Patriot Advisory Group

Sequence Risk

What is Sequence Risk and why am I writing about it? Sequence Risk is also called Sequence of Return Risk. It becomes a danger as an individual takes withdrawals from their retirement accounts. The order or the sequence of annual investment returns is a primary concern for retirees who are living off the income and capital of their investments. I am writing about Sequence Risk because it does not show up in the fancy reports investment advisors produce every day to entice clients to invest with them and that based on long term market returns their retirement is safe. Beyond the obvious retirement mistake of not saving enough, the greatest retirement risk for my clients is Sequence Risk. Often when discussing a client's retirement I am asked "Why does this matter? After all, over the long term, equity returns average out to 7% to 10%....right?" At this point, I go into education mode.

The fact of the matter is, once a client retires, the sequence of annual returns is of CRITICAL importance. The danger for my clients IRA rollover accounts comes when the portfolio receives lower or negative returns while withdrawals are made from their investment accounts. Long-term average returns matter less during the accumulation stage of retirement, it's the returns after you retire that have the greatest impact for most clients.

If a portfolio has a decade of positive returns, it reaches my clients goal for retirement where it can withstand simultaneous losses from withdrawal and Market dips. However, if I am only selling positions for clients and not buying when a market correction occurs it is all downside for my client. The portfolio drops dramatically in value, and you end up selling low without the ability to gain buying low. As an investment advisor I also have to sell more of a position to generate the same amount of income, **WHICH MEANS YOU'RE SELLING OFF YOUR NEST EGG SHARES AT A FASTER RATE**… again in most of the retirement planning reports I review Sequence of Return Risk is not addressed.

Sequence Risk & Safe Withdrawal Rates

How much can you safely withdraw from your nest egg every year? It depends on how long you want your nest egg to last, as well as the returns in the first decade of your retirement.

Many financial experts recommend following the 4% rule when it comes to retirement withdrawal rates. The concept is simple: If you withdraw no more than 4% of your nest egg every year, it should last for at least 30 years. In other words, 4% is a safe rate at which to withdraw money from your portfolio for a 30-year retirement.

Imagine you have $1 million set aside for retirement, and you need to sell off $40,000 for your living expenses in the first year of retirement. In a moderate year with, say, a 7% increase in stock market values, your portfolio rises in value to $1,070,000. You sell off $40,000 to live on, and your portfolio ends the year at $1,030,000.

But what if, instead, the market crashes by 30% in your first year of retirement? Your portfolio drops to $700,000. That means the $40,000 you're withdrawing is a much larger percentage of your portfolio – 5.7% instead of 4%. Now you're down to a nest egg of $660,000.

For you to recover to your initial $1 million nest egg in the next year, the stock market would need to rise by 52% before you take next year's living expenses out of it. By the time the recovery hits, your portfolio will have seen massive losses because you've been selling so many stocks to produce the same amount of income. You don't get to buy the dip; all you can do is sell it for losses.

An Example of Sequence of Return Risk

Say you retired on January 1, 2000 with $1 million invested in an index fund that tracks the S&P 500. Assume you followed the 4% rule and withdrew $40,000 in your first year of retirement, then adjusted the dollar amount of the withdrawal upward by 2% every year to account for inflation. How would your nest egg perform over the next 15 years?

As you probably know, 2000 to 2015 wasn't a stellar stretch for U.S. stocks. The dotcom bubble burst in 2000, causing three terrible years in a row. Then, in 2008, the Great Recession hit. The average annual return on the S&P 500 from 2000 to 2014 was 4.07%, not adjusting for inflation.

But imagine if the three terrible years from 2000 to 2002 took place at the very end of the 15-year period, rather than the beginning. If you swapped the returns from 2000 to 2002 with the returns from 2012 to 2014, how would it affect your retirement portfolio?

Dramatically, as it turns out. Simply by swapping when those returns occurred, your ending portfolio balance in 2014 would be over three times higher – $890,871 instead of a measly $273,438.

Here's how the numbers play out over 15 years in both scenarios:

	Withdrawal	Return (Actual)	Portfolio Balance	Return (Swapped)	Portfolio Balance
2000	$40,000.00	-10.14%	$858,600.00	13.41%	$1,094,100.00
2001	$40,800.00	-13.04%	$705,838.56	29.6%	$1,377,153.60
2002	$41,616.00	-23.37%	$499,268.09	11.39%	$1,492,395.40
2003	$42,448.32	26.38%	$588,526.69	26.38%	$1,843,640.98
2004	$43,297.29	8.99%	$598,137.95	8.99%	$1,966,087.02
2005	$44,163.23	3%	$571,918.86	3%	$1,980,906.40
2006	$45,046.50	13.62%	$604,767.71	13.62%	$2,205,659.35
2007	$45,947.43	3.53%	$580,168.59	3.53%	$2,237,571.70
2008	$46,866.38	-38.49%	$309,995.32	-38.49%	$1,329,463.98
2009	$47,803.70	23.45%	$334,885.52	23.45%	$1,593,419.58
2010	$48,759.78	12.78%	$328,924.11	12.78%	$1,748,298.82
2011	$49,734.97	0%	$279,189.14	0%	$1,698,563.85
2012	$50,729.67	13.41%	$265,898.73	-10.14%	$1,475,599.80
2013	$51,744.27	29.6%	$292,860.49	-13.04%	$1,231,437.32
2014	$52,779.15	11.39%	**$273,438.15**	-23.37%	**$890,871.27**
Average Return:		**4.07%**		**4.07%**	

In both scenarios, the average annual returns are the same. The only difference is the order, i.e., the sequence of those returns.

Ways to Reduce Sequence of Return Risk

Nobody knows when the next big market correction is going to hit. However, while you don't have control over the stock market, you can call your retirement advisor for personal advice on how to mitigate Sequence of Return Risk.

DIVERSIFY YOUR INVESTMENT INCOME, CREATE A BOND LADDER, AND BE FLEXIABLE WITH YOUR SPENDING. My personal favorite: keep cash reserve and always insure part of your retirement savings. The greatest reward for your hard work should be the freedom from worrying about the future. Fixed Income Annuities help you generate income and weather market conditions throughout retirement and eliminate Sequence of Return Risk!

The bottom line… your retirement plan will depend on regular systematic withdrawals at retirement, than meet with your retirement advisor and discuss Sequence of Return Risk and make plans to reduce this risk from breaking your retirement plan.

Patriot Advisory Group
159 Lafayette Road, Ste. 14 * Rye, NH 03870 * Telephone (603) 319-1807, Fax (888) 249-9189
Email: mark@patriotadvisory.com * Website: www.patriotadvisory.com