Rethinking Risk

Why it's important to start playing defense early in retirement

"It's important to finish strong."

This is a common mantra in sports, and many investors also feel the same way, assuming that they can make up for early portfolio losses if they have strong years later on. However, it's not always possible for a portfolio to rally – especially for retirees.

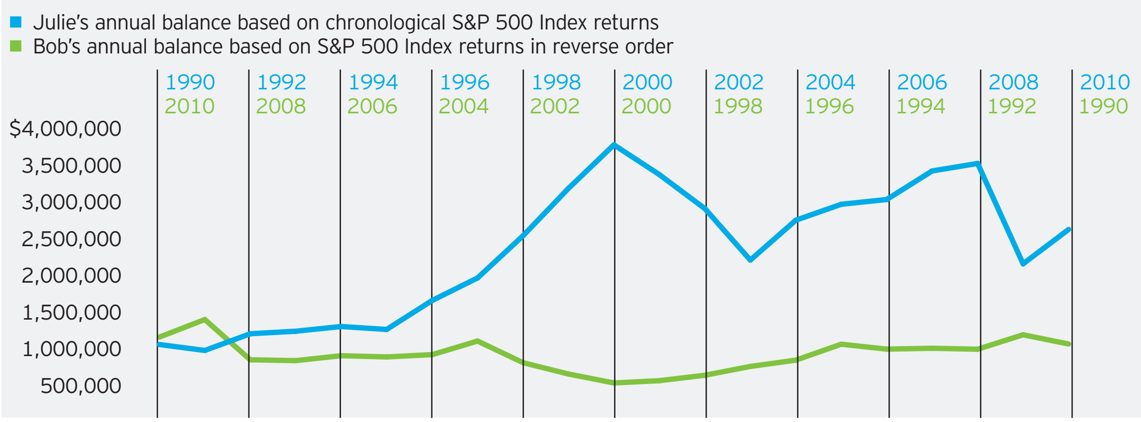
Making the move from saving to spending

Investors' ultimate portfolio value depends greatly on where their good years and their not-so-good years fall in their investment timeframe. Due to the power of compounding, early losses can have a more significant impact than losses that occur later in time. This is an important concept for all investors, but particularly for retirees who are living off of their portfolio income.

Julie Blue's retirement portfolio started strong. Her returns, shown below, follow the actual returns of the S&P 500 Index from 1990 through 2010, taking into account an annual $50,000 withdrawal (indexed for inflation). As you may remember, the returns in the early '90s were stronger than returns since 2008. But even though Julie's portfolio took some major hits in 2002 and then again in 2008, strong early returns sustained her portfolio so that she ended up with more than twice what she started with – all while taking out money to live on each year.

During Bob Green's retirement, the market finished much stronger than it started. His returns are also based on the S&P 500 Index – but in the reverse order of Julie's. So Bob experienced early setbacks, not early gains. Therefore, even with strong market returns in later years, his portfolio never fully recovered.

It's more important to start strong than to finish strong
$1 million beginning balance invested in S&P 500 Index
$50,000 annual withdrawals, increased 3% annually, from 1990-2010



Source: Lipper. Data as of Dec. 31, 2015. For illustrative purposes only. Past performance does not guarantee future results. The S&P 500 is an unmanaged index considered representative of the US stock market. An investment cannot be made directly in an index. Each portfolio assumes a first year withdrawal that was subsequently adjusted for a 3% increase annually. The table assumes annual withdrawals are taken at the end of each year.

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Bob was hit with a 36.99% loss in year three, which hurt his future growth potential.

Examining the statistics behind Julie's and Bob's results

A portfolio's sequence of returns doesn't matter as much when you're putting money in, but it could make a difference when you begin to withdraw your savings.

Year	S&P 500 Index (in order from 1990-2010)	Julie's annual balance based on actual S&P 500 Index returns	S&P 500 Index (in reverse order from 2010-1990)	Bob's annual balance based on actual S&P 500 Index returns in reverse order
		1,000,000.00		1,000,000.00
1	-3.11	918,900.00	15.08	1,100,800.00
2	30.40	1,146,745.60	26.47	1,340,681.76
3	7.61	1,180,967.94	-36.99	791,718.58
4	10.06	1,245,136.96	5.49	780,547.58
5	1.31	1,205,172.82	15.78	847,442.54
6	37.53	1,599,510.47	4.91	831,088.27
7	22.95	1,906,895.51	10.87	861,724.95
8	33.35	2,481,351.47	28.67	1,047,287.80
9	28.60	3,127,679.49	-22.09	752,603.42
10	21.03	3,720,191.83	-11.88	597,955.47
11	-9.10	3,314,458.55	-9.10	476,345.71
12	-11.88	2,851,489.18	21.03	507,309.52
13	-22.09	2,150,307.18	28.60	581,111.99
14	28.67	2,693,373.56	33.35	701,486.16
15	10.87	2,910,513.78	22.95	786,847.74
16	4.91	2,975,521.64	37.53	1,004,253.33
17	15.78	3,364,823.63	1.31	937,173.73
18	5.49	3,466,910.06	10.06	948,811.02
19	-36.99	2,099,378.38	7.61	935,893.89
20	26.47	2,567,408.53	30.40	1,132,730.33
21	15.08	2,864,268.18	-3.11	1,007,196.86

For illustrative purposes only. Past performance does not guarantee future results.
Returns based on the S&P 500 Index. The average annual total return of the index from 1990 to 2010 = 9.45%. One cannot invest directly in an index.

Talk to your advisor

The takeaway: For retirees, it's more important to start strong than to finish strong. If you're approaching retirement – when you will no longer add to your portfolio, but instead draw from it to provide steady income – talk to your advisor about steps you can take to potentially lessen the risk of a significant hit to principal early in your retirement. That could include balancing the growth potential of stocks with other investments such as bonds or alternatives, which have the potential to rise when stocks fall, and vice versa. Generating growth may still be important, even in retirement, but the risks need to be carefully balanced with the return potential.