

PlanScout

Beyond Probability: A practical guide to *real-world* risk conversations

Move beyond *Monte Carlo Models* to
meaningful, actionable financial planning.





At PlanScout, we believe a financial plan is more than just a forecast; it's a dynamic tool designed to empower clients with better decision-making in the present, ultimately shaping their future financial success.

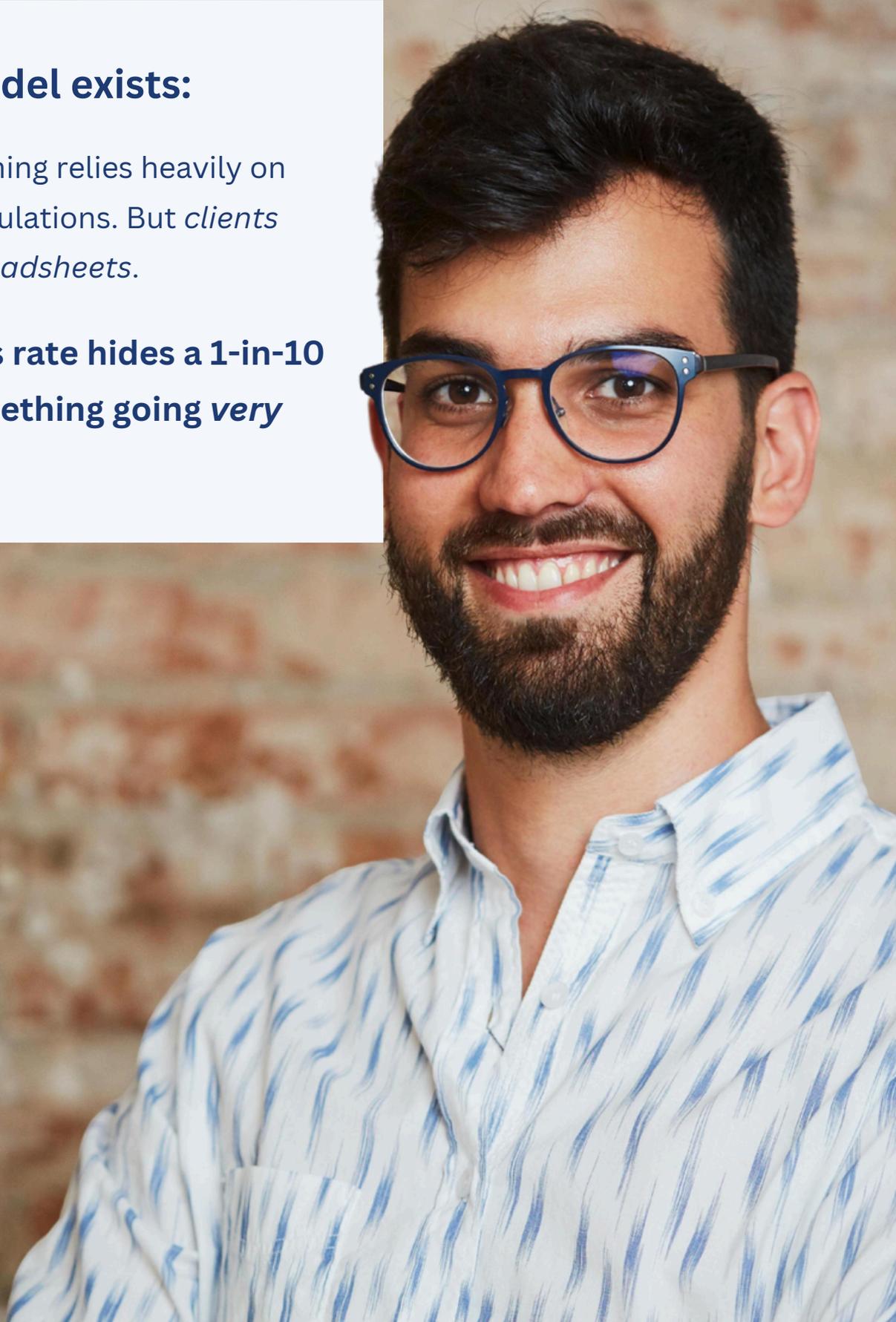
While Monte Carlo simulations have become a commonly used tool for stress-testing financial plans, this white paper will explore why their reliance on statistical assumptions and complex probabilistic outputs can be fundamentally flawed and often counterproductive for the average client.

