Sequence Of Returns:

Preparing for Bear Markets

THE RETIREMENT GROUP LLC
PARTNERS IN RETIREMENT

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Introduction

Sequence risk, (sequence-of-returns risk) is defined as the risk of receiving lower or negative returns early in a period when withdrawals are made from an individual's underlying investments. These negative returns combined with withdrawals can seriously impact how long a retiree is able to stretch their money. It is important to understand these risks as it can help with important decisions such as when to retire, or if it is a good idea to keep working for a few years into retirement to decrease the chance of money running out before retirement has ended.

Sequence of return risk is also important in deciding what withdrawal rate is appropriate during retirement. It explores the idea that even if two different portfolios that are experiencing withdrawals average the same returns over the long-term, one of the portfolios could run out of money much sooner if it experiences more negative returns earlier on than its counterpart. One of the reasons is that instead of having compounding returns, by experiencing losses and withdrawing, it is causing the portfolio to experience compounding losses.

From a numbers standpoint, it does not make a difference if the bad returns come first or later on, as long as there are no withdrawals from or deposits out of the portfolio. As an example let's look at a portfolio with $100,000 that has returns of -25% and 50% over two years while a second portfolio of the same size over the same time period experiences returns of 50% and -25%. Despite one portfolio experiencing an early good return followed by a bad one, and vice versa, they both end with the same value of $112,500 and average the same returns (arithmetic average for the returns are 12.5% while the geometric average is around 6.1%). So what kind of impact does the order of returns have when you add withdrawals into the equation?

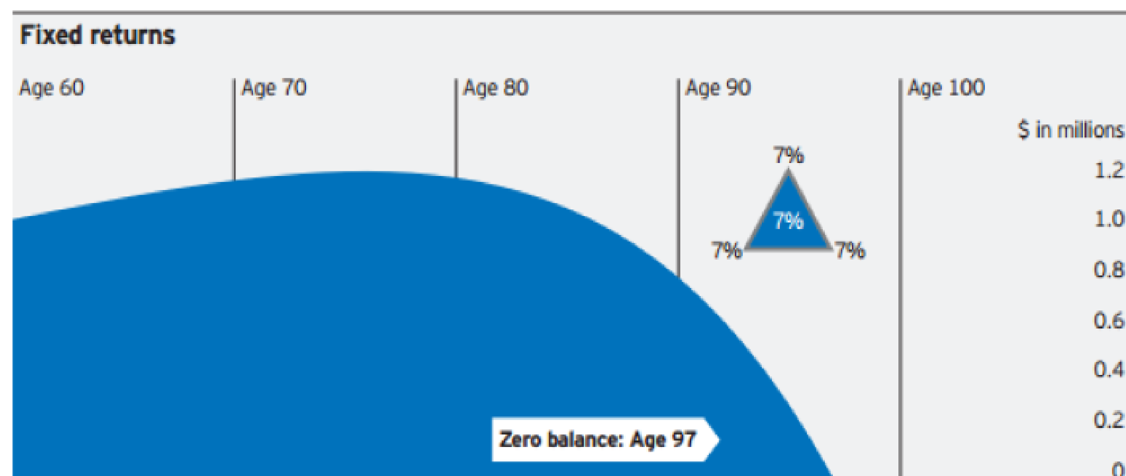
Let's look at an example by INVESCO Ltd. on how sequence of returns affects how long assets are able to last given different sequence of returns (below and continued on next the next page). *For illustrative purposes only, not indicative of any specific investment product.

Meet the retirees

They're newly retired, excited about their new life and fairly confident about their retirement income strategy – and they're hypothetical.[1]*Here are the basics:

Retirement age	60 years old
Investment at retirement	$1,000,000
Annual distributions	$50,000, increased 3.5% annually to help offset inflation
Compounded annual rate of return	7%

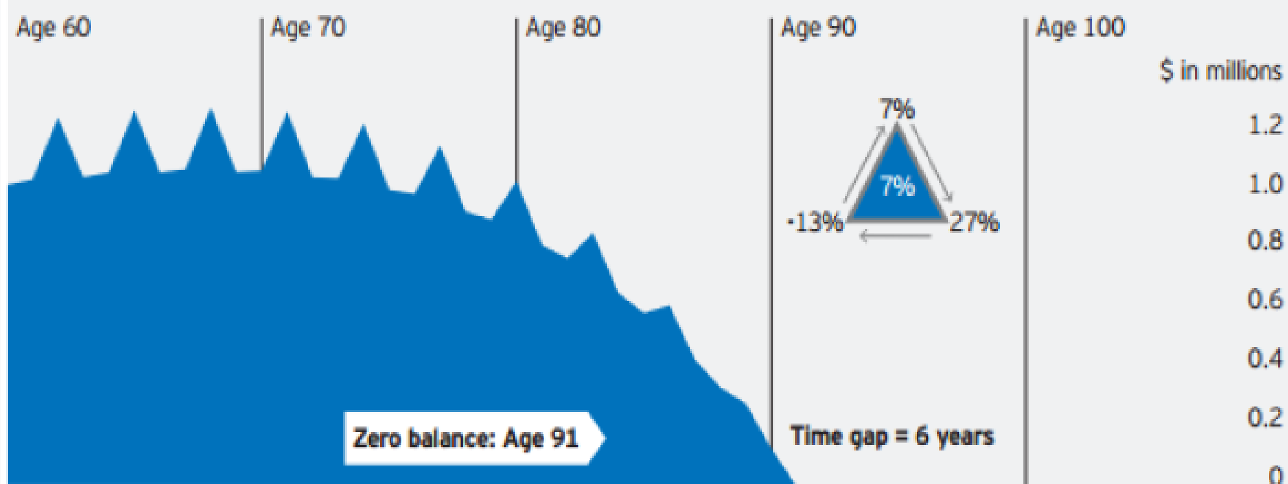
■ **Outcome 1:** With a fixed rate of return of 7% annually, the retirees run out of money at 97.



