RIA Advice

In 2004, I was fortunate to discover the unique financial planning body of work created by Canadian-based planner and Chartered Market Technician Jim Otar at an investment conference. His strategy focuses on the survivability of distribution portfolios and the strong likelihood of retirees running out of money before they run out of life, when comparing results to conventional financial planning programs (employed by most brokers and advisors). Jim was dismayed by how financial services industry tools calculated probabilities and generated market randomness which lead to optimistic outcomes too often. **In other words, a majority of the programs gave the green light to retirement while his model flashed RED.** Jim incorporates real, past market cycles into his planning model. **What he calls an ?*aftcast*,? is how his program tests distributions through past market cycles ? from 1900 through the previous year using broad market long-term performance.** •His philosophy was like nothing I?ve heard before in my circle. Mainstream financial authors, industry experts I read would never embrace this technique because it clearly exposes the underbelly of market cycles. Sometimes markets are down. Or flat. For many years. Years that you may be in retirement and living off your investments. **I knew it was my responsibility to learn all I could about his research.** After the tech bubble burst in 2000, I spent hours studying market trends and read as much market history as I could get my hands on. Based on intuition and analysis, I began to aggressively moderate portfolios by reducing equity exposure and increasing to bonds. I firmly believed we were about to enter a stock market cycle that would deliver below-average returns. At least for the next two decades. Throughout the years, my focus on learning about long-term market cycles rarely wavered. I became wary of the ?buy and hold? philosophy I was being force fed by my employer at the time. I sought out authors, academics that resonated with me, like Yale professor Robert Shiller and author of multiple iterations of his book *?Irrational Exuberance.?* **It was in 2007 I came across value manager Vitaliy N. Katsenelson?s seminal book *?Active Value Investing: Making Money in Range-Bound Markets,?* and realized I wasn?t imagining things.** Markets didn?t move perpetually higher regardless of what I was being fed to believe and regurgitate to clients. There are periods when markets go nowhere and wealth can diminish exponentially. Can you imagine? In September 2007 *(the 27th day to be exact)*, I employed Jim?s model to back-test retirement plans for clients at my former firm. **In every case, it appeared our program?s results deviated dramatically from the output generated by Jim?s Retirement Optimizer.** I was concerned enough to generate the data, 4 inches thick, to validate my case. I forwarded all the research to the senior management team in charge of financial planning. I explained how I shouldn?t be advising clients to retire based on the results of our current model and greatly feared they?d run out of money based on the results of Jim?s program. I got nothing. An acknowledgement of the work. That was it. Little response. No change. Thank goodness as a fiduciary today, (and I acted as one then which wasn?t favored by my employer), I have a strong mission to make certain our clients receive real results. Thanks to Jim. **I decided, at this juncture in stock markets, the length of this cycle, to ask him a few questions and share it with Real Investment Advice readers who appreciate the *?real?* story.**

Jim my feeling is your most realistic planner is not wholly embraced by the industry. •Do you believe that?s valid, and why?

Yes. When we ? financial planners- prepare plans for our clients, we are in an inherent conflict of interest. **To attract new clients, or even to retain existing clients, we would like to show them an *?assumed growth rate?* that might work, which is usually the average market growth in recent years.** When we do that, **we dismiss the unfortunate *?bad sequence of returns?* that can happen a few times during retirement, as *?one-time?* events.** However, these one-time events can shorten the portfolio life, or sustainable withdrawal rates significantly. If we show clients scenarios where *?bad events?* happen, the outcome can look really bad and we might lose that account. **That is the essence of the conflict of interest I am talking about. •**In reality, to me, retirement planning means ***?to plan for the worst, and then hope for the best?***. That is a difficult message to convey to clients without scaring them away. ***There is always another advisor looming nearby, who claims he/she can get better returns.*** However, here in Canada, Financial Planning Standards Council (FPSC) has *?Assumption Guidelines?* for the advisory business. *(Inflation rate: 2%, and a balanced portfolio growth rate of 3.3%).* Eventually advisors might start using these for their clients. The assumptions generally coincide with the *?unlucky?* outcomes using my retirement calculator.