We will argue that a more meaningful and actionable approach to understanding financial plan resiliency lies in direct risk identification, targeted mitigation strategies, and intuitive stress-testing scenarios that resonate directly with a client's lived experience.

Why this model exists:

Traditional planning relies heavily on Monte Carlo simulations. But *clients don't live in spreadsheets.*

A 90% success rate hides a 1-in-10 chance of something going *very wrong.*



What you'll get in this guide:

- ✓ **Real-world risk talking points**
- ✓ **Advisor-approved conversation cheatsheet**
- ✓ **A visual example of better planning**
- ✓ **Links to try PlanScout's approach**



The Flawed Foundation: The Normal Distribution Assumption

Monte Carlo simulation is a powerful computational technique that models the probability of different outcomes in a process that cannot easily be predicted due to random variables.

In financial planning, it typically involves running thousands of hypothetical scenarios, each with randomly generated investment returns, to project a range of potential financial futures for a client's plan. The core output is often a "probability of success," indicating the likelihood that the plan will meet its stated goals.

However, a critical underlying assumption in many Monte Carlo models, particularly concerning investment returns over shorter timeframes, is that stock market returns are normally distributed. This assumption suggests that returns will cluster symmetrically around an average, with extreme positive or negative events being highly improbable.



As recent market history and academic research repeatedly demonstrate, this assumption is often incorrect. **Actual historical stock market returns exhibit what statisticians call "fat tails" and "skewness."**

Fat Tails:

This means that extreme market events – significant crashes or booms – occur more frequently than a normal distribution would predict. A Monte Carlo simulation built on a normal distribution might underestimate the true risk of a major downturn or overestimate the likelihood of consistently moderate returns, leading to a false sense of security or an overly aggressive plan.

Skewness:

Real-world returns are rarely perfectly symmetrical. They might show a positive skew (more frequent small gains, fewer but larger losses) or, at times, a negative skew. This asymmetry is not adequately captured by a standard normal distribution.

Market Regimes:

The market is not a static environment. It moves through different "regimes" (e.g., bull markets, bear markets, periods of high or low inflation, interest rates, and volatility). The distribution of returns can vary significantly between these regimes, making a single, static normal distribution assumption problematic for accurately reflecting future possibilities.

By relying on a statistically convenient but practically inaccurate model for market behavior, **Monte Carlo simulations can provide a misleading picture of a financial plan's true resilience to real-world market volatility.**





A 95% chance of success still means a *1-in-20* chance of failure. **Would you fly on that plane?**

-Raygar, PlanScout CEO



The Communication Conundrum: Probability of Success

Beyond the statistical shortcomings, there's a significant challenge in how the output of a Monte Carlo simulation, the "probability of success", is communicated and understood by clients.

While a financial advisor may grasp the nuances of a 70%, 80%, or 90% probability, the average client often struggles to translate this abstract concept into actionable insights for their own financial life.

Imagine boarding an airplane, and before takeoff, the pilot announces, "Ladies and gentlemen, we have a 95% probability of reaching our destination safely." Would you remain seated?

For most people, a 95% probability of success in such a critical scenario is terrifyingly low. That 5% chance of failure, however remote statistically, represents a catastrophic outcome.



