Assumptions for financial planning

Robert Lockie FIFP CFP^CM
You don’t need assumptions... if you can reliably and consistently predict the future
General considerations

- Real or nominal?
- Forward-looking
- Pre- or post-tax?
- Pre- or post-costs?
- Spurious precision
- Test the sensitivity
- Regular reviews
Rates of return for FSA prescribed projections

Report of PricewaterhouseCoopers and peer reviewers’ comments

April 2012
Inflation

- Purpose
- RPI or CPI?
- Expenditure
- Earnings – is your client average?


Education costs

http://www.isc.co.uk/Research_ISCResearchPublications.htm

- Is your child’s school average?
- University costs?
Long term care costs

• Current average c.3.5% ahead of inflation
• Look behind the figures
• Average may not be what your client pays
Mortality

Life expectancy

Assumed life expectancy

Average age at death

Age now

Males
Females

Life expectancy

- 10
- 20
- 30
- 40
- 50
- 60
- 70
- 80
- 90
- 100
- 110
- 120
Annuity rates

• Determining factors
  – Long bond yields
  – Mortality expectations
  – Frequency and timing of payments
  – Costs
  – Other factors
• Use current rates or actuarial principles?
• Have a default basis?
Investment returns

• Asset class or wrapper-based?
• Which is the main driver?
• Where do the differences in returns arise?
Cash & bonds

• Cash
• Government bonds
  – Nominal
  – Index-linked
• Corporate bonds
Cash & bond risk factors

- Cypriot bank deposits
- More risk, more return
- Less risk, less return
- Short gilts
- Long gilts
Why own long bonds?

Risk and return from bonds 1964-2002

Maturity

Annualised compound return

Annualised standard deviation
Cash & bond returns

Inflation

+ Maturity premium

+ Default premium
Equity returns

- UK, US, EU, Japan, Pacific, emerging?
  OR
- Global thematic?
  OR
- Market, value, small?
Market portfolio of all equities. Value and small cap effects cancel out along purple line. INCREASED EXPECTED RETURN. Reduced expected return. Small capitalisation companies. ‘Growth’ companies (low BtM). ‘Value’ companies (high BtM). Market portfolio of all equities. Value and small cap effects cancel out along purple line. Large capitalisation companies.
Derived portfolio returns

- Diversified growth
- Defensive
Costs

- Underlying asset costs (TER)
- Third party management costs
- Advice & planning costs
- Custody & wrapper costs
- Portfolio turnover costs
- Hidden costs
- Taxes
Impact of costs

Portfolio annual cost comparison (before tax)

Existing portfolio

Recommended portfolio

- Underlying assets
- Management
- Custody
- Transactions (assumed)
A cautionary tale for spreadsheet users

<table>
<thead>
<tr>
<th>Year</th>
<th>Fees</th>
<th>Fund at start of year</th>
<th>Growth</th>
<th>Fund at end of year</th>
</tr>
</thead>
<tbody>
<tr>
<td>2011</td>
<td>£10,000</td>
<td>£200,000</td>
<td>£206,000</td>
<td>£196,000</td>
</tr>
<tr>
<td>2012</td>
<td>£10,700</td>
<td>£196,000</td>
<td>£201,880</td>
<td>£191,180</td>
</tr>
<tr>
<td>2013</td>
<td>£11,449</td>
<td>£191,180</td>
<td>£196,915</td>
<td>£185,466</td>
</tr>
<tr>
<td>2014</td>
<td>£12,250</td>
<td>£185,466</td>
<td>£191,030</td>
<td>£178,780</td>
</tr>
<tr>
<td>2015</td>
<td>£13,108</td>
<td>£178,780</td>
<td>£184,143</td>
<td>£171,035</td>
</tr>
<tr>
<td>2016</td>
<td>£14,026</td>
<td>£171,035</td>
<td>£176,166</td>
<td>£162,141</td>
</tr>
<tr>
<td>2017</td>
<td>£15,007</td>
<td>£162,141</td>
<td>£167,005</td>
<td>£151,998</td>
</tr>
<tr>
<td>2018</td>
<td>£16,058</td>
<td>£151,998</td>
<td>£156,558</td>
<td>£140,500</td>
</tr>
<tr>
<td>2019</td>
<td>£17,182</td>
<td>£140,500</td>
<td>£144,715</td>
<td>£127,533</td>
</tr>
<tr>
<td>2020</td>
<td>£18,385</td>
<td>£127,533</td>
<td>£131,359</td>
<td>£112,975</td>
</tr>
<tr>
<td>2021</td>
<td>£19,672</td>
<td>£112,975</td>
<td>£116,364</td>
<td>£96,692</td>
</tr>
<tr>
<td>2022</td>
<td>£21,049</td>
<td>£96,692</td>
<td>£89,593</td>
<td>£78,545</td>
</tr>
<tr>
<td>2023</td>
<td>£22,522</td>
<td>£78,545</td>
<td>£80,901</td>
<td>£58,379</td>
</tr>
<tr>
<td>2024</td>
<td>£24,098</td>
<td>£58,379</td>
<td>£60,130</td>
<td>£36,032</td>
</tr>
<tr>
<td>2025</td>
<td>£25,785</td>
<td>£36,032</td>
<td>£37,113</td>
<td>£11,327</td>
</tr>
<tr>
<td>2026</td>
<td>£27,590</td>
<td>£11,327</td>
<td>£11,667</td>
<td>£15,923</td>
</tr>
</tbody>
</table>

