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# Focus On: Retirement Planning



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## Sequence Risk

One of the basic rules of investing is that a prudent long-term strategy is self-correcting. By investing a steady amount of money month after month and year after year, the average return generated should be solid. The noted scientist Albert Einstein is quoted as saying, “Compound interest is the world’s eighth wonder.” Charlie Munger of Berkshire Hathaway fame adds color to that simple strategy: “the first directive to compounding is never to interrupt it.”

Retirement is a long-term game. To plan for the long term, retirees must estimate their retirement portfolio’s average growth rate (AGR) over the years and even decades. Compounding is a powerful investing concept that involves earning returns on the initial investment within a retirement portfolio and on the returns generated within the portfolio over time. The compounding effect can result in significant growth over the long term. Annual market returns become critically important once a retiree starts taking distributions from their retirement portfolio. Significant market losses in the early years of retirement can shorten the longevity of a portfolio, even if better-than-average market returns occur in later years. This is the risk posed by the sequence of returns.

A retirement portfolio is usually not just a large sum of cash sitting within a savings account waiting to be drawn down until a retiree dies or the portfolio runs out of money. Retirement funds are often a mix of investments initially positioned to provide both income and growth opportunities. The goal is for the growth allocation within the portfolio to replenish at least a portion of what distributions are taken out, making the portfolio withdrawals more sustainable over the length of the retiree’s retirement.

However, suppose the financial markets are experiencing a decline in the early years of a retiree’s retirement. In that case, it can change a portfolio’s ability to perform over a retiree’s life. When distributions are taken from a retirement portfolio as it is losing value, the retiree will have to sell off more investments to raise the funds needed for an already established planned distribution. When that happens, not only would that distribution help to drain a retirement portfolio more quickly, but it also leaves the portfolio with fewer assets that can generate growth and returns during potential future market corrections.

But at some point, in time, retirement does kick in. Contributions are no longer being added to a retirement portfolio, as planned withdrawals continue to be distributed on a regular basis. If this happens during a bull market, new gains may offset portfolio withdrawals, at least in part. When a bear market is in effect for months or even years, each withdrawal takes a bite out of the portfolio balance and is not offset by new contributions. These withdrawals are being taken out in what is now a steadily shrinking portfolio.

The growth in company-sponsored defined-contribution retirement plans over the more traditional defined-benefit retirement plans has changed retirees’ financial security regarding their retirement, given the economic risks within the financial markets. Bear markets create a unique challenge for new retirees, who must manage the dual effect of portfolio withdrawals and poor returns when financial markets are declining in the first years of retirement, as withdrawal strategies that would be prudent under most other market conditions can move sequence -of-return risk into the longevity risk of outliving a retirement portfolio.

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To help explain sequence risk, we start with two portfolios; one benchmarked to begin to take withdrawals in 1973, while the other would start to take withdrawals beginning in 1974. Each portfolio would be invested into a balanced portfolio, evenly split between stocks and bonds, set to rebalance monthly, and designed to provide a preset retirement distribution for 35 years. Each portfolio's starting balance would be \$500,000, with the initial withdrawal rate set at \$25,000 per year (5%) and adjusted for inflation. During the period of time under review, the long-term performance of each portfolio was quite similar, with the performance results of 5.23% for the 1973 portfolio and 5.10% for the 1974 portfolio. However, each portfolio has very different outcomes when factoring in the planned withdrawal of 5% and indexing for inflation (Vanguard Research, 2020).

The 1973 portfolio, whose first withdrawal happened during a severe stock market decline, would have run out of money after 23 years, and by postponing the first withdrawal by just one year, which was at the tail-end of the previous bear market, would have maintained a balance of nearly \$300,00 for most of the 35 years and had a remaining balance of a quarter of the pre-retirement amount. The one-year difference in return, incorporating a severe bear market decline in 1973, considerably lessened the longevity of the 1973 portfolio.

If A Portfolio Declines	Required Rate of Return to Break Even
10%	11%
20%	25%
30%	43%
40%	66%
50%	100%
60%	150%
70%	233%
80%	400%

For further information on our Retirement Planning services, please contact JCG Private Wealth Management at [Jeffrey.Goodrich@LPL.com](mailto:Jeffrey.Goodrich@LPL.com).

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