Advisor Workstation Office Edition User Manual: Planning FAQs

Overview

This document will answer some Frequently Asked Questions about the Planning module.

The questions have been arranged by topic on the following pages and cover usage, methodology and calculation issues.

Creating a Plan

How much information do I need to enter for a client to create a plan?

For each client member included in a plan, you must enter the following information:

- Relationship (to the original client)
- Birthdate, and
- Gender.

Accounts you have created for the client will also be available for inclusion in the plan.

If I add members or accounts in the Planning module, are they saved back to my Practice area?

Yes. Client members and accounts added from the Planning module will appear on the Clients and Accounts pages.

Market Assumptions

What do I use for market assumptions when creating a plan?

When you create a plan, the default market assumptions are the Morningstar Basic set of 14 asset classes. You can also choose the Morningstar Consolidated (7 asset classes) or Morningstar Expanded (19 asset classes) market assumptions.

While you cannot manipulate the values in the Morningstar market assumption sets, you can change the market assumptions used for a plan via the following process:

1. Duplicate a set of Morningstar market assumptions
2. Change the values for the asset classes or inflation.
3. Save it under a new name.

Can I create my own asset classes to be used in a set of market assumptions?

Yes. You can do this from the main application via the Definition Master, or from within the Planning module. Morningstar provides 32 asset classes to use in creating a set of market assumptions; you cannot delete any of these 32 asset classes.

On what time period are the default market assumptions based?

Default market assumptions are based on monthly returns since 1972.

Are returns used for market assumptions nominal or real?

The default market assumptions use nominal returns, the values have not been adjusted for inflation or other factors.

How do I change the inflation rate being used for a plan?

You can change the inflation rate by editing a set of market assumptions that you create. No separate field exists for Inflation outside of the New/Edit Market Assumptions dialog box.

How do I change the market assumptions for a saved plan?

You cannot change the market assumptions for a saved plan. You will need to create a new plan and change the market assumptions from there.

What indices does Ibbotson use to represent the various asset classes?

Benchmark indices for Morningstar's default asset classes used in the Planning module can be viewed (but not changed) in the Definition Master by going to the menu bar and selecting **Tools**…**Edit Definition Master**. When the Definition Master dialog box appears, select **Asset Classes**. Look for the Planning Benchmark column.

Current Accounts

Can I alter an account once it has been added to a plan?

Yes. Double-click the row for an account you want to change. The Account window opens, and you can make any changes here that you would from the Practice tab. You will be prompted to apply the changes to the plan.

Why would I use a Generic account?

A Generic account can be used for several purposes:

- It could represent the one-time income generated from the sale of a house.
- It can be used to model an IRA, which the client does not already have.
- It can take the place of an actual client account that simply has not been entered yet.
- You can use Generic accounts as a sort of back door to making multiple contributions to another actual account.

Risk Tolerance

Can I skip filling out the Risk Tolerance questionnaire?

Yes. You can bypass the pages of questions by clicking **Next**, then manually entering the client's risk tolerance on the Risk Profile step. You will need to select the desired values for the following areas:

- Investing horizon
- Long-term volatility tolerance, and
- Short-term volatility tolerance.

What if I disagree with the results of the Risk Profile? Can I change the client's setting?

If you disagree with the results of the Risk Questionnaire, you can manually change the Investing horizon, Long-term volatility tolerance, and Short-term volatility tolerance by clicking on the blocks on the Risk Profile screen. You cannot directly change the Overall Risk Tolerance, as this is updated based on your selections for the other items on this screen.

Constraints

What are some good Constraints I should set?

If you examine the Expected Return and Standard Deviation columns on the Market Assumptions page, you will have a good idea as to which asset classes will be favored by the Efficient Frontier. Look for the following:

- Asset classes that have a low Standard Deviation and relatively high Expected Return.
- An asset class that, given a similar Standard Deviation to another asset class, has a slightly higher Expected Return.

Those will be the items you need to set constraints for at the upper end. For example, in the Morningstar Basic set of market assumptions, US Large Cap Value has both a lower Standard Deviation and a higher Expected Return than US Large Cap Growth. If these were the only two asset classes being used, the system would never allocate assets to US Large Cap Growth, because it looks like a bad bet compared to US Large Cap Value.