Fees assumed to increase at 6%pa
Portfolio assumed to increase at 4%pa
A better approach

<table>
<thead>
<tr>
<th>Year</th>
<th>Fees</th>
<th>Fund at start of year</th>
<th>Growth</th>
<th>Fund at end of year</th>
</tr>
</thead>
<tbody>
<tr>
<td>2011</td>
<td>£10,000</td>
<td>£200,000</td>
<td>£208,000</td>
<td>£198,000</td>
</tr>
<tr>
<td>2012</td>
<td>£10,600</td>
<td>£198,000</td>
<td>£205,920</td>
<td>£195,320</td>
</tr>
<tr>
<td>2013</td>
<td>£11,236</td>
<td>£195,320</td>
<td>£203,133</td>
<td>£191,897</td>
</tr>
<tr>
<td>2014</td>
<td>£11,910</td>
<td>£191,897</td>
<td>£199,573</td>
<td>£187,663</td>
</tr>
<tr>
<td>2015</td>
<td>£12,625</td>
<td>£187,663</td>
<td>£195,169</td>
<td>£182,544</td>
</tr>
<tr>
<td>2016</td>
<td>£13,382</td>
<td>£182,544</td>
<td>£189,846</td>
<td>£176,464</td>
</tr>
<tr>
<td>2017</td>
<td>£14,185</td>
<td>£176,464</td>
<td>£183,522</td>
<td>£169,337</td>
</tr>
<tr>
<td>2018</td>
<td>£15,036</td>
<td>£169,337</td>
<td>£176,111</td>
<td>£161,074</td>
</tr>
<tr>
<td>2019</td>
<td>£15,938</td>
<td>£161,074</td>
<td>£167,517</td>
<td>£151,579</td>
</tr>
<tr>
<td>2020</td>
<td>£16,895</td>
<td>£151,579</td>
<td>£157,642</td>
<td>£140,747</td>
</tr>
<tr>
<td>2021</td>
<td>£17,908</td>
<td>£140,747</td>
<td>£146,377</td>
<td>£128,469</td>
</tr>
<tr>
<td>2022</td>
<td>£18,983</td>
<td>£128,469</td>
<td>£133,607</td>
<td>£114,624</td>
</tr>
<tr>
<td>2023</td>
<td>£20,122</td>
<td>£114,624</td>
<td>£119,209</td>
<td>£99,087</td>
</tr>
<tr>
<td>2024</td>
<td>£21,329</td>
<td>£99,087</td>
<td>£103,051</td>
<td>£81,722</td>
</tr>
<tr>
<td>2025</td>
<td>£22,609</td>
<td>£81,722</td>
<td>£84,990</td>
<td>£62,381</td>
</tr>
<tr>
<td>2026</td>
<td>£23,966</td>
<td>£62,381</td>
<td>£64,877</td>
<td>£40,911</td>
</tr>
</tbody>
</table>

Fees increases 6%
Portfolio growth 4%
So how did we do?

RPI  CPI  Earnings (to 12/2012)  Cash  FTSE All Share  FTSE World ex-UK  MSCI Emerging Markets  Index-linked gilts
What about the experts?

The Forecast: Asset classes of choice for institutional investors in 2011*

- Fixed Income
- Equities
- Commodities

*Barclays Capital Investor survey, Dec 14, 2010
What about the experts?

The Forecast: Asset classes of choice for institutional investors in 2011*

- **Fixed Income**
- **Equities**
- **Commodities**

The Outcome (to Nov 30, 2011)**

- **Fixed Income** +3.82%
- **Equities** -5.49%
- **Commodities** -9.94%

---

* Barclays Capital Investor survey, Dec 14, 2010

** Source: Returns Program. Fixed Income represented by BCGA Bond Index; Equities by MSCI World Index (net div); Commodities by Dow Jones-UBS Commodity Index – all in US dollars.
“It is tough to make predictions, especially about the future.”

Yogi Berra
At the end of the day…..

expect all your assumptions to be wrong
and tell your clients that you do…
and expect the unexpected
Disclaimer

This document is intended for informational purposes only and no action should be taken or refrained from being taken as a consequence of it without consulting a suitably qualified and regulated person. It does not constitute financial advice under the terms of the Financial Services and Markets Act 2000. It is not an offer to sell, or a solicitation of an offer to buy, the instruments described in this document. Interested parties are advised to contact the entity with which they deal, or the entity that provided this document to them, if they desire further information. Past performance is not a reliable indicator of future results. The information in this document has been obtained or derived from sources believed by Bloomsbury to be reliable, but Bloomsbury does not represent that this information is accurate or complete. Any opinions or estimates contained in this document represent the judgment of Bloomsbury at this time, and are subject to change without notice.

BLOOMSBURY is a registered trade mark used under an exclusive sub-licence from Raymond James Investment Services Limited (Raymond James). Raymond James is a member of the London Stock Exchange and is authorised and regulated by the Financial Conduct Authority. Registered in England and Wales 3779657. Registered Office 77 Cornhill, London EC3V 3QQ. © 2013 Bloomsbury