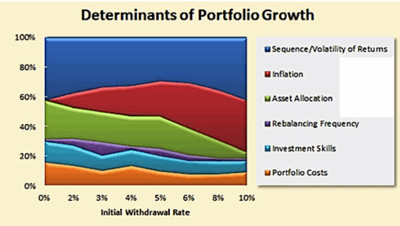
Unconventional Wisdom

By Editor Test *Mon, Apr 15, 2013*

In his latest monograph, which isn't as scary to read as its title suggests, Toronto-area advisor/researcher Jim Otar challenges the intellectual bases for Monte Carlo forecasting, asset allocation strategies and "bucketing."



Advisor/researcher Jim Otar doesn't suffer conventional wisdom about investing gladly, perhaps because he's never been satisfied with conventional investment results. Trained as an engineer, he might also possess an inborn mistrust of easy assumptions.

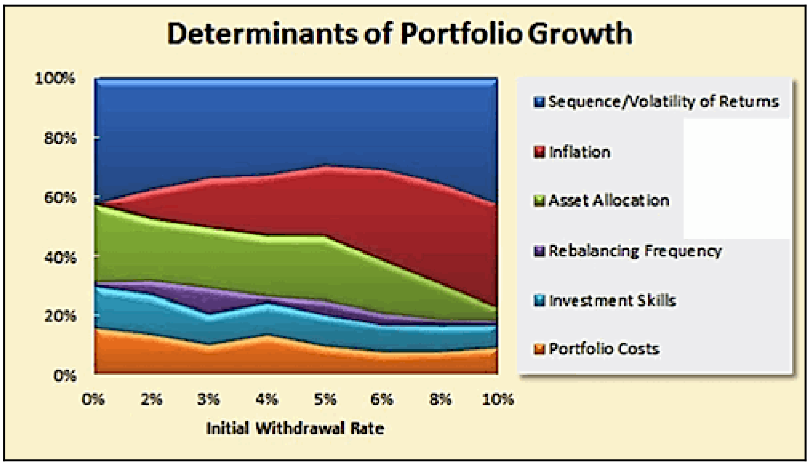
In his latest monograph, which isn't as scary to read as its title ("Distributions of Growth in Distribution Portfolios: A Non-Gaussian Approach") suggests, Otar challenges the intellectual bases for Monte Carlo forecasting, asset allocation strategies and "bucketing." He also takes a close look at the impact of portfolio rebalancing, advisor skill and costs (See "Determinants of Portfolio Growth" below at right).

Take Monte Carlo analyses. Instead of using Monte Carlo to predict the probabilities of financial outcomes, Otar uses his own creation, which he calls "aft-casting." It confines the universe of possible future events, or sequences of events, to the sequences that have actually occurred.

"Aft-casting does not predict anything," he writes. "It only shows what would have happened in history given a specific set of input data. There is no claim or suggestion that past events will be repeated in the future. We are not interested in what happened in a specific year in history, other than to demonstrate it in the examples.

"However, we are very interested in *the frequency, the size and the persistency* of extreme events (that is, market and/or inflation events) that happened in the past in real life, i.e. a non-Gaussian framework. These extremes are our starting point for designing a robust retirement plan for our clients."

Aft-casting helps reveal risks that may go undetected by Gaussian (normal, or bell-curve) distributions. Like Nassim Nicholas Taleb and like the late Benoit Mandelbrot, Otar believes that so-called "Black Swan" events or "discontinuities" in financial trends have been a regular feature of the economic past and will occur regularly in the future.



"If something already happened in the past then it is likely that it will happen again," Otar wrote in an email to *RIJ*. "From the probability point of view, many events definitely happen more often than the Gaussian model suggests. The real world events, where one event can trigger another event, follow less of the Gaussian model and more of the Mandelbrot model, in my humble opinion."

Regarding asset allocation, Otar doesn't think a portfolio's ratio of stocks to bonds has as big an impact on long-term returns as most people assume. (If you read the source of asset allocation theory—Gary Brinson's research—you find out right away that it applies to the differences between the returns experienced by pension fund managers, not to the absolute returns of individual investors.)

"The dynamics of cash flow in a pension fund are entirely different from the dynamics of cash flow in an individual retirement account," Otar writes in his paper. "A pension fund has a continuous inflow of money over time. In an individual retirement account, inflow of money occurs mainly during working years. After retirement, there is usually no more inflow but only outflow."

As for bucketing, Otar is also not the only one who has questioned this retirement income strategy, which generally calls for holding a bucket of cash equivalents for short-term, bonds for medium-term and stocks for long-term needs. He's not necessarily against bucketing: he recommends holding enough cash in retirement for up to five years' living expenses.

But while Otar acknowledges that bucketing can protect against *volatility* risk, he doesn't believe that it can protect against the menace of sequence-of-returns risk, which he regards as Public Enemy Number One for retirees.

Sequence-of-returns risk was long over-looked, because it doesn't matter much during the accumulation stage. But it can be deadly during decumulation. Just as a poker player's presence at the table will probably end earlier if he loses several big hands early in the game, a retiree's savings could run out early if a streak of poor investment returns occurs near the beginning of retirement, when he has begun taking withdrawals.

"The bucketing strategy can help with the volatility of returns by reducing the effects of reverse dollar cost averaging over business cycles. Nothing more," Otar said in his email. "On the other hand, the sequence of returns creates a much more serious damage to a portfolios longevity and bucketing strategy can do nothing against that."

The best way to fully understand Otar's approach to decumulation, including his recommendations on annuities, safe withdrawal rates and the warning signs of retirement trouble, is to read his self-published book, "Unveiling the Retirement Myth," and using his calculator, the "Retirement Optimizer." Both can be found at his website.