You will need to constrain both the Maximum Holding for asset classes the system is likely to favor, and the Minimum Holding for asset classes that are likely to be left off of the Efficient Frontier.

Efficient Frontier

What methodology is used by the Efficient Frontier?

The Efficient Frontier utilizes mean-variance optimization.

Does the Wealth Forecasting Engine adjust a client's asset allocation as the client ages?

No, asset allocation is not adjusted over time; however, a client's allocation can be manually updated.

Why can’t I see a model I created displayed on the Efficient Frontier?

The models displayed on the Efficient Frontier are tied to the set of Market Assumptions you have chosen for the plan. Therefore, if you create a model in Workspace tied to the Morningstar Consolidated set of Market Assumptions, and then create a plan using the Morningstar Basic set of Market Assumptions, the model cannot be displayed on the Efficient Frontier.

Income

What amount should I use for employment income?

You should enter gross employment income, because the Planning module accounts for federal and state taxes. You can enter savings and ongoing investments made from employment income on the Account Contributions step.

Can multiple sources of income be added?

No. Only one income record can be added per client member included in the plan.

How do I model income earned during retirement?

You can create a Generic Account (on the Current Accounts step), then make a contribution to it on the Account Contributions page.

Is the Social Security benefit age-adjusted?

On the Social Security page, 65 is used as the default age. If the age is changed and the Calculate Default Benefit button is clicked, benefits will be age based.

Who can be named as the beneficiary for a life insurance policy?

The insured must be the client or spouse, but any member of the client can be named as the beneficiary. To add new client members from within the plan, go to the Overview screen and click **Add**.

Account Contributions

Is there a limit to how many account contributions I can add?

You can specify only one contribution per account included in the plan. If it is necessary to demonstrate more contributions, consider creating a Generic account on the Current Accounts step.

How do I enter Employer Match(%)?

Employer Match is entered as a percentage of the employee's contribution, not as a percentage of the employee's income. For example, if the client contributes 10% of his income to a 401(k) and his employer matches up to 5%, the Employer Match should be entered as 50%.

Forecast

How do I interpret the Forecast graph?

The Forecast graph shows vertical bars, displaying the projected percentile returns of the client's current allocation and their target allocation, and two horizontal lines projecting the Current asset allocation and Target asset allocation median returns.

The Percentile return bands have three colors, representing the 10%, 50% and 90% levels. Percentile levels are the opposite of confidence levels. A portfolio in the 90th percentile is among the top 10% of portfolios (those performing best). The higher a percentile level, the less likely the results.

The Wealth Table

Why is the beginning balance from one year different from the ending balance from the previous year?

The values displayed in the wealth table are selected extractions from the results of a Monte Carlo simulation. The Ibbotson Wealth Forecast Engine (IWFE) runs 500 individual simulations of the client's portfolio, and tracks the values associated with each run on a year-by-year basis. Advisor Workstation Office Edition displays in the wealth table the results for a specific percentile level, not a specific run. The default view in the wealth table is the median, or 50th percentile. For any given year, the simulation results for each run in that year are sorted by ending balance. The 50th percentile value is the individual run whose ending balance is exactly in the middle of the sorted list of 500 runs. For the individual run found at the 50th percentile level in a particular year, the wealth table displays the beginning balance, total additions, total withdrawals, investment gains/losses, and ending balance. This means that each row (year) in the wealth table is (almost certainly) from a different simulation run.

Why are withdrawals taken from the portfolio in years in which I have not specified withdrawals?

The IWFE simulates both the price return (capital gain) and income return (dividends or coupon payments) of the portfolio. The "unexpected" withdrawals you see in the wealth table are most likely withdrawals to cover the payment of income taxes on dividends and coupon payments.

What tax rates are used in the wealth forecast?

IWFE calculates the income tax and capital gains tax rates based on the client's income and state in which the taxes are paid. As the client's income changes, the federal tax rates will change accordingly. State taxes are treated as fixed. IWFE does not model the tiered tax rates used by some states. You may override state taxes in the Tax Info screen of the client window.

Why is there a withdrawal in the year after a withdrawal I've specified?

IWFE subtracts the withdrawal amount from the portfolio in the year of the withdrawal, then subtracts additional money the following year to pay the capital gains tax on the withdrawal from the prior year.