Source: Invesco

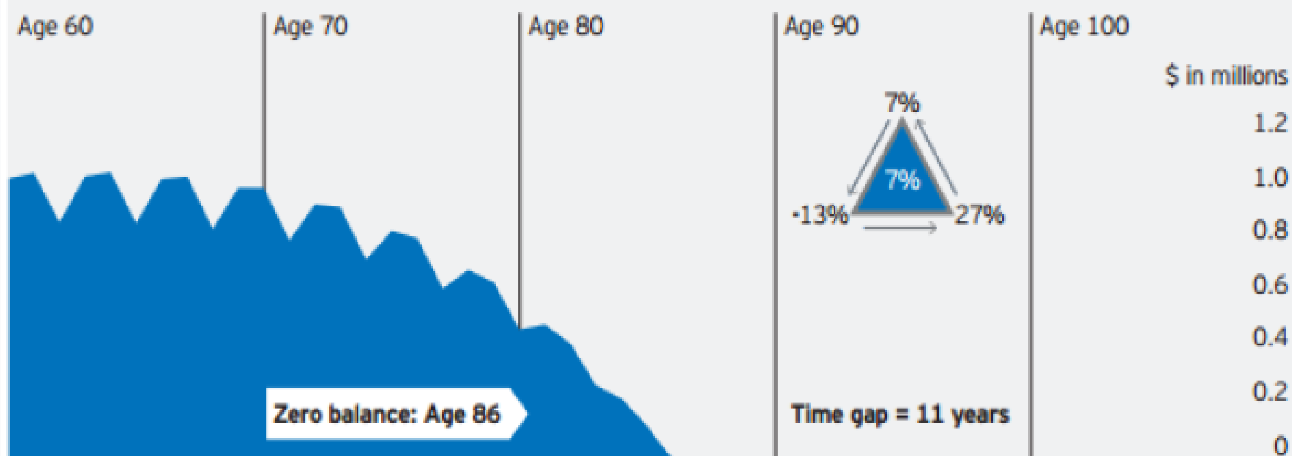
Sequence of Returns: Long Assets

- **Outcome 2:** Rather than earning 7% every year, the investment earns 7% the first year, 27% the second year, -13% the third year and then repeats that sequence in clockwise order. The volatility means they run out of money six years earlier, at age 91.



Source: Invesco

- **Outcome 3:** In this example, the investment earns 7% in the first year, -13% in the second year and 27% in the third year – the negative return happens a little earlier. As a result, the investment runs out of money 11 years earlier than with the 7%/7%/7% sequence of returns – at age 85, even though the average rate of return is still 7%.

