

# Interview With Financial Planner Jim Otar

By Robert Brokamp

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*Jim Otar is a former engineer, a current Certified Financial Planner, and the author of Unveiling the Retirement Myth: Advanced Retirement Planning Based on Market History. Otar's website, [RetirementOptimizer.com](http://RetirementOptimizer.com), features several articles, a free trial to Otar's retirement calculator, and the PDF version of his book for purchase.*

**Robert Brokamp: Let's start with the title of your book, *Unveiling the Retirement Myth*. Why don't you tell us a little bit about what the retirement myth is?**

**Jim Otar:** For many people, at least for many years, the retirement myth was that you can assume an average growth rate -- maybe 6%, 7%, 8% -- [and assume] average inflation, and make a projection that you should be OK. What most people missed was you cannot design individual plans using averages. The averages do not deduce to individuals. Individuals make up the averages, but not the other way around, so that was one of the biggest things that I found when I first started in 1999 looking into this problem.

The next problem was the importance of asset allocation, and advisors use it less than honestly when trying to convince their client if you have a good asset allocation you don't need to worry about anything. And asset allocation contributes very little to the longevity [of a retirement portfolio].

The next thing was diversification. A few years ago I discovered why all these things happened after reading *Fooled by Randomness* and *The Black Swan*, and they talk about market extremes. And that is basically [how the market behaves]. We make money 2.5% of the time, lose money 2.5% of the time; the rest of the time, not much happens. That is another myth: Markets are not random.

Another thing I discovered was the mathematics of loss. We [in the financial services industry] all tell our clients that markets eventually come back. Markets do come back, but portfolios don't, once you start taking money out of the portfolio. So that was a wake-up call for me. The most important thing is sequence of returns, as well as income *allocation*, as opposed to asset allocation, once you start relying on your retirement savings for income.

**RB: Why don't you talk a little bit about sequence of returns risk, and what someone should do about it?**

**JO:** If you look at the market's history, about 50% of the time we are in a sideways market; you may have 16 years, 18 years, 20 years of no growth whatsoever, just a cyclical bull market and bear market, up and down within a 20- or 16- or 18-year timeframe. The rest of the time, or 46% of the time if we are looking at the last century, you may be in a bullish trend and making 15% average growth rate, and that is great. But the sequence of returns [risk] kicks in if you are not lucky enough to be retiring in a time frame that is the beginning of a good sequence of returns, a

secular bullish trend. If you retire at the beginning of a sideways trend, the portfolio life is usually no more than 16 or 17 years; if you retire at the beginning of a good, secular, bullish trend, the portfolio may last 30 or 40 years for no other reason than being lucky. That is created by that sequence of returns.

"Sequence of returns" means having maybe two negative years or four flat years that works against you and unfortunately, unlike the accumulation portfolio where time is your friend, in a distribution portfolio, time is your enemy. The longer you withdraw money without any significant increase in the portfolio, you are just losing your capital.

So in an accumulation portfolio, asset allocation works well because it controls the volatility of returns. But in a distribution portfolio, what you need to do is control the sequence of returns, and the better way of doing that is "income allocation." That means we have to put some of your money into instruments that give you guaranteed income through an annuity. Once you do that, then the rest of the portfolio can continue its accumulation; time becomes your friend again. You have to allocate your assets to guarantee income for the basic income needs, just to make sure the rest of the portfolio can work for you.

**RB: Should people be looking at an optimal time in terms of age, and should people be looking at a straight income annuity or should they get the inflation-adjusted variety?**

**JO:** OK, several questions there. First of all, when to retire. If you want to leave money to children, if you want to create an estate for the survivors, you would need at least 30 times of the first year's income at age 65. If you are at age 65 and you need \$20,000 a year from your portfolio -- in addition to Social Security and all that -- to meet your basic income, you need 30 times that, or \$600,000 in an investment portfolio. Short of that, if you don't have that money or if you don't care about leaving money behind, then you need at least 20 times, which will buy you a CPI-indexed life annuity at age 65. [CPI stands for consumer price index, the most common measure of inflation.] Even with these low rates, it will give you that income if you are 20 times the first year's income. So for \$20,000 [in required annual retirement income], you need about \$400,000 -- actually, a little bit more than that, about \$420,000 -- to buy a CPI-indexed life annuity.

Whether you want [an inflation-adjusted annuity] or not depends on what the use of that money is for. If it is part of the basic income that you need, you should have it CPI-indexed. But if it is in excess, like if you are trying to finance your travel needs or things that are not essential, then you can use non-inflation-indexed annuities or variable annuities of income from those sources.

You have basically three financial risks for retirement. The first one is the longevity risk, the second one is the market risk, and the third one is the inflation risk. Longevity risk means you have to plan for a long enough time period. In most cases, I use a 10% survival rate, which brings you to age 95. If you design your plan for age 95, there is about 10% survival rate after that; 7% for men, 14% for women, and that is good enough for me and for most clients.

