

For example, one of the first things financial planners learn is the concept (and power) of compound interest. Three percent real growth produces a doubling every 25 years or so; 7% growth translates into doubling every decade.

In 50 years—well within the planning horizon of many clients—3% growth would give us an economy four times as large as today's. Seven percent grows by a factor of 32 in a half-century.

The numbers work—just read your calculator; it's reality that fails.

Try to imagine a world with four (or 32) times as much production and consumption as we have today. Even at the bottom end of the range, will there be four interstate highway systems? Four Shanghais? Four Mexico Cities? Four times the production of food?

Where will the water come from, and the energy, to make this happen? What about the pollution?

And if you can answer these questions, will growth suddenly stop in 2060? Or will the next half-century see those levels grow by another four (or 32) times, so we'd have 16 times what we have now?

Economist Herb Stein famously said, "If something cannot go on forever, it will stop." Before making any long-term assumptions about the rate of growth of a portfolio or the

economy, ask whether there are limits to growth (or decline) that might apply in a particular situation. If you choose to believe that there are no limits, and nothing is impossible, at least make those beliefs explicit, so that your clients or others who rely on your numbers can judge for themselves whether to accept them.

The recent housing bubble was based on the belief that housing prices would never decline, and in fact that these prices would continue to grow faster than inflation and the general level of the economy. Those who expressed such beliefs (including many prominent officials and investment leaders) clearly didn't run the numbers.

If the real price of homes grew even 2% per year faster than incomes, at some point the ratio of house payments to total income would rise to an unacceptable level. This fact was hidden for a long time by falling interest rates, but eventually, there weren't enough people who could afford ever-rising prices without an expectation of being rescued by even higher prices, and the bubble popped.

RETIREMENT SCENARIOS

The question of aging is another one that frequently arises when projecting how much money someone will need for a comfortable retirement. Some life extension enthusiasts suggest that life expectancies will soon extend well beyond 100 years.

Yet the super-short list of supercentenarians on Wikipedia includes only 80 confirmed and 65 unverified cases worldwide of people now living past the age of 110, only 45 confirmed and 20 more claimed over the age of 111 and 20 confirmed, plus four unverified over 112. Since longer life assumptions reduce the amount of spending someone can do today, it seems imprudent to assume such a low-probability event.

On a related issue, many people have not accumulated much in investment assets they can use in retirement, and they are assuming they will be able to continue working as they get older. Financial planners often include that expectation in their plans. Yet many people over 55 who have lost jobs in the recent economic downturn are having trouble finding new positions in a troubled job market.

One recent study shows only about a quarter of retirees ever worked for money after they retired, and less than 16% of seniors are currently employed (mostly self-employed part-time). If post-65 or 70 employment is to be a reality for someone, preparing for it should be an ongoing active strategy, not just an assumption.

It takes conscious effort to develop the habit of questioning the assumptions that so many people take for granted.

WHERE TO START

Many other assumptions, including those at the start of this article, should similarly be questioned on the simple basis of what a friend once called the Ditmas test. Does it make sense?

Is there a limit to how high debt levels or stock prices can go before they are unsupportable? How many more office buildings can a city expect to build?

It takes conscious effort to develop the habit of questioning the assumptions that so many people take for granted. When you see a 20-year projection or a number based on the experience of the last 100 years, how can you analyze it to know whether it is reliable or deceptive? Some of these projections are made with an agenda in mind, while others are simply thoughtless applications of history by people who failed to look behind the curtain.

Here are five resources to get you started. Much more information on each of these can be found via simple online searches.

Albert Bartlett. Understanding Colorado University professor Albert Bartlett is a great way to begin. He has lectured over 1,600 times since 1969 on his favorite topic, *Arithmetic, Population and Energy*.

His core thesis is that "the greatest shortcoming of the human race is our inability to understand the exponential function." Every financial planner should watch the video, read the charts and then decide for himself or herself whether growth can continue forever in a finite system. (Hint: It can't.)

Eric Beinhocker. Most financial planners learned an economic approach that began in the 19th century based on assumptions that people are rational and systems are always returning to normal or equilibrium. The evidence for these beliefs is thin—look around you—but the math is elegant, so this framework is taught and still used widely today.

A few years ago Eric Beinhocker offered a very different economic framework in *The Origin of Wealth*. Beinhocker views the economy as a complex adaptive system with evolution, not equilibrium, as its overall driving principle.

He shows how some simple yet plausible assumptions can lead to a wide range of dynamic behaviors that are like those we observe in real life.

Growth and innovation are hard to explain in classical economics, but they are inevitable residents in Beinhocker's worldview.

Charles Hall. Unfortunately, both classical and evolutionary economics employ the belief that the resources on which the economy is based are essentially unlimited. If supply seems to falter, there are always substitutes or additional supplies available at an acceptable price, or so the assumption goes.

As we watch the threat to world resources, including such items as energy, soil, climate capacity and many more, it becomes more pressing. Professor Charles Hall of the SUNY College of Environmental Science and Forestry is developing an alternative approach called biophysical economics.

In brief, Hall and others propose that real (physical and biological) resources, structures and processes of the economy are more fundamental than the financial and abstract systems and processes of neoclassical economics. We can run out of things (or room to live), and there are things that we cannot do (or cannot afford).

U. S. Department of Defense. Few projections and assumptions used by financial planners take into account the limits to energy use and other resources being driven by peak oil and global climate change. While Richard Heinberg (*Peak Everything*), Bill McKibben (*Eaarth*) and Lester Brown (*Plan B 4.0*) are leading authors on these controversial topics, one unusual place to start researching these issues would be the recently updated *Joint Operating Environment* 2010 report by the U.S. Department of Defense.

The military needs to anticipate the kind of world it will be working in when it makes its plans for the future. Part two of this report explores "trends influencing the world's security," including challenges through demographics, budgets, energy, food, water, climate change and pandemics.

Mark Anielski. Finally, while Beinhocker's book breaks major ground, it has one notable omission; he never attempts to define wealth, the ostensible subject of his book. Similarly, when we evaluate the overall health of the economy, we often rely on one factor alone—the growth rate of growth domestic product—instead of looking at the bigger picture.

Planners often define "more" as the main goal of a financial plan. Mark Anielski, a Canadian, wrote *The Economics of Happiness* a few years ago, suggesting that we pay attention not just to financial capital, but to human, social, natural and built capital as well.

Other writers are noting that there is a thin relationship between financial wealth and happiness once basic needs are met. In the 1990s, I saw the results of two questions from the same poll: Only about 20% of respondents thought "rich" people were happier than the respondents were, yet 80% of respondents wished they had more money.

Getting people to recognize and step off the hedonic treadmill thus seems like a good idea, especially if general expectations about perpetual income growth are not reliable. My book, *Enough Money*, and the work of George Kinder, Rich Kahler and others, help provide ways to challenge the most fundamental assumption in our economic life—that more is almost always better—and to pursue, instead, basic values that include community, integrity, creativity, family, faith, service and vision. FP

Richard Vodra, CFP, is vice president of Legacy Advisors in McLean, Va. He can be reached via email at richard.vodra@legacy-advisors.com.

INDUSTRY RESEARCH MADE SIMPLE

THE FINANCIAL-PLANNING.COM WHITE PAPER LIBRARY

Browse a wide range of industry reports and white papers on the latest market research and trends within the investment advisor community.

FOR FREE ACCESS, VISIT
WWW.FINANCIAL-PLANNING.COM

FINANCIAL PLANNING