Financial Insights

from Quinn+Cardy Wealth Management
of BMO Nesbitt Burns

Why Sequencing of Returns Matters

The sequence of returns — the order in which markets rise and fall and the corresponding returns — can make a difference to a retirement withdrawal strategy. Here is why:

During periods where portfolio values are under pressure, any withdrawal will put further downward pressure on the portfolio. When depressed values occur at the start of retirement, they can make a difference to the longevity of the account. This is because withdrawals during down years at the onset can deplete an account faster than anticipated. When the markets eventually reverse their course, the portfolio cannot benefit as much because there are fewer dollars remaining.

To understand the potential impact, we compare the outcomes of two identical investment portfolios of $500,000, with an annual withdrawal of $20,000 per year increased by 2.5 percent per year for inflation. For Investor A, we use the actual performance of the S&P 500 Index from 2000 to 2015. For Investor B, we reverse the sequence of returns. As the analysis shows, the early losses of Investor A in the first three years lead to a significantly lower ending balance than Investor B, who experiences those same losses at the end. Of course, this is an extreme example.

How Sequencing of Returns Can Impact a Retirement Portfolio of $500,000

Based on Annual Withdrawals of $20,000 (at a 2.5% Inflation Rate) Using Historical S&P 500 Returns (2000 to 2015)

Investor A: Negative Returns at Onset of Retirement					Investor B - Negative Returns at End of Retirement				
Age	Return	Withdrawal	Growth	Ending Value	Age	Return	Withdrawal	Growth	Ending Value
66	-10.14%	$20,000	-$48,672	$431,328	66	-0.73%	$20,000	-$3,504	$476,496
67	-13.04%	$20,500	-$53,572	$357,256	67	11.39%	$20,500	$51,938	$507,934
68	-23.37%	$21,013	-$78,580	$257,663	68	29.60%	$21,013	$144,129	$631,050
69	26.37%	$21,538	$62,266	$298,392	69	13.41%	$21,538	$81,736	$691,248
70	8.99%	$22,076	$24,841	$301,156	70	0.00%	$22,076	—	$669,172
71	3.00%	$22,628	$8,356	$286,884	71	12.78%	$22,628	$82,628	$729,172
72	13.62%	$23,194	$35,915	$299,605	72	23.45%	$23,194	$165,552	$871,530
73	3.53%	$23,774	$9,737	$285,568	73	-38.49%	$23,774	-$326,301	$521,455
74	-38.49%	$24,368	-$100,536	$160,664	74	3.53%	$24,368	$17,547	$514,634
75	23.45%	$24,977	$31,819	$167,505	75	13.62%	$24,977	$66,691	$556,348
76	12.78%	$25,602	$18,135	$160,039	76	3.00%	$25,602	$15,922	$546,669
77	0.00%	$26,242	—	$133,797	77	8.99%	$26,242	$46,786	$567,213
78	13.41%	$26,898	$14,335	$121,235	78	26.37%	$26,898	$142,481	$682,797
79	29.60%	$27,570	$27,725	$121,389	79	-23.37%	$27,570	-$153,126	$502,100
80	11.39%	$28,259	$10,607	$103,737	80	-13.04%	$28,259	-$61,789	$412,052
81	-0.73%	$28,966	-$546	$74,225	81	-10.14%	$28,966	-$38,845	$344,241

The good news is that historically the equity markets have not had sustained periods of negative returns. There have only been two instances in the past 50 years in which U.S. equity markets have seen losses that lasted at least two consecutive years: 1973-1974 and 2000-2002; and only one instance in the Canadian markets: 2001-2002.

However, from time to time, there will be the inevitable down periods and there are actions that can help to mitigate the sequencing of returns risk. Including a fixed-income component within a portfolio can provide income. Having a flexible approach to withdrawal rates can help, including withdrawing a fixed percentage of a portfolio's value as opposed to a fixed amount. Taking planned withdrawals in strong market years and keeping this on the sidelines may help avoid having to withdraw assets during down periods to allow more of the portfolio to recover when asset values eventually rebound.

If you have questions about this, or any other investing matters, please call the office.

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