Why are the withdrawals much larger than the amounts I've entered?

Withdrawals from the portfolio are generally specified in current value amounts, so future withdrawals are adjusted each year for inflation and are presented by default in future value. You may select the Current Value option near the top of the wealth table to view all amount in terms of current value. If the withdrawals are still much larger than you expect, it may be due to one of the following reasons:

- The total withdrawal amount for one year may also include tax withdrawn from the portfolio to pay for the capital gains taxes on the previous year's withdrawal.
- IWFE models early withdrawal penalties. If the taxable account has been depleted, and the withdrawal is being taken from a tax-deferred account, the additional amount of the withdrawal might represent the cost of the early withdrawal penalty.

Why are the withdrawals after retirement less than the retirement needs I've specified?

Retirement needs are not subtracted directly from the client's portfolio. The retirement needs are offset by social security and pension income. After these post-retirement income amounts are subtracted from the retirement needs, any remaining amount is withdrawn from the portfolio.

Also, if you've specified retirement needs as a percentage of income, keep in mind that the employment income is entered as pre-tax income, while the retirement needs amount is calculated as a percentage of the estimated post-tax income.

How does income affect the simulation?

Prior to retirement, income is used primarily to determine the appropriate tax rate for the employee for a particular year. Employment income is not directly added to the portfolio amount, because IWFE operates on the assumption that income prior to retirement is used to pay day-to-day living expenses, and that any surplus savings amount will be entered separately as account contributions. Employment income is also used to calculate the value of account contributions which are specified as a specific percentage of income.

After retirement, income plays a more direct role in the value of the portfolio. As described above, post-retirement income is used to offset retirement expenses, and only the retirement expense not covered by retirement income is subtracted from the portfolio.

Why are there additions to the portfolio after retirement?

IWFE models minimum required distributions from retirement accounts. If these distributions are greater than the amount that would normally be withdrawn from the portfolio to pay for retirement expenses, the excess will be deposited into the client's taxable account. Therefore, you may see both additions and withdrawals in the same year after the client reaches age 70.

Allocate

Does the Portfolio Optimizer take anything into account, such as tax efficiency, or does it simply monitor expected return/ standard deviation?

The Portfolio Optimizer is not based on expected returns or standard deviation; it is driven by asset allocation. At the beginning of the Planning workflow, you determined a target asset allocation using the Efficient Frontier Graph. This target asset allocation was based on acceptable expected returns and standard deviation using default or custom market assumptions.

Given the investment list or model portfolio you have selected on the Allocate step, the Portfolio Optimizer strives to replicate the target asset allocation by allocating funds to the various securities. If multiple securities have similar asset allocation, the security with the lowest tracking error will be selected to achieve the desired asset allocation. Tracking error represents the standard deviation of the difference in returns between a security and the benchmark(s) associated with the security's respective asset class or classes.

Can I use propose a portfolio against certain funds instead of asset classes?

No. Independent, non-overlapping asset classes (US Stocks, Non-US Stocks, Cash, etc.) must be used. You cannot attempt to model a portfolio compared to certain funds or indexes representing these asset classes.

If a plan uses different accounts, can I specify different investment lists for different accounts, to account for the fact that a 401(k) might have a limited amount of available investments?

Currently, accounts in the Planning tool are viewed on the aggregate level. Future enhancements to use multiple investment lists or models in the Portfolio Optimizer are being explored.

Reports

How are report settings saved?

For the Investment Policy Statement and Investment Recommendation Reports, changes to titles and descriptions can be saved as the default for each section.

After making changes to a section, check the **Save changes as default for this section** box. If this box is not checked, changes will only affect the plan you are working in at the time the change is made. Also, note that if you check this box you are changing that section not just for that report, but for the other two report types as well. For example, if I change the Risk Profile section on the Investment Policy Statement report to read "Client Risk Profile," then save the change as the default, that same change will appear on the Investment Recommendation and any Custom Report I create.

For Custom Reports, the sections added to the Select Report Sections column are saved independent of the client. At this time, multiple Custom Report templates cannot be saved.

What sections of Investment Policy Statements and Investment Recommendation Reports can be excluded?

The only sections that can be excluded from these reports are text-only sections such as Introduction, Legal & Regulatory, Unique Needs & Circumstances, and Agreement.