UNDERSTANDING SEQUENCE OF RETURNS RISK

TO AVOID COMMON RETIREMENT PITFALLS

Mastering the Clock: The Important Role of Timing to Help Protect Your Retirement Against Sequence of Returns Risk

When many people plan for retirement, they consider how much to save, what to invest in, and how to generate a monthly income. But there's another vitally important aspect of retirement planning that's often overlooked – timing.

Specifically, if you're not planning for sequence of returns risk, you could be inadvertently derailing decades of hard work spent saving and planning for retirement.

Read on to learn more about the importance of preparing for sequence of returns risk as part of your retirement strategy.

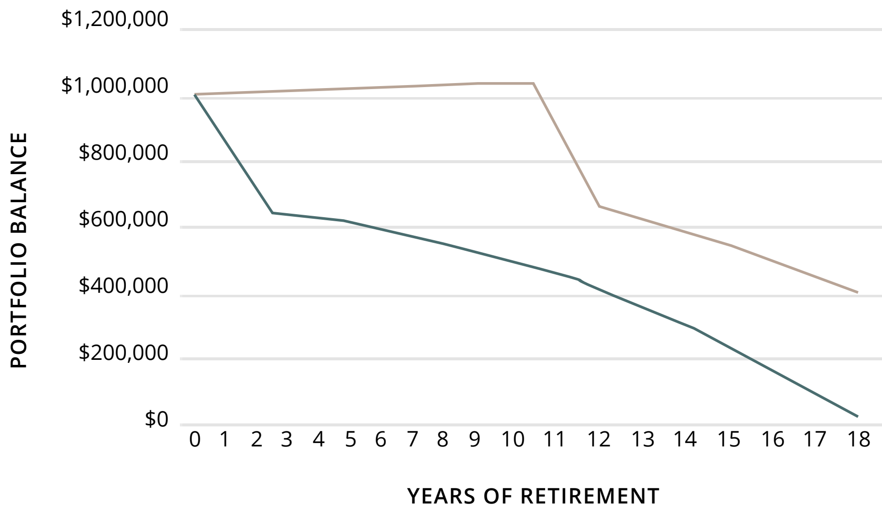
What is sequence of returns risk?

Sequence of returns risk refers to the possibility that, due to market volatility, your investment values take a hit early in retirement, resulting in less income available to you throughout your retirement years.

When you sell out of equities at a low point in the market, you must sell more shares to equal a certain value of assets. Not only does this result in selling at a loss, you are also taking money out of the market that could otherwise have potentially benefitted from a future market recovery. That means you may need to work longer or make changes to your desired retirement lifestyle to offset your lower income.

If you are in your early retirement years, this can be a significant loss that's difficult to recover from. On the other hand, if the same market downturn occurs while you are in the later years of retirement, it may not have nearly as big of an impact on your retirement savings.

Consider the following hypothetical example[1]:



Source: Schwab Center for financial research

Investor 1 experiences a 15% decline during the first two years of retirement.

Investor 2 experiences a 15% decline during the 10th and 11th years of retirement.

As you can see, both Investor 1 and Investor 2 enter retirement with $1,000,000 in savings. Both investors take an initial withdrawal of $50,000, and increase that amount by 2% each year as they withdraw throughout retirement. Both investors also experience a 15% market decline. However, Investor 1 experiences the market downturn during the first two years of his retirement, while Investor 2 experiences the market downturn during the 10th and 11th years of her retirement.

As you can see, the market downturn has a much more significant impact on Investor 1's portfolio balance, making it virtually impossible for him to recover from the loss. However, because Investor 2 had more time to grow her assets early in retirement, and fewer years' expenses to fund following the downturn, her portfolio wasn't impacted nearly as drastically as Investor 1's.

1 This chart is hypothetical and for illustrative purposes only. Both hypothetical investors had a starting balance of $1 million, took an initial withdrawal of $50,000, and increased withdrawals 2% annually to account for inflation. Investor 1's portfolio assumes a negative 15% return for the first two years and a 6% return for years 3–18. Investor 2's portfolio assumes a 6% return for the first nine years, a negative 15% return for years 10 and 11, and a 6% return for years 12–18. Does not reflect expenses, fees, or taxes. Example does not reflect any specific product or investment,.

Strategies for mitigating sequence of returns risk

You may be wondering, “How can I protect my portfolio from sequence of returns risk?” Great question!

The following strategies can help protect your portfolio and your retirement lifestyle from an ill-timed market decline.

