

Don't Forget About Sequence Risk, the Overlooked Threat to Financial Sustainability in Retirement

Long before the grand ball, Cinderella's father bequeathed \$1 million to her and her two stepsisters. This sum was intended for their retirement at the age of 65, a distant future event for the three young ladies.

However, in his trust, he stated that the trustee would offer a rate of return for each of them, but they were to decide on the return during the reading of the trust. "Take heed," cautioned the trust document, "once you have made your decision, it is irreversible. Make a thoughtful calculation, for this is the only money you will have when you retire."

The trust provided two choices:

Option A

A negative - (8)% rate of return for the first 10 years of their retirement, but then a positive 40% rate of return for the next 20 years. This equated to a 22% average annual return.

Option B

A 10% return for the first 15 years of their retirement and a 0% return for the next 15. This yielded a much more modest 4.7% annual rate of return.

Cinderella's Evil Stepmother used her laptop to open Excel and run calculations. After analyzing the projected \$1 million they would receive at retirement, she found that by the end of the 30th year, Option A would accumulate an impressive \$363 million, thanks to the magic of compounding interest. In contrast, Option B would reach just slightly over \$4.1 million.

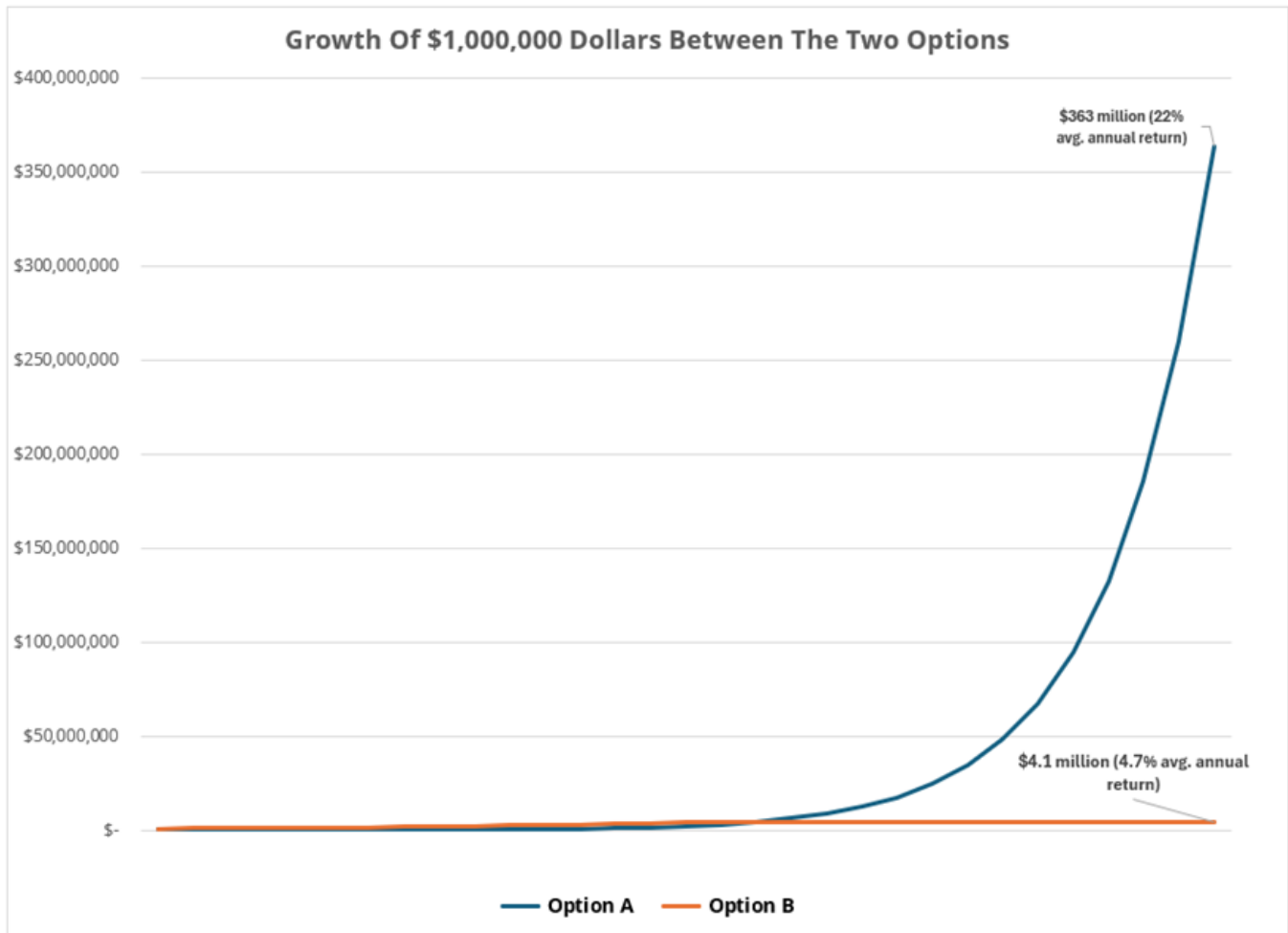


Figure 1: For illustrative purposes only

Sir David Osgood, the Trustee for Cinderella's father's estate, told the young women to decide.

The two stepsisters quickly chose Option A, and their mother nodded with her approval.

