

# DiNuzzo Index Advisors, Inc.

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## FEE-ONLY WEALTH MANAGERS

### Interim Market Correspondence

September 26, 2012

#### The Value of Estimates

In this age of ever-expanding technology, the data-gathering process for a financial plan has gradually become less complicated and intrusive. Computers can now pull the latest values of your 401(k) plan and bank account balances into various evaluative software programs, and update them automatically. We can model future returns on a variety of different portfolio combinations with a few mouse clicks, and future government income benefits are sent regularly from the Social Security Administration.

But a great deal of hard work still falls on the shoulders of financial planning clients. People still have to figure out how much they expect to spend in retirement, and how much income they expect to need to pay their living expenses. You have to make decisions about your future lifestyle, and estimate the costs of each component part, often by taking a closer look at your current expenses than you ever have before.

And this, of course, is complicated by questions like whether you plan to work during the traditional retirement years, what hobbies you plan to pursue, whether you'll keep your current home or downsize, and how long you'll live. You look at the list of questions and realize that anything you write is an estimate or an attempt to quantify something that you cannot possibly know with precision. You can be forgiven for wondering: what's the point of all this effort? Why should I have to go through with this? Can't we just create a workable plan using current account information and what we know today?

The answer, alas, is no--and the reason is interesting, and not always well-understood. The truth is that being able to live a successful financial life, and meeting your goals, is far more dependent on a person's behavior than his or her financial planners. Even if the financial planner were to get an extraordinary rate of return on your investments over a long period of time (and this is usually not possible), how much you save and invest from your monthly budget will still be a more important factor in how wealthy you will become. And the amount of your future expenses will be more important still in whether you'll be able to fund your future lifestyle.

In addition, and related to this, it is important to know whether the amount you're saving and investing today is likely to be enough to meet your future expectations. If not, it's better to make a course correction now, before it's too late.

In addition to that, it's always better to have an understanding of your future expectations, so you can start making concrete plans for that part of your life when work becomes optional. For some people who enter their retirement years and look back, this advance planning and preparation turned out to be the most valuable part of a financial planning relationship.

But isn't the future uncertain? Of course it is. That's why the advisory profession has been adopting new ways to do a better job of understanding and planning around that uncertainty. In the 1980s, most retirement plan projections were linear; that is, they assumed that each future year would achieve the same expected rate of return, year after year--which, as you might have noticed from your own investment experience, is hardly realistic. Today, many advisors use Monte Carlo analyses, which look at tens of thousands of different sequences of possible returns, and determine how many times a retirement portfolio, would fail using different assumptions. If the potential failure rate is unacceptably high, they will recommend more savings, a later retirement date or scaled back spending in retirement--or adjustments in all three areas.

More recently, some advisors are distinguishing between the types of future lifestyle expenses that they are assuming in their models. For instance, suppose your retirement plan calls for staying in your current home, dining out three times a week, buying a new luxury automobile every five years and taking a trip abroad once a year. If the market collapses the way it did in 2008, you might suddenly have a frighteningly high probability of running out of money in retirement, based on the newest Monte Carlo projections.

But a new evaluation might look at a retirement where you downsize the home, or cut back to eating out once a week, or buy a less expensive automobile, or take a trip every other year. A truly pared-down retirement expense model might look only at the costs of food, rent, gas, utilities and other expenses necessary for living comfortably. You might have virtually 100% chance of affording your pared-down retirement, a high probability of affording the reduced future lifestyle, and still have a reasonable shot at affording everything you hope for.

This broader evaluation allows you to look at the alternatives. If you decide to work an additional two years at your current job, you will raise the odds of affording your optimal retirement. Saving and investment more each month raises the odds still further.

None of this analysis is possible, however, until the unpleasant homework assignment has been completed, until you've provided your projected spending information after taking a hard look at your current spending habits. In the computer industry, they have a phrase: "garbage in, garbage out," which means that if the data that is used in an analysis isn't accurate or precise, the analysis will give you meaningless outputs. This is also true in financial planning, where no professional wants to give out a garbage plan, and no client wants to receive one.

Sincerely,



P.J. DiNuzzo, CPA, PFS®, MSTx, MBA  
President, Founder, and Chief Investment Officer