On the Case: Jim Otar Answers Our Income Challenge

By Kerry Pechter *Thu, Aug 3, 2017*

'I would not worry too much about complicated strategies,' Otar wrote after reviewing Andrew and Laura's retirement finances. 'They probably don't need guaranteed income (annuities), a bucket strategy or anything fancy to cover their shortfall.'

Jim Otar, a Toronto-area CFP, has made lasting contributions to the field of retirement income planning. Every retirement income specialist should be familiar with his "aft-casting" technique, his book, his **Retirement Optimizer** software, and his useful classification of new retirees into green, yellow or red "zones."

When RIJ invited Otar to suggest a solution to the case of Andrew and Laura, he replied that the couple is "on the border of the green zone." In Otar-speak, this means that they can relax. With about $1.24 million in savings and $1.8 million worth of real estate, they're unlikely ever to run out of money.

"I would not worry too much about complicated strategies," he wrote after a preliminary review of the information we provided about Andrew and Laura's finances. (They're a real couple, ages 63 and 64, whose names we've changed.) "They probably don't need guaranteed income (annuities), a bucket strategy or anything fancy to cover their shortfall," he said, referring to the difference between the couple's desired annual income and their income from Social Security and pensions.

Keep in mind that, two weeks ago in RIJ, Mark Warshawsky, also a much-published explorer of the retirement income space, recommended that Andrew and Laura put about half of their savings into safe income annuities and invest the rest in equities. Otar's solution takes Andrew and Laura in a very different direction.

Quick take-away

In hoping for a pretax income of about $140,000 per year in retirement starting at ages 65 to 70, Andrew and Laura want more income than their $1.24 million portfolio alone can safely furnish for 25 or 30 years, according to Otar's simulations. So he ran simulations based on a plan where they withdraw $50,000 per year. He determined that if the couple reduces expenses by at least $15,000 a year (requiring $35,000 from savings) or agree to sell their home at age 85 (if their portfolio looks like it might fail), they can both retire by age 70 or earlier.

RetirementOptimizer's assumptions

- Andrew and Laura are in Otar's "Green Zone," which means that their retirement is well-funded. They have enough savings and other assets to retire on, assuming they don't over-spend or retire too early. Green-zoners don't have to transfer their longevity risk to an insurance company via the purchase of a life annuity—though they have the option to do so if it makes them feel more comfortable or opens up other options (like taking on more market risk).

People in the yellow zone (“constrained”) must change their plans if they hope to retire safely. They need to work longer, save more, cut expenses, abandon non-essential goals, or consider longevity-risk-pooling products like annuities or reverse-mortgages. People in the red zone (“underfunded”) have little choice but to consider risk-pooling products or simply bear longevity risk. Anyone, regardless of wealth level, can be in any of the zones; it depends on the ratio between their expenses and their income-generating resources.

- Andrew and Laura want $50,000 a year from their $1.24 million in SEP-IRA and other savings to top up their combined Social Security ($72,000) and pension income ($7,000).
- Otar will project the distribution of possible future market performance scenarios through “aft-casting,” a proprietary technique that he uses instead of Monte Carlo simulations. Rather than based on purely randomized sequences of market returns, his projections are randomized among actual historical sequences of returns starting in 1900. In his experience, this method better accounts for the possibility of “black swan” events; it recognizes that “markets are random in the short term, cyclical in the medium term, and trending in the long term.”

Advice point: Invest in a balanced portfolio

Since Andrew and Laura don’t need annuities as a solution to longevity risk (i.e., living long enough to run out of money), Otar recommends a balanced asset allocation for their retirement savings. His analyses are based on a portfolio of 58% equities, 39% bonds and 3% cash, with annual rebalancing to that allocation. In this preliminary analysis, he doesn’t specific individual investments or make assumptions about investment expenses.

Advice point: Provide more detailed list of expenses

Andrew and Laura need to provide more details about their annual expenses than they have so far, especially if they hope to reduce them in retirement. “I normally ask for three pages of line-items of expenses,” Otar said.

