HOW SEQUENCE OF RETURNS RISK AFFECTS RETIREMENT

There is much debate surrounding the 4% withdrawal rate in retirement. Some believe that the markets will continue to perform adequately for retirees, allowing them a withdrawal rate of 4% per year adjusted for inflation while safely ensuring they never run out of money.

But some leading economists and financial planners argue that the 4% rule can no longer be used and that the withdrawal percentage should be considerably lower until interest rates return to historical norms.

With interest rates still near 300-year lows and the 10-year US Treasury note at 3.50% [1], the traditional, conservative, fixed-income, bond-heavy retirement portfolio has been abandoned over the years in favor of seeking extra yield and growth, often taking on additional risk in the overall portfolio in the form of dividend stocks and/or high-yield bonds.

Investors are also confronting the highest rates of inflation since the late 1970s and early 1980s. Due to the recent increase in cost of goods and services caused by high inflation and the lack of returns from both equity and fixed income investments, investors may need to withdraw more than 4% from their portfolio for a period of time to compensate for the increased cost of living.

If, in fact, financial advisors are providing holistic planning to their retirees and pre-retirees, this environment can be difficult to manage. This is because there is little research and planning that goes into the commonly overlooked protection phase of the investor life cycle. The data below will illustrate the potential negative impact of sequence of returns during a time of higher inflation. These hypothetical scenarios, based on stock market history, indicate that timing of returns can drastically affect portfolio success, and a solution to provide retirees and pre-retirees with a potentially more predictable retirement is available.

[1] *1/13/2023*

SEQUENCE OF RETURNS RISK IS ALL ABOUT TIMING

Two Scenarios with Exactly the Same Returns—In Reverse Order

- In both scenarios, the retiree is 65 years old and retires with $1 million.
- In both scenarios, the retiree withdraws 4% per year plus a 3.5% annual increase for inflation Each year through age 87.
- Scenario 2 shows the actual S&P 500 Index stock market returns from the years 2000 through 2022. Scenario 1 simply reverses those same returns, starting with the 2022 S&P 500 Index return.

SCENARIO 1:

AGE	RETURN	WITHDRAWAL	ENDING PORTFOLIO VALUE
			$1,000,000
65	-19.44%	$40,000	$765,572
66	26.89%	$41,400	$930,055
67	16.26%	$42,849	$1,038,423
68	28.88%	$44,349	$1,293,951
69	- 6.24%	$45,901	$1,167,343
70	19.42%	$47,507	$1,346,533
71	9.54%	$49,170	$1,425,755
72	- 0.73%	$50,891	$1,364,504
73	11.39%	$52,672	$1,467,257
74	29.60%	$54,516	$1,847,068
75	13.41%	$56,424	$2,038,239
76	0.00%	$58,399	$1,979,792
77	12.78%	$60,443	$2,172,420
78	23.45%	$62,558	$2,619,386
79	- 38.49%	$64,748	$1,546,547
80	3.53%	$67,014	$1,534,119
81	13.62%	$69,359	$1,673,698
82	3.00%	$71,787	$1,652,139
83	8.99%	$74,300	$1,726,424
84	26.38%	$76,900	$2,104,961
85	- 23.37%	$79,592	$1,533,525
86	- 13.04%	$82,377	$1,251,135
87	- 10.14%	$85,260	$1,039,020
TOTAL	4.26%	$1,378,417	$1,039,019

SCENARIO 2:

