RAYMOND JAMES

Portfolio Insights: Investing for retirement

Safeguarding a portfolio when approaching retirement

Many components go into developing a successful retirement plan. Ideally, the process starts 40-50 years before the milestone date with some goals being set and saving habits developed. As the years inevitably speed by, good advice, sound investments and effective financial planning will hopefully result in an investment portfolio that provides income for years to come.

Of course, there will always be setbacks along the way, including unexpected expenses and market declines. If investors remain disciplined and follow wise counsel, many of these obstacles can be overcome with time and additional savings.

However, as retirement nears – that next phase where growing incomes and savings rates are replaced with net withdrawals – time and excess cash flows may not be there to allow for full recoveries. This concept is typically referred to as "sequence risk."

OBJECTIVE

The objective of this paper is to illustrate the profound impact of sequence risk on purchasing power during retirement.

KEY TAKEAWAYS

Sequence risk is the potential shortening of an investment portfolio's lifespan due to encountering low/negative returns sooner, rather than later, during the retirement years.

The compounding effect can have a significant impact on asset value by creating an asset cushion for inevitable market corrections or unexpected life events. The impact of sequence risk from declining markets, however, disrupts the compounding effect.

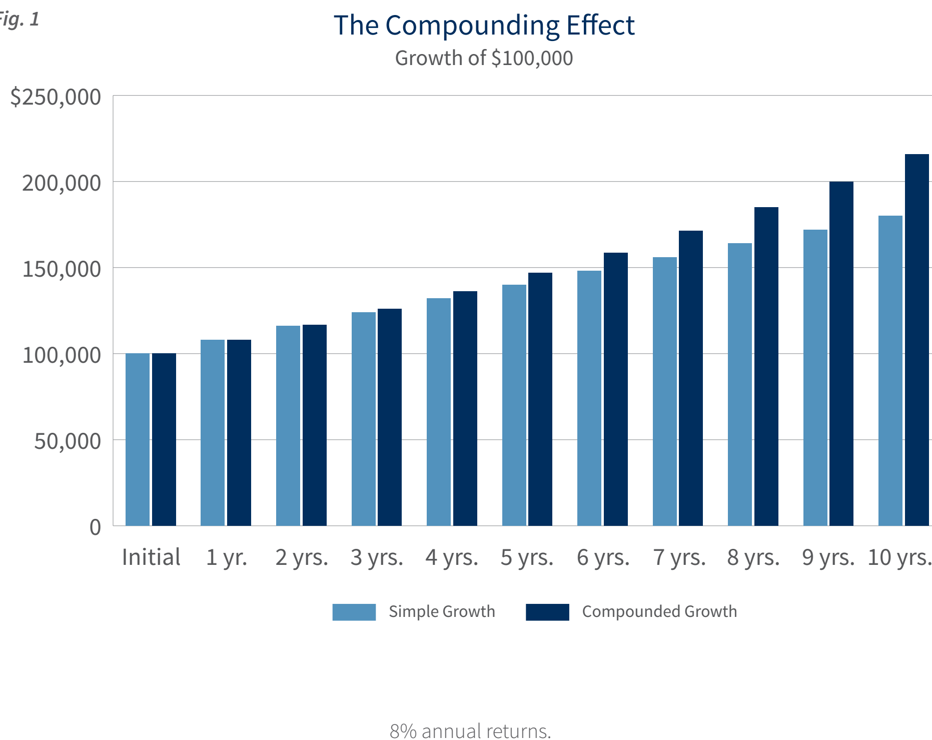
While even the most comprehensive financial planning cannot fend off or predict the timing of a market decline, there are investment strategies that can lessen the impact.

SEQUENCE RISK DEFINED

Simply put, sequence risk is the potential shortening of an investment portfolio's lifespan due to encountering low/negative returns sooner, rather than later, during the retirement years.

During retirement, longer initial periods without market declines provide more opportunities for the "compounding effect" to sustain or grow investment assets. If investments are left to appreciate over time, compounding allows not only for the dollars invested to grow, but also for every dollar of growth to appreciate at the same rate. This can have a significant impact by creating an asset cushion for future market corrections or unexpected life events.

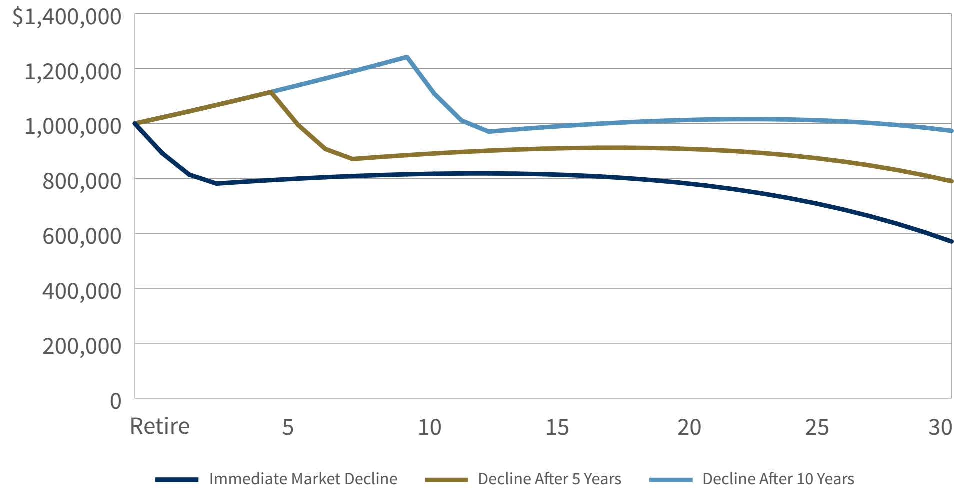
Fig. 1



8% annual returns.

