SEQUENCE OF RETURNS: A RISK WORTH LEARNING ABOUT

So far in our series on preparing for and living in retirement, we explored the idea that true financial safety is preserving your purchasing power in retirement. People often forget two factors that can affect their purchasing power over time – longer life expectancies and the hidden erosion of value from inflation. The truth is that your biggest risk isn't market or economic volatility, but running out of money before you die. Although stocks can be volatile in the short term, in the long run they generally aren't. During your accumulation phase, volatility doesn't matter as much because you don't need to access your savings on a regular basis. However, when you retire your relationship with market volatility can change.

In retirement, most people make systematic withdrawals from their savings to support their lifestyle. The timing of your withdrawals and market volatility can be very important in shaping your portfolio's future outcomes and growth potential.

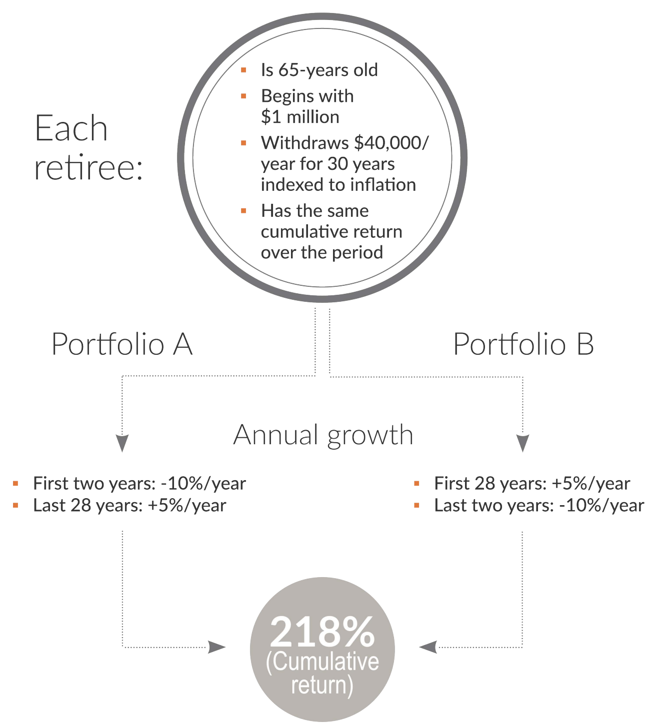
Your expenses don't care about how the markets are doing

Withdrawing while markets are down means that you're cashing out of investments that are priced below their previous levels and locking in losses (or reducing your gains). This is what most people refer to as "selling low". What's even worse is that you need to sell more of your holdings to generate the same amount of money to cover your expenses. This means that your portfolio now has a lower exposure to these investments, leaving you with less ability to take advantage of compounding growth once the markets recover.

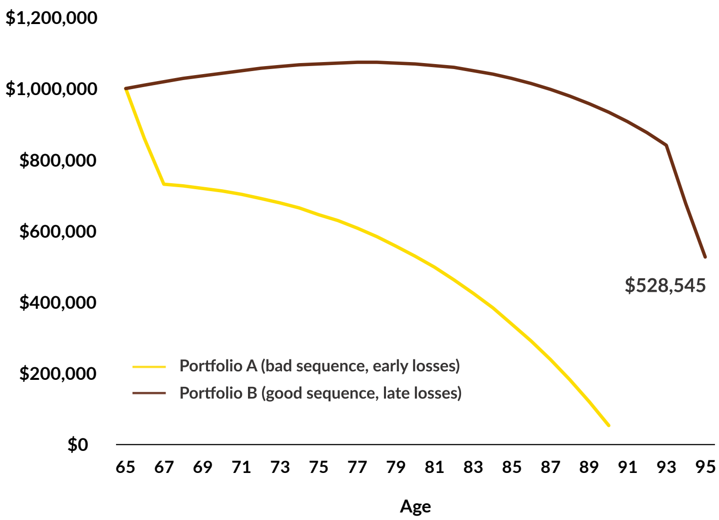
We never advise investors to try and time the market, but depending on the timing of withdrawals, two investors who begin with the same balance in the same investment could have drastically different end results. This is called "sequence-of-returns risk." Let's look at an example.