#1 – DIVERSIFY.

One common way to help weather market volatility is with a diversified retirement portfolio. Investing in different types of assets helps spread out your risk so that when one asset class, sector or type is performing poorly, a stronger-performing asset can help smooth out volatility. While diversification can't ensure a profit or guarantee against losses, it may be able to help reduce the risk of losing too much by being overly invested in the low performing sectors of the market.

Work with a financial professional to diversify your investments across stocks and bonds, large and small companies, domestic and international stocks, and across various sectors such as technology, healthcare, finance, energy, etc.

#2 – INCORPORATE A FIXED ANNUITY.

Income annuities can be used to help mitigate sequence of returns risk. With an income annuity, you pay a premium in exchange for guaranteed income* that lasts the rest of your life. Because income annuities are unaffected by market volatility, they can help protect your assets from sequence of returns risk.

Income annuities provide different methods to help mitigate the sequence of returns risk. Three methods are listed below:

- They offer a guaranteed source of monthly income that is not correlated to market performance, offering diversification of account types.

- Because they are not correlated to market performance, they provide an opportunity to avoid losing or risking your principal while taking distributions. Fixed Annuities have no downside risk, so you will never see your account balance go backward due to market conditions.

- Income annuities provide monthly income to support your living expenses, which can help you avoid the need to sell investments at a loss to pay for your daily expenses.

Because income annuities are not subject to market fluctuations, they can help reduce the impact of volatility on your overall portfolio and provide another source of guaranteed lifetime income, regardless of market performance.

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* Annuities contain limitations including withdrawal charges, fees and a market value adjustment which may affect contract values.

  Annuities are products of the insurance industry; guarantees are backed by the claims-paying ability of the issuing company. Guaranteed lifetime income available through annuitization or the purchase of an optional lifetime income rider, a benefit for which an annual premium is charged.

#3 – BUILD A BOND LADDER.

Within your diversified portfolio, consider laddering your bonds. This strategy involves purchasing a variety of bonds with different, evenly spaced maturity dates that span a specific timeframe. Establishing bonds that mature at different dates allows you to generate consistent retirement income without the need to sell out of equities at inopportune times.

For example:
Jesse wishes to implement a 10-year bond laddering strategy. To do so, he purchases a bond that matures in one year, one that matures in two years, one that matures in three years, etc., up to 10 years. Jesse is then able to receive income each year for the next 10 years as his bonds mature. As an added benefit, he does not need to worry about market volatility or sequence of returns risk because his bonds are earning a set interest rate that is uncorrelated to stock market performance.

#4 – ESTABLISH A WITHDRAWAL STRATEGY.

Another effective way of addressing sequence of returns risk is by establishing (and sticking to!) a disciplined withdrawal strategy. By strategically withdrawing from your various retirement accounts over time, you aim to avoid selling out of too many assets during an inopportune time in the market.

Consider implementing one of the following retirement withdrawal strategies.

- **Traditional withdrawals** – With this approach, you withdraw from your various accounts according to their tax status. Typically, retirees using this approach withdraw from their taxable accounts early in retirement, followed by their tax-deferred accounts, and finally, their tax-exempt accounts. This approach allows tax-advantaged accounts to grow for a longer period of time, providing an opportunity to accumulate compounding interest. However, a downside to this approach is that your taxable income will likely vary greatly from year to year, based on what types of accounts you're drawing from.
- **Proportional withdrawals** – For some people, it makes more sense to establish a target percentage to withdraw from each account each year, based on the proportional composition of their portfolio. The benefit to this approach is that it provides more consistent tax exposure from year to year, which can help you save on taxes over the course of your retirement.

An experienced financial professional can help you implement a withdrawal strategy that makes sense for your personal financial situation and retirement goals.

* Hypothetical example shown for illustrative purposes only.

Could you use some help planning for retirement income while aiming to minimizing your sequence of returns risk?

Schedule a call to learn more about how we can help you develop a custom retirement planning strategy that meets your needs and helps achieve your goals.

ASPIRE WEALTH MANAGEMENT

913.322.3500 | TODDSCHICK@ASPIREWEALTHMGT.COM

7450 W. 130TH ST., SUITE 140, OVERLAND PARK, KS 66213

5601 NE ANTIOCH RD., SUITE 8, GLADSTONE, MO 64119

17331 E US 40 HWY., SUITE 101, INDEPENDENCE, MO 64055

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WEALTH MANAGEMENT
& TAX CENTER