Yet, in financial planning, advisors often present a 90% or 95% "probability of success" as a good outcome, implying a high degree of safety for the financial plan. **This disconnect highlights a fundamental flaw in communication:**

- **Abstract vs. Tangible Risk:** Clients relate to tangible risks (e.g., "What if inflation erodes my savings faster?"). A probability percentage, however, remains abstract and fails to convey the real-world impact of the "failure" scenarios.
- **False Sense of Security:** A high probability of success can inadvertently lead clients to believe their plan is "bulletproof," discouraging them from making necessary adjustments or adopting more conservative strategies for income they need in a short-term time horizon.
- **Difficulty in Decision-Making:** How does a client use a 85% probability of success to decide if they should retire next year, or spend less on their discretionary travel? The connection between the probability and a concrete decision is often tenuous at best.

A Better Way: Proactive Risk Management and Understandable Stress Testing

At PlanScout, we advocate for an approach to financial planning that prioritizes actionable insights, direct risk mitigation, and transparent communication.

A financial plan should serve as a dynamic blueprint for making better decisions now that positively influence future financial success.

Instead of relying on opaque probabilities, we recommend focusing on the following techniques.



1. Mitigating Sequence of Return Risk through Time Horizon Alignment

One of the most significant risks to a financial plan, particularly for those in or nearing retirement, is sequence of return risk. This refers to the danger that poor investment returns early in retirement (when a client is drawing down assets) can disproportionately derail a plan, even if average long-term returns are favorable. A Monte Carlo simulation might show a low probability of this specific "bad sequence" occurring, but it doesn't offer a direct strategy to mitigate it.

A more thoughtful approach involves aligning investments with the time horizons your clients will need to access those investments to fund their lifestyle and goals.



Short-Term Needs (0-4 years):

Funds required in the near future for essential living expenses or known large expenditures (e.g., a down payment, a child's first year of college) should be held in highly liquid, low-volatility assets like cash, money market accounts, or short-term bonds. This creates a "safe landing strip" that protects against immediate market downturns.

Mid-Term Needs (5-10 years):

Capital for goals further out (e.g., future travel, home renovations, later college years) can be invested in moderately conservative portfolios, offering some growth potential while managing volatility.

Long-Term Needs (10+ years):

Assets intended to fund later stages of retirement or legacy goals can be allocated to more aggressive growth-oriented portfolios to maximize long-term compounding, as these funds have ample time to recover from market fluctuations.

This strategy provides a practical, tangible way for clients to visualize and manage their risk exposure based on their actual spending needs, rather than relying on a statistical probability.

It ensures that necessary funds are protected when markets are turbulent, reducing the impact of negative return sequences.





2. Actionable Stress Testing in *Understandable* Terms

Instead of abstract probabilities, PlanScout recommends engaging clients in stress tests that use scenarios they can intuitively understand and relate to their financial lives. This allows for a direct conversation about potential vulnerabilities and, crucially, actionable adjustments. Here are key scenarios to consider:

Sustained Higher Inflation:

"What if inflation remains at 4-5%, instead of the historical 2-3%? How would this impact your purchasing power and the longevity of your savings?" This scenario highlights the need for inflation-adjusted income streams or more efficient spending.

Increased Spending:

"What if your discretionary spending increases by an extra 10% per year due to unforeseen circumstances or simply enjoying life more than anticipated? How does that affect your ability to meet long-term goals?" This helps clients visualize the impact of lifestyle creep and prompts discussions about budget flexibility.

Advisor Talk Cheat Sheet

Use these to steer conversations beyond vague stats:

- “That 90% hides a 1-in-10 chance of disruption. *Let’s talk about that 10%.*”
- “If markets drop 20% next year, *what gets cut first—travel or healthcare?*”
- “What changes if you *live to 100*, not 85?”

The “What If” Scenarios:

Model these stress tests that *clients understand!*

Longevity Risk:

“What if you live to 100?”

Inflation Risk:

“What if inflation stays at 5%?”

Sequence Risk:

“What if the market dips when you retire?”

Lifestyle Creep:

“What if you spend more than expected?”

