Investment

Returns & Risks

What you need to know for your future.

By Brian Bernatchez, CFP®

Sequence of Investment Return Risk– The "FLAW" of Averages

With the bull market in U.S. stocks reaching its 5 year anniversary and most companies trading at multiples of current earnings which exceed historical averages, I thought it was a good time to get a little nerdy with numbers and write about a risk which doesn't get a lot of attention in good markets– SEQUENCE OF RETURN RISK.

The financial services industry has done an excellent job over the years of training investors to expect 10% average annual returns from the stock market. Unfortunately it has largely failed to emphasize how important the sequence of return is for retirees who withdraw a consistent percentage (typically 4%-5%) of their portfolios annually.

In reality, although the stock market as measured by the Standard & Poors 500 index has indeed averaged 10.20% per year since 1926, the yearly returns have rarely been anything close to 10%. As the chart below illustrates, in only 7 of the 87 years since 1926 has the return been between 5% and 10%. In addition, there have been 12 years in which the loss was 10% or more and in 6 of those years (including 2002 and 2008) the market fell by more than 20%.

Calendar year returns: U.S. Stocks (1926-2013)

	-35% or more	-35% to -30%	-30% to -25%	-25% to -20%	-20% to -15%	-15% to -10%	-10% to -5%	-5% to -0%	0% to 5%	5% to 10%	10% to 15%	15% to 20%	20% to 25%	25% to 30%	30% to 35%	35% to 40%	40% to 45%	45% to 50%	50% to 55%
15																			
												2012							
10												2010			2013				
												2006			2003				
												1988	1999		1997				
							1990			2007	2004	1986	1998		1991				
						2001	1969	1994		2005	1993	1982	1996	2009	1985				
5						2000	1962	1981	2011	1992	1971	1972	1983	1989	1980				
						1973	1946	1977	1987	1978	1968	1964	1967	1979	1955	1995			
						1966	1940	1953	1984	1956	1965	1952	1963	1976	1950	1975			
	2008			2002		1957	1932	1939	1970	1948	1959	1949	1951	1961	1938	1945	1958		1954
	1931	1937	1974	1930		1941	1929	1934	1960	1947	1926	1944	1942	1943	1936	1927	1928	1935	1933

Source: Vanguard

Note: For U.S. stock market returns, we use the Standard & Poor's 90 from 1926 to March 3, 1957; the Standard & Poor's 500 Index from March 4, 1957 to 1974; the Wilshire 5000 Index from 1975 to April 22, 2005; and the MSCI US Broad Market Index thereafter.

Sequence of return risk only exists for an investor in the distribution phase, not the accumulation phase:

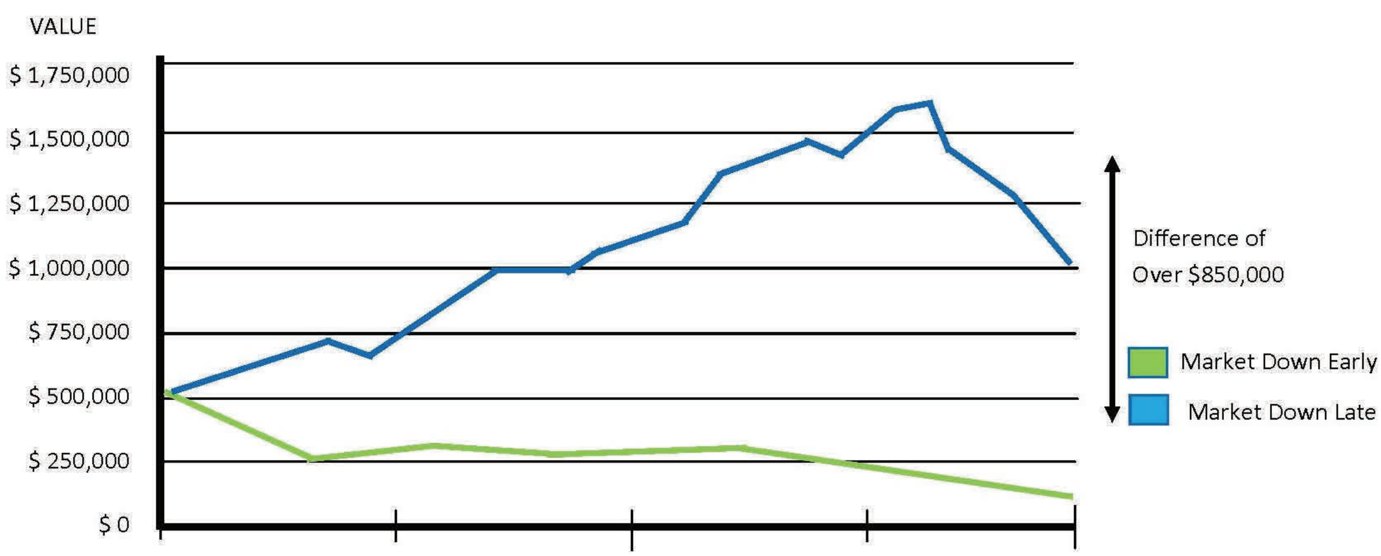
Rate of Return During Accumulation Phase

