THE WALL STREET JOURNAL.
WSJ.com

OCTOBER 8, 2010, 8:05 AM ET

VOICES: Rand Spero, On Clients' Income Volatility

Rand Spero is president of Lexington, Mass.-based Street Smart Financial.

Rand Spero

A lot of my clients are entrepreneurs, contractors, freelancers or small business owners. That means their cash flow is more volatile than someone with a secure job who earns a regular paycheck. The market for freelancers and contractors has grown during the recession as firms cut back on hiring permanent employees. Job security, meanwhile, is lower as a result.

However, earned income volatility doesn't just apply to self-employed people. It also applies to people who might be earning a steady monthly paycheck, but are under constant threat of losing their job. Both situations require financial planning that takes into account the possibility of sudden changes in cash flow.

In this job market, I always have to ask my clients to envision worst-case cash-flow scenarios. I ask them to estimate the chances that they will be laid off, or that contracts or freelance work will dry up, in the next year or so. If the chances are fair to good that they'll face a sudden drop in income, we begin the process of planning for the worst.

I start with a series of questions. Do you have an emergency fund? Could you dip into a retirement savings account without incurring a huge fee, or rely on home equity to pay essential bills? Do you have valuable investments or a second source of income? Could you become self-employed if you get laid off?

The answers to all of these questions should impact both spending and investment decisions. Too many advisers look exclusively at market volatility and the age of the client when putting together a portfolio, and assume that his income is a constant. Even if my client is young and making a good living, high income volatility can affect how I put together his portfolio. I include the added risk when calculating an acceptable investment risk, and modify the asset allocation accordingly. A client with more income volatility needs less risk in his investments.

Income volatility can also affect discretionary spending choices. This can be very difficult for some people. One couple I work with is concerned with future dips in cash flow — but they take annual vacation trips to Europe. One of them has family in Europe and feels the trips are nonnegotiable expenses, the other feels they are discretionary. At that point, the adviser has to let the clients decide for themselves if the expense is worse the potential downside.

In the end you're dealing with uncertainties, and it's got to be up to the client whether or not he or she wants to spend time planning for worst-case scenarios. We like to assume that if we're making a good living now, we'll be able to continue to do so in the future. Unfortunately, that's just not a guarantee anymore.