> ***Rosso?s note:*** *Sales quotas are tough to reach if you discuss how markets behave in reality.*

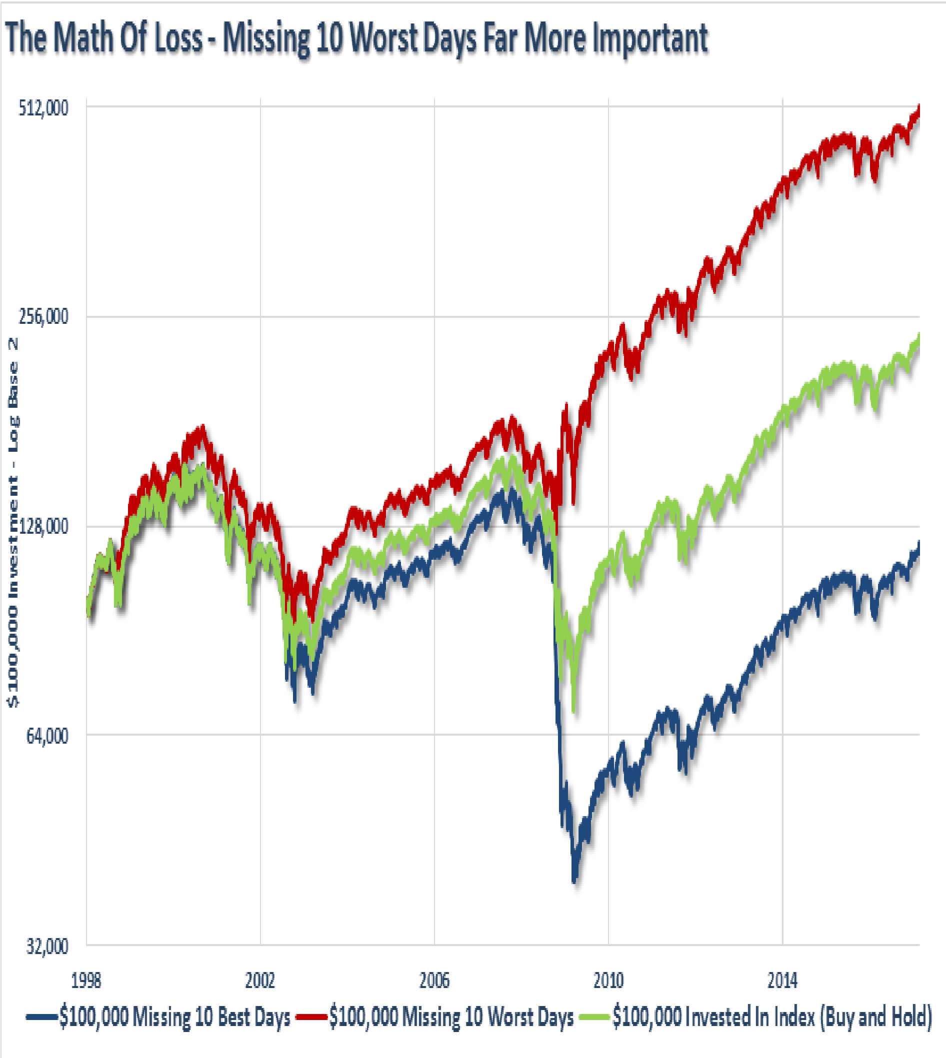
Why do you believe brokers ignore market cycles when it comes to planning, especially for distribution portfolios?

Many brokers are trained and indoctrinated with the accumulation stage in mind. They try to help clients accumulate, not distribute wealth. Every market cycle is allegedly a great opportunities to invest, or to dollar-cost average. Many brokers are unaware that when you switch from accumulation to distribution, almost all of the math turns on its head. Many of the great concepts that are good for accumulation become useless or bad during the distribution stage. ***In short, I would say, we have abundant ignorance about math for distribution portfolios in our business.*** A lot more education is needed, especially those who provide advice to anyone over 60. And I am not talking about the standard, run-of-the-mill, so-called continuing education breakfast meetings, I am talking about serious, comprehensive educational content.

> ***Rosso?s note:*** *You can understand why I love this man, correct?*

A majority of planning tools increase plan success with greater market risk while the Otar Retirement Optimizer does the opposite. How can investors protect themselves whether they?re in the accumulation or the distribution stages? *Contrary to popular belief, the actual market history shows* ***?higher risk does not increase the plan success? during retirement.*** Higher risk might elicit higher returns ONLY IF you are in the accumulation stage (adding money to the portfolio) and you have a 10 year time horizon before you need to start withdrawing funds from your savings. ***The Math of Loss indicates that a bad sequence of returns while you are withdrawing money from your portfolio creates permanent loss for life, never to recover, once your actual withdrawal rate exceeds 4% of the portfolio value in the current year.***

