Kaizen's Approach to Investment Planning: Hope is not a Strategy

Here at Kaizen Wealth Strategies, we approach financial planning, and investment management (which together, we call Investment Planning) a little differently. We don't assume that we know the best asset allocation for you right out of the gate. We typically engage in an information-gathering process, whereby we establish a "baseline" level of your average spending, based on actual cash flows coming into, and going out of your bank account. Usually, in order to smooth out and obtain an accurate average, we ask for a year's worth of spending data; and we try to eliminate or at least normalize one-time items that are not likely to recur. Knowing this information is a critical input to both tax-planning, as well as your holistic financial plan.

Next, we gather information about your household income, and your existing balance sheet; as well as ask for a rough idea of when you are expecting to retire. We then marry this information with some conservative, yet accurate, capital markets assumptions. What do leading financial institutions believe stocks and bonds will return over the long run? What will inflation be for different categories of items such as food, gasoline, and your kids' college educations? These are all critical variables to estimate, and plan for.

Finally, we program this information into a sophisticated financial planning software that runs through tens of thousands of iterations of "what the market could do," to come up with a probability of success, based on your spending data. This lays the foundation for how much risk you can and cannot be taking. For young couples just beginning to save money, the focus may be on long-term capital appreciation. For retirees who are starting to draw money out of their portfolio, the goal may be a mixture of capital preservation and income.

Whatever the goal is, finding the smoothest and safest path to getting there requires a strategy called "Liability Driven Investing." LDI, as it is called in the industry, is a concept borne out of the institutional investing world. Back in the

1980's, pension funds used to go bankrupt with startling frequency, because they didn't do enough homework to understand their own financial liabilities; and perhaps most important, they did not understand the sequence of when those cash flows would come due. Specifically, having a stream of cash outflows (such as paying out pensioners' monthly income) without an inflow stream from stock dividends or bond interest in order to meet those demands on the portfolio, worked well sometimes (namely, when stock markets went up), but performed very poorly through adverse market conditions. When markets go up, it is totally fine to sell some principal in order to pay out pensioners. However, when markets go down, eating into principal causes a financial death-knell known as "reverse-compounding." Reverse-compounding occurs when stocks need to be sold at inopportune moments to meet cash outflows. If it happens during a large drawdown, such as the great financial crisis of 2009, enough damage might be sustained that the portfolio may never recover.

This same risk exists for individual private wealth clients, or those with 401(k)'s. Unwitting investors, or their unwitting advisors, likely don't know about the concept of LDI, and thus will structure their portfolios to have a high income-uncertainty ratio. The income-uncertainty ratio is the proportion of one's cash expenses in any given year, that is not accounted for in one's income. Income usually comes from wages, but in retirement it comes from your portfolio. So, during working years, let's pretend you earn $100,000 in wages, after tax, and your annual expenses are $50,000. Congratulations, you have no income uncertainty! In fact, you are saving 50% of your wages. However, let's look at this same client and pretend that once they go into retirement, they realize their portfolio only generates $25,000 of annual income. Well, in this case, the income uncertainty ratio is 50%, because out of the $50,000 of expenses needed by the client to survive, their portfolio is only generating $25,000 in portfolio income. So, just like the pension example, in good years if the market goes up, it might feel like no problem to sell some principal to get the extra $25,000. But when the market goes down, you will need to sell at a loss. See the problem here? Eventually, this could cause your portfolio to bleed out, or worse, bankruptcy.

The goal here isn't to scare anybody. Rather, the goal is to plan for a host of scenarios. While it may feel unpleasant to imagine something negative happening to your money, it is better to think about an optimal path in advance, in order to avoid the chance of something negative happening! In this sense, I hope that you found some utility in this short article, even if we don't end up working together. I wish you the best on your journey to financial independence, good luck!