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The Investment Risk You May Not Know About

What can you do to allay this risk?

Provided by Diane Woodward, CFP®, RICP®

Knowledgeable investors are aware that investing in the capital markets presents any number of risks – interest-rate risk, company risk, and market risk. Risk is an inseparable companion to the potential for long-term growth. Some of the investment risks we face can be mitigated through diversification.[1]

As an investor, you face another, less-known risk for which the market does not compensate you, nor can it be easily reduced through diversification. Yet, it may be the biggest challenge to the sustainability of your retirement income.

This risk is called the sequence-of-returns risk.

The sequence-of-returns risk refers to the uncertainty of the order of returns an investor will receive over an extended period of time. As Milton Friedman once observed, you should "Never try to walk across a river just because it has an average depth of four feet."[2]

Sequence of Returns. Mr. Friedman's point was that averages may hide dangerous possibilities. This is especially true with the stock market. You may be comfortable that the market will deliver its historical average return over the long term, but you can never know when you will be receiving the varying positive and negative returns that comprise the average. The order in which you receive these returns can make a big difference.

For instance, a hypothetical market decline of 30% is not to be unexpected. However, would you rather experience this decline when you have relatively small retirement savings or at the moment you are ready to retire – when your savings may never be more valuable? Without a doubt, the former scenario is preferable, but the timing of that large potential decline is out of your control.

Timing, Timing, Timing. The sequence-of-returns risk is especially problematic while you are in retirement. Down years, in combination with portfolio withdrawals taken to provide retirement income, have the potential to seriously damage the ability of your savings to recover sufficiently, even as the markets fully rebound.

As you consider your options, keep in mind that a certain amount of risk is unavoidable.

Diversification is helpful, to a degree, but it can also be helpful to have a plan in mind if you face a difficult year ahead. Are you able to delay retirement for a year or more, potentially adding additional years to save as well as allowing the financial environment to recover? Another alternative may be to reconsider, downsize, or delay some of your bigger plans. These alternatives may not be preferable, but you can take comfort in having those plans and ideas in place, should they ever become necessary.

If you are nearing retirement or already in retirement, it's time to give serious consideration to the "sequence-of-returns risk" and ask questions about how you can better manage your portfolio.

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Citations.

1 - https://www.kiplinger.com/article/retirement/T047-C032-S014-is-your-retirement-income-in-peril-of-this-risk.html [7/3/2018]
2 - https://quotefancy.com/quote/868218/Milton-Friedman-Never-try-to-walk-across-a-river-just-because-it-has-an-average-depth-of [2018]