Canaccord Genuity Wealth Management

Financial Focus

Becker Orr Wealth Management

Retirement Risks **March 2021**

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Common retirement questions are: how much do I need to retire? When can I retire? How long will my money last? All these questions are important, but an often-overlooked risk in retirement is the sequence of return risk. Most online retirement calculators or retirement projections can help you answer the questions above, but they use a flat rate of return - they assume the return is the same every year. In reality, investment returns fluctuate, and the sequence of the return in retirement matters, as it can impact the bottom line. Let's look at an example.

Assume you retired at the beginning of 2001. You were getting a bit of money from your work pension, some from CPP and some from OAS. In addition, you had saved $500,000. You needed to withdraw $30,000 a year from your investment portfolio to get to your desired retirement income. That means you are taking 6% from your portfolio every year. Also assume over the next 20 years your investment portfolio achieves the following returns:

2001	2002	2003	2004	2005	2006	2007	2008	2009	2010
-12.57%	-12.44%	26.72%	14.48%	24.13%	17.26%	9.83%	-33.00%	35.05%	17.61%

2011	2012	2013	2014	2015	2016	2017	2018	2019	2020
-8.71%	7.19%	12.99%	10.55%	-8.32%	21.08%	9.10%	-8.89%	22.88%	5.60%

Those returns are not chosen at random. Those numbers are for the S&P/TSX Composite Total Return Index, and in short, that data is the total return on the Canadian stock market over the last 20 years. I downloaded the numbers from investing.com. The average annual return is 6.16%. If you are taking $30,000 out of your portfolio, or 6% of the portfolio, and on average your investments earn 6.16% per year, your portfolio is earning more interest than you are withdrawing, so your $500,000 portfolio should remain intact, right? If every year your portfolio returned 6.16% that would be true. Unfortunately, investment returns fluctuate, so the outcome is not as straightforward. In retirement, you need money every year. In our example that means you are drawing $30,000 from your portfolio every year, regardless of your investment return.

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If you had $500,000 at the beginning of 2001, withdrew $30,000 a year and your portfolio experienced the returns mentioned above, by the end of 2020 your portfolio would be worth $339,369.

If we repeat the exercise, but instead reverse the order of the returns, so in year one our return is 5.60% instead of -12.57% and in year two it is 22.88% instead of -12.44%, if we experience the returns in reverse order, by the end of the 20 year period our portfolio is worth $524,910. A $185,542 improvement! We withdrew the same $30,000 every year, the portfolio had the same 6.16% average annual return over the 20 years, we simply changed the sequence of the returns.

Unfortunately, we cannot pick the order in which we experience our investment returns - we do not know when there will be a good market or a bad market. However, the above example shows that sequence of returns matters and the more volatile the returns the greater the risk. If you earn 4% one year, -5% the next and 10% the following year, that can be an issue. The volatility in the rate of return is the key concern, which is why in retirement folks often strive for lower risk more consistent investment portfolios.

The example above is simplistic, the portfolio has only one asset class, Canadian stocks. To lower the risk and achieve more consistent returns we need to diversify. Ideally the investments in the portfolio do not move in sync, so if one is down, the other might be up, which means if we need to withdraw money, we could take it from the asset that is currently in an uptrend and not touch the asset that went down, providing it time to recover. To illustrate, suppose we repeat the example above, but instead of just Canadian stocks, we add Canadian bonds, split the money 50/50 and rebalance every year. In this case the average annual return would be slightly lower at 6.03%, but, if we experienced the returns in chronological order, by the end of the 20-year period instead of our portfolio being worth $339,369 it would be worth $423,884. We added just one additional asset and there is already a substantial improvement.

Proper diversification and rebalancing can help mitigate the sequence of return risk. A robust financial plan will not only address the big retirement questions, but also manage the little details, which will help you mitigate sequence of return risk, and overall helps lower the risks to your retirement.

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