



## Dispelling uncertainty: Scenario analysis for client security

### Editor:

Theodore J. Sarenski, CPA/PFS

### Author:

Brooke A. Salvini, CPA/PFS

**Scenario analysis helps reduce uncertainty and alleviate clients' fear and anxiety about the future.**

Clients often approach financial planning with numerous questions. What are the best steps for me? Can I avoid risk and still make money? How much risk is too much? How much will I lose if I make a mistake? What is the worst that can happen?

A multitude of anxious questions can lead to analysis paralysis. That glib name for a very real phenomenon seems to get more and more use in an increasingly complex market. With retirement concerns, lower investment returns, increased market volatility, unpredictable health care costs, and worries about aging, any attempts to plan for the future may lead to even more uncertainty. In the end, it is easy to see how a client could be overwhelmed into doing nothing.

In the past, it might have been sufficient to champion diversification and a commitment to a portfolio. But in turbulent times, a range of economic, political, personal, and other uncertainties can lead to deep-seated fears about doing any one thing. Clients who tolerate higher risk may be eager for even bigger returns and not satisfied with the tried-and-true advice that has been the bedrock of financial planners for decades. Without a crystal ball, the adviser's goal would be to alleviate their uncertainty, build greater tolerance for ambiguity, and help clients position themselves to take advantage of opportunities or address challenges as they arise.

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### Scenario analysis to the rescue

Whether the goal is to assuage a client's fears or to find the best choices for an adventurous investor, scenario analysis is the answer. This versatile tool helps planners assess potential future developments by using a systematic evaluation to identify potential events and results. Here is one key factor: It does not focus on one specific prediction but is instead adaptable to many possible outcomes.

When clients are overwhelmed by future uncertainty, scenario analysis provides them reasonable assumptions for creating a narrative for future outcomes based on specific steps taken. The narrative form is more accessible than random questions and the technical charts that may answer those questions. Clients can consider issues and potential events that are completely out of their control and use them to construct a series of scenarios they can use to build a financial

plan that leaves them feeling as if they are in control.

The four goals of the process are to:

- Minimize client stress by removing uncertainty;
- Identify and consider risk areas;
- Spot opportunities; and
- Find the best possible course for the client in any one of several possible scenarios, making it easier to determine near- and long-term steps and goals.

### Taking it step by step

The first step in the process is to identify the chief goals or concerns. A client with many questions about the current market or the economy may be seeking answers on these topics because he or she is anxious about a retirement portfolio or about the prospects for his or her small business. These key concerns may not be revealed unless the CPA probes into why the uncertainty matters so much. Doing so can help clarify the next steps in the process and make it easier to find the answers clients need. Ask clients, as well, if they can verbalize any fears they have so that the CPA can address other uncertainties and possible misunderstandings. This may involve delving into areas of the client's life—either professional or

personal—that are in flux, so the CPA can develop a full picture of the issues he or she is facing.

Once an objective or worry is identified, both the planner and the client have specific responsibilities in the process. The planner uses his or her expertise and knowledge of the current environment to develop reasonable assumptions about potential financial outcomes. Some technical tools that aid this process include portfolio summary statistics, data on annual returns and intra-year declines, information on market volatility and on asset-class winners and losers, and details on portfolio diversification using real assets. The planner's assumptions might also encompass:

- Expected adjustments to tax policy;
- The state of, and prospects for, the overall stock market, based on current economic and corporate health and other considerations;
- Potential changes to health care coverage based on current proposals;
- The prospects for renewed inflation, given the vigor of the economy and recent Federal Reserve actions or statements;
- The strength of the current real estate market, especially if the client is a homeowner and his or her home is a significant asset; and
- The state of the local economy and the regulatory environment, if the client is a business owner.

The client can also contribute qualitative information to include in assumptions, using details about:

- Important near-term developments, including a home purchase, higher-education expenses for a child, expected changes in a career or business, or health or retirement issues;
- Ideal or acceptable lifestyle expectations; and
- Current health or family longevity issues.