The impact of sequence risk from declining markets, however, disrupts the compounding effect. Figure 2 (on the following page) illustrates how this works. While each of the three hypothetical scenarios experiences identical long-term returns and three-year declines, the "Immediate Market Decline" scenario (represented by the dark blue line) produces the lowest future values and the shortest lifespan.

Fig. 2



	Retirement	5 Yrs	10 Yrs	15 Yrs	20 Yrs	25 Yrs	30 Yrs
Immediate Market Decline	$1,000,000	$793,925	$815,105	$815,459	$784,871	$709,501	$570,504
Decline After 5 Years	$1,000,000	$1,114,566	$884,807	$908,297	$908,524	$874,198	$789,868
Decline After 10 Years	$1,000,000	$1,114,566	$1,242,176	$986,011	$1,012,034	$1,012,065	$973,497

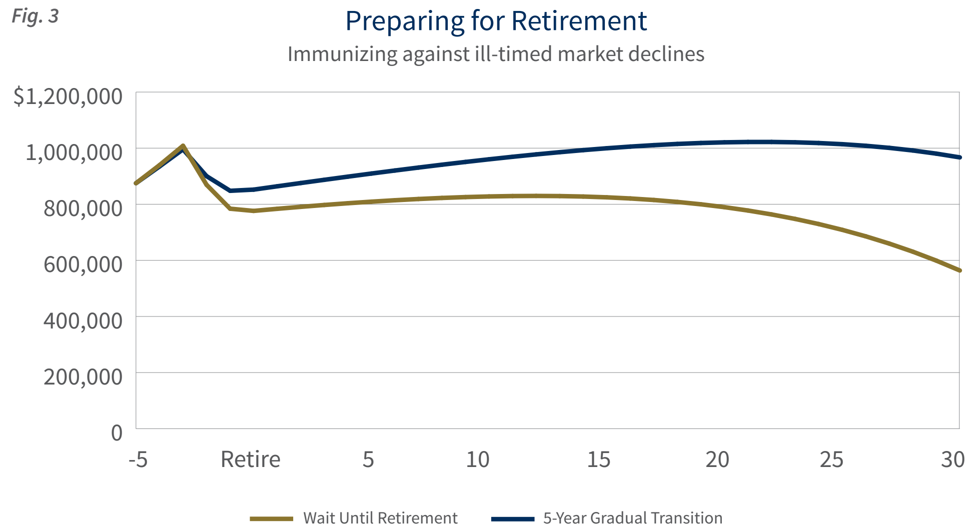
For illustration purposes only. These hypothetical scenarios utilize static performance and inflation rates solely to highlight differences due to the timing of a market decline. Assumptions: 50% equity, 50% fixed income allocation; years 1-30 avg. annualized returns are 6.60% (equity) and 3.00% (fixed income); three-year equity decline consists of -18%, -13%, -2% annual returns; annual withdrawals begin in year 1 of retirement at $35,000 and are subject to a 2.2% inflation rate.

PLANNING FOR SEQUENCE RISK

While even the most comprehensive financial planning cannot fend off or predict the timing of a market decline, there are investment strategies that can lessen the impact. One of the most effective strategies is to start scaling back the portfolio's equity exposure – typically the most volatile component – five to 10 years in advance rather than doing so at retirement. While this may result in slightly lower returns if the equity markets outperform fixed income, the benefits can be much greater if there is a significant stock market selloff just before or during the early years of retirement. This process of gradually scaling back the portfolio's volatility via equity exposure, often referred to as a "glide path," is a popular practice with money managers who have created target-date mutual funds that systematically de-risk portfolios as the retirement phase approaches.

The effects of this strategy can be quite beneficial. Figure 3 illustrates a scenario where a three-year equity bear market occurs two years before retirement. The first portfolio maintains a growth-oriented 80% equity exposure up to retirement, while the second portfolio reduces the equity weighting by 5% per year, starting five years before retirement.

Fig. 3



	Before Retirement					During Retirement				
Year	-5	-4	-3	-2	-1	1	5	10	20	30
Equity	80%	80%	80%	80%	80%	50%	50%	50%	50%	50%
Fixed Income	20%	20%	20%	20%	20%	50%	50%	50%	50%	50%
Equity	70%	65%	60%	55%	50%	50%	50%	50%	50%	50%
Fixed Income	30%	35%	40%	45%	50%	50%	50%	50%	50%	50%

For illustration purposes only. These hypothetical scenarios utilize static performance and inflation rates solely to highlight differences due to the timing of a market decline. Assumptions: 50% equity, 50% fixed income allocation; years -5 to 30: avg. annualized returns are 6.60% (equity) and 3.00% (fixed income); three-year equity decline consists of -18%, -13%, -2% annual returns; annual withdrawals begin in year 1 of retirement at $35,000 and are subject to a 2.2% inflation rate.

CONCLUSION

Sequence risk is just one of many risks investors face in the financial markets today. Raymond James is an industry leader in implementing successful strategies that identify and plan for a variety of these unknowns. Contact your financial advisor to help you set a course for a life well planned.

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