Why Sequence Risk Matters

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Investors planning for long-term goals like college or retirement must cross a minefield of risks: inflation, economic downturns, fraud, putting too many eggs in one basket.

At the heart of any strategy are assumptions about investment return over time. Guessing wrong can be a disaster.

But there's another risk that's easy to overlook and impossible to predict: *sequence risk*, also referred to as *sequence-of-returns risk*. That's when an investment with a perfectly respectable return plunges at the wrong time, like the moment the investor will need to withdraw funds.

The stock market collapse of 2009 is a prime example. Even though it recovered fairly quickly, investors who had to withdraw funds during the downturn may still not have healed completely.

In your working years, you have a paycheck coming in and you're contributing to your retirement, NOT making withdrawals. But it's a different story when you're retired, the money inflow stops and you are dependent on those assets for your income and livelihood. During the market crash of 2008 – 2009, retirees who wanted to withdraw a consistent income from their equity portfolio found that they needed to increase the % withdrawn by as much as 80% to maintain the same stable income, resulting in an erosion of their assets and threatening to deplete their savings years sooner than they had planned. Historically, major market declines occur every 5 to 7 years, producing up to 6 drawdowns of equity during retirement.

S&P 500 INDEX PERFORMANCE 2008 - 2012

$25,000 ANNUAL INCOME FROM $500,000 PORTFOLIO DURING MARKET CORRECTION

YEAR	BEGINNING BALANCE	S&P 500 INDEX % CHANGE	GAIN OR LOSS	WITH-DRAWAL	% WITH-DRAWN	ENDING BALANCE
2008	$500,000	-38.49%	-$192,450	$25,000	5%	$282,550
2009	$282,550	23.45%	$72,120	$25,000	9%	$322,960
2010	$339,234	12.78%	$48,522	$25,000	7%	$339,234
2011	$339,234	0%	$0	$25,000	7%	$314,234
2012	$314,234	13.41%	$57,421	$25,000	8%	$337,373

"Sequence-of-returns risk is the risk of receiving lower or negative returns early in a period when withdrawals are being made from an individual's investment account," says Robert R. Johnson, president of the American College of Financial Services in Bryn Mawr, Pennsylvania. "Essentially, it recognizes that the order of returns matters, particularly when one is approaching a seminal point like the retirement date."

Dave Buckwald, a senior partner at Atlas Advisory Group in Cranford, New Jersey, says the issue is particularly important today because many investors, including those in retirement, have heavy emphasis on stocks due to low yields on bonds, which have traditionally been a mainstay in retirement accounts. Also, the steady rise in stocks since the depths of the financial crisis have increased stock allocations in many investors' portfolios.

"While increases in the percentage of equities held has historically increased long-term returns, if you're near retirement it can introduce a dangerous level of volatility within your portfolio," Buckwald says. "So while a stock-focused strategy may make sense for someone still saving for retirement, the game changes when it's time for retirement distribution."

Imagine a portfolio that fell by 50 percent in a crash, owned by an investor who'd planned on taking out a lump sum annually for ordinary expenses, starting at 4 percent of the portfolio's value the first year. If the downturn lasted for three years, the portfolio would fall to 38 percent of its pre-crash level because of those withdrawals. It would have to nearly triple to get back to its original size, and further withdrawals would make the recovery even slower.

Recovering from Losses

\$100,000 investment -50% loss \$ 50,000 \$ 50,000 +50% gain \$ 75,000 (still a 25% loss) A 50% loss = 100% gain just to break even	When retirees cash out their mutual fund shares in a down market, in order to meet living expenses and receive a stable, consistent income, the dilemma they face and the price they pay is using up their investment portfolio sooner than expected.

Potential Portfolio Investment Loss	Gain Required to Get Back to Even
-10%	+11%
-20%	+25%
-30%	+43%
-40%	+67%
-50%	+100%
-60%	+150%

"Since removing assets from the portfolio during a period of poor performance essentially locks in the loss, the probability of a portfolio recovering from the downturn is greatly impaired," says John Knolle, principal at Saranap Wealth Advisors in Walnut Creek, California. "An investor encountering this risk early in their withdrawal period may find that their portfolio can no longer sustain the planned withdrawal rate due to its reduced size."Some investors are more vulnerable to sequence risk. For retirees who have just begun withdrawing retirement distributions, managing this risk is far more important than seeking greater returns. Taking risk off the table right before retirement is a prudent move.

Can Your Nest Egg Last Your Whole Lifetime?

The Wall Street Journal, March, 2013, says: **Say Goodbye to the 4% Rule**
Conventional wisdom says you can take 4% from your savings – consisting of a 60/40 blend of stocks and bonds – the first year of retirement, and then that amount plus a little extra to account for inflation each year, without running out of money for at least 3 decades.
In recent years, the 4% rule has been thrown into doubt because of the risk of a prolonged market rout the first 2 or 3 years of your retirement. If your nest egg loses 25% of it's value just as you start using it, the danger of running out of money increases.

When Your Savings Portfolio Runs the Risk of Running out of Money

1) A big drop in stocks in the early years of retirement
2) A long period of anemic returns
3) Interest rates rising causing bond holdings to drop in value
4) Inflation causing portfolio decay

The risk is even worse for investors who are concentrated in just a few stocks or narrowly focused funds, because an individual holding may be wiped out or permanently damaged even if the broad market rebounds.
Experts warn, however that diversification is no guarantee. In a market meltdown – all equities might collapse together. "With the globalization of financial markets, the empirical evidence shows that global financial markets are becoming much more highly correlated," Johnson says, meaning stocks, bonds and other assets can all drop at the same time. "And, as markets become more highly correlated, the diversification benefits of spreading investments across global markets also decline."

Another strategy is to try to minimize expenses to be able to live on less to avoid big investment withdrawals during a downturn. Most important is to cut expenses that cannot be trimmed on the fly, like the mortgage and other costs of owning an expensive home.

Investors can also look for ways to increase guaranteed income with immediate or deferred annuities. Delaying the start of Social Security benefits offers a guaranteed increase in retirement income, Buckwald says.

Do you want your income Guaranteed?

Everything we have that is of value, we insure. Everybody insures their home, their cars, and their lives. Why? Do you want a fire in your home? No. Do you want your car totaled? No. Do you want to die tomorrow? No. We insure for protection and replacing those things which we value and are important to us. Using an annuity and/or life insurance for a portion of your money can insure your retirement income and give you peace of mind. Even in the worst case scenario, your basic needs will be taken care of.

"You mitigate risk by not putting all your money in the market," says Michelle Morar, owner of Innovative Insurance Solutions in Greensboro, North Carolina. "Take a portion of your money and put it into an annuity to cover basic expenses because that money will last as long as you do."
Annuities pay a monthly income for life in exchange for an upfront premium.

Buckwald also suggests holding some assets in Roth individual retirement accounts and 401(k)s, because tax-free treatment of withdrawals will help investments last longer by avoiding withdrawals to pay taxes. Also, Roth accounts do not face required minimum distributions after age 70½, allowing those investments more time to grow and strengthen the portfolio against a downturn.