YEAR	1	2	3	4	5	6	7	8	9	10	11	12	13	14	15	16	17	18	19	20	AVG.	ENDING VALUE
INVESTOR A MARKET DOWN EARLY	-15	-5	-15	5	25	20	10	15	5	10	15	10	20	0	5	10	5	15	10	15	8%	$2,115,025
INVESTOR B MARKET DOWN LATE	10	25	15	5	10	10	25	15	5	15	10	20	10	5	0	15	5	-15	-5	-15	8%	$2,115,025

The chart above compares 2 investors who both average 8% annually on an initial investment of $500,000 over 20 years, but get there on much different paths. Investor A's first three years have negative returns and a string of positive ones at the end. Investor B has very good returns early on with some negative years at the end. Assuming both remained fully invested the entire time they end up with the exact same amount at the end of 20 years- $2,115,025.

However, once an investor begins to withdraw annual income the sequence of annual returns is a critical factor in maintaining or growing principal. Consider the chart below:

Rate of Return During Withdrawal Phase



These are the same 2 investors as in the previous chart, each investing $500,000 initially. The only difference is that they begin to withdraw 5% annually immediately, (with a 3.5% annual increase in the withdrawal amount each year for inflation).

How can it be that investor A and investor B both averaged 8% annually, and withdraw out the same amounts but investor B ends up with over $ 1 million while investor A has less than $200,000?

Investor B was lucky enough to experience a series of good annual gains early on with no significant losses until the end– providing enough capital gains to offset the steep losses at the end of the 20 year period. However, poor investor A had 3 years of significant losses right at the beginning, and the portfolio was reduced so much that it was never able to recover even though the market had strong gains during the next few years.

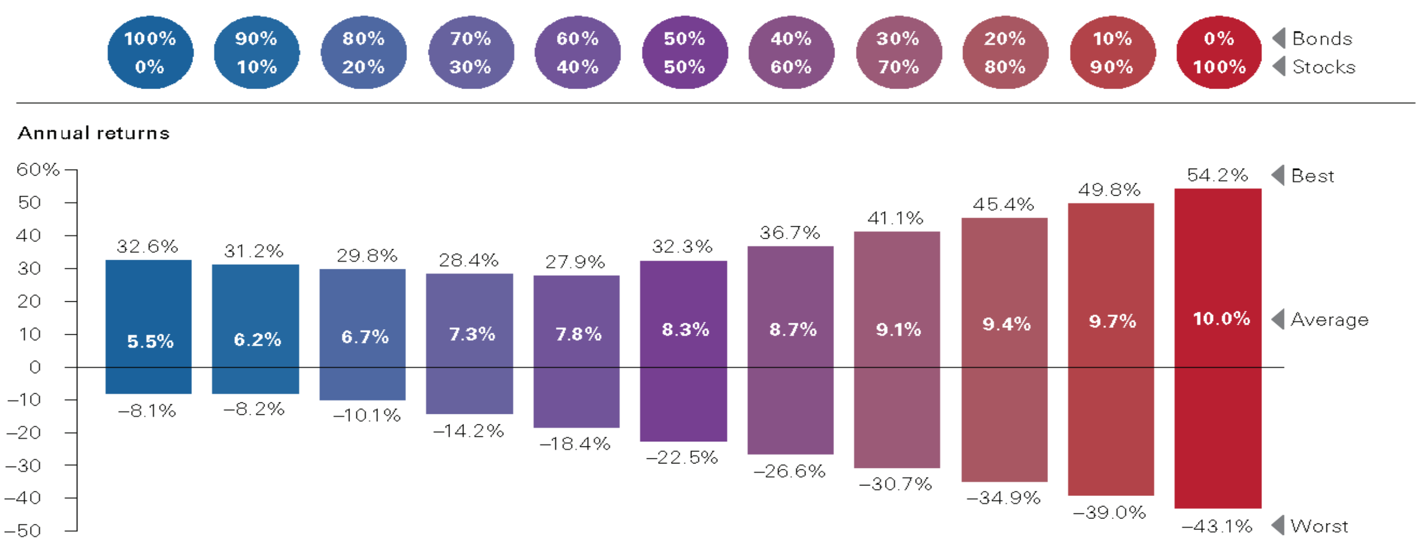
As investment advisors, one of our primary objectives is to “manage” the range of potential returns as much as possible without managing out the potential for long-term capital growth. In addition, it is important that we attempt to avoid significant capital losses in the years immediately preceding and following retirement.