AGE	RETURN	WITHDRAWAL	ENDING PORTFOLIO VALUE
			$1,000,000
65	-10.14%	$40,000	$858,608
66	-13.04%	$41,400	$705,223
67	-23.37%	$42,849	$497,591
68	26.38%	$44,349	$584,509
69	8.99%	$45,901	$591,176
70	3.00%	$47,507	$561,410
71	13.62%	$49,170	$588,701
72	3.53%	$50,891	$558,588
73	-38.49%	$52,672	$290,939
74	23.45%	$54,516	$304,660
75	12.78%	$56,424	$228,774
76	0.00%	$58,399	$287,180
77	13.41%	$60,443	$198,998
78	29.60%	$62,558	$195,346
79	11.39%	$64,748	$152,849
80	-0.73%	$67,014	$84,725
81	9.54%	$69,359	$23,444
82	19.42%	$27,997	$ -
83	-6.24%	$ -	$ -
84	28.88%	$ -	$ -
85	16.26%	$ -	$ -
86	26.89%	$ -	$ -
87	- 19.44%	$ -	$ -
TOTAL	4.26%	$936,197	$0

SCENARIO 1:

This hypothetical retiree was lucky—the portfolio was able to provide $1,378,417 in cumulative income withdrawals from age 65 through age 87 while still maintaining $1,039,019 in value net of income, even though in the first year of retirement the portfolio had negative returns.

Adding those two figures together, the total portfolio benefit to the client and heirs finished at $2,417,436.

SCENARIO 2:

This hypothetical retiree was unlucky because there were multiple years of portfolio losses in the initial years of retirement. Even though the annualized returns were the same as Scenario 1, the timing of returns prevented this portfolio from being successful.

The portfolio was only able to provide $936,197 in cumulative income withdrawals, and the portfolio was completely depleted in 17 years.

This is what is meant by sequence of returns risk: the timing of returns can affect portfolio income success.

PROTECTION-BASED PLANNING HELPS MITIGATE SEQUENCE OF RETURNS AND INCOME RISK:

To decrease the potential havoc that the timing of portfolio returns can create, more time must be spent researching and discussing the protection phase of investors life cycle.

THERE ARE FOUR STAGES OF AN INVESTOR'S LIFE CYCLE:

1. Accumulation
2. Protection
3. Distribution
4. Legacy

Most advisors, probably 90% of which are solely focused on AUM, talk about two phases of the investment life cycle: the accumulation phase and the distribution phase. They don't mention the stage most critical to retirement planning, the all-important five to 10 years prior to retirement and the years immediately following a client's start to retirement: the protection phase. Traditionally, little planning goes into the protection phase. Most advisors stick to what they know—traditional stocks and bonds, your average 60/40 portfolio design with assets under management (AUM). They avoid protection-based and holistic financial planning. However, as they choose to ignore the protection phase of the investment life cycle, they could be setting retirees up to experience similar outcomes to those we saw in the 2000 -2003 dot-com bear market and the 2008 financial crisis as illustrated in the scenario above.

The proper advisor for you should seriously consider how they will mitigate some of the major risks in retirement like sequence of returns, longevity, lack of income, and potentially higher inflation and taxes. That begins with a hard look and in-depth analysis of each person's pre-retirement portfolio. They must also determine how each individual retiree or pre-retiree will be able to live off their accumulated assets for the rest of their lives as opposed to simply offering an offhand guess about a percentage they might be able to withdraw every year, if they're lucky.

Traditionally, protection-based planning begins five to 10 years before you want to retire (sometimes even sooner) and up to five years after you retire. Think age 50 to 55 or so. The exact age depends on the individual and the financial plan laid out by the advisor. These critical pre-retirement and early retirement years are when a financial advisor—especially an advisor with a fiduciary duty—should begin to deleverage the portfolio by introducing non-correlated asset classes and lower volatility solutions to the portfolio. Advisors should be using this time to assess and solve for potential pain points in the upcoming retirement stage of the financial plan. They should also be adept at fielding your questions about how they're implementing this process into your unique plan.

Let's examine how a protection-based approach can be used to mitigate sequence of returns and income risk by utilizing a fixed indexed annuity during the protection phase of an investor's life cycle.

GUARANTEED INCOME STRATEGY:

Fixed Indexed Annuities

FIXED INDEXED ANNUITIES ADDRESS UP TO FIVE RETIREMENT RISKS

1. Longevity ✓
2. Health ✓
3. Sequence of Returns ✓
4. Inflation ✓
5. Income ✓

An often-overlooked asset class for retirement is the guaranteed income provided by a fixed indexed annuity (FIA). Fixed indexed annuities and riders can address many different retirement risks, including the aforementioned sequence of returns.