> ***Rosso?s note:*** *The math of loss can wreak havoc on your retirement plans. See Lance?s chart.*



Starting Value	% Draw Down	$ Loss	Ending Value	% Return Back To Breakev en
$100,000	10%	$10,000	$90,000	11.11%
$100,000	15%	$15,000	$85,000	17.65%
$100,000	20%	$20,000	$80,000	25.00%
$100,000	25%	$25,000	$75,000	33.33%
$100,000	30%	$30,000	$70,000	42.86%
$100,000	35%	$35,000	$65,000	53.85%
$100,000	40%	$40,000	$60,000	66.67%
$100,000	45%	$45,000	$55,000	81.82%
$100,000	50%	$50,000	$50,000	100.00%
$100,000	55%	$55,000	$45,000	122.22%
$100,000	60%	$60,000	$40,000	150.00%
$100,000	65%	$65,000	$35,000	185.71%
$100,000	70%	$70,000	$30,000	233.33%
$100,000	75%	$75,000	$25,000	300.00%

So, how do you protect yourself, Jim?

Let?s break it down: **Accumulation Stage (building wealth):**

- Asset allocation (no more than 70% in equities), diversification, stocks that have a great dividend track record, ***save at least 15% of income before anything else (more if possible) regularly,*** *make sure there is protection against catastrophic risk (life, disability insurance),* ***minimize expenses, maximize love*** *(divorce can have the largest negative impact on best-laid retirement plans unless you are filthy rich).*

Distribution Stage: (distributing wealth): Asset allocation ***(no more than 45% in equities).*** An initial withdrawal rate at the start of retirement no more than 3.5% (at age 65), and make sure essential ***(NEEDS)*** expenses are paid by lifelong, guaranteed income such as ***(social security, pensions, rental income, annuities).*** **Both Stages:**

- *If you are using a standard retirement calculator:* ***Do a stress test the plan with following assumptions: 2% inflation, 3.3% annual portfolio growth, and increase income required by 20%****. See if that still works for you.*

- *If you are using my calculator:* ***You can already see the historical worst case scenario*** *(whether you like it or not!)*

What is the greatest benefit of your planning philosophy vs. the other planning systems?

Fewer surprises, lower expectations, **clients trust me more because I give them the worst and the best case outcomes.** Personally, I end up with clients who are conservative in their spending and investments, and those who can afford retirement *(what I call the green zone)*. Those who want or need higher risk, higher return, or those who need annuities and don?t want them, move on to other, more ?promising? advisors.

What advice would you provide to a person retiring today?

Today? I am going put on my technical analyst hat. **Let?s look at the long term trends. I am not talking about 4 or 5 year market cycles, I am talking about 15-20 year trends that we call generational trends.** Since the beginning of 1900, there have been three types of long term trends: **Bullish, Sideways, and Bear. During the last century, we were in long-term bullish trends in 43% of the time. The rest, 57% we were in long-term sideways or bearish trends.** The last sideways trend started in year 2000 with the technology crash. **Current market levels are a lot higher than the previous peak in July 2007. Technically, this indicates that we might be now at the beginnings of a new long-term bullish trend.** However, before we can say that, we need a *?confirmation?*. **That confirmation will come in the next cyclical downturn, whenever it happens. Maybe this year, maybe next.** If the low-point of the next downturn is at a higher point than the January 2009 bottom, then that means we are indeed in the next long-term bullish trend (similar to 1981). On the other hand, if the low of the next downturn is at same levels or lower than the January 2009 lows, then we are still in the sideways trend *(similar to what happened after 1934 which lead into the Second World War).* With that background: **My advice to a person thinking about retiring now: Don?t count on this long, *cyclical* bull market that we have been experiencing last several years to continue forever.**

There will be a correction. Be ready for it.

How? **Stay conservative until next correction, make sure your withdrawals are sustainable**

(3.5% at age 65),* figure out how much of the expenses are essential and make sure essential expenses are paid by lifelong, guaranteed income such as *(social security, pensions, rental income, annuities). If you don?t fit into this molding, try to delay your withdrawals *(or retirement)* until after the correction. **And, good luck!•**

> ***Rosso?s note:*** *And never discount luck in your plan. When you retire, where you are in a cycle at that time, is indeed luck. Will you experience a market return headwind or tailwind?*

Nobody knows. However, you better be monitoring or work with a fiduciary who may help you monitor over multi-year periods so adjustments can be made Appreciate you, Jim. And your ?real investment advice.?