How Does Sequence Risk Affect My Portfolio?

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Let's face it: retirement fundamentally changes your relationship with your money. Instead of focusing on growing your assets, you're likely more interested in preserving and protecting them. During this transition, the timing of your withdrawals could make or break your retirement.

Sequence risk, known as sequence-of-returns risk, is the potential danger that arises from the timing and order of investment returns when withdrawing from your retirement savings. Experiencing a significant market downturn in your retirement, paired with withdrawals, could impact the longevity of your portfolio.

Understanding Sequence Risk

When contributing to investment accounts, you may not have concerned yourself with year-to-year market volatility. If this is the case, you may have automated deposits and followed a set-it-and-forget-it mentality. During this phase, you often have a long time horizon. While a down year may cause anxiety and stress, your ability to stay invested will grant you exposure to market upswings.

Eventually, you retire and become a consumer of your wealth. This is when the current state of the market matters a little bit more as you need to withdraw money regardless of market conditions. Those retiring when the market is experiencing positive returns have a nice head start. However, not everyone is so lucky. Some retire and immediately experience a market downturn, which may lead to making difficult financial decisions.

Withdrawing when the market is down can harm a portfolio because you are withdrawing a larger percentage of your overall assets. This harm is compounded by selling more investments at lower prices, resulting in less potential to grow and recover lost value.

Example of Sequence Risk

To illustrate, let's compare two investors side by side. Assume both investors have a $1,000,000 portfolio and withdraw $50,000 at the beginning of each year for five years.

Retiree A Portfolio

	Annual Market Return	Withdrawals	Portfolio Balance
Year 1	30%	$50,000	$1,235,000
Year 2	15%	$50,000	$1,362,750
Year 3	5%	$50,000	$1,378,388
Year 4	-5%	$50,000	$1,261,968
Year 5	-20%	$50,000	$969,575

Retiree B Portfolio

	Annual Market Return	Withdrawals	Portfolio Balance
Year 1	-20%	$50,000	$760,000
Year 2	-5%	$50,000	$674,500
Year 3	5%	$50,000	$655,725
Year 4	15%	$50,000	$696,584
Year 5	30%	$50,000	$840,559

At the end of the five years, Retiree A has a balance of $969,575 and Retiree B has a balance of $840,559. Just because Retiree B started their retirement during a market downturn, they lost close to three years of retirement funding ($129,016).

How Do I Prevent Sequence Risk?

While sequence risk cannot be eliminated entirely, there are strategies you can employ to mitigate its impact and create a more resilient retirement plan.

Diversification: Spreading your assets among various investments can help reduce the impact of poor performance in any one area. This way, if one investment performs poorly, it won't significantly impact your overall portfolio. Think of it as not putting all your eggs in one basket.

Asset Allocation: Understanding the tenants of diversification when it comes to investments is just the start. You also need to consider which types of assets you want to include in your portfolio. The most common are stocks, bonds, cash, and alternative investments. Each asset class has different risk/return expectations and will behave differently when the market goes through ups and downs.

Emergency Fund: Maintaining an emergency fund can help mitigate sequence risk as it allows you to withdraw money from cash rather than your investments. However, an emergency fund should only be used to cover large expenses during a market downturn, not to supplement your lifestyle. You should have just enough to get you through the short term.

Flexibility: Being adaptable and open to adjustments can be vital while navigating sequence risk. Consider scaling back or delaying some expenses until your portfolio recovers.

Debt: Contrary to popular belief, there is a way to use debt to your advantage in retirement.

Current Debt: You shouldn't retire debt-heavy. Doing so may mean you're forced to withdraw from your portfolio to cover loan payments. By having fewer monthly bills, you can have more flexibility with how much you need to withdraw.

Future Debt: This is where the controversy comes in. Assuming you don't have a pile of debt already at your feet, it may make sense to have a line of credit at the ready in case the market takes a plunge during the beginning of your retirement.

This is the same concept as your emergency fund: a pool of money you can utilize instead of your portfolio. Depending on what interest rate the line of credit has, it may be beneficial to draw from debt instead of pulling from your portfolio. Once the markets recover, you can then make a withdrawal to pay off the new debt.

The Bottom Line

By understanding sequence risk and implementing these strategies, you can protect your retirement savings. Remember, a well-diversified portfolio, thoughtful asset allocation, and an emergency fund are powerful tools to weather the storm. Taking proactive measures will help you navigate uncertainty and enjoy the retirement you've always envisioned.