Retirement isn't easy: 'Sequence of returns'

floridatoday.com /story/money/business/2017/11/06/retirement-easy-sequence-returns/107377044/

Steven Podnos Published 3:02 a.m. ET Nov. 6, 2017

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No one should say that retirement is easy! Your investments in retirement should not necessarily look the same as when you were working, for when retirement actually begins, your portfolio is then subject to an important new risk called the "sequence of returns."

If your investments (particularly stocks) go down in price while you are accumulating funds for retirement, all the better. You might not like it, but it is always best to buy things at a discount. But once you are depending on a portfolio to sustain you financially in retirement, a prolonged bear market can cause irreparable harm.

Think about it. Assuming you save regularly, a bear market before you retire allows you to buy stocks at a cheaper price. You should both want and enjoy lower prices as you accumulate wealth. Since markets are cyclical, having a wonderful bull market just prior to retirement can be a bad thing-just ask someone who retired in 1999 with a large stock portfolio.

Conversely, a prolonged bear market (or even a moderate one) while you are taking regular withdrawals from your portfolio can cause you to sell your holdings at a lower price. You must sell more of any given holding to make the same withdrawal amount as well, and once assets are sold, you can't make the losses up. The difference in outcomes for two investors having the same "average return" but in different timing can be stunningly dissimilar. For example, the investor with a bear market early in retirement will potentially run out of money much quicker than if the bear market of the same magnitude is later on.

There are important ways to mitigate against the risk of a bad sequence of returns. Starting with a “safe withdrawal rate” is the first approach. This method takes the input of remaining life expectancy and portfolio allocation to help calculate an initial rate of withdrawal that is likely to last for a lifetime. Another way is to have a “bucket” of assets that should not drop in price when the stock market goes down, and that is large enough to sustain your withdrawal needs for several years. The strategy is to take most if not all your withdrawals from that bucket when the stock market is depressed, and to replenish the bucket when stocks recover. This method is of course dependent on how long the market stays down.

This worked well after 2008, but not as well in 2000-2002 when many stocks did not recover (so portfolio makeup also counts). Another method to reduce the sequence of returns risk is to start your retirement years with a relatively low allocation to stocks and then gradually increase it. This method seems to be in opposition to conventional advice (“ the percentage of stocks in your portfolio should be equal to 100 minus your age”), but in fact may make good sense when reviewed by academic studies.

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