# Choosing investments based on retirement goals

Estimating the chance of successful goal attainment based on uncertain investment results and cash needs

* Demonstrate the approach using a fictional narrative
* Input your own goal and investment assumptions into this free calculator (no signup or personal information required)

**The Client:** Mabel is a single 65-year old retired school teacher who is considering how to invest $400,000. Her pension and social security cover her basic needs, such as housing and groceries. Therefore, her goal for the discretionary portfolio is to enjoy retirement. She intends to spend $40,000 in inflation adjusted dollars each year for the next 10 years on travel, restaurants, remodeling her home, and leasing a luxury car.

Mabel meets with her financial planner, Carla, to determine how to invest the $400,000. Mabel informs Carla that she is only comfortable investing in stocks and annuities she does not understand other investments.

Carla simulates the performance of various stock and annuity allocations. Each year, a $40,000 withdrawal is subtracted from the invested amount. If the portfolio value is insufficient to cover the withdrawal in any year, then the simulation is a failure for all subsequent years. Otherwise, the simulation is counted as a success.

Carla initially runs the simulations for an equal-weighted portfolio with $200,000 invested in both stocks and annuities. Of the 1,000 simulations, only 19% successfully cover the required cash flows. Mabel wonders if a better result is possible. Carla calculates the chances of success for various allocations as indicated in Graph 1.

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***Graph 1: Probability of Goal Attainment (Bubble Size) vs Amount Invested in Stocks (Y Axis) and Years Invested (X Axis) based on Initial Cash Outflow of $40,000 and 2% Inflation***

Therefore, investing in 100% stocks seems to be the best choice since it results in the highest probability of success for 10 years. However, she only would have a .5% chance of success of meeting the cash flows over 30 years. This seems low to Mabel. She wonders: what would happen if they adjusted the cash flows to be $20,000 instead. Graph 2 summarize these results.



***Graph 2: Probability of Goal Attainment (Bubble Size) vs Amount Invested in Stocks (Y Axis) and Years Invested (X Axis) based on Initial Cash Outflow of $20,000 and 2% Inflation***

This scenario presents a dilemma. Additional amounts invested in the annuity increase the probability of meeting cash flows after ten years but come at the cost of increasing the chance of not meeting cash flows at year 30. If Mabel is more concerned about meeting cash flows over the next 10 years, she might consider allocating 50% or 75% of her funds in the annuity.

**The Forecaster:** To create the above analysis, Carla relied on forecasts from Chris. In particular, she needed a long-term forecast for stocks. Chris started with historical data as a baseline, and then altered the estimates based on his judgment to create a realistic prediction. First, he collected daily stock market gains and losses from 12/1/2007 to 12/1/2017. He resamples these with replacement 1000 times for 252 simulated trading days. This results in 1000 simulated annual gains and losses. Table 1 summarizes the results:

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| Minimum | 10th Percentile | Median | 90th Percentile | Maximum |
| -48.7% | -16.3% | 8.9% | 40.0% | 120.3% |

***Table 1: Annual summary statistics from resampled gains and losses from 12/1/2007 through 12/1/2017 (Daily Gains and Losses from Yahoo Finance)***

To alter the above baseline forecast, he followed the following steps:

1. *Assume the most likely scenario is equal to the Median.*
2. *Adjusted the historical results to be symmetrical:* He rounds the Minimum scenario to -50% and the Maximum to 50%.
3. *Estimated the average investment gain:* Chris spends a great deal of effort on this assumption. He reasoned that the stock market should outperform treasury bonds over the long term. Therefore, the current yield of 3% on 10 Treasuries might constitute a lower bound for the long-term expected gain of stocks. At the other extreme, US stocks have historically performed extraordinarily well. The historical analysis indicates the average gain on stocks over the past 10 years is approximately 10% a year. Chris believes this is overly optimistic for the future. He consulted the following [Vanguard paper for other methods](https://personal.vanguard.com/pdf/s338.pdf). The CAPE ratio of 33 indicates a 3% long-term gain. Forward price-to-earnings of 18 suggests 5.6%. At last, estimated a 5% long-term expected gain, which is roughly the 10 year treasury yield plus the target inflation of the Federal Reserve.
4. *Estimate Volatility:* Chris referenced the VIX. It was at 11.7, which is near historical lows (~9). The historical data indicates a volatility (Standard Deviation) of 25. Since the historical period contained an abnormally volatile period, and the current volatility is well below historical norms. Chris estimated a volatility of 16.
5. *Estimate Gain vs Loss Asymmetry:* Although the historical period resulted in a positively asymmetrical risk-reward profile (.54 Skewness), it is late in the business cycle; consequently, Chris projects a slightly negative asymmetry of future gains and losses (-.28).
6. *Estimate Frequency of Extreme Gains and Losses:* The historical data exhibit more frequent extreme gains and losses than the normal distribution (Excess Kurtosis of .9). Chris references [a paper indicating that financial data is more chaotic than Modern Portfolio Theory acknowledges.](https://www.jstor.org/stable/2350970) With this in mind, he estimates more frequent extreme events (.54 Excess Kurtosis) than the “bell-curve” would suggest.

As a result of these steps, he inputs his estimates into software that yields a probability distribution shown in Graph 3:



***Graph 3: Estimated Long-Term Forecast for the Stock Market assuming a current price of 100. Software generates the above graphs based on the input scenarios and interpolating straight lines between each scenario.***

When Carla runs the analysis for Mabel, the above graph dictates the simulated investment results.

**Conclusion**