In fact, the only asset class that can help mitigate up to five risks in retirement—longevity, health, sequence of returns, inflation and income—is an annuity with guaranteed income.

A **fixed indexed annuity with an optional guaranteed income rider*** provides guaranteed lifetime income that may help offset portfolio sequence of returns risk. Guaranteed income lessens the reliance on the portfolio to generate income, helping mitigate the risk of negative timing of returns while also providing security to cover income needs.

Having guaranteed income gives the retiree the option to leave money in the portfolio during market downturns rather than being forced to take withdrawals for living expenses which can hasten a portfolio's decline.

**Guaranteed by an insurance carrier. Optional enhancement riders may be added to the policy for an additional charge. These are hypothetical average numbers based off of A+ rated carriers.*

HOW GUARANTEED INCOME CAN MITIGATE SEQUENCE OF RETURNS RISK

Scenario 2 Option, Adding an FIA

YEAR	RETURN	WITHDRAWAL	FIXED INDEXED ANNUITY	ENDING PORTFOLIO VALUE
			$200,000	$800,000
2000	-10.14%	$40,000	$ -	$678,887
2001	-13.04%	$20,732	$20,668	$569,609
2002	-23.37%	$21,458	$20,668	$415,057
2003	26.38%	$22,209	$20,668	$502,342
2004	8.99%	$22,986	$20,668	$524,534
2005	3.00%	$23,790	$20,668	$516,485
2006	13.62%	$24,623	$20,668	$562,204
2007	3.53%	$25,485	$20,668	$556,563
2008	-38.49%	$26,377	$20,668	$315,988
2009	23.45%	$27,300	$20,668	$362,801
2010	12.78%	$28,256	$20,668	$380,921
2011	0.00%	$29,245	$20,668	$351,667
2012	13.40%	$30,268	$20,668	$368,539
2013	29.60%	$31,327	$20,668	$446,304
2014	11.39%	$32,424	$20,668	$464,717
2015	-0.73%	$33,559	$20,668	$427,782
2016	9.54%	$34,733	$20,668	$433,837
2017	19.42%	$35,949	$20,668	$482,140
2018	-6.24%	$37,207	$20,668	$414,860
2019	28.88%	$38,509	$20,668	$496,154
2020	16.26%	$39,857	$20,668	$536,966
2021	26.89%[2]	$41,252	$20,668	$640,119
2022	19.44%[2]	$42,696	$20,668	$472,965
TOTAL	4.26%	$710,243	$454,696	$472,965

SCENARIO 2 OPTION:

The hypothetical 65-year-old retiree with $1 million saved who experienced market downturns early in retirement could have avoided running out of money by using a guaranteed* income fixed indexed annuity.

If the client had allocated $200,000 of the portfolio to a fixed indexed annuity with guaranteed income at age 60 during the protection phase of his investor lifecycle before retirement, the FIA could generate $20,668 in guaranteed income annually and $454,696 in total as shown, assuming income is deferred to age 66, the year after his portfolio suffers a negative return.

In this scenario, the portfolio was able to provide $1,164,939 in cumulative income withdrawals while still maintaining a $472,965 portfolio balance, unlike the original scenario which had the portfolio depleted in 17 years without the proper planning.

**Guaranteed by an insurance carrier. Optional enhancement riders may be added to the policy for an additional charge. These are hypothetical average numbers based off of A+ rated carriers.*

This material is not a recommendation to buy, sell, hold, or roll over any asset, adopt a financial strategy or use a particular account type. It does not take into account the specific investment objectives, tax and financial condition or particular needs of any specific person. You should work with your financial professional to discuss your specific situation. Guarantees are provided and backed by the financial strength of an insurance company. Optional enhancement riders may be added to the policy for an additional charge. Hypothetical average FIA numbers are based off of A+ rated carriers.