The market risk means the probability of depletion, the probability of running out of money in your portfolio. The third one is the inflation risk. You want to make sure the loss of purchasing

power throughout your lifetime is no more than 10% for your basic income needs. But if [the income from the annuity is for something like travel], you travel less with time anyway and you can have that income non-indexed [to inflation].

That is the division between indexed or non-indexed. If it is for basic income, I would buy CPI-indexed annuities; if it is not, I would buy non-indexed.

Now, one of the reasons advisors don't promote life annuities is because of the lower commissions they pay. It is important to know for the non-financial planner. We make about 5% if we sell a variable annuity or an investment portfolio or something upfront in most cases, and then there is a trailer fee [which are ongoing commissions paid to the advisor] for the rest of that portfolio's life. If it is a life annuity, you get maybe a 2% onetime commission and nothing after that.

So basically you are losing every time you sell a life annuity. The portfolio is reduced, there is less money to make trailers on, and there is less commission to make on that client. The business value of your financial planning enterprise goes down if you sell life annuities, in general, if you are commission-based. This is why life annuities are not, in my opinion, as strongly promoted as they should be for retirees.

**RB: That brings up a good point. I've written an article for the newsletter about risks for retirees, and I mentioned the three that you mentioned, but I added another one and that is ...**

**JO:** Advisor risk.

**RB: Exactly, getting bad and/or expensive advice. So maybe you could piggyback on what you said and talk about how portfolio costs affect the sustainable withdraw rate and portfolio survivability.**

**JO:** Huge, huge difference. It can move the portfolio life forward and backward by almost the same amount as the benefits of asset allocation in a distribution portfolio. If I can optimize a portfolio -- have a great improvement in the returns -- that is basically going to the advisor. It is not one-to-one, but if you look at the numbers, they appear to be one-to-one.

For most intents and purposes, especially in Canada where we have a lot higher management fees than in the States, I buy ETFs [exchange-traded funds with expense ratios] of 0.2% and just leave it there. If you want to trade it a little bit, it costs nine bucks to trade maybe half of the portfolio. Eventually people will understand that, but many advisors are good salespeople, so the individual investor can lose money on the management costs and advisor fees -- and advisors being ignorant, not understanding the risks of loss of income.

**RB: Let me pick up on something that you have mentioned a couple of times, and that is asset allocation. I can't remember exactly what you said, but it was something along the lines of that asset allocation doesn't contribute as much to portfolio survivability as many people would think. Some people would find that surprising and would say, "Certainly a**

**50-50 split between stocks and bonds is better for a retiree than all stocks." So what is the importance of asset allocation, and how does a retiree choose the optimal allocation?**

**JO:** Let me just expand on what you have said. If you have 50-50 asset allocation or 100% stocks and you are retired, this is not enough information. You need to ask, "What is the withdrawal rate?" If the withdrawal rate is high, it makes no difference whether you are 100% in stocks. I shouldn't say there's no difference; mathematically, there is some difference. But in the number of years [the portfolio will last], it makes very little difference whether we are 50-50 or 100-0. If you have a 3% withdrawal rate, then asset allocation goes more in favor of equities. If you have a 1% withdrawal rate, you have an accumulation portfolio. Asset allocation may be 60-40, 70-30, something like that. So to optimize the asset allocation, you have to throw in the withdrawal rate.

In most cases, if you are withdrawing any money from the portfolio, up to maybe a 5% or 6% withdrawal rate, the optimum asset mix is around 40% equities, 60% fixed income. If you go beyond that, you are creating unnecessary volatility which reduces portfolio life somewhat. But if you withdraw money, you are creating what is called reverse dollar-cost-averaging. That can eat the portfolio very fast. So the optimum is generally -- if you want just one number for the purpose of the article -- for most retirees it is 40% equities, 60% fixed income.

One of the myths of retirement planning is that some advisors will say, "Oh, you don't have enough money in your portfolio for retirement. You can't take out this much money. If you need to take out more money from your portfolio, from the assets you have, you have to take higher risks." What happens is in a virtual portfolio, if you put more equities, more than, say, 50%, you are just creating additional losses likely. The benefit is insignificant; the losses are very significant.

The reason advisors will tell you that you have to go higher in equities is because we [in the financial-services industry] make money with equities. We don't make money if your money sits in a money market or cash or anything like that. There is some biased advice there. It comes under what you call the advisor risk. The advisor will generally do what is best for him first and then next what is best for the client, based on research he reads.