To the astonishment of Cinderella's stepmother and two stepsisters, Cinderella said, in a loud, confident voice, "Option B. Thank you most kindly." Her confidence sent a chill up and down their spines.

You see, Cinderella understood the impact of "**Sequence Risk**" when it comes to retirement and generating income from your assets.

Sequence risk, an often-overlooked danger, poses **a significant threat to your retirement savings**. It involves the risk of depleting all of your funds and literally going broke during retirement due to the timing of market returns during the withdrawal phase of your retirement investments.

It revolves around the order in which investment returns occur and can significantly impact portfolio outcomes, especially for retirees who begin taking income from their portfolios at the start of a market downturn.

The concern is that experiencing poor market performance early in retirement makes it challenging to maintain income sustainability, even if the market recovers later, and **can deplete your retirement portfolio faster**.

This was a key point that Cinderella recognized but was overlooked by her stepsisters and their mother.

Option A provided the two stepsisters with an average rate of return of 22%, while Option B provided Cinderella with an average 4.7% rate of return. This is where the concept of sequence risk comes into play.

Cinderella considered a crucial factor ignored by her stepsisters, which was that they each needed \$40,000 a year in income, with this amount growing at 2% annually for inflation. **It is the income being withdrawn from the retirement portfolio that sequence risk feasts on when the order of the returns starts out poor for the retiree**, as it did for Cinderella's stepsisters.

Take a look at the graph below comparing the investment portfolios in the retirement of Cinderella and one of her stepsisters.

