BY BROOKE A. SALVINI, CPA/PFS, CFP

Unraveling Unpredictability

Effective Scenario Analysis Can Help Clients Deal with Uncertainty

In periods of high uncertainty, it's not enough to recommend to clients that they keep their retirement savings diversified and to stay the course with their investments. Although academic evidence supports this as a sound, long-term investment strategy that leads to the most successful outcomes, the advice sounds thin when times are turbulent—and frequently isn't enough to truly assuage the deep fears of some clients.

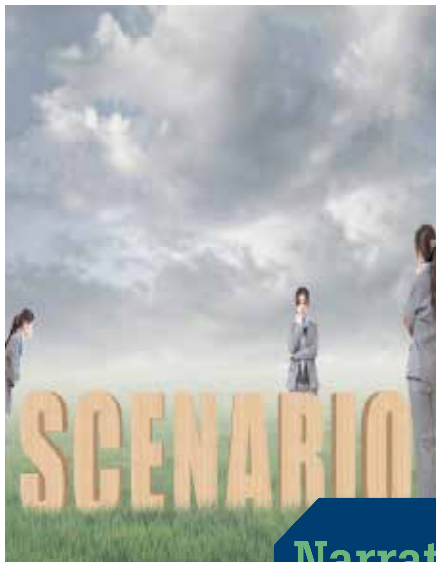
Moreover, the stay-the-course strategy isn't enough to help clients with appetites for risk find opportunities.

As a most trusted adviser we can play a large role in helping clients understand and cope with the risks and opportunity generated by uncertainty. We can do this by using scenario analysis to help ground them in reality and lighten their fear of the unknown.

For example, earlier this year during a period of higher uncertainty, I found it helpful for a very risk adverse and nervous client to map out their exact concerns by using financial modeling software. What if the value of their retirement savings dropped by 40 percent, pension income was cut 10 percent and their home value fell by 20 percent? Could they successfully weather the downturn? Would they have to go back to work? Or worse: Would they have to depend on their children for financial support?

When we plugged in these scenarios, we discovered their fears were unfounded. Even if they realized a big loss in wealth as modeled in a worst-case scenario, the client would have enough to enjoy their current lifestyle. They probably wouldn't leave as much to the children, but enough to care for themselves through their elder years. Equally important would have been to learn that serious lifestyle changes would be necessary to deal with a change in circumstances.

As a CPA financial planner I helped this client flush out their fears and make realistic assessments of risk and opportunity based on evidence.



Scenario Analysis & Storytelling

Scenario analysis is the tool to deal with an unpredictable future—and is possibility the next best thing to the crystal ball.

Stress testing of portfolios with Monte Carlo simulation is an important single variant analysis, but multi-variable scenario modeling adds the planning depth to help the client visualize possible futures. Scenario analysis has been a regular part of enterprise risk management for years and can be equally effective when applied in personal financial planning engagements.

The goals are fourfold:

- Reduce client stress caused by ambiguity.
- Flesh out areas of risk.
- Highlight opportunities.
- Chart a course that will result in a financially secure and satisfying life in any one of multiple possible futures.

One of the reasons scenario analysis is so effective is because we're storytelling creatures by nature. In "Sapiens: A Brief History of Humankind," Dr. Yuval Harari proposes that Homo Sapien was successful over the other hominoids not because of strength or adaptability, but because of the ability to effectively tell stories. Narratives help us incorporate the past into lessons for the future. Modeling and scenario analysis is modern day storytelling applied analytically.

> **Narratives** help us incorporate the past into lessons for the future.

Our job as planner in applying scenario analysis to a client situation is to develop sound assumptions, such as investment returns, inflation and tax rates for the scenarios based on our expertise. The client fills in the narrative with the qualitative information, such as family longevity and ideal or acceptable lifestyle goals, based on their expertise.

Together, planner and client create and agree upon a scenario, or story, about the future. Best case, worst case, likely and most likely versions give the possibilities to consider and become the planning framework, which also becomes the opportunity for clients to self-reflect and improve understanding of their risk sensitivity.

A narrative story is easier to relate to than isolated questions about declines in portfolio value or expected investment returns. The story can be internalized and a better strategy agreed upon. Even at this point in the financial planning process without any solutions or an action plan in place, the client is usually feeling more confident dealing with uncertainty.

The next step is assigning a probability to each scenario. Both the planner's expertise and the client's opinions need to be considered, otherwise the client will likely disregard the entire process if the scenarios and probabilities don't reflect their world view and values. Weighting the outcomes gives a sense of urgency preparing for the alternative scenarios, as well as an appropriate level of expectation. However, though a best or worst case scenario may only rate a 5 percent probability, having a defined course of action for the scenario is an essential part of the plan.

Full Steam Ahead: Planning

With scenarios developed and probabilities assigned, the planning process starts in earnest. The client's financial situation and path are tested against each of the scenarios to reveal risks, gaps and opportunities. A plan takes shape to mitigate the risks and take advantage of the opportunities. The best- and worst-case scenarios function as boundaries that help client and planner gauge progress and course correct.

In the planning process, proactive steps such as increasing monthly savings, rebalancing investment allocations, purchasing insurance and establishing trusts are identified. The power of scenario analysis in helping clients deal with uncertainty occurs because trends and triggers can be spotted in advance.

For example: If investment returns are more than negative 20 percent in any one year, the client must reduce discretionary spending the following year by 5 percent. Or if real estate values decline in a particular market, cash saved for such an opportunity will be deployed. Determining in advance "if this, then that" actions increase client agility and improve confidence when facing uncertainty. Those of you involved in business planning will recognize that the same thought processes and basic analysis around capital allocation applies to personal financial planning. The storytelling effect of implementing scenario analysis creates relevance and connection for a client to their financial plan.

Updating and evaluating the scenario narratives at regular intervals will increase client comfort with investing in an uncertain world, confidence in living with ambiguity and decrease counter-productive behavior that can unexpectedly derail a financial plan. In the same way a muscle grows stronger with consistent work, we become more resilient facing uncertainty by regularly contemplating the possible scenarios and our plans to adapt. Implementing a structured scenario analysis procedure can lead to more success for client and adviser.

For more information about personal financial planning, technology resources or opportunities to expand your practice to include financial planning in the mentoring program, please visit the CalCPA Personal Financial Planning Committee webpage at www.calcpa.org/members/committees-sections/personal-financial-planning. CPA

Brooke Salvini, CPA/PFS, CFP is the owner/operator of Salvini Financial Planning. You can reach her at brooke@salvinifinancial.com.

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Scenario Analysis: Best Practices

- Adopt firm-level economic viewpoint and investment thesis.
- Base assumptions (returns, inflation, tax rates) on supported evidence.
- Include client's point of view and values in assumptions (jointly created story).
- Adjust for client's risk sensitivity, capacity, and tolerance.
- Prepare best, worst, likely and most likely scenarios.
- Assign probability to each scenario.
- Establish guidelines and resulting actions (if this, then that).
- Update scenarios periodically.
- Modify financial plan based on new information.
- Apply process consistently across client base.