

# Live Long and Prosper!

To ensure that your clients enjoy retirement, you need a winning strategy for reducing risk and increasing portfolio longevity. Here it is.

BY JIM OTAR

THIRD IN A THREE-PART SERIES



cost averaging, but it does not handle random fluctuations.

The fourth model is the same market cycle model, but with random volatility superimposed. Now, we have a model that handles all: inflation, market cycles, reverse dollar-cost averaging and random fluctuations. I call this the True Market Model, and it may be downloaded for free at [www.cotar.org](http://www.cotar.org). (These models are shown in Figure 1.)

Now, let's see how these models work in real life. A client walks in with a whole pile of money to invest for his retirement. You do all your homework, interview your client and perform a risk assessment. You're ready to implement an investment plan. The only thing you are not sure of is the direction of the market.

If you follow the straight-line model or the random market model (Monte Carlo simulation), then you would invest all of the money as per the agreed asset mix. You hope and pray that the markets move upward, but of course there is no guarantee that the market won't crash the day after you invest all of your client's money.

However, if you believe in the true market model, here are three methods you can use to reduce the initial risk for this new money.

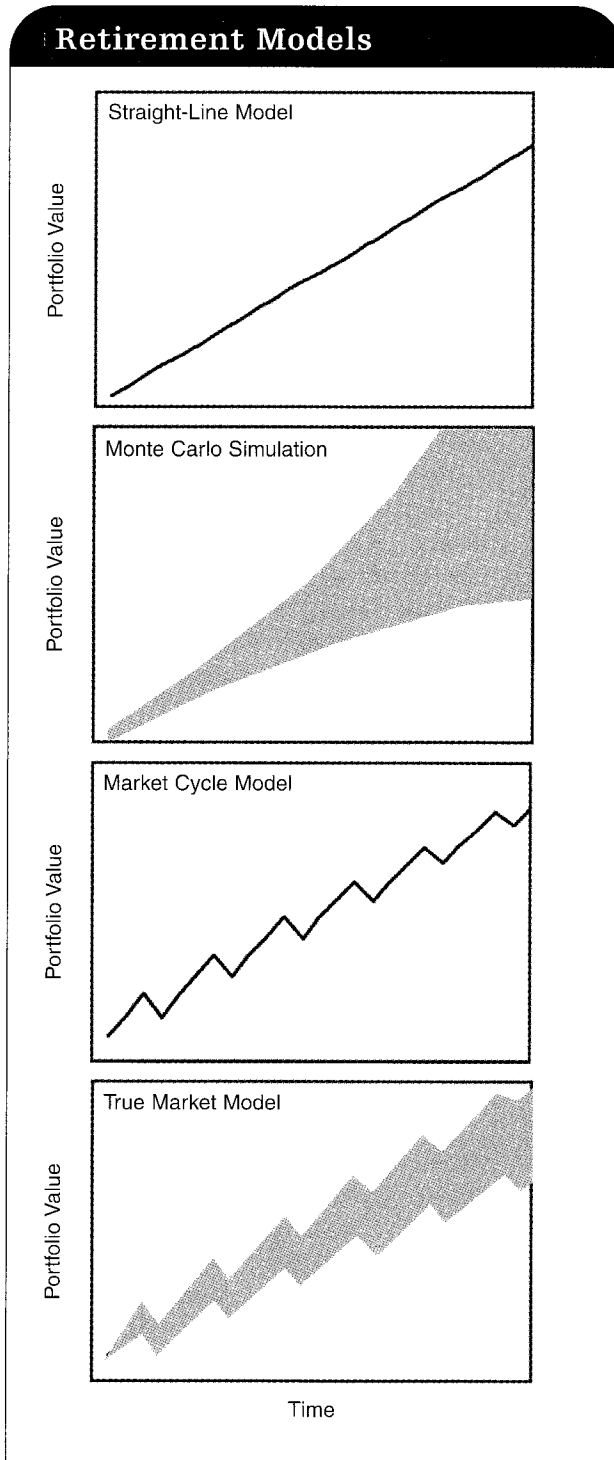
1. Dollar-cost averaging. Invest fully all of the money allocated to fixed-income. As for the equity side, instead

**W**hen it comes to retirement planning, there are four models from which to choose: The straight-line model assumes a constant growth rate. This is the one used in most retirement plans. It handles inflation well, but it does not handle market cycles, reverse dollar-cost averaging and random fluctuations.

The straight-line model with random volatility, also known as the Monte Carlo Simulation, is becoming popular. It handles inflation and random fluctuations reasonably well, but also does not handle market cycles and reverse dollar-cost averaging. To compensate for its inability to handle market cycles, often a volatility band that is wider than the random fluctuations of the market is applied. This "curve-fitting" diminishes its value as a predictive tool.

The market-cycle model that I cited in the first part of this series is the only model that responds well to inflation, market cycles and reverse dollar-

Figure 1



of investing the whole amount at once, invest 25% each year over four years until the final asset mix is achieved. This method reduces the risk of retiring into a bear market during the crucial first four years of retirement. For

are rising. Here is how it works: First, determine the optimum asset mix. Let's say it is 60% fixed-income and 40% equities. On the fixed-income side, invest fully, but on the equity side, invest only 10%. Put the balance of the equity allo-

the study period between 1900 and 1999, it increased the minimum portfolio life by about 8%.

2. Dollar-cost averaging based on the U.S. presidential cycle. Instead of investing 25% of the money allocated to equities each year, why not vary the percentages to synchronize with the U.S. presidential cycle? After crunching numbers for the years between 1900 and 1999, here is the optimum technique: Of the money that is allocated to equities, invest 10% in equities if it happens to be the first, third or fourth year of the presidential term. Invest 70% of the money if it happens to be the second year of the presidential term. This method achieved the longest portfolio life; the minimum portfolio life increased by 12% to 16%.

3. Growth averaging. Both dollar-cost averaging methods are time-based. Growth averaging does not have a specific timetable; money is added to equities only if markets

are in a money market. At the anniversary, if the value of the equities has increased by 15% or more, then transfer 10% of the total portfolio value from the money market into equities. If the value of the equities did not go up by at least 15%, then do nothing. Repeat this process at each anniversary until the asset mix has reached its target.

Growth averaging does not significantly increase the portfolio life. However, it does minimize the devastating effect of retiring just at the beginning of a bear market or a mega-bear market. No money is added until the bear market is over; you then have plenty of money to take advantage of the subsequent market recovery.

The difference between the three methods is worth noting. Dollar-cost averaging is a mechanical system; it does not anticipate any market action, it just reduces the risk during the first four years of your retirement. Dollar-cost averaging based on the presidential election cycle leads the market action; it reduces the risk based on the memory of this cycle. Of the three methods, it adds the most number of years to the minimum portfolio life. (Keep in mind that if this cycle manifests itself differently in the future, the results may not be as favorable.)

Growth averaging lags the market action. The market has to move upward before triggering the next installment of investment into equities. Because it does not count on the memory of cycles, it may be more reliable than the other two methods. It prevents someone from investing heavily in equities in long bear markets by ignoring the market history and the cycle theory. A word of caution: Not too many clients are patient enough to follow through the growth averaging method due to its time span.

Figure 2 shows the difference in the portfolio volatility during the first four years of retirement between 1900

