

## **The Flaw of Averages**

### ***Top Four Financial Mistakes***

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Probably the most common mistake is using averages in assumptions about your future and investing. Let's review the concept of average performance in the stock market. Over the last seventy-five years, the average stock return has been about 11 percent annually. Similarly, the average intermediate bond total return has been about 6 percent annually. The problem occurs when you use average returns from individual securities or broad market indices in a planning program.

In reality, equity returns, including the market indexes, vary substantially from year to year. The return is rarely average! For example, the annual market return as measured by well-known market measures, such as the S&P 500 Index, have been as much as 50 percent above average or 25 percent below average on any given year! When a person is withdrawing money to live on, things look very good when the markets are going up 40 percent. On the other hand, things become very disheartening when they plummet 20 percent in a year. It's easy to see that relying on "the flaw of averages" for planning can be financially dangerous. That's often the biggest mistake investors make.

Until recently, all financial planning models shared one trait. Technically speaking, they were *deterministic* models. Stated in plain English, these models give a single answer. In a deterministic model, variables such as rate of return or inflation are entered into the model and run. The model "determines" an outcome, usually stated as a single set of numbers or a graph.

You might already recognize the inherent problem with deterministic forecasting. The future is uncertain. No one can guarantee a future specific return each year for the rest of your life. The reality of uncertainty in the future makes this type of financial planning model inaccurate. Not wrong, but inaccurate. Why are they inaccurate? These models give "average" results, literally. *The problem is, your life isn't "average," and the chances of your actual future coming out exactly "average" is quite remote.*

Some planners using deterministic models may try to compensate in presentations with comments such as "This is a ballpark estimate." They're right about the "estimate," but their estimate could very well be *outside* the ballpark! Today, deterministic modeling by itself is becoming passé for planning purposes. With the advent of today's high-speed processors, making excuses for a model's limitations is unnecessary.

*To read more about avoiding the flaw of averages, check out this article on [stochastic modeling](#), a sophisticated analysis that provides a more realistic approach to managing your situation and raising the probability of financial invincibility in your future.*