Advice point: Put expenses in a value hierarchy

With a nod toward goal-based income planning principles, Otar recommends that Andrew and Laura categorize their expenses as essential (i.e., food shelter, etc.), basic (i.e., customary or lifestyle-related) or discretionary (“bucket list” items). “If I had more a detailed list of expenses to work with, the outcomes would likely be more favorable,” he said, implying that expense-adjustments can often make or break a retirement income plan.

Advice Point: Clients need to decide how they view their real estate

Adam and Laura need to come to a decision about their homes. That is, are they committed to living in their primary house and second home indefinitely (perhaps as part of the bequest to their two daughters)? Or would they consider including the value of their homes in their retirement income plan, perhaps by planning to downsize or sell one of the homes later in life?

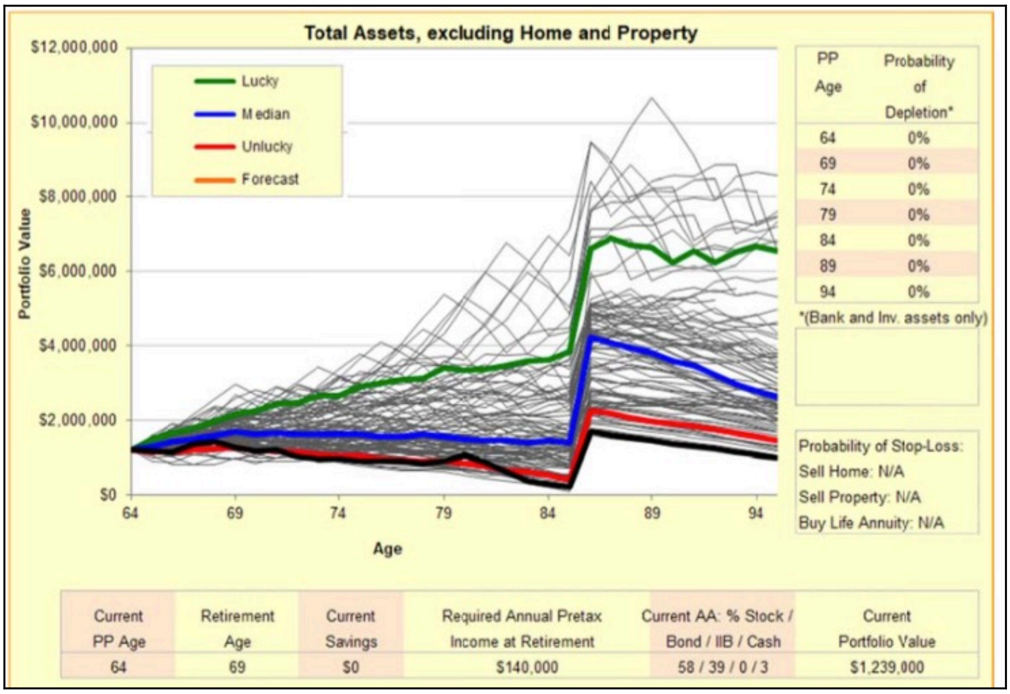
Recommendations

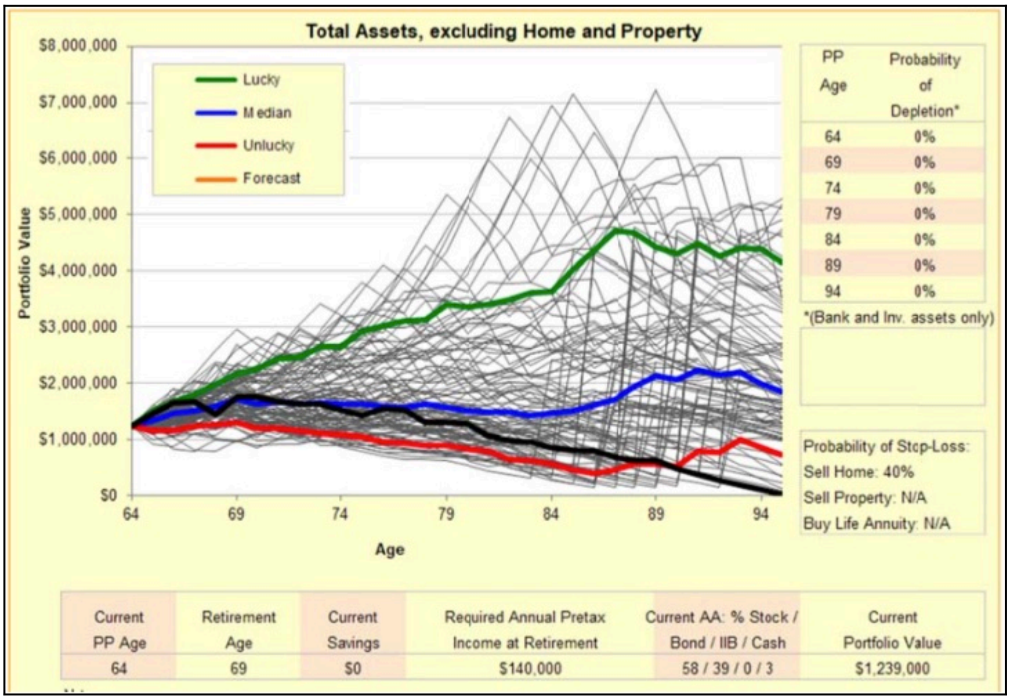
Otar offered three options for Laura and Andrew. They could:

Consider selling their home as a "stop-loss" strategy. They can both stop working by the time Andrew reaches ages 69, Otar said, if they agree that at age 85 they will sell their current home, put the proceeds of the sale into a cash-equivalent account and move into their second home.

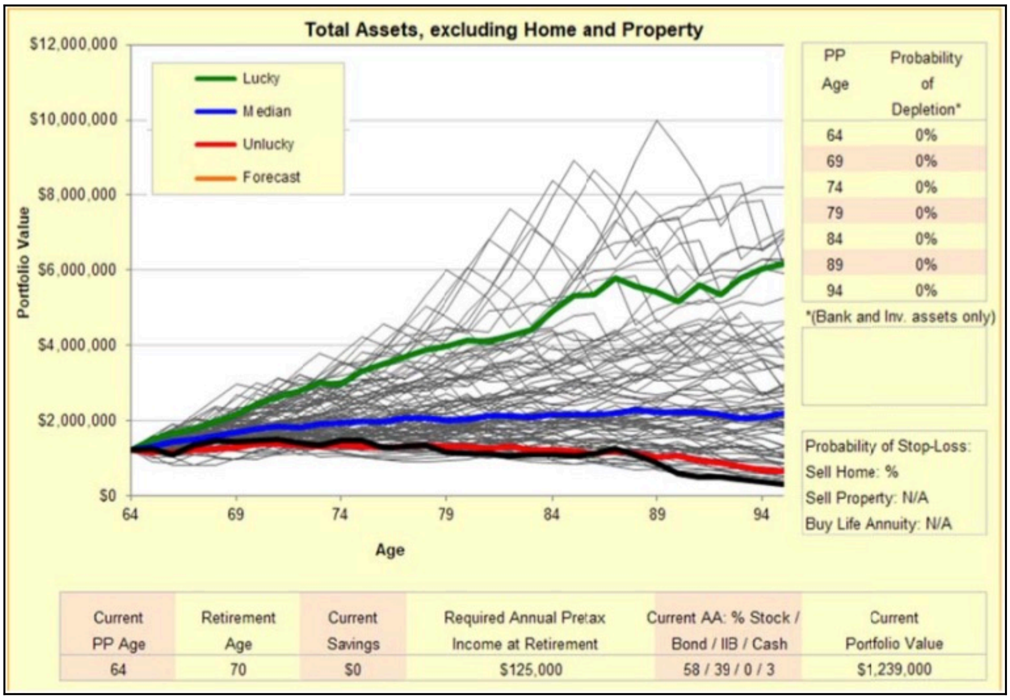
They should execute this strategy in 20 years if their investments are in danger of running out before they reach age 95. Historically, there is a 40% chance of that happening. The proceeds of the sale of the primary home should be put in cash because of the couple's short time horizon.

