

What's Your Future Worth?

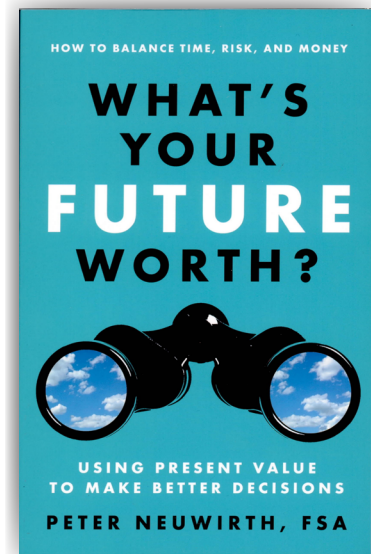
Using Present Value to Make Better Decisions

Peter Neuwirth, FSA

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KEY CONCEPTS

People are often called upon to make decisions today that will have consequences in the future. Using the concept of *Present Value*, Peter Neuwirth presents a straightforward, systematic decision-making process comprising five steps:

1. *Clarify the choice.* The most important step when attempting to make better decisions is simply to clarify the choice, and be clear about what decision specifically needs to be made.
2. *Imagine the future.* Becoming firmly “present in the present” is the only way to mentally prepare for the uncertainties the future can hold. Ideally, being open to any possible outcome rather than attached to one particular outcome can greatly impact the idea of Present Value.
3. *Evaluate the possibilities.* Once any and all possibilities are imagined, they must be evaluated. Often people will use past experiences or personal biases to evaluate future possibilities in the present. Neuwirth strongly advises against this, and instead urges people to uncover what is truly measurable, what is not, and what clues could be used to ascertain what might happen next.
4. *Weigh the now and the later.* Neuwirth believes that each person is “discounting” future consequences and assigned value judgments to them. Additionally, it is important to determine exactly how far into the future it is necessary to think about and assign endpoints to all future scenarios.
5. *“Do the numbers.”* Often, the process of going through the first four steps is enough to make the eventual decision seem glaringly apparent. Neuwirth has found that if the problem is not easily solved by math or is overly complicated by applying too many strategies, it is best to step back and look at the scenarios simply and without formulas.

SUMMARY

INTRODUCTION

In an age of endless access to data and information, making choices, both complex and simple, has become more difficult than ever. More often than not, the amount of data associated with making a decision can cause a person to feel paralyzed rather than empowered. In **What's Your Future Worth?**, Peter Neuwirth offers a systematic way to make choices without becoming paralyzed by an onslaught of information. Using *Present Value*—the value of something today that might also occur in the future—Neuwirth explores a five-step process to making better overall decisions in everyday life.

MORDECAI'S PROPOSITION—A QUESTION OF PRESENT VALUE

In 1979, Neuwirth began his career working at Connecticut General Life Insurance as an actuarial student for a top actuary named Mordecai. Instead of teaching Neuwirth about the importance of understanding Present Value, Mordecai opted to engage him in real-life scenarios. He asked Neuwirth if he was willing to “sell” him a piece of his future earnings—1 percent of future yearly earnings in exchange for \$10,000 up front. Neuwirth had to systematically think about the future and what it was worth to him in the present. He had to consider all possibilities—would he make a significantly higher salary in the future? Would inflation increase, making the \$10,000 he received up front a tiny sum? Would there be more job opportunities in the future for actuaries, or less? And from a relationship standpoint, how would those in Neuwirth's life feel about the burden of those 1 percent yearly payments?

After considering all possibilities, Neuwirth decided to turn Mordecai down. The \$10,000 payment in the present was not as valuable to him as the possible large payments and salaries he expected to make in the future. But Mordecai had made Neuwirth consider the most important question of his career: What was his future worth?

PRESENT VALUE IN THE DAY-TO-DAY WORLD

The idea of Present Value is an inherent part of everyday decisions. Knowing how to better incorporate Present Value into the decision-making process will ultimately lead to making better choices. Simple decisions, even mundane ones, are determined more effectively when considering Present Value and future possibilities.

For example, Neuwirth recounts using Present Value to determine whether he should buy a new refrigerator. The Present Value of his electric bills was high because of the large amounts of electricity being used by the struggling refrigerator. So, Neuwirth looked at the cost of buying a new refrigerator versus the total amount of keeping the old one and paying more in electricity bills over several years. In the end, the total projected future cost of a higher electric bill would have been more than the present cost of a new appliance.

Don't let an “expert” make your decisions for you. Present Value works—but only if you take responsibility for owning the process and doing it yourself.

