November 2022

Understanding (and Managing) Your Sequence of Returns Risk

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The Key Wealth Institute is a team of highly experienced professionals from across wealth management, dedicated to delivering commentary and financial advice. From strategies to manage your wealth to the latest political and industry news, the Key Wealth Institute provides proactive insights to help grow your wealth.

With a well-planned investment strategy, you can navigate today's market downturn with confidence and get the most out of your golden years.

Retirement is just around the corner. Up until now, the order of your annual returns has had no impact on your portfolio value. This changes as you shift to taking distributions from your portfolio. With proper planning, retirees can be ready to enjoy leisure-filled hours working on their golf game, traveling, and dining out, even during times of a down market.

Sequence of returns risk is the dynamic an investor faces if the market suffers major losses in the early retirement years, which shortens the life of a portfolio, even when above-average returns are achieved in later years. It is important to understand whether you can ride out the bad years or must take a distribution to meet living expenses or age requirements – because taking money from principal will also diminish potential future returns.

Understanding the sequence of returns is especially relevant now, with the S&P 500 index, the broad measure of the stock market's performance, dropping this year.

Many clients focus on market risk in their investment plan, but a risk that is often overlooked is the effect of sequence of returns during the initial years of portfolio distribution.

Key has multiple strategies that can mitigate your sequence of returns risk.

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The examples below illustrate how the sequence of returns can affect the value of your portfolio over five years.

This investor retires at 65 with a portfolio of $500,000, split 60%-40% between stocks and bonds, without distributions or contributions during this period. Here is how the portfolio will perform with early market losses and later gains.

	Returns	Year-end value
Year 1	-20%	$400,000
Year 2	- 8%	$368,000
Year 3	5%	$386,400
Year 4	9%	$421,176
Year 5	15%	**$484,352**

The next example shows how the same portfolio performs during early market gains and later losses, assuming no distributions or contributions over five years.

	Returns	Year-end value
Year 1	15%	$575,000
Year 2	9%	$626,750
Year 3	5%	$658,087
Year 4	- 8%	$605,440
Year 5	-20%	**$484,352**

The outcome is the same under both scenarios.
However, the sequence of returns will change if the investor makes contributions or takes withdrawals.

Here is what happens if the retiree takes a $10,000 distribution at the beginning of each year with two years of market losses followed by three years of gains.

	Returns	Year-end value
Year 1	-20%	$392,000
Year 2	- 8%	$351,440
Year 3	5%	$358,512
Year 4	9%	$605,440
Year 5	15%	**$425,359**

Here is what happens to the same portfolio under the reverse scenario when gains occur before losses, with the same $10,000 withdrawal each year.

	Returns	Year-end value
Year 1	15%	$563,500
Year 2	9%	$603,315
Year 3	5%	$622,980
Year 4	- 8%	$563,942
Year 5	-20%	**$443,154**

The outcome is lower when initial returns are negative.

Other risks to consider

Market risk is the risk of investment losses because of events that affect the entire market at the same time, such as natural disasters, war, terrorist attacks or recession. Diversification – although prudent – offers limited protection, depending on the event. A hedging strategy can mitigate this type of risk and certain financial products such as annuities are impervious to market gyrations.

Longevity risk is the risk that you will outlive your retirement savings. This may be the most difficult risk to manage because we cannot predict with any certainty how long we will live, and many people underestimate their life expectancy. Consequently, their savings do not keep up with healthcare costs or inflation, let alone basic living expenses. The Social Security Administration offers guidance on average life expectancies for men and women retiring at 65, but keep in mind that a good percentage of retirees will live longer than the average.

Inflation risk means your savings can lose purchasing power over time. With inflation surging in 2022 to an annualized rate of 8.2% at the end of September, this is a major concern for retirees on a fixed income who are confronted with rising costs of health care, housing and food. So, if your investments are yielding 5% but the inflation rate is flirting with 9%, your money does not go as far. Your financial advisor can show you how inflation has affected the value of the dollar historically so you can plan future distributions and spending. Your advisor can also factor in cost-of-living adjustments to your Social Security payments and modest increases in the value of your investments. If you are still contributing to a retirement plan, use a model that adjusts for inflation at the higher rates we have been experiencing rather than continuing with the lower assumptions from previous years.

Interest rate risk means your stocks and bonds could fluctuate in price and value should the prevailing rates change in either direction. Stocks usually react negatively to an increase in interest rates but rebound when rates fall; bonds are trickier. Generally, as rates rise, bond prices fall. Conversely, certain types of bonds are not as sensitive to interest-rate risk and can offset other investment losses, so know which types are in your portfolio and how they might perform under each scenario.

Key advisors can help you determine solutions that best fit your situation. Key recommends several strategies for mitigating your sequence of returns risk.

Bucket strategy

Place cash or a conservative portfolio (bonds) in one “bucket” and equities in another “bucket” to give time for equities to recover from a potential loss, thereby avoiding the need to sell equities at a loss to raise cash. For example, you could keep a couple of years of cash in reserve in case the market takes a big downturn, riding it out while other investments have time to recover.

Equity glidepath

Spend down fixed-income assets in early years to purposely let equity exposure rise throughout retirement.

Ratcheted spending

Start out spending ultra-conservatively and potentially increase spending every few years after reviewing the portfolio.

The 4% rule

A study by William Bengen found that a withdrawal rate of 4%, with adjustments for inflation, can provide income for at least 30 years.[1] However, some have found that the 4% rule runs the risk of leaving you with too much at the end of your life. Why is that a problem? You may have deprived yourself so much of what you worked for: those leisure-filled hours working on your golf game, traveling and dining out, especially in the early years of retirement when you are likely to be the most active.

Dynamic spending

Dynamic spending can lessen the risk of ending up with too much. Base your annual withdrawal rate on a series of sequential years and adjust spending according to what happened during that time period. You can set markers for yourself. For instance, if you started with a 5% withdrawal rate, you could cut back when withdrawals exceed 6% of your portfolio. Conversely, if the withdrawal rate dips below 4% of your portfolio, you could increase your distributions.

Key advisors can use investment analysis tools to test recommended strategies over 1,000 trials of various economic environments. These types of analyses can provide clients with information as to probabilities of success in meeting their stated retirement goals.

The importance of planning

A well-designed analysis considers market volatility and can help you brave the ever-changing ebbs and flows of the market. If you do not have a plan yet and are just focusing on investing advice, you are missing out on the sense of security that a quality investment analysis can provide. During times of volatility or amid a bear market, it is important to remember to stay focused on the big picture and on achieving your financial goals. This will allow you to endure the inevitable bad times with confidence. Consult your advisor who can help you determine your tolerance for risk and which strategy is best for you as part of your overall financial plan.

For more information, please contact your advisor.

[1]Hopkins, J. (2019, October 30). 4 Ways To Manage Sequence Of Returns Risk. Forbes. Retrieved October 17, 2022, from https://www.forbes.com/sites/jamiehopkins/2019/10/30/4-ways-to-manage-sequence-of-returns-risk/?sh=5af3a29d27eb.

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