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Excessive Optimism in Financial Plans

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Here at Guideway, we have been busy finishing a paper we intend to have published about statistical errors in standard financial forecasting. The paper conveys some reasons why financial plans should be more conservative than common industry tools usually indicate. We would like to share some highlights of the findings.

A high percentage of financial planners rely upon software tools to create financial plans, especially for retirement. Many programs use a common method for risk assessment and forecasting called Monte Carlo. Monte Carlo works well with perfectly accurate input data. However, the historical data for financial returns is limited – there is only a certain amount available. When Monte Carlo is fed a limited amount of data, the forecast errors tend to be large. Imagine trying to forecast a baseball player's season batting average by only using the average from his first game. The first game can produce an extreme batting average that would not be close to the season average. The same is true for financial forecasting. The potential for misleading results from a small set of historical returns, such as only 20 years, is very large. Extrapolating forecasts over longer periods, like in 30 or 40-year retirement plans, compounds the error.

To make matters worse, the errors are generally on the optimistic side, meaning investors are presented a rosier picture than reality. This is especially true of forecasts and risk assessments for younger investors, conservative investors, and for portfolios that include international or other newly created funds. As an example, for a 30-year old who can tolerate a 10% chance of a shortfall in yearly retirement income, Monte Carlo will project an income at age 90 that is five times higher than unbiased projections, on average. Furthermore, the actual risk of shortfall will be 27% instead of the reported 10%.

While adjustments to Monte Carlo may possibly lessen the bias, the modifications would be challenging and perhaps not precise. For this and other reasons, Guideway has implemented proprietary planning software that does not require Monte Carlo, and it eliminates the optimistic bias altogether. As far as we know, ours is the only software that accounts for limited data, and this feature significantly reduces the risk of shortfall for clients.

Forecasts and plans from Guideway may seem more conservative than others, but when it comes to retirement planning, accurate projections are very important. No one wants to find out later in retirement that they over spent because of an overly optimistic financial plan.