Now the research [about asset allocation] is based mostly on [Brinson's study](#). It is nothing to do with withdrawal portfolios. That study has nothing to do with that type of portfolio. The Brinson study applies only to pension funds, only the best market that happened between 1974 and 1994 - it was really one big bull market. It is nonsense to say asset allocation is 90% of the difference in returns. It is not. You can pick a good advisor, good fund manager, bad fund manager. You can pick a bad company, good company. Asset allocation may be at best 30% of the whole equation.

**RB:** When it comes to retirement portfolio, you do recommend that people keep a certain amount of money out of the market. If I am remembering correctly, it is the first five years' worth of income, along those lines.

**JO:** Along those lines, yes. Now, there are three types of market risks. The first one is the sequence of returns, whether you catch a secular bull wave or not. The second type is inflation waves; whether you catch an inflation wave makes a huge difference. And the third one is cyclical waves, which creates reverse dollar-cost-averaging. If you want to minimize the effect of reverse dollar-cost-averaging, I do recommend keeping three years in money market or cash and another three to four years into short-term bonds. That will keep away the effect of reverse dollar-cost-averaging.

It doesn't eliminate it totally. In some cases it does automatically, but you do the rebalancing -- that sort of forces you to rebalance in bad markets -- that does reduce its effect. It will remove most of the reverse dollar-cost-averaging and it will give some peace of mind to the advisor and the client that there is some cash and you can ride out the storm.

**RB: You just brought up rebalancing, which is a topic you discuss in your book. Could you mention what you consider the optimal frequency of rebalancing?**

**JO:** What I found is rebalancing makes little difference. If you take the 100-year market average, rebalance once a year or once every three months or once every four years, it makes little difference. If you look at the average, it is only a 2% difference. Now, the impact that is most important is in a bad market. Usually if you have a secular bear market and you keep rebalancing, you are just throwing good money after bad.

But if you are looking at [the number of years a portfolio will last in retirement], what I found out is if your withdrawal rate is less than 4.5% or 5%, I hit the longest portfolio life if I rebalance once every four years because I am avoiding throwing good money after bad in bad cycles.

So the rule of thumb is, if the withdrawal rate is 4% or less, rebalance once every four years, at the end of presidential election years because it matches to the [presidential election year cycle](#) really nicely. If the withdrawal rate is more than 4%, then it has almost no effect, it is the same thing because the withdrawal itself creates a bad portfolio or bad market. So if the withdrawal rate is high, there is not much of anything that can help anyway, so rebalancing should be annual if your withdrawal rate is more than 4%.

**RB: In your book you talked a little bit about what is sometimes considered a dirty word, "market timing." You used the terms "technical analysis" as well as "tactical asset allocation." We have actually discussed tactical analysis a little bit in our newsletter. Tell us a little bit about how you feel about it and what indicators you use.**

**JO:** What I do for clients is different than what I do in my personal portfolio; I have to disclose that first.

I use something called the five-month, 12-month moving average. I front-load it, sort of, in my clients' portfolios. If the market looks not that great, if the client says, "Here is some new money I want to invest," I will say, "Look, let's put it in cash; the five-month moving average is below the 12-month moving average." Sometimes I don't say that at all; sometimes I just remark, "It doesn't look so good," and the money sits for a while in cash. I don't, on a wholesale basis, move

portfolios back and forth. Generally, my client portfolios are conservative, not more than 50% in equities. I know I don't make money on the bonds and cash, but that is the way I like it. I just want to make sure people don't lose too much.

In my personal portfolio, I follow [MACD](#) and [RSIs](#), and I may be trading -- I may hold a stock for a week, for three months, maybe a year, something like that, but I play chicken if I see anything wrong in the market. If MACD turns negative for the market or for the sector or for the individual stock, I am out of it; I don't wait around to lose too much. So in 2008, I think I lost something like 4% -- well within my risk tolerance, well within in the recoverable zone, so that was in my own personal portfolio.

As for my clients, many of them lost on the average 7% overall in their portfolio. A couple of them, one or two, lost 15%, and that to me is uncomfortable. It is difficult to recover from a 15% loss. You have to start doing other things, talk to the client, educate them if they have too much money in equities or in the wrong sector. The clients that are aggressive -- because of the way I invest, I am conservative -- and we are in rip-roaring bull markets, they just leave me. They want to make more money, and that means maybe I haven't educated them well enough on the downside, but aggressive clients left me. I have conservative clients to deal with and I feel very comfortable with that.

**RB: Let me go back to something you said at the very beginning in talking about using average returns and average inflation in retirement calculators. People still have to use some sort of tool to figure out whether they have enough and how much they need to save now in order to retire when they want. How do you recommend an investor does that?**

**JO:** Ten years ago, when I first started looking into this, I said, "Gee, that is very simple. I will use a [Monte Carlo simulator](#)." We do that in engineering to simulate plane landings and take-offs and all that. You put in different weights and different factors and distribution curves; everything becomes very simple, and Monte Carlo is a very simple model. So I did that and I realized I am missing quite a bit because markets are not random; they are random about 95% of the time and non-random 5% of the time, and we make or lose money during those 5% of the time.

