Planning To Fail

According to Benjamin Franklin, “If you fail to plan, you are planning to fail.” That is good advice for all aspects of life, especially investing.

You might assume that failing to plan for your financial future is a trait of inexperienced or lackadaisical people, but that hasn’t been my experience. I’ve provided numerous examples in newsletters about smart, experienced investors I have talked with who failed to think ahead and plot a sustainable course of action. My intention is not to pick on them, but to provide a warning to existing and future Servo clients. In a recent Wall Street Journal article, we were introduced to a few others; of course, the article didn’t spell it out this way.

Dr. Sklar is a Connecticut ophthalmologist who plans to retire in a few years. At 62 years of age, this would be the perfect time for him to develop and transition to a retirement income strategy that could support his rising cash flow needs for the next few decades. Instead, the article tells us, he panicked in March and sold most of his stocks. He has “more cash as a percentage of his portfolio than he’s had in decades” at a time when interest rates are at their lowest levels in history. This wasn’t a temporary move. The article states that he isn’t planning to get back into the stock market.

How does he plan to grow his investments to offset two or three decades of rising inflation, which will slowly but surely strip away his retirement income purchasing power? He doesn’t—not now anyway. His current concern is the temporary market decline and the mistaken belief that it could take decades to recover. “I don’t have 10 to 15 years left to recover my losses,” Sklar says. Unfortunately, the fact that every bear market in the last half-century has experienced a full recovery within just a few years is lost on Dr. Sklar. If only he had read my October 2019 newsletter, “The Scariest Part of Investing,” before he made any rash decisions.

Dr. Sklar is not alone in failing to plan. The article also mentions Mr. Eberlin, a 66-year-old small business owner in Illinois, who hopes to retire in two to three years. His “plan” to get there? A portfolio of mostly CDs and cash. He got out of the market after the 2008 decline and missed over 350% gains on stocks (S&P 500) from 2009 through 2019.

But his biggest concern? “What I’d rather not do is invest at this point and then see the market plunge 40% to 50%.” Unfortunately, we can’t forecast the short-term future for stocks, so losing 40% or 50% is always possible; it happened from 1973-1974, 2000-2002, and 2008. But it’s not likely. In each case, stocks fully recovered in a few years. What you don’t recover from is the loss of 350% gains that you forgo by sitting on the sidelines worrying about the next temporary decline.

How can you avoid the financial missteps of Dr. Sklar, Mr. Eberlin, and countless other investors?
Goals

You shouldn’t begin investing until you’ve determined what you’re trying to accomplish. What are your goals? As a younger investor, you hope to retire someday. Your retirement cash flow will depend mostly on your savings, so you better have a significant amount. As you approach retirement, you need to calculate how much income you will need to live comfortably when you are no longer working; you also should understand how long you’ll likely need that income (think several decades) and how it will need to grow over the years. Finally, as your retirement progresses, you will hopefully have more assets than you’ll ever be able to spend, which means you should think about how you want to handle your financial legacy—both during and after your life.

Plan

“If you don’t know where you’re going, you’ll end up someplace else,” said Yogi Berra. But even when you know where you’re going, it’s hard to get there without a plan. For many people, creating a financial plan is like undergoing a root canal. The good news is a plan can (and often should) be as simple as calculating how much you have and will be able to contribute to your goals, and what rate of return those resources need to earn to achieve your goals.

If I have $500,000 saved with a goal of accumulating $2M in 15 years and can earn 8% annually, I need to save $16,000 per year or about $1,300 per month. If I only have eight years, I instead need to save over $8,000 per month (or reduce my goal/increase my time horizon)!

If you’re in your early to mid-60s with a need for $50,000 a year from your portfolio for 25-30 years, you’ll need at least $1M in investments to make that possible—4% is a reasonable withdrawal assumption and 5% is possible, if perhaps lofty. But you can’t expect to earn 4% or 5% and be successful.

Your retirement income will likely need to grow by around 3% a year (or more—in the 60s and 70s inflation was 6-7% per year!), so you’ll need a higher investment return than your initial withdrawal rate to support your increased spending in later years.

Consider, your 30th year of income might have to be as much as 3x your first-year withdrawal, just to keep pace with inflation!

If you need to spend 5% of your first-year retirement portfolio balance and increase that amount annually for inflation, earning just 4% per year on your investments would mean running out of money in 24 years. A 5% annual return would force you out of money in year 27. Only at 7% per year could you hope to maintain your original $1M into year 30 while still receiving your annual withdrawals. Factor in year-to-year volatility, and you need a return closer to 8% per year.

Portfolio

Only once you understand your goals and have a plan to achieve those goals—a dollar/date specific target, if possible, and a required rate of return—does it make sense to design an investment portfolio. The portfolio is the funding vehicle of the plan. Its goal is simply to bring the plan to fruition.

Traditionally, bonds are considered “safe” investments; stocks are “risky.” But if we’re investing for our goals, “safe” and “risky” take on new meanings. Being forced to work an extra five to seven years before you retire, or the need to reduce your retirement spending in your later years, are what you’re trying to avoid. Those are the risks. “Safety” means minimizing or avoiding risks. The safest approach is to earn a sufficient long-term return on your investments to prevent coming up short. Said differently, a “risky” portfolio is one with little chance of achieving the goals; a “safe” portfolio is one that has a margin of error.

What is a “safe” portfolio, and what is a “risky” portfolio today? Hopefully, you’ll understand that this is unique to each investor because everyone has different long-term goals and resources. But we can certainly discuss this generally. Next month’s article will do just that.


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Contact Eric Nelson, CFA at eric@servowealth.com with any questions, comments, thoughts, or to discuss your personal financial situation.