This effort will encompass spotting certainties as well as uncertainties. For example, if retirement funding is the

concern, the CPA adviser can estimate how much annual income the client might need, based on current spending and lifestyle choices, making it a relative certainty, even though longevity and health concerns remain an uncertainty. Retirement lifestyle expectations can be a rich topic for discussion—one that may be based on a number of incorrect assumptions. Clients may not have an accurate idea of how much they actually spend, or they may have unrealistic ideas about how much income they will need in retirement. For example, they may contemplate a simple lifestyle, but in fact, the travel and leisure activities they anticipate could offset other savings. Conversely, they may not be taking into account the savings they could realize from lower income taxes, reduced housing and property tax costs if they downsize, and no commuting costs. CPA advisers may be able to help clients correct these and other mistaken assumptions.

In all cases, the goal of the scenario analysis should be to base the assumptions on facts or reliable data rather than guesses or estimates. All of the information gathered, along with any other pertinent considerations, can be used to create four types of scenarios:

- Best case;
- Worst case;
- Most likely; and
- Likely.

For example, consider a client who is 10 years away from retirement and fears that she will outlive her savings. For the worst-case scenario, the planner could assess what would happen if the client's retirement account dropped by 40% and the value of her home, her most important asset and a potential source of retirement funds, fell by 20%. Of course, the planner and the client can work together to reject some assumptions that seem improbable or less relevant than others. The worst-case scenario is an extreme one, which is where probabilities come into play.

### The tools you need to get started

Do you want to be well-prepared to help clients with any uncertainties they may encounter? Or are you seeking to add financial planning to your services and want to learn more about the many opportunities available to CPAs in this niche? The AICPA Personal Financial Planning Section (available at [aicpa.org/PFP](http://aicpa.org/PFP)) offers resources that can help CPAs and advisers work with clients in a variety of situations, as well as start or better manage their practices and enhance their careers.

Using the planner's expertise and incorporating the client's opinions, the next step is to assign probabilities to each scenario. If an analysis determines that the worst-case and best-case scenarios have only a 5% or 10% chance of occurring, for example, then the planning should focus on the likely or most likely scenario. In fact, the best-case and worst-case scenarios can generally serve as the "guardrails" for the planning process, marking the outer limits of what should be considered.

Working with scenarios based on real numbers instead of worries and uncertainties, the client and the planner can see exactly how long her funds would last over her longest expected lifespan and determine how to respond. Rather than dealing with isolated questions, the client and planner can consider outcomes based on several possibilities.

### What do I do now?

The planning process also identifies steps the client can take based on the scenarios. For example, if the most likely scenario finds there will be insufficient funds for projected college tuition needs, potential steps might include increasing the client's savings rate or considering higher-growth investments, based on the client's financial situation and risk tolerance. In another situation, if the likely scenario envisions the investment portfolio's value dropping by 10% in one year, the client could consider cutting discretionary spending by 5% and using the cash to replenish the portfolio until the market recovers. Clients can more easily deal with uncertainty because they can identify possible trends and triggers in advance and determine workable solutions or responses. Setting up "if this, then that" options offers clients real choices and enhances their confidence.

In addition to tax planning, the overall financial process should encompass goals, cash flow management, investing, retirement, education funding, insurance and risk management,

and legacy planning. Scenario analysis can be applied in any of these areas. The process covers the client's current financial situation, develops action items to be addressed now, includes updates and revisions, and works toward ultimate accomplishment of client goals.

### A deeper bond

The final step in the process is to revisit the scenarios and plans regularly to make updates and revisions. Clients will come away from the process with more comfort in their choices and more confidence when making financial decisions in a complicated and uncertain world. Both the client and the adviser will be more successful when they include structured scenario-analysis procedures in the financial planning process.

Scenario analysis can help clients overcome uncertainty and achieve peace of mind about their planning and financial decision-making. Clients will appreciate the value that the analyses add to their planning. The process will open up a conversation that can lead to additional services and a deeper bond between CPAs and their clients. ■

### Contributors

*Brooke A. Salvini* is the principal of Salvini Financial Planning in Avila Beach, Calif. Ms. Salvini is currently chairman of the California Society of CPAs Personal Financial Planning Committee. *Theodore Sarenski* is president and CEO of Blue Ocean Strategic Capital LLC in Syracuse, N.Y. Mr. Sarenski is chairman of the AICPA Advanced Personal Financial Planning Conference. He is also a past chairman of the AICPA Personal Financial Planning Executive Committee and a former member of the Tax Literacy Commission. For more information about this column, contact [thetaxadviser@aicpa.org](mailto:thetaxadviser@aicpa.org).