So what I did was, instead of forecasts of any sort, I sort of invented something called an "aftcast" -- the exact opposite of forecast. When I am looking at an aftcast, I am looking at market history. I cannot enter average growth rates; I cannot enter average inflation, or average anything. What I did was I said, "I have \$1 million; I need \$50,000 a year." What would have happened if I retired at the beginning of 1900? Then 1901, and then 1902, and put all those lines into the same chart -- which does look like a Monte Carlo simulator to the untrained eye -- and that gives me a bird's eye view of what happened in the last century.

Now, that doesn't mean anything, right? History is different than the future always, and so what I did was then I said, "OK, America prospered last century, so this is how the aftcast looks." Then I said, "OK, Japan prospered too, but they lost two world wars and they had atomic weapons dropped on them and they have been in a recession the last 22 years. How does that look?" So I put in different markets with different events, but there is nothing artificial in it.

People don't like the name "Monte Carlo" anymore. They use "Economic Scenario Generator" instead of "Monte Carlo," but all the scenarios in Monte Carlo are artificial as opposed to what I have in my aftcast; all the scenarios are real scenarios. I don't really care what year it is -- 1932 or '49 or '51 -- but what I care about is the range of outcomes. How does that affect the retirement portfolio?

So I put them into my chart and show it to my client. I say, "Look, in your situation, with your assets, with your cash flow requirements, if you look at the last 100 years, this is what would have happened." I can't forecast anything with the client, but this is what would have happened. Let's plan for the worst case and hope for the best so you can have money left for your kids or something. But the highest priority is that you have a life-long income.

How do we make that happen? In many cases, people with a low level of assets, they do need to buy life annuities. There is not enough money there to cover their market risk or inflation risk or longevity risk, so this is what I have done. It is called aftcasting, and I have that solution on my website. Anybody can download the trial edition for free and see for themselves how it would work for them. So I avoid any kind of assumptions; I just look at market history to tell myself and my clients what has happened in the past, based on specific individual financial picture.

**RB: Can the market give us any clues how long our portfolios will last?**

**JO:** Remember we said that if you have a bad sequence of returns at the beginning of retirement, your portfolio life goes down significantly, like by half or so. How do we know we are going to experience a bad sequence of returns or good sequence of returns? I have two indicators.

The first one is a predictive one. You look at the markets and we ask this question: Are markets overvalued or undervalued? If it is overvalued, it means there is a high likelihood of a correction. A correction means a bad sequence of returns for this client or for this retiree. When I looked at the market P/E and the portfolio life, I discovered they are very much correlated. Now, I didn't just invent this thing out of the blue sky. There are many articles that correlate the current P/E ratio of the markets with how the markets perform during the subsequent 10 years.

My criterion is not the growth rates of the portfolio in the next 10 years, but the life of the portfolio, so this is the correlation. On the average, and as a rule of thumb, if the P/E ratio at the beginning of your retirement is less than 12, then you will likely have lifelong income at reasonable withdrawal rates, up to 5%. If you have a P/E ratio over 12, it is likely that you will run out of money before 30 years. So the P/E ratio tells me the probability of bad sequence of returns in the first few years of retirement.

Now sometimes you don't know that. Sometimes it is difficult to see in a sideways market if you have bad luck or good luck. So what I have is the fourth-year test. On the fourth year of retirement -- on the fourth anniversary of having started withdrawals -- you ask yourself a simple question: Do I have more money or less money compared to my starting amount? If after four years you have less money in the portfolio, it is highly likely you will run out of money during the next 20 years. Probably a lot sooner, but my timeframe was the next 20 years.

If you have more money in the portfolio after the first four years of retirement, then it is likely you will have lifelong income. We can take it back to mathematics of loss. If you are unlucky at the beginning of your retirement, there is no way you will turn lucky after a number of years. It doesn't matter how long you wait; it is not going to happen. But if you are lucky at the beginning of your retirement, there is a chance that you will be lucky for quite a while and you will have lifelong income.

So the first one is the P/E ratio, and that is predictive. It tells you if you are likely to experience a correction, a bad sequence of returns in early years of retirement. The second one, the fourth-year checkup, looks back and analyzes if you have experienced a bad sequence of returns. I have all these percentages in my book.

Those two will make up my mind for most clients, and I will tell them, "Look, markets are hot right now. The P/E ratio is not under 12. Do you want basic income? Then buy a life annuity because your portfolio may experience another bad event like 2002 or 2008 or 1974. You want to make sure there is money, income coming in that lasts a lifetime, so you buy a life annuity. The P/E ratio is not favorable."