Guest IRA Expert

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For Retirees, Timing Is Everything

Every day, roughly 10,000 Baby Boomers will kiss the workplace goodbye and enter the world of retirement. Their monthly paychecks will cease, so many Boomers will rely upon a combination of Social Security, a pension (for those fortunate enough to have one), and withdrawals from their hard-earned savings.

These retirees may think they're home free, assuming they have an ample nest egg, but there's a dangerous trap they need to dodge. This pitfall is known as sequence of returns risk, and it's of great importance to clients early in the retirement distribution stage. This sequence risk can affect IRA planning, pre-and post-retirement. The more of a client's assets that are held in a traditional IRA, the more advisors should do to mitigate this peril.

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Low Interest Rates Have Led Some Retirees to Invest More in the Market

With interest rates hovering near historical lows, investment grade bonds may fail to generate adequate income for many seniors. The result has been a shift into riskier asset classes as part of a so-called "reach for yield," and larger allocations to stocks for many retirees.

This introduction of riskier asset classes into a portfolio may increase the expected return, but it also increases the volatility within the account. The recent stock market surge has led many to abandon conservative investing and pour money into equities. This stock-focused strategy may make sense for someone saving for retirement, but the game changes when investors begin withdrawing in retirement.

Sequence Risk Less of a Concern During Retirement Accumulation

Advisors may have heard that the sequence of returns – the order in which gains and losses occur – is more important than average returns. That's true for anyone, but even more so for retirees who have just started portfolio distributions. Some examples can explain this key distinction.

Say that John Jones, age 45, changes jobs and rolls over his $1 million 401(k) account to a traditional IRA, which he invests in a 50-50 portfolio, large-company U.S. stocks and long-term government bonds. Those asset classes have posted annualized returns of 9.2% and 7.0%, respectively, over the 20 years through 2013, according to Morningstar's Ibbotson subsidiary, so let's assume John has an annualized portfolio return of 8%. If the portfolio earns 8% every year, for 20 years, John's IRA will grow to about $4.48 million.

In another scenario, John runs into a three-year bear market upfront, leading to annualized losses of 15%, 5%, and 15% again. Then John goes 17 years without a further loss, bringing the 20-year return back to 8% a year. Depending on the actual yearly results, John's $1 million might grow to about $4.23 million.

Alternatively, John starts out successfully but runs into similar losses in years 18, 19, and 20. With an otherwise identical return pattern, John's $1 million would grow to around $4.21 million. The bottom line is that return sequence is only marginally important for pre-retirees like John. The difference that return sequence can make is probably not enough to meaningfully disrupt retirement planning.

Sequence Risk Amplified During Retirement Withdrawal Phase

To see the real threat of sequence of returns risk, consider John's Aunt Mary, who retires at age 65 and rolls her $1 million 401(k) into a traditional IRA the same year, and invests in the same 50-50 portfolio. Assume that Mary starts by withdrawing 6% ($60,000) of her $1 million IRA and increases her withdrawal by 3% each year, the inflation rate of the past three decades, so that she's pulling out some $105,000 by age 85.

With that very hypothetical 8% return each year, Mary will reach 85 with over $1 million left in her IRA – more than she started with. Of course, such uniform returns are unlikely.

Suppose that Mary starts out very strong with a return of more than 8% per year but that late losses bring her 20-year average return down to 8% per year. Assuming the same return pattern that grew John's $1 million to over $4 million, Mary would still have more than $1.7 million in her IRA and likely would feel confident about her future.

Now look at the alternative scenario: losses of 15%, 5%, and 15% in the first three years of retirement,

followed by positive years that bring the annualized return up to 8%. While this sequence would have brought nephew John's $1 million to $4.23 million in 20 years (down from $4.48 million if returns were a consistent 8%), Aunt Mary's escalating withdrawals in retirement will completely deplete her $1 million portfolio after 16 years.

As these examples indicate, the impact of sequence of returns prior to retirement is minimal, long-term, if the annualized returns are near historic averages. Conversely, the impact of portfolio losses in the first few years of retirement can be devastating, even with historic long-term returns, causing clients to either draw down their portfolio or sharply decrease withdrawals of needed cash flow.

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Planning To Reduce Sequence Risk

How can advisors help clients reduce sequence risk? The usual suspects – work longer, save more – can provide more funds for retirement. Delaying Social Security as long as possible can increase cash flow in retirement and thus reduce dependence on portfolio drawdown.

Similarly, Roth 401(k) contributions and partial Roth IRA conversions during a client's working years can help to build up a pool of cash that can be tapped in retirement, tax-free. Having a source of tax free income may reduce pre-tax withdrawals from traditional IRAs and thus avoid rapid portfolio depletion.

Moreover, advisors should urge clients to adopt a prudent distribution plan. If Mary were to start with a 4% initial withdrawal rate, rather than the 6% in the example above, she won't go through her savings so rapidly.

Most importantly, planners can suggest to vulnerable clients that they enter retirement with a portfolio that's unlikely to suffer sizable losses, even in a severe bear market. One way to do that is to put together a well-diversified portfolio. Although diversification does not assure against market loss, such a portfolio wouldn't be heavily weighted to equities, which can post the largest and most protracted losses, as we've seen in this century.

Besides bonds and comparable holdings, fixed annuities and commodities might be suitable diversifiers, along with real estate and precious metals and energy master limited partnerships and perhaps some "liquid alts": long-short or market neutral or merger arbitrage funds, for example. Advisors may have some alternative investments they prefer.

A well-diversified portfolio might have a relatively small allocation to domestic and foreign stocks, decreasing the risk of an early retirement plunge in value. In addition, non-correlation among investments can dampen portfolio volatility so that any ill-timed reversals can be modest instead of major.

Using "Buckets" to Reduce Sequence Risk

A well-diversified portfolio can lend itself to a "multi-bucket" plan for retirement distributions. Aunt Mary, for example, might segment her IRA into three buckets. The first bucket could hold enough cash for income in Year 1 of Mary's retirement. This bucket should be made up of liquid, ultra-safe investments including money market funds and bank accounts.

Mary's second bucket can be designed to meet near-term income needs, generally Years 2-11 of retirement. In order to lessen the impact of sequence risk, this bucket should be heavily weighted towards investments that deliver stable retirement income.

Reducing the risk of market fluctuations within this second bucket allows a retiree to invest the third and final bucket more aggressively. Holdings here generally will include stocks and other securities with high appreciation potential.

Ideally, assets in Bucket 2 will feed into Bucket 1 from investment interest, bond redemptions, annuity payouts, and so on. Thus, seniors always should have access to ready cash. Concurrently, assets can flow from Bucket 3 to Bucket 2. Advisors can play a key role here, suggesting which Bucket 3 assets to tap and perhaps offering assistance in timing these transfers.

The goal is to establish a disciplined strategy for retirement distributions. Even if clients have the misfortune to retire just before a vicious bear market, having 10-12 years' worth of withdrawals in low-volatility holdings can take the bite out of sequence risk. ■

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