FINANCIAL fitness

by Thomas K. Brueckner

When you Incur Risk Makes All the Difference

Did you know that two investors can average the same return over time, yet one can have nearly twice as much money at age 65 as the other? Advisors call this Sequence of Return risk, and it's a retirement killer.

In the early 90s, when major brokerage firms used the results of studies and back-testing to demonstrate "truths" about the market, a popular brochure told of how one man bought $10,000 worth of the S&P 500 on the lowest (best) valuation day of each year for 25 years, while his hapless brother bought the same $10,000 of the index on the highest (worst possible) day of each year. While one might assume a huge difference after 25 years, the annualized yield of the first portfolio was only 1.2% per year higher than the second, proof that time in, rather than timing the market leads to desirable results.

What was not discussed was the age of the investor, implying that all investors had a 25-year time horizon, and that as long as one just stayed in the market over time, all would be fine. When one incurs massive losses in ones portfolio has far more to do with a sustainable retirement than any other single factor. Per Investopedia:

"It is not just long-term average returns that impact your financial wealth, but the timing of those returns. Two retirees with identical wealth can have entirely different financial outcomes, depending on when they start retirement. A retiree starting at the bottom of a bear market will have better investing success in retirement than another starting at a market peak, even if the long-term averages are the same."

Another consequence of this to a retiree no longer contributing to their 401(k) from income, is the ability to recover their losses after a big decline becomes greatly diminished, and the risk of outliving their assets will likely increase significantly. Guaranteeing a lifetime income from some of one's financial assets can help mitigate sequence of returns risk.

Sequence of return risk is rarely discussed by advisors making their living, not by acting as fiduciaries, but from an AUM (assets under management) trail commission so long as their clients remain fully invested. As regulators are now pointing out, this sometimes creates a conflict of interest between the retiree, who can no longer afford excessive risk on monies it's taken them 40 years to save, and their advisor whose income is dependent upon their client remaining fully invested in various market holdings.

A March, 2011 Financial Planning magazine article found that "…advisors have a history of being significantly disconnected from their clients' needs." When clients were asked what their top concern was, 88.6% said "losing our wealth." When advisors were asked the same question, only 15.4% believed "losing their wealth" was most important to those clients, virtually the polar opposite of how clients view their needs.

Perhaps it is time to discover whether sequence of returns risk is likely to derail your retirement.

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