No-Nonsense Income Planning

By Kerry Pechter *Wed, Dec 16, 2015*

Jim Otar has explained his "zone" approach to retirement income planning in hundreds of presentations to thousands of advisors since 1997. He spoke at the IMCA retirement conference in Scottsdale earlier this month.

If you're a registered investment advisor you may feel compelled to steer retirees away from annuities. If you're an insurance agent you may naturally want to sell your clients annuities with ample commissions. Jim Otar, a Toronto-area advisor, prefers to let the his clients' funded status—green, yellow or red—dictate his recommendations.

For almost two decades, Otar has presented his commonsense, no-nonsense "Zone" method of retirement income planning to thousands of advisors at countless events. Although he claims to be "slowing down," he gave yet another of those presentations at the recent IMCA retirement conference in Scottsdale.

A mechanical engineer by training, Otar designs retirement plans the way engineers design bridges: To bear the peak stress, not just the average stress. Bengen's 4% rule does much the same thing, but Otar has added nuance, detail and flexibility to that hoary heuristic. He readily shares his methods, and doesn't give a hoot if you buy into them or not. That's part of what makes him so credible.

"Zone" theory

At 20, Otar emigrated to Canada from Istanbul. He earned BS and MS engineering degrees at the University of Toronto. In the 70s, he started managing his own money. Then he managed money for his relatives, and by the mid-1990s had become a CFP. He's also licensed to sell insurance in Ontario. He documented his methods in the 2009 book, "**Unveiling the Retirement Myth.**"

Otar may be known best for his "Zone" matrix, which serves planning as well as practice management purposes. He categorizes clients as Green, Yellow and Red. Green zoners have enough money to fund their spending needs indefinitely; they and their advisors can afford to focus on estate planning. Red zone clients need (or want) more income than their savings can safely muster. Yellow clients fall in between.

These definitions help guide Otar's annuity recommendations. Clients who start out in the red zone, for instance, can move to yellow or green, for example, by reducing their spending rate or buying guaranteed income. Otar says that red clients buy income annuities "for insurance reasons," as protection from longevity risk. Green clients, on the other hand, buy income annuities for “investment reasons”: to take more risk with their other assets.

The zone strategy also helps frame the annuity discussion. “It gives you a precise guideline about when risk must be exported to create a lifelong income,” Otar said. For instance, an advisor and client can easily see that a $500,000 life annuity that pays out $30,000 a year would benefit someone who needs $30,000 but can only withdraw $20,000 safely from investments. On the other hand, someone who needs only $18,000 a year from $500,000 can take or leave the annuity.

Otar's Safe Withdrawal Rates
(As percentages of risky assets at different retirement ages and for different types of spending)

	Safe withdrawal rate for		
Retirement age	Essential expenses	Basic expenses	Discretionary expenses
60	2.91	3.56	4.27
65	3.18	3.92	4.71
70	3.54	4.44	5.42
75	4.16	5.20	6.72
80	5.37	6.59	8.90
85	7.81	10.05	13.9

Source: Jim Otar. Assumptions = 40% equity (S&P500 Index); 60% fixed income (historical 6-month CD yield plus 1%); Age of death, 96.

Withdrawal rates should vary depending on how the income will be used, Otar believes. Other advisors might divide a retiree’s assets into risky, low-risk and risk-free buckets, or they might segment savings into one-year, five-year and ten-year buckets, and then use a uniform 4% withdrawal rate. Otar uses a different prism in his approach.

The more indispensable the income, the lower the safe withdrawal rate. Otar divides expenss into “essential” (survival), “basic” (lifestyle) and “discretionary” (aspirational). While a retiree could prudently spend 4.7% a year from a discretionary account (in an example Otar uses), he might be prudent spending only 3.9% a year from a lifestyle account and only 3.2% and calculates a different withdrawal rate (based on different risk tolerances) for each spending category. (See chart at right.)

Factors like age, market levels at the time of retirement, sequence risk and inflation also guide Otar’s withdrawal rate recommendations. Someone who retires at age 60 and/or when the equity price-to-earnings ratio is 25, for instance, should spend much more cautiously than someone who retires at age 70 when the P/E ratio is seven. Assuming a 30-year retirement, which Otar does, means that inflation can blow up the best-laid plan. “A bad sequence of inflation, he said, “can cut portfolio life up to 40%.”

Fat tails and discontinuities

As a third insight, Otar (after reading **William Bernstein**) recognized the limits of Monte Carlo simulations. “Many in our business think that Monte Carlo simulations adequately represent the luck factor. But Monte Carlo assumes random fluctuations around an average growth rate. It assumes a Gaussian distribution. Markets don’t work that way. Even if you add ‘fat tails,’ Monte Carlo doesn’t simulate black swans efficiently,” he says. (For more on the non-Gaussian behavior of stocks, see the late Benoit Mandelbrot’s “**The (Mis)Behavior of Markets.**” Basic Books, 2002.)

Instead of using Monte Carlo simulations, Otar created a method he calls “aftcasting” to test the adequacy of a retirement portfolio. In an aftcast, he can see how each portfolio would have behaved starting in every year since 1900. His method incorporates actual performance sequences over 30-year periods, which reflect the interdependencies and feedback effects of various market variables. Aftcasting reveals the true frequency of market “discontinuities,” Otar has written.

If you’re an advisor, you may find yourself agreeing with Otar’s approach but unable to implement it. Your business model may not allow it. Advisors in fee-only practices, for instance, may never be able to recommend an income annuity, no matter how deep in the red zone a client may be, because it would reduce their AUM.

On the other hand, an advisor who relies on commissions, such as an insurance agent or a fledging broker-dealer advisor, might naturally lean toward recommending a large annuity purchase , no matter how deep in the green zone a client may be; it’s the only way he or she is rewarded. Otar makes a point of not putting himself, or his clients, into either of those boxes.