Imagine the investment portfolios of two retirees, Portfolio A and Portfolio B. Each begins with $1,000,000 at the age of 65. Each retiree plans to withdraw $40,000 per year for 30 years from this portfolio, and each has exactly the same returns over a 30-year period — only in reverse order — or "sequence". Assume an inflation rate of 2.5%.

- Portfolio A experiences returns of -10% annually in the first two years and 5% annually thereafter
- Portfolio B earns 5% per year in all but the last two years, at which time it loses 10% per year.



Retirement portfolio values
Same cumulative return, different order of returns*



Overall, both portfolios have the same cumulative return of 218%. However, portfolio A, which experiences the losses and withdrawals from the portfolio in the early years, runs out of money after 25 years, while portfolio B still has over $500,000 left after 30 years.

This is the main problem with sequence-of-returns risk. If you need to withdraw from your portfolio when markets are declining, especially near the start of your retirement, it could do lasting damage and reduce your portfolio's growth potential for the rest of your life. That may sound bleak, but fortunately you can protect yourself.

The buckets

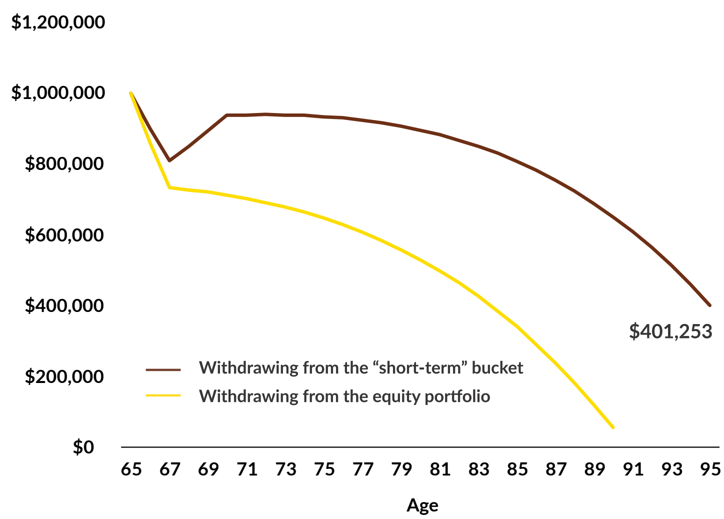
Keeping your specific circumstances in mind, your advisor can develop a plan for managing the sequence-of-returns risk by allocating your savings into different buckets that will cover your short-, mid- and long-term needs.

Each bucket is invested in a different way – a short-term bucket invested in bonds or cash, while long-term money is invested in equities.

This bucket strategy allows you to cover near-term financial obligations without worrying about a market downturn. It gives the equities in your portfolio time to rebound from any potential downturn as it eliminates the need to sell when the market is down just to pay for groceries and other essentials. It aligns your portfolio with your investment horizon and goals to make sure you accomplish all of your goals – not just the ones that occur first.

Let's assume the retiree with the bad sequence of returns (Portfolio A from our example above) was advised to keep a separate bucket with five-years' worth of cash for short-term needs. If they withdrew from that short-term bucket in the first five years to allow the equity portfolio to recover from the market downturn, their outcome would have been drastically better.

Portfolio A: bad sequence (early losses)
Withdrawing from different buckets*



The sequence–of-returns risk is the most damaging in the early years of retirement (the first five to 10 years). If you have a good sequence of returns during this period, then you may never need to worry about this risk ever again.

Investing for the long-term means having to endure occasional market downturn but having a solid plan for those unavoidable periods is the best way to get through them and emerge in strong financial shape.

*The above scenarios are hypothetical portfolios used to illustrate the effect of investing in different vehicles. The results don't represent actual returns of an investible portfolio.

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