Getting as close as possible to the “8% guaranteed sign”...

When explaining how we manage risk and volatility to new clients, I often joke with them that if we could put a sign out by the road which read “8% Returns Guaranteed” we would have a line each morning stretching for miles of investors who had cashed in low investment savings accounts and CD’s to invest at 8%. I also tell them that if it says “ too good to be true” it always is. I don’t know of any investments which guarantee returns anything close to 8% per year and historical average returns are typically even lower.

For retirees withdrawing 3%- 6% of their portfolio annually we see our job as attempting to get as close as possible to the 8% number on the fantasy sign by the road over the long term. In order to pursue this, we commit to a long-term stock/bond allocation strategy which attempts to reduce the range of potential returns but still provides the potential for long-term returns to exceed withdrawal percentages enough to offset inflation.

Portfolio Allocation



Note: *Past performance does not guarantee future results. The performance of an index is not an exact representation of any particular investment, as you cannot invest directly in an index.*

Stocks are represented by the Standard & Poor’s 90 Index from 1926 to March 3, 1957; the S&P 500 Index from March 4, 1957, through 1974; the Wilshire 5000 Index from 1975 through April 22, 2005; and the MSCI US Broad Market Index thereafter. Bonds are represented by the S&P High Grade Corporate Index from 1926 to 1968; the Citigroup High Grade Index from 1969 to 1972; the Barclays U.S. Long Credit AA Index from 1973 to 1975; and the Barclays U.S. Aggregate Bond Index thereafter. Data are through December 31, 2012.

Source: Vanguard.

The chart above shows hypothetical combinations of stocks and bonds and the average return as well as the highest gain and biggest loss since 1926. No surprise that the highest average annual return is from a 100% stock portfolio. However, as I have shown earlier, Sequence of Return Risk would be way too high as experienced by the 43.1% loss in the worst year (2008).

Take a look at the 40% bond 60% stock allocation. It has 87% of the average annual return of an all stock portfolio, but only 60% of the maximum downside risk as measured by the worst annual loss. Not surprisingly our normal target allocation for most investors withdrawing 3%-6% income annually is about 60% stock and 40% bond. What we hope to do over time is select active managers who outperform the index, and adjust normal targets based on an assessment of the current economic cycle. In addition we slice off little pieces of the conservative core to invest in smaller companies, international companies and high yield bonds.

If you are a retiree who feels as though you missed out on the last 5 years of the stock market growth, you should proceed with caution and resist the temptation to dramatically increase the risk in your portfolio in attempt to make up for lost time in the market. Instead, consult with your financial advisor and design a long-term asset allocation strategy with a systematic reallocation in place. However, be willing to accelerate your reallocation if the greed that has crept into the markets over the last few years suddenly turns to fear which causes lawn sale prices on great companies.

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