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Sequence of returns risk can ruin your retirement

Not all losses are created equal

As we enter our golden years, we may face a different set of challenges or risks that may not have existed in the earlier stage of our lives when our main aim was to accumulate wealth. These risks can have a dramatic effect on our retirement income sustainability. Today, we will explore one of these unique risks called the “sequence of returns” (SOR) risk.

Many senior citizens are aware of the fact that they are too old to start taking risks, and that they will not have the time to recover if they incur huge unexpected losses. Actually, this is commonly referred to in financial planning circles as SOR risk. It is precisely because of this risk that I am often more cautious about which entry strategy I recommend for new investors entering the market when they are nearing retirement or are already retired.

SOR risk emerges as we approach retirement

SOR risk is a very real risk as we approach retirement, and failure to consider it could derail us from our retirement goals. This is because during the 10 years just before and after retirement, which I dub the "vital risk period", an investor's assets are most sensitive to the damage from negative market returns. We call this sensitivity to poor returns "SOR risk", which primarily arises from two critical factors.

First, the bulk of our funds are at stake just prior to and after retirement. As a result, the effect of dollar cost averaging during this stage is limited. And second, the impact of withdrawals magnifies the damage from initially poor returns after retirement. If portfolio investment returns are sequenced such that negative or poor returns are experienced early on in retirement, the sustainability of our targeted retirement income will be threatened. This is illustrated in the example below.

Assumptions:

The client starts with a \$2 million investment portfolio at the onset of his retirement.

In both scenarios, a simple average annual return of 4 per cent was generated over a 12-year period.

Six per cent of his initial capital is withdrawn annually for his retirement needs.

Scenario A – Negative Returns in Early Years				Scenario B – Negative Returns in Latter Years			
End of Year	Rate of Return	Withdrawal at Beginning of Year	Ending Account Value	End of Year	Rate of Return	Withdrawal at Beginning of Year	Ending Account Value
1	-30%	\$120,000	\$1,316,000	1	25%	\$120,000	\$2,350,000
2	-15%	\$120,000	\$1,016,600	2	20%	\$120,000	\$2,676,000
3	-9%	\$120,000	\$815,906	3	15%	\$120,000	\$2,939,400
4	2%	\$120,000	\$709,824	4	7%	\$120,000	\$3,016,758
5	5%	\$120,000	\$619,315	5	11%	\$120,000	\$3,215,401
6	8%	\$120,000	\$539,260	6	9%	\$120,000	\$3,373,987
7	9%	\$120,000	\$456,994	7	8%	\$120,000	\$3,514,306
8	11%	\$120,000	\$374,063	8	5%	\$120,000	\$3,564,021
9	7%	\$120,000	\$271,847	9	2%	\$120,000	\$3,512,902
10	15%	\$120,000	\$174,624	10	-9%	\$120,000	\$3,087,541
11	20%	\$120,000	\$65,549	11	-15%	\$120,000	\$2,522,409
12	25%	\$120,000	-\$54,450	12	-30%	\$120,000	\$1,681,686

Disclaimer: This example is hypothetical and is for illustrative purposes only. It is not meant to represent performance of any particular investment and is meant to solely demonstrate the impact of “sequence of returns” risk.

How to insure against SOR Risk

To avoid SOR risk, you should first manage your cash flow prudently, and then diversify your assets.

Financial advisors have long preached the importance of asset diversification to manage risk. This established doctrine is based on well-cited studies which have found that asset allocation is

the single most important driver of investment returns, far outweighing the importance of selecting individual securities.

But once it is time to retire and start withdrawing income from our accumulated assets, the role of asset diversification diminishes in importance and cash flow management instead emerges as the core focus. In short, to manage SOR risk during retirement, income planning surpasses asset allocation in importance, when success is measured in terms of lifetime income sustainability.

While a diversified portfolio of stocks and bonds will be important regardless of age and the stage of life that you are in, it is cash flow management that will take centre stage during retirement. The greatest fear of all retirees is for their money to run out before they pass on. They typically do not care what the “internal rate of return” is as long as their retirement income objective is met. Sacrificing one to two percentage points in compound returns to insure their retirement plan from failure seems to be the right thing to do for most.

The retirement income approach that I often advocate is designed to positively increase the chances that retirees can receive a sustainable retirement income throughout their lifetime. It involves a simple strategy of utilising a series of products to ensure stable periodic income payouts for their retirement lifestyle needs, and also to satisfy their legacy requirements.

Cash flow instruments to manage SOR Risk

I usually suggest that my clients use a combination of three categories of cash flow instruments for their retirement portfolio. These are:

- 1) Short-duration endowment plans involving deferring maturities and payout sequences,
- 2) Almost-fully financed rental properties, high-dividend blue-chip stocks or lightly-leveraged REITs, and
- 3) Fixed deposits or plain vanilla saving accounts.

It is best for individuals and their advisors to determine the exact allocation and investment vehicle mix that will both balance their SOR risks and serve their legacy planning goals.

Conclusion

Just as we have no control over the precise length of our golden years or the rate of inflation during our retirement, we also cannot control the timing of an inevitable bear market. Thus rather than trying predict when a bear market will strike, I believe we should just insure ourselves against adverse outcomes by using appropriate cash flow strategy. In short, our objective should be to simply hedge against SOR risk while keeping in mind our retirement income goals.