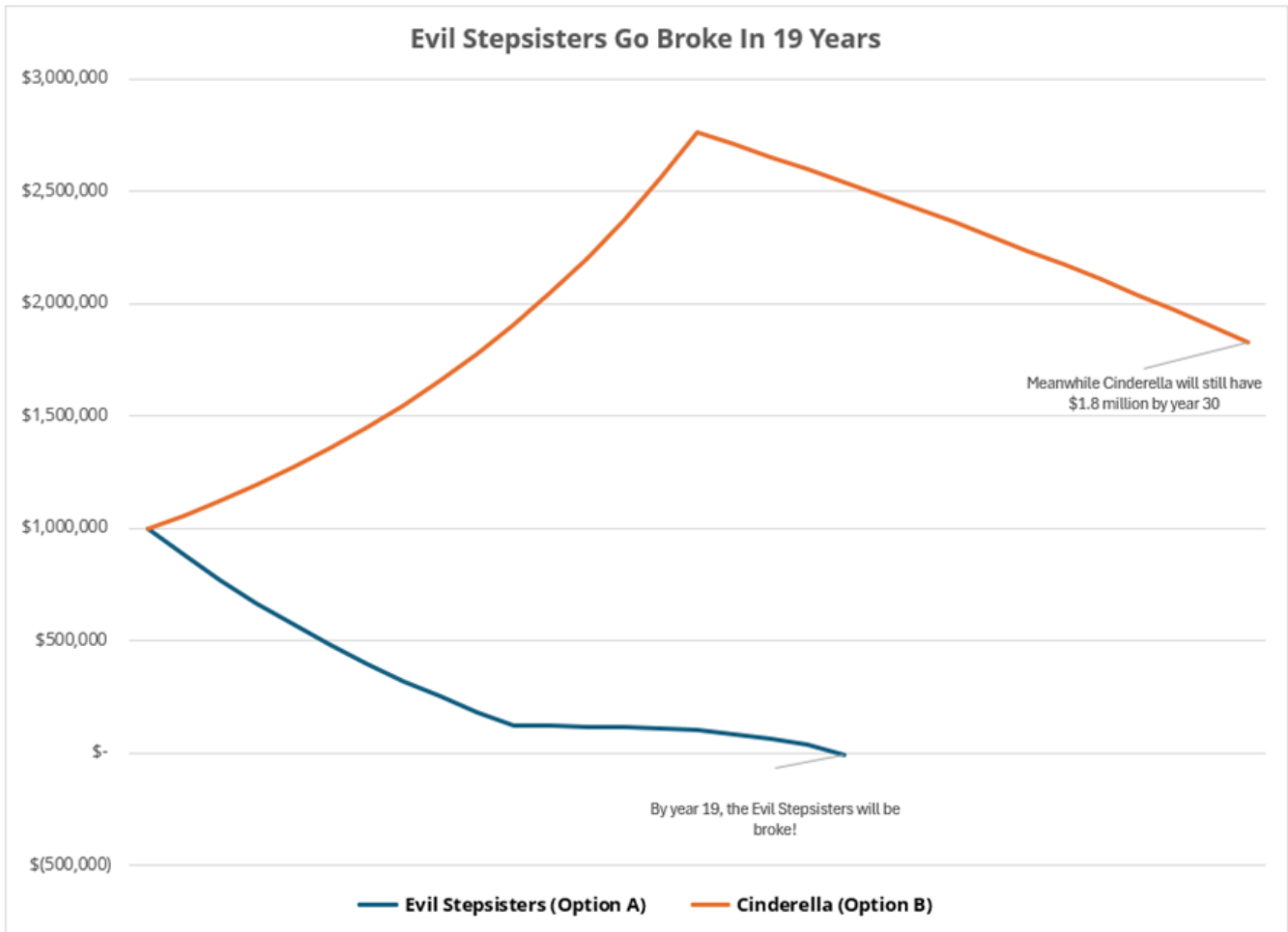


Figure 2: For illustrative purposes only

Due to the poor sequence of returns, the stepsister will run out of money and have no remaining assets within 19 years after retiring, at the age of 84.

On the other hand, although Cinderella had a lower average rate of return over the 30 years, the sequence of her returns would result in a retirement account valued at over \$2.5 million within the same 19 years post-retirement.

After the 30 years, at age 95, Cinderella would find herself with over \$1.8 million in her retirement account despite experiencing a 0% return for the last 15 years. This showcases the impact of sequence risk working in favor of the retiree, thanks to a **sound rate of return in her early years. That was the key factor at play.**

This reworked fairy tale illustrates the profound impact of sequence risk. Cinderella's choice of Option B created favorable early returns that became the foundation of her financial stability as the years unfolded. Even in the face of a 0% return during the latter part of her retirement, she emerged at age 95 with a robust \$1.8 million in her retirement account. She didn't need Prince Charming to rescue her, and she didn't need to worry about her riches disappearing at midnight.

In a twist of fate, Cinderella's stepsisters, who had once lived a life of privilege, taking advantage of Cinderella, now found themselves in a different reality. Running out of money, the stepsisters turned to Cinderella for support. The roles reversed, and the stepsisters were now penniless and on the other end of doing chores around the house.

This updated story of Cinderella highlights the importance of understanding sequence risk and serves as a reminder that financial well-being is quite dynamic, and more tenuous than we realize. Strategic decisions, or blunders, in the early years of retirement can make a lasting impact. As the clock ticks, may we all find inspiration in Cinderella's tale to navigate our financial lives with wisdom and foresight.

Disclosures