MAKING BIG DECISIONS

Even when the calculations are not simple or straightforward, such as in Neuwirth's example of buying a new refrigerator, Present Value can be applied. It is a key tool for helping people make greater, more complex decisions that usually occur when there is more at stake than a smaller electric bill. Sometimes such decisions can alter a person's life path.

There are two types of larger decisions that would be better made with the use of Present Value:

1. *Career choices.* Nearly everyone could benefit by taking a more systematic approach to making a career move. The first time that Neuwirth decided to change jobs, he examined the future scenarios, considered the likelihood of each occurring, and tried to place a Present Value on each possibility. He calculated that the Present Value of his future earnings would be higher if he left; therefore he accepted a new position.
2. *Investing in education.* When considering investing in additional education, people would be wise to use Present Value to determine whether the long-term financial benefits of the added education (e.g., completing an MBA program) would offset the initial costs. For such a scenario, it is important to also address all of the possible future outcomes and their uncertainties.

[W]hen we find ourselves in a quandary, we ask ourselves "What should I do?" . . . By now it should be clear that there is another more precise question that should be asked . . . "What are the alternatives that I am trying to choose between?"

THE MECHANICS OF PRESENT VALUE—WHAT IS A DISCOUNT RATE?

Even though Present Value can be understood without employing all the formulas and mathematical equations that actuaries typically use, Neuwirth believes there is one equation that should be known for Present Value to truly be used correctly. He poses the question: Should someone take \$1,000 today or \$1,100 a year from now? Many people would first think about the *interest rate*, or the rate at which \$1,000 today would grow. The interest rate could be viewed as the projected future value of money. Alternatively, the *discount rate* is simply the opposite of this—it is the projected future value today, not in the future. The two rates are the same, but from different vantage points. The element of risk is also considered in the calculation.

THE FIVE-STEP PROCESS

Actuaries use a great deal of math, formulas, and equations when calculating Present Value and projections, but Neuwirth believes that the actuarial perspective can be translated with virtually no math at all. He presents his five-step process to apply this perspective and offer a systematic approach to making better real-world decisions:

1. *Clarify the choice.* The most important step when attempting to make better decisions is simply to clarify the choice, and be clear about what decision specifically needs to be made. This does not always mean that there is a clear choice that needs to be made—sometimes the possible alternative paths simply need to be properly envisioned and evaluated.
2. *Imagine the future.* According to Neuwirth, *chaos theory* best explains how people move from the present to the future. While chaos theory is a vast concept, essentially chaos at its core means a process that is "deterministic but not predictable." Becoming firmly "present in the present" is the only way to mentally prepare for the uncertainties the future can hold. That means being open about any possible future outcomes and not mentally attached to one particular future outcome, which can significantly improve the notion of Present Value. Accurately dealing with future scenarios works best when a person can envision as many scenarios as possible, even those that seem unlikely.
3. *Evaluate the possibilities.* Once any and all possibilities are imagined, they must be evaluated. Often people will use past experiences or personal biases to evaluate future possibilities in the present. Neuwirth strongly advises against this, and instead urges people to uncover what is truly measurable, what is not, and what clues could be used to ascertain what might happen next. For example, Neuwirth recounts his experiences with colleagues attempting to evaluate future possible outcomes with various teams in baseball. Most often, trying to predict future possibilities based on past performance fails, as the effects of randomness or

sheer luck are not measurable factors. Instead, evaluating the possible outcomes really boils down to the order of significance of the chances that each possibility would occur.

4. *Weigh the now and the later.* It is important to recognize that a personal discount rate is being used (often without knowledge of it). Neuwirth asserts that each person is “discounting” future consequences and assigning value judgments to them. For example, when people opt to accept lump-sum payments of pensions or 401k plans instead of receiving them over time, they are discounting the future value without evaluating its importance. Being aware of these personal discount-rate biases can aid in accurately assessing Present Value. Additionally, it is important to determine exactly how far into the future a person should think about. There should always be an endpoint in future time scenarios—which Neuwirth refers to as a *time horizon*—for there is always a point when scenarios are no longer relevant in the future (e.g., when projecting how many running shoes to buy in the present for the future, the endpoint would be when a person reaches roughly 80 years old; it can be predicted that the shoes would be useless after that point).
5. *“Do the numbers.”* Sometimes the process of going through the first four steps is enough to make the eventual decision seem glaringly apparent. In this final step, Neuwirth tells the story of how his second boss, Charlie, explained how to “do the numbers” when necessary, but also how to use other means to get a final answer or decision. When Neuwirth was tasked with an incredibly difficult equation and scenario, he brought it to Charlie after spending long hours working on it and being unable to make a clear decision from it. Charlie wondered if there was an easy way to solve it from Neuwirth’s perspective, which there was not. That was the only answer Charlie was interested in. Simply put, Neuwirth learned that if the problem is not easily clarified by math or is overly complicated by applying too many strategies to it, the future answer would be useless. Instead, a person must maintain a “relaxed, playful attitude” and ask intelligent questions when investigating alternatives. Also, a person may need to go with his or her “gut”—which will be a much smarter decision after following steps 1–4.

