"I wish that I knew what I know now when I was younger."

— ***Rod Stewart, "Ooh La La"***

Wise Beyond Your Years

Apr 1, 2011 | by Mary Brunson and Robert Bray

The farther down the road of life we travel, the more we seem to face life choices that while they seemed clear at the time, find each of us perhaps looking back in bewilderment, muttering the rhetorical question: "What was I thinking?"

Imagine the power of being able to peer into your future to gain a good idea of what your life will be like in the future. One particular area of your life where such foresight would be very valuable is your finances. Knowing how much you will likely have saved, how much you will likely be able to live on, and how much you will likely leave behind for your kids, grandkids or favorite charity is considerably valuable information.

One way to peek into the prospects of your financial future is through a probability simulation commonly known as the **Monte Carlo Method**. This often-relied upon analysis is considerably superior to more commonly heard advice such as "just invest 5% of your paycheck and hope for the best." The Monte Carlo Method simulates the potential effects of volatility, compounding wealth and inflation during an investment lifetime.

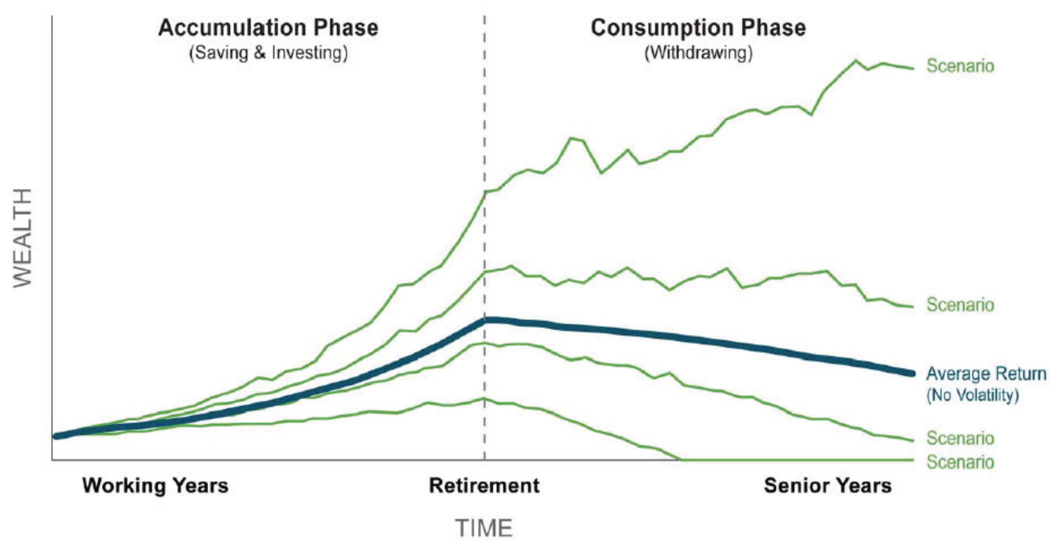
By drawing from actual historical data for a specific risk level, The Monte Carlo Method simulates thousands of portfolio outcomes to arrive at a distribution of success at achieving a desired outcome.

Generally speaking, a level of satisfaction for a particular outcome is reached when 95% of the simulations either reach or surpass the intended goal. IFA employs random number generation from 83 or 50 year periods of historical data sets and assumptions particular to the investor. These assumptions include the investor's timeline to retirement, contributions, and the risk and return characteristics of the specific IFA Index Portfolio used, as well as whether or not the Index Portfolio has been set to Glide Path (reducing a level of risk with each passing year).

The graph below illustrates the two phases of an investor's life: accumulation (saving phase) and consumption (spending phase). Applying the same starting assumptions, the possible outcomes range from prosperity to defeat, all depending on the range of volatility associated with the investments.

Monte Carlo Introduction

Retirement Planning Challenge Illustration



This conceptual graph illustrates that all investors face a wide range of potential wealth outcomes in the future. The blue line shows an average return assumption, which does not consider that a portfolio will experience up and down years (volatility) over time. The green lines show only four potential scenarios out of a much larger set of possibilities. The purpose of Monte Carlo simulation is to help investors envision the uncertain future in terms of probabilities. The Monte Carlo technique creates thousands of investment trials (or scenarios) in which the investment parameters (savings and withdrawals) are provided by the client. The investment returns used to generate each trial are drawn from a normal distribution, whose parameters are specified by the client. This is for illustration purposes only and does not reflect an actual or simulated portfolio.

3 Mark Sellers, "Could Stocks Still Be Undervalued?", Morningstar, February 18th, 2004.

The Monte Carlo simulation (http://www.ifa.com/montecarlo/home/)enables an investor to get a good handle on how much money they need to accumulate so they will have enough to meet their needs (and hopefully some wants) in retirement. If the results do not provide a high enough probability of success, investors have valuable foreknowledge to help them improve their odds for success. An investor can identify a shortfall that may trigger them to save more, increase their risk level (to the greatest extent their risk capacity allows), decrease their anticipated expenditures in retirement, or push back their retirement all together, giving the investor more time to accumulate and less time to consume.

Revisiting the Monte Carlo Simulation each year allows investors to make sure they are on course — much like an onboard navigation system for a car. The closer one gets to their destination, the more finely tuned the directions become.

Work out your financial future right now using the Monte Carlo Simulation. This sort of disciplined analysis will likely go a long way toward preventing the regret of looking back to your younger days wishing you knew what you know now. This process might permit your 75 year old self the opportunity to tap your current self on the shoulder and say, “Thought you’d like to know.”

It is IFA’s privilege to share this information with you. Each of our investment professionals welcomes the opportunity to assist you in your quest for risk-appropriate, low-cost returns. To learn more, please call 888-643-3133 or visit ifa.com.

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