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India Mutual Fund

How Sequence of Return Risk can impact Retirees portfolio

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Dear Investors and Partners,

Our life is mired by risks, and we have learnt the art of managing risks and getting better in everything that we do. The same is applicable to investing. Investing in the stock market can be a rewarding endeavour but it's not without its risks.

One such risk that many investors may not be familiar with is "SEQUENCE OF RETURN RISK." In simple terms, this risk refers to the order in which investment returns occur and how it can impact the value of a portfolio, especially during retirement.

Let's delve deeper into what sequence of return risk is and how it can affect investors, using portfolios as examples.

What is Sequence of Return Risk? Sequence of return risk is the danger that the timing of withdrawals from an investment portfolio, particularly during retirement, coinciding with a period of poor investment returns. In other words, it's the risk of experiencing negative returns early in retirement when withdrawals are being made, which can significantly deplete portfolio value and increase the likelihood of running out of money later on.

Example: Imagine Investor A has a retirement portfolio of INR 1 crore, and she plans to withdraw 4% of portfolio's value each year to cover her living expenses. In the first year of her retirement, the stock market experiences a significant downturn, resulting in a negative return of 20%. Despite the market decline, Investor A still withdraws INR 4 lakhs (4% of INR 1 crore) from her portfolio. As a result, her portfolio balance decreases to INR 76 lakhs (1 crore - 20 lakhs - 4 lakhs). Even if the market rebounds in the following years, Investor A's portfolio may struggle to recover from the initial loss, especially if she continues to withdraw funds.

Now, let's consider Investor B, who has a similar retirement portfolio of INR 1 crore but retires during a bull market. In the first year of her retirement, she experiences a positive return of 20%. Despite withdrawing INR 4 lakhs for living expenses, her portfolio balance increases to INR 1.16 crores (1 crore + 20 lakhs - 4 lakhs). Even if Investor B faces a period of negative returns in the following years, her portfolio has already grown significantly, providing a buffer against market downturns.

The impact of Sequence of Return Risk: In both examples, Investor A and Investor B withdrew the same amount from their portfolios during retirement, but the timing of their withdrawals and the sequence of investment returns had vastly different outcomes. Investor A's portfolio suffered from an early market downturn, which reduced its value and made it challenging to recover, while Investor B's portfolio benefited from a strong start, providing a cushion against future market volatility.

Although the examples here may be hypothetical, but they are not very far away from reality which retirees face. It is not only that the retirees may face sequence of return risk only. Another risk that retires portfolio may face is “Mongevity”(money not lasting the retirement period). This risk arises as a result of building a conservative portfolio without any exposure to equities and thus may not be able to beat inflation over the long period of their retiree’s life.

Strategies to Mitigate Sequence of Return Risk: Given the negative impact of sequence of return risk on retirement portfolios, it's essential for investors to implement strategies to mitigate this risk. Some strategies include:

Asset Allocation: Maintaining a balanced asset allocation based on risk tolerance and investment goals can help spread risk and minimize the impact of market volatility. This may even take care of the risk of Monegivity.

Diversification: Diversifying investments across different asset classes such as stocks, bonds, and real estate, can help reduce the impact of poor performance in any single asset class.

Withdrawal Strategies: Adopting flexible withdrawal strategies such as the "3 bucket approach" or maintaining an emergency fund to use it during market drawdowns, can help adjust spending based on market conditions and portfolio performance. (Both of these withdrawal strategies have been discussed in my earlier communications.....here* & here*).

Long-Term Perspective: Maintaining a long-term perspective and staying invested through market downturns can help avoid making hasty decisions based on short-term fluctuations.

To conclude, sequence of return risk is a crucial concept for investors, especially those planning for retirement. By understanding how the timing of investment returns can impact portfolio value, investors can better prepare for and mitigate the effects of market volatility. Implementing diversification, asset allocation, and prudent withdrawal strategies can help reduce the impact of sequence of return risk and ensure a more secure financial future. Taking help from a trusted financial advisor for your financial plan is advisable.

Remember, you cannot avoid risk completely but you can manage/mitigate it to some extent.

Happy Investing!

*https://www.pgimindiamf.com/docs/default-source/factsheets/factsheet-2024/factsheet---january-2024.pdf?sfvrsn=d4c9baec_4
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