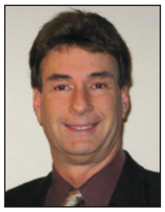
WHAT IS SEQUENCE OF RETURN RISK?



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Sequence of returns risk can affect your long-term income the most in your early-retirement years. That is the timespan just before and right after you retire. You may have heard of that period called the "retirement red zone," or generally the 10-year spread prior to and after retirement.

It's true that average returns for the S&P 500 from 1928 to 2017 have exceeded seven percent. But averages can be deceiving for long-term income planning. What matters just as much is the order of returns, or the actual timing of when a portfolio grows or loses value. As we will see, losses in those early years could make or break your income goals, setting up the risk of running out of retirement money.

This potential hazard is called sequence of returns risk, or just sequence risk. It's a scenario in which having portfolio losses early in the game, when you might start drawing on that portfolio for income, could mean you have to play catch-up for the rest of your retirement.

Sequence Risk in Action

Now, let's take a look at two hypothetical portfolio scenarios. In the first, both portfolios will be tracked over a 21-year period. The order of annual returns for the second portfolio will be reversed so we have negative returns showing up in the early years of our 21-year performance period. Here's an overview of our assumptions.

Hypothetical Retirement Portfolios: Scenario 1

- Names of Portfolios: Portfolio A-1 and Portfolio B-2.
- Starting Portfolio Values: $400,000.
- Number of Years: 21, including one extra for 20 years of performance.
- Portfolio A-1 Performance Range: S&P 500 index calendar-year total returns, 1996-2016, includes reinvested dividends.
- Portfolio B-2 Performance Range: Reversed order of same S&P 500 index calendar-year total returns.

Source: New York University Stern School of Business, data from FRED database of Federal Reserve Bank of St. Louis

Even with the order of returns reversed, both portfolios ended up with the same final value of $691,303. Now, what happens when annual withdrawals are introduced?

Hypothetical Retirement Portfolios: Scenario 2

- Names of Portfolios: Portfolio A-1 and Portfolio B-2.
- Starting Portfolio Values: $400,000.
- Number of Years: 21, including one extra for 20 years of performance.
- Portfolio A-1 Performance Range: S&P 500 index calendar-year total returns, 1996-2016, includes reinvested dividends.
- Portfolio B-2 Performance Range: Reversed order of same S&P 500 index calendar-year total returns.
- Portfolio Withdrawals: Annual withdrawals starting at $16,000 with withdrawal rate of four percent.
- Inflation: Increasing withdrawal amounts by two percent annually to account for inflation

Source: New York University Stern School of Business, data from FRED database of Federal Reserve Bank of St. Louis

Here, the second portfolio ran out of money in year 17, with its account balance shooting below zero.

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What is Sequence of Return Risk?

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How Can Sequence of Returns Risk Affect Your Retirement?

For the unlucky who retired in 2008, during which the S&P 500 fell 37 percent that year alone, their retirement savings were significantly depleted. While the market would recover, they had fallen so deeply into a hole that it would be difficult to reach the retirement account balances they were on track to achieve. And what if they had already started drawing on income from those accounts? Then the path to recovery would have been even harder. Retirees need to be thinking about a more complete model that incorporates these considerations when developing their retirement income strategies.

What's in Your Portfolio?

As inflation continues to rise, compounding growth of assets is important, since you no longer have the sources of income you had while you worked to fuel your household spending needs.

But perhaps just as more important is holding on to what you have. Evaluate your current retirement income plan and ask the tough question: Would my retirement income plan survive the pressure of sequence of returns risk? Consider incorporating financial vehicles that may help reduce the risk during your retirement.

Risk-Averting Action Items

Knowing that the retirement-savings rug could be pulled out from under you, be sure to consider the dynamics of the market. With the date of March 9th having passed, the bull market has entered its ninth year. That makes it the longest-running bullet market on record. Short of having a crystal ball, discuss with your financial professional what this could mean for you. Discuss your asset allocation and consider pursuing a lower level of market risk. Think about diverting part of your retirement nest egg toward strategies that provide guaranteed income, no matter how the market performs.

Consider all the ways you can preserve the savings and assets you have built over the years. And make sure your plan equips you to maximize spendable income after fees, inflation, and taxes. Greg Koch can be reached at: 610.370.7268; email: Greg@KochInsBrokers.com; www.KochInsBrokers.com.