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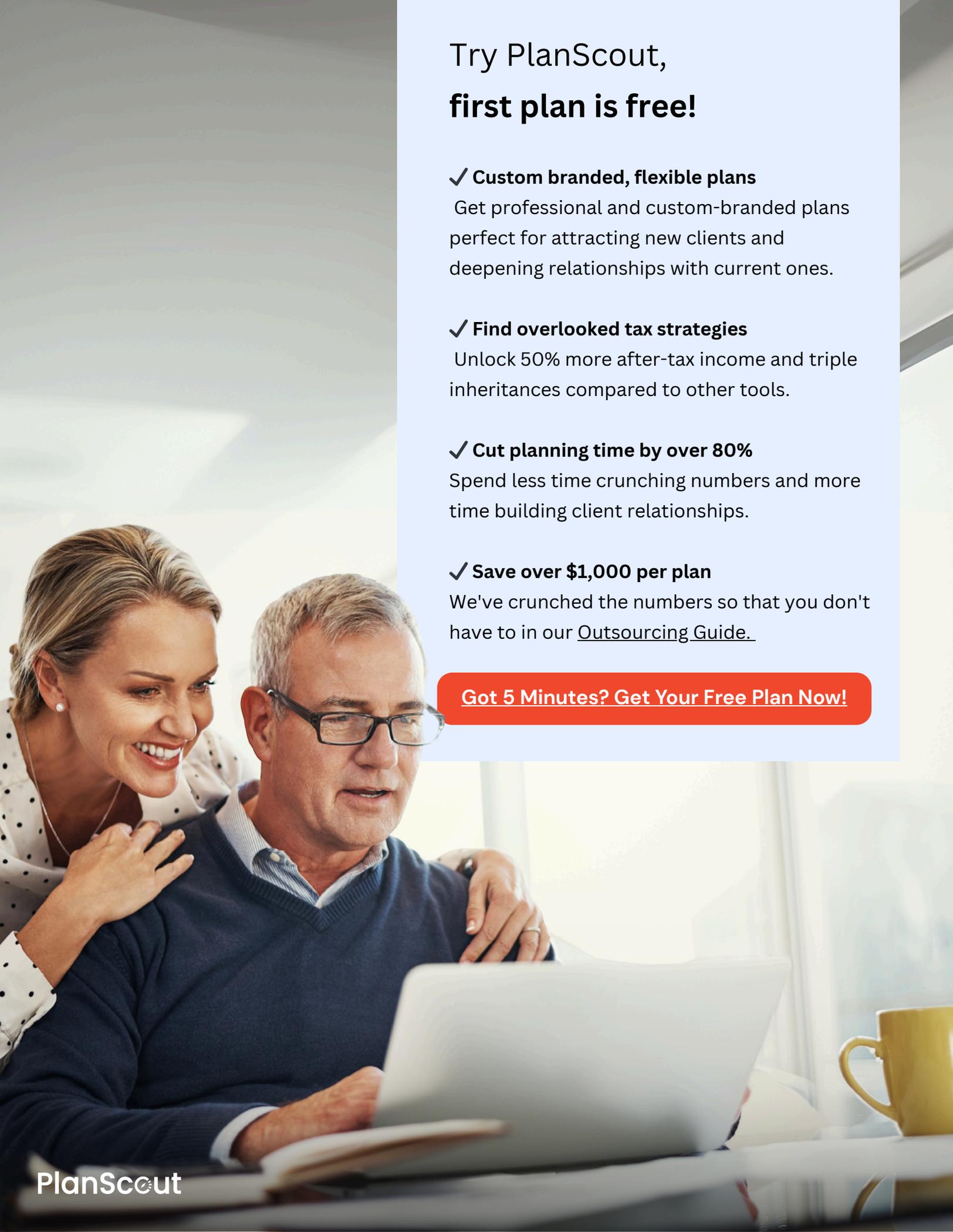
What changes
if you live to
100, not 85?



Your clients aren't statisticians. Give them a story they can follow.

PlanScout provides the tools and framework for advisors to deliver this superior level of planning, transforming their clients' financial futures by truly aligning investments with life's real risk models, offering clients clarity, confidence and peace of mind.

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