Case Study

Sequencing Risk

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Sequencing Risk

Our superannuation system is based on Australians building up funds during our working lives and then drawing down on it in retirement. For young accumulators, when the level of savings is small, maximising returns matter the most as you are able to weather market fluctuations over the long term. However, as your accumulated funds grow larger as you approach retirement, there is a greater focus on the short-term because unfavourable market conditions can lead to catastrophic results.

If you experience poor investment returns immediately prior to or in the early stages of retirement, your portfolio may not recover even when the market does eventually rebound.

It can lead to actions that individuals would prefer to avoid – working longer, reducing expenditures or needing to increase investment risk to achieve higher growth.

This risk of experiencing poor investment returns at the wrong time is called sequencing risk.

Sequencing risk is one of the biggest financial risks faced by retirees because it is a major cause of longevity risk: the risk of outliving one's savings.

An example:

As you will see from the example below from AMP Capital, sequencing risk has the potential to make a large difference to how long your savings will last in retirement.

Investor A and investor B both start retirement with an opening balance of $691,527. Both withdraw an annual income of 5% of the opening balance (approximately $35,000), adjusted for inflation of 3% per annum. Both portfolios generate the same investment returns – however, the pattern of these returns is reversed. So, investor A's portfolio will deliver three consecutive negative returns early on in the period, while investor B's portfolio will deliver negative returns at the end of the period.

Age	Investor A		Investor B	
	Annual return (%)	Year-end value ($)	Annual return (%)	Year-end value ($)
65		$ 691,527		$ 691,527
66	-12	$ 578,117	29	$ 838,850
67	-21	$ 428,577	18	$ 947,819
68	-14	$ 337,030	25	$ 1,138,922
69	22	$ 365,082	-6	$ 1,035,071
70	10	$ 358,782	15	$ 1,145,578
71	4	$ 331,447	8	$ 1,193,934
72	11	$ 322,079	27	$ 1,463,863
73	3	$ 287,941	-2	$ 1,392,912
74	-5	$ 231,933	15	$ 1,551,478
75	21	$ 226,051	19	$ 1,792,573
76	17	$ 210,113	33	$ 2,322,320
77	5	$ 170,363	11	$ 2,524,649
78	-10	$ 108,959	-10	$ 2,227,816
79	11	$ 64,583	5	$ 2,285,892
80	33	$ 16,336	17	$ 2,613,303
81	19		21	$ 3,096,915
82	15		-3	$ 2,950,187
83	-2		3	$ 2,979,829
84	27		11	$ 3,242,271
85	8		4	$ 3,308,907
86	15		10	$ 3,571,104
87	-6		22	$ 4,278,273
88	25		-14	$ 3,622,339
89	18		-21	$ 2,807,738
90	29		-12	$ 2,408,958

In this example, the pattern of returns has made a big difference. Regular withdrawals, together with a string of poor investment returns early on mean Investor A has less time to recover. This is because the portfolio has less capital off which to rebound in value. Unfortunately, Investor A will have his funds depleted by age 80. Investor B will continue to accumulate wealth in retirement despite making the same annual withdrawals as Investor A. This is because Investor B has the better fortune of starting his retirement when the markets delivered three consecutive years of positive, double-digit returns.

What are the solutions?

Various solutions have been suggested to manage sequencing risk. Unfortunately there is no "silver bullet" and sequencing risk can never be eliminated because returns are unpredictable.

Individuals can hope to retire when markets are rising, but hope is clearly not a strategy on which to hinge a successful retirement.

Retirees can adjust their spending if their savings dramatically fall in value, however, this is a reactive strategy and it is not particularly useful if living and medical expenses are increasing year after year.

One strategy is to increase the exposure of low risk assets such as fixed interest as you approach etirement. However, a greater exposure to fixed interest, especially when current interest rates are at multi-decade lows, is unlikely to keep pace with inflation. This will result in a retiree drawing down their savings even faster than expected and consequently accelerating the risk of portfolio ruin.

Retirees therefore seem to be caught between a rock and a hard place. A high allocation to fixed interest reduces sequencing risk, but it is unlikely to match inflation, at least in present market conditions, leading to greater withdrawals from savings. Conversely, a high allocation to equities will provide a good inflation hedge but with the volatility that goes with an exposure to market linked investments.

Having a high level of diversification does help, but even with greater diversification, poor performance still can occur.

Keeping sufficient assets (up to two years of expenditures) in liquid assets avoids the need to cash out investments after a significant fall in the markets, before markets have had time to recover. But this does not provide protection from risk on the balance of the portfolio.

Ultimately, prevention is the best cure to the problem.

A proactive strategy is required for retirement savings.

Those accumulating for retirement should make every attempt to contribute more into their superannuation and build a larger balance to better withstand volatility as they approach retirement.

Clearly a different strategy is required for those approaching or in retirement and are therefore unable to make significant injections to their retirement nest egg. Creating a well-diversified, lower risk, income orientated portfolio helps mitigate the effects of sequencing risk while still providing a good long term hedge to inflation.

In this scenario, it is important for retirees to maximise 'investor returns' not 'investment returns', so outperforming in down markets is much more important performance in strong markets as it is harder to regain lost capital when drawing on your savings. Furthermore, a well-constructed, diversified, lower risk portfolio that has an additional objective of delivering higher income will dramatically increase the success rate of retirement as it will reduce the likelihood of drawing down on capital given the level of income that is being provided.

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