The first slide below demonstrates the outcomes if the couple intends to sell their house at age 85. The second slide demonstrates the outcomes if the couple holds that option (a 40% likelihood) open.

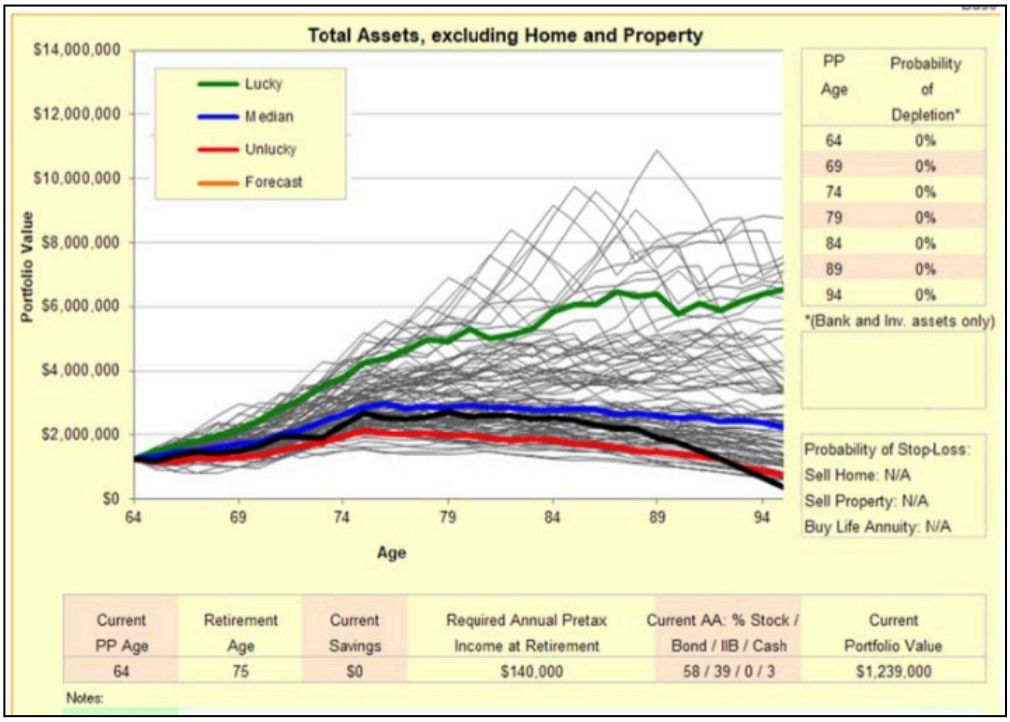


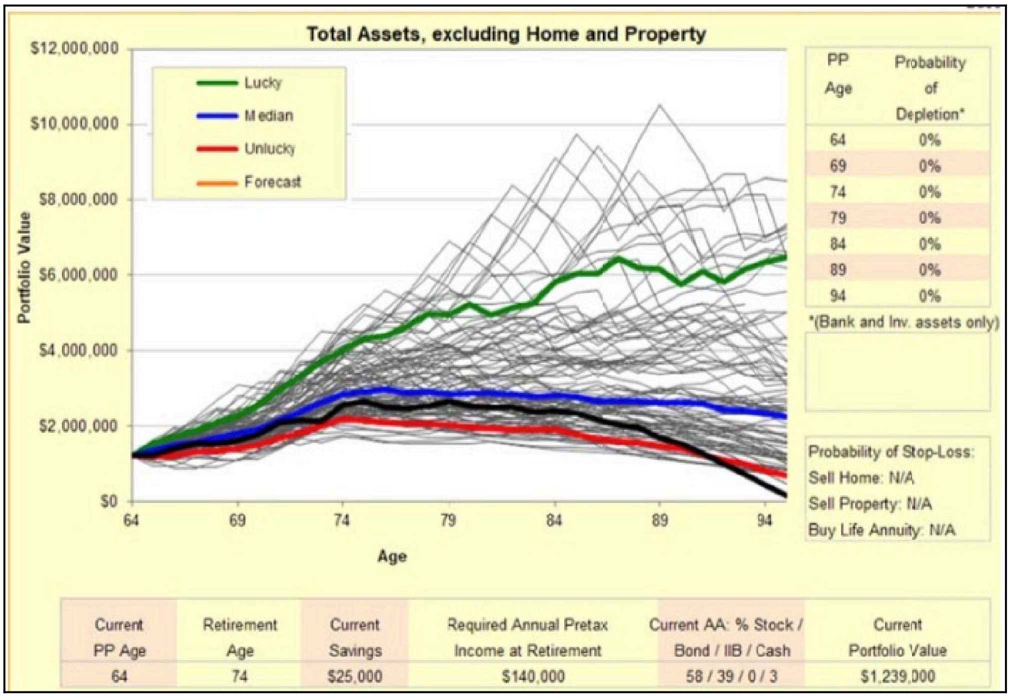


Reduce expenses and/or find other sources of income. If Laura and Andrew reduce expenses by $15,000 per year, or find an equal source of income (e.g., rent part their home, work part-time or as consultants), or any combination the two, then they can retire at age 70 and stay in their primary home for life without tapping into the value of the home.



Keep working until age 74 or 75. If the couple is determined to achieve an income of $140,000 a year (from Social Security, pensions and withdrawals from investments) and to live in their home for life (and leave it as a bequest), one of them will need to work until age 75 (See first slide below). If they save $25,000 a year over the next ten years, they can both be retired by age 74 (See second slide below).





Bottom Line

Given their good health and the significant possibility of a 30-year retirement, Andrew and Laura need to be a bit more realistic about how much they can spend from savings in retirement, even with savings of $1.24 million.

They will have enough money, however, if they draw on their real estate wealth in retirement and are willing to sell their primary home (or selling both homes and moving into a rental) at age 85. The good news: If future returns are as high or higher than the historical median (as calculated by Otar), their portfolio will be worth at least $2 million in 30 years.