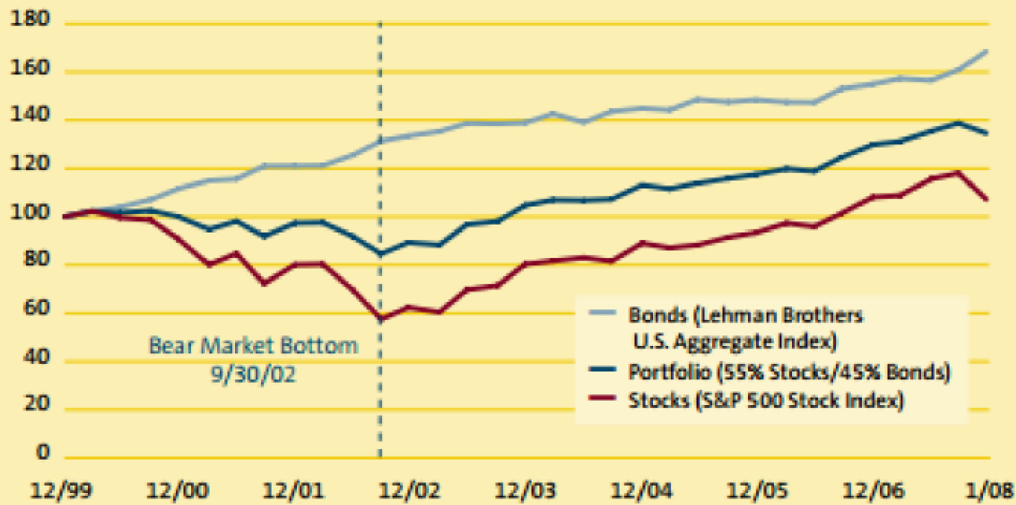


Source: Invesco

Ideally, retirees will have planned to have enough sustainable income for at least a 30-year period, but nothing is guaranteed and even a well thought out plan can be disrupted by a bear market. “In general, if retirees limit their initial withdrawals to 4% of their investment portfolios—and then increase that amount by 3% a year for inflation—they should stand an almost 90% chance of being able to sustain that income stream over 30 years without running out of money, according to a T. Rowe Price internal Monte Carlo program using thousands of potential market simulations”[2]. But what happens if retirees have bad timing and retire in the beginning stages of a bear market?

Performance of Stocks, Bonds, and Retirement Portfolio

Total Return Indexed to 100 as of December 31, 1999, Through January 31, 2008



Annualized Return	Bonds	Stocks	Portfolio
January 1, 2000–September 30, 2002	10.5%	-18.2%	-5.9%
September 30, 2002–January 31, 2008	4.8	12.4	9.1
January 1, 2000–January 31, 2008	6.7	0.9	3.7

Source: T. Rowe Price.

Reality is that bear markets can be detrimental to the long run success of a retiree's portfolio if the proper precautions are not taken. While experiencing negative returns is never desirable, getting through the first five years of retirement are the most critical. Experiencing poor to negative returns decreases the likelihood that money outlives the retiree. "The reason for this is simple: Any money that retirees take out of their portfolios or that they lose in market declines in the first five years of retirement has a higher cost because it's money that won't be invested to earn returns in succeeding years when the markets recover," says James Tzitzouris, Jr., investment analyst on T. Rowe Price's asset allocation team, who conducted the simulation study. "And the less they have invested after a bear market, the less potential they have to benefit from the compounding of any earnings in subsequent years."

For Retirement Success, the First Five Years Are Critical

Odds of Success Plummet if Withdrawal Amount Exceeds Portfolio Returns

This chart shows the probability of not running out of money over a 30-year retirement for an investor who withdraws 4% of his portfolio the first year and increases the annual withdrawal amount by 3% for inflation. If portfolio returns are weak in the first five years and the investor does not cut back on the amount withdrawn, the likelihood of not running out of money can drop sharply from the 89% probability of success at the start of retirement.

Assumptions: Analysis assumes a static portfolio composed of 55% stocks and 45% bonds.

[1]Assumed returns and fees: U.S. large-cap stocks, 10.0% with 1.211% fees; investment-grade bonds, 6.50% with 0.726% fees. The example does not take into account income taxes or required minimum distributions.

*Chances of not running out of money over a 30-year retirement period assuming different annualized rates of return in the first five years of retirement. These projections are based on 10,000 potential scenarios of market outcomes.

Source: T. Rowe Price Associates.

It also might be critical to cut down on withdrawals if retirees have found themselves in a bear market early in retirement. While this is most likely the best option to ensure that they're not going to outlive their money, this requires a lot of discipline and self-control; or it might not even be a realistic option for those retirees who are already living on the bare minimum. Another less drastic method would be to keep withdrawal amounts the same for a few years instead of increasing them year-to-year to account for inflation. Other protective measures include maintaining a really conservative portfolio with most assets in safer alternatives than stocks (like cash or treasuries), or even start with a small 20% allocation in stocks and gradually increase it over five years until the majority of the risk has passed, or work a few years into retirement to have an income stream to supplement cash needs.

Survival to Retirement

The key for survival for retirement assets will always be preparing for the worst case scenario. Cash flow projections and a proper asset allocation will help prepare retirees so their assets and their income streams can survive through a bear market and continue to provide needed income all the way through their 30+ year retirement. On the off chance that retirees are caught in a bear market or a sideways market early in their retirement, they must re-evaluate their retirement plan and make decisions on how to protect and supplement current and future income streams.

The market is highly unpredictable and while some assumptions can be made with some confidence over the long-term, there are no guarantees that they will come true, and it is even more unpredictable in the short term. No one can predict with certainty when a bear market will occur or how long it will last. Therefore, investors should look to control what they can be protecting against risk and being conservative when approaching or entering retirement. "Starting with a conservative initial withdrawal amount and perhaps cutting back when encountering sustained periods of market decline can help mitigate the impact of such fluctuations on the retiree's long-term financial success. It may also enable investors to increase withdrawals later as markets recover".[2]

Sources

[1] http://www.whatsnext.com/content/how-deal-bear-market-near-retirement-age
[2]https://individual.troweprice.com/staticFiles/Retail/Shared/PDFs/retPlanGuide.pdf
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