BONDS

**Scarsdale Investment Group, Ltd.**

*All Bond Portfolios*

# Dependable Financial Planning - the Scarsdale Way

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## Summary

Traditional financial planning poorly serves investors doing long-term planning for retirement or financial independence. Why? Because financial planning programs are not at all accurate. Why? Because no one can accurately make the required assumptions as to returns on stocks, future interest rates and future inflation rates required by the financial planning software. If the assumptions are off by 1% over 30 years, the financial projections will be off dramatically.

As a better way to do financial planning, we provide Dependable Financial Planning – The Scarsdale Way, which depends upon predictable cash flows.

## Traditional Financial Planning

Traditional financial planning is designed to help clients with the following tasks:

- Maximize their investment returns on stocks and bonds.
- Minimize their risks of outliving their assets.
- Protect against the impact of inflation.
- Create and monitor budgets.

The usual tool used to accomplish these financial planning tasks is a powerful computer software program or package of programs. Whether the financial planner interviews you or you use a robo advisor, the output is a long report designed to accomplish the above tasks. While this may seem very routine and traditional, we believe one important factor is missing: A detailed analysis and discussion of the assumptions that are put into the computer program.

At the very inception of the project, the assumptions required by financial planning software include the following long-term projections: Rate of return on equities, Interest rate projections and Inflation rate.

As the programs become more powerful, additional assumptions are required. The good part of using this software is that you can change the assumptions and run the program again. The problem is that you may still be left with a variety of outcomes based on hypothetical assumptions.

No one can correctly make the required assumptions regarding return on equities and project future interest or inflation rates. If the suppositions are off by 1% over 30 years the result will be off dramatically.

We suggest that before you run the financial planning program, it would be a useful exercise to evaluate and discuss each of the assumptions that are inputs to the financial planning program including the following:

**Rate of return on equities**. It is always assumed that there will be a significant gain on equities over the relevant period. However, this may not be true for your particular retirement period. And if there is a gain, when the gains and losses occur (at the beginning or the end of your projected retirement) is immensely important. If this assumption is off by more than 1% over a long period of time, the assumed outcome will not be accurate.

**Interest rates**. These are harder to predict than the return on equities and just as important. A typical asset allocation is 60% equities and 40% debt, or something in between. What happens if when you retire, interest rates rise significantly? Does the program give you some order of magnitude if this were to occur? While it may be unusual, it is not unlikely since interest rates are at a very low level historically and have been declining since 1981.

**Inflation**. What is the measure of inflation, the CPI or other measure? For example, it is not well known that the major inputs to the CPI are “imputed rent”, oil products and food. We personally own our own home and spend very little on food and oil products. The CPI is a good measure for a family of four earning between $50,000 to $60,000 per year. It is not useful for high net worth individuals who have many choices in their discretionary spending. How do you think increases in these items might affect you?

**Fees and Expenses**. Include in your analysis the impact in your particular case of investment fees by the advisor and the underlying fees in the funds and other investment products that will be chosen. Depending upon the investment products chosen, this will have a significant impact on returns over a long period of time.

**Taxes**. Your tax impact may change significantly as a result of your retirement. In addition, the tax law may change significantly. Are you paying capital gains as part of your distribution? What is the rate now and historically? Will your investment be subject to ordinary income taxes? What will happen in the future is unknown, but you can create your own 'what if' situations.

Financial Planning – The Scarsdale Way

At the Scarsdale Investment Group, Ltd. we focus on a financial analysis based upon factual matters that can be simply calculated and which we know to be true. We do not run financial planning programs with the inherent uncertainties and flawed outputs discussed above.

There are 2 basic principles:

First: Protect your principal at all costs. When you are saving for retirement or in retirement, this should be a basic principle. Don't play in the casino of hope and fear. If you lose your principal, you may not be able to make it back. Thus, we consider only the safest investments. We believe that the highest quality individual bonds meet this test. Focus your investing around your goals, not what you think will perform the best (because you won't know the answer to this anyway).

Second: Focus on cash flow, not gains and losses. Ask the question: What will be the cash flow resulting from an investment, on an after-tax basis, in my taxable accounts. It is only with the highest quality tax-exempt municipal bonds that you can predict the after-tax cash flow on a definitive basis for many years in the future. For example, a $100 3.5% coupon bond purchased at par (100) will return $3.50 each year until it is called or comes due. Within your retirement accounts, you can plan your Required Minimum Distribution by generating cash flow from interest and the redemption of principal.

Here is how we apply our basic principles to the financial planning that we do. It takes but a moment once you know what your budget costs. Your goal is to have your yearly cash flow equal to your yearly budget. You may want more cash flow to take inflation into account and to create a cushion. We also believe that you should not spend your principal for your current budget expenses. Your principal should be used for emergencies for you, your family and friends.

Here is an example of how we do our simple financial analysis: Let's say that you are retired and your budget is $50,000. Further assume that your social security payments are $20,000. Thus, if you invested about $860,000 in 3.5% individual tax-free muni bonds at par, you would receive $30,000 per year after tax. Financial plan is achieved.

Financial planners may say that if you invest in fixed income you will never achieve your financial goals because the rates are too low. That is when you have to decide if you are going to try to achieve the retirement of your dreams, along with the dream financial plan, or you are going to accommodate your retirement plans to the cash flows you can create.

Consider whether seeking a greater return by taking on significant risks is a worthwhile goal. Consider this question: If you can reach your goal of financial success without taking a significant risk, consider why you should take a risk with your financial future.

Consider that stocks don't always outperform bonds (see the last part of our book entitled: Bonds, The Unbeaten Path to Secure Investment Growth, Second Ed, John Wiley & Sons, where we show that bonds have outperformed stocks over many long periods of time). Even if the assumption that stocks outperform bonds were true over the long run, it does not mean that when you retire, when you need access to your funds, that the stock market will be priced above your purchase price. This is called sequence risk. Stock prices and your retirement needs are just assumed by the media to coincide. Do question the timing of when you will begin to live off your assets and the possibility of low or negative returns in the stock market. To do otherwise fogs the message that stocks always outperform cash and bonds. Imagine if you had retired in 2008 for example.

## Conclusion

The traditional financial planning analysis provides possible scenarios for your retirement planning. There is no way to know which possible scenario will be your outcome.

An analysis based upon predictable cash flow provides a reliable basis for retirement and financial planning.