The future is vast, and until we adopt a humble attitude and take the time to contemplate all that might occur, we will never be able to determine how likely any particular scenario is, let alone what will occur.

PRESENT VALUE FOR ORGANIZATIONS AND COMMUNITIES

All organizations—whether government, company, or community—use Present Value in everyday decisions, but often it is referred to as the *discounted cash flow method*. These concepts are very similar in principle; however, the main difference is that organizations tend to focus only on the most likely future scenarios and do not attempt to envision all future possibilities. Sometimes envisioning all possible future scenarios includes negative impact situations—these become very important to plan for if they were to happen. Organizations often miss unlikely negative possibilities in their calculations.

Organizations that use a discounted cash flow method must be sure to extend their projections far enough into the future. Additionally, they must consider a very wide range of possibilities. Organizations usually only consider financial or measurable factors in any decision-making process. Present Value encourages using these factors as well as all other psychological and nonrational (even random) factors in order to incorporate all possible paths, scenarios, outcomes, and future decisions. Using only rational and measured thinking does not allow for the best possible decision in the end.

WHEN MONEY DOESN'T MATTER

As previously stated, Present Value is a concept that at its core involves math and formulaic calculations. However, Neuwirth states that there are situations in which numbers and money are not a measurable factor in any way. These scenarios typically deal with matters of life and death.

When Neuwirth's longtime friend Rob was diagnosed with an aggressive form of cancer in which he was given two years to live, he had to use the concepts behind Present Value to determine whether or not the medical treatments would prolong his life or simply make him suffer during his last months. Without a specific future time line on the horizon, Rob considered how his life would continue in between medical treatments and weighed the costs and benefits of the time he had left. Even without measurable numbers or dollars involved, Present Value helped Rob determine, on his own personal scale, the *relative value* of each cost, benefit, and negative aspect, and ultimately helped him make the decision to undergo treatment and live as long as possible.

PRESENT VALUE AND THE DISTANT FUTURE—PLANTING TREES AND LEAVING A LEGACY

Although Present Value works best when a set time period is envisioned, it is important for a person to use Present Value to consider his or her lasting legacy—specifically, what will happen to any and all assets after that person's death. Thinking about the end of one's life is never enjoyable, but it can be important to consider when there are family members who remain.

Neuwirth recommends that people consider obtaining charity gift annuities (CGA) for any assets that they wish to use for their retirement or to leave behind to family members. A CGA is essentially a contract under which a charity, in return for a transfer of cash or other assets, agrees to pay a fixed amount of money to one or two individuals for their lifetime(s). Most people are not aware of CGAs as alternative avenues for asset management and growth. Investing money in a wide array of charities as opposed to private equity firms or insurance companies will only help society grow stronger for future generations.

THE VALUE OF THE ACTUARIAL PERSPECTIVE AND "THE REST OF YOUR LIFE"

Present Value is not a new concept—actuaries have been relying on it for more than a century. Yet it can be an effective tool for everyone. Harnessing the value of the five-step Present Value process and can help people live with more awareness in the everyday, present moments. Present Value can be applied to personal issues such as individual financial planning as well as large, complex concerns like fixing an unsound global retirement system. The more that people are aware of Present Value and its implications on the future, the more likely they will be able to live in the present with as little fear as possible.

FEATURES OF THE BOOK

Estimated Reading Time: 3–4 hours, 216 pages

Every person would like to make better decisions about the future. In **What's Your Future Worth?**, Peter Neuwirth offers a systematic process to do just that. He uses examples and stories from his experiences as an actuary and from his everyday life to illustrate the importance and lasting effects of Present Value in the decision-making process. The book includes a comprehensive notes and references section, which includes further examples and detailed formula breakdowns. Business professionals, actuarial students, and those interested in planning for their future or making better overall decisions would benefit from reading this book.

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ABOUT THE AUTHOR

Peter Neuwirth, FSA, has been an actuary for over 35 years, and is a senior consultant at Towers Watson, serving as one of the firm's thought leaders and national experts in the area of financing nonqualified executive retirement plans. In his personal life, he has used Present Value to decide what kind of running shoes to buy and whether to get married, among other quandaries.

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