Otar didn't include nursing home expenses in his plan. The couple has long-term care insurance to protect their wealth, and Otar said he would have included the insurance in his models if he had seen the specific terms of the contract. His plan leaves the value of the second home untouched, so there's room to absorb uncovered health care costs.

Otar considers this type of work-up to resemble one of the rough drafts of a retirement income plan. "I would use these scenarios as discussion points with the client," he told *RIJ*. "In many situations in my practice, once I discuss multiple options with the client, then a clearer solution develops over time."

Current Asset Allocation		
Classes	Amount	Pct.
Cash and cash investments	$49,500	4%
Fixed income (Index funds, ETFs and actively managed funds. Largest single position: DoubleLine Total Bond, ~$100,000)	$340,000	27%
Equities (Index funds, ETFs and actively managed funds in all sectors and style boxes. Largest single position: Apple, ~$90,000)	$745,000	60%
Alternatives	$60,500	5%
Other	$44,000	4%
Total	$1,239,000	100%

Qualified Accounts		
Andrew's qualified accounts		
Traditional IRA		$52,000
	Equities, $52,000	
SEP-IRA		$415,000
	Equities, $168,000	
Roth IRA		$88,000
	Equities, $95,000	
Laura's qualified accounts		
Traditional IRA		$60,000
	Equities, $65,000	
SEP-IRA		$341,000
	Equities, $103,000	
SEP-IRA		$146,000
	Equities, $146,000	
Roth IRA		$104,000
	Equities, $116,000	
Total qualified		$1,206,000

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