The Impact of Sequence of Returns on Your Retirement Portfolio

Leading up to your retirement, as you amass assets and grow your money – known as the 'accumulation phase of investing' – market volatility is generally tolerable; volatility may make you uncertain, but the impact is sustainable, as long as you're not making withdrawals and staying the course.

When you retire, however, or as you begin drawing down on accumulated assets and create an income stream – known as the 'de-accumulation phase' of investing – market volatility takes on greater significance, especially if your portfolio is subject to this volatility at the beginning of retirement. More specifically, market fluctuations and the order in which positive and negative investment returns occur, or 'the sequence of returns,' can have a detrimental effect on your retirement savings. The simple reason for this is that market volatility, combined with regular withdrawals, may increasingly diminish your retirement capital.

Timing of retirement can have an impact

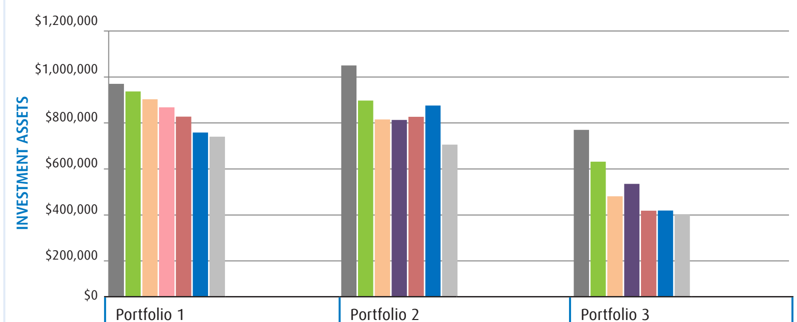
Looking more closely at sequence of returns risk and the timing of retirement, if negative returns happen near the beginning of retirement, overall capital will decrease. And, with each income withdrawal, coupled with continued market volatility, capital continues to decline causing retirement savings to erode more quickly, compared to a portfolio with positive returns at the beginning of the retirement withdrawal period. This is why the first years of retirement are so important; what happens during that period may determine whether or not you'll outlive your savings or if you'll have to lower your desired standard of living later in retirement to extend these savings.

As seen in **Figure 1**, three similar retirement portfolios can end up having very different outcomes, depending on the market conditions they're under and the sequence of returns. In each scenario, the portfolio earns an average annual 7% per year return over the seven years and assumes a $100,000 withdrawal per year from an initial capital investment of $1 million. We can see that Portfolio 3, with a low variable rate of return at the beginning, faces a greater depletion of capital and is left with a considerably lower balance compared to Portfolio 1 and Portfolio 2, at the end of year seven.

Figure 1

Capital accumulation and depletion over a 7-year period

Each scenario has an average annual 7% per year return and assumes a $100,000 withdrawal per year from an initial capital investment of $1 million.



Year	Retirement Capital Constant Return	Constant Return Rate	Retirement Capital Variable High start	Variable Return Rate (High start)	Retirement Capital Variable Return Low start	Variable Return (Low start)
1	$970,000	7%	$1,050,000	15%	$770,000	-13%
2	$937,000	7%	$897,500	-5%	$631,500	-5%
3	$903,553	7%	$815,450	2%	$480,980	-8%
4	$866,802	7%	$813,304	12%	$534,894	32%
5	$827,478	7%	$827,167	14%	$418,847	-3%
6	$758,401	7%	$876,057	18%	$419,370	24%
7	$740,379	7%	$705,972	-8%	$403,244	20%

Source: BMO Financial Group

Mitigating sequence of returns risk

Knowing the significance of sequence of returns risk on retirement portfolios, how can investors, particularly those close to retirement, defend or mitigate this risk? After all, market volatility is not something you or your BMO financial professional can control, so timing when you retire or when you begin withdrawing funds for retirement is probably not a viable option.

Fortunately, there are a number of important steps you and your financial professional can take.

- **De-risk your retirement portfolio** – You can reduce sequence returns risk by decreasing the risk itself within your portfolio. One way of doing this is by reducing your exposure to riskier investments, such as stocks, perhaps at the outset, when you begin retirement. As your retirement progresses you and your financial professional can plan on gradually increasing exposure to these investments, if and when appropriate.
- **Diversify across asset classes** – Diversification is generally a key principle when investing, but perhaps is even more important during retirement, to ensure more stable, consistent returns. Speak to your financial professional about ensuring your retirement savings are diversified across major asset classes, to mitigate volatility of returns.
- **Constant rate of withdrawal** – Consider a prescribed dollar value withdrawal, rather than one adjusted for inflation, from your retirement portfolio, especially at the outset and where market volatility is a concern.
- **Flexible spending** – Those who want upside in their savings, should be flexible with their spending and willing to make adjustments. In particular, spending on 'big ticket' items should be carefully planned during retirement with the help of your financial professional.
- **Plan ahead** – In general, it's important to map out your utilization of retirement savings with your financial professional. Understand what your objectives are for retirement and what your expected spending will be to ensure ample income to live comfortably. If you have enough wealth to ensure a comfortable retirement, the goal, for example, may be to protect wealth for the next generation, support a charitable cause or leave a legacy that makes you proud. Plan ahead with your financial professional to make sure all your goals are achievable through your retirement income.

Planning for a comfortable retirement

Your BMO financial professional is dedicated to helping you plan for your retirement success, and can answer any questions you have about all the risks associated with the sequence of returns discussed in this article. Contact him or her today to begin planning how to optimally position your retirement portfolio.

BMO Wealth Management

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