

The Biggest Retirement Risk that you've never heard of

Eventually the day will come to exit the corporate rat race and to enjoy retirement. You've envisaged your retirement for quite a few years and it is finally time to wind down.

There is just one problem; how do you ensure that your retirement savings are invested in a manner that provides the income and growth that you require?

Nobel laureate in the field of economics, Will Sharpe, stated that retirement planning is the most complex problem he has faced in his career.

In lieu of your salary, in retirement you will require a regular monthly income. This income should increase annually, by inflation, to ensure that you are able to maintain your standard of living. Whilst in retirement, a more conservative asset allocation is required, while simultaneously ensuring that your investment grows optimally.

Perhaps one of the biggest risks to your retirement savings is something you may have never heard of before. It's called Sequence Risk, and it's worrisome...

What is Sequence Risk?

Sequence risk is also known as sequence-of-returns risk. It becomes perilous when an individual withdraws from a fund's underlying investments. The order or the sequence of annual investment returns is a primary concern for retirees who are living off the income and capital of their investments.

An example of sequence risk is detailed below:

In the following scenario we consider 3 investors (Emma, Raj and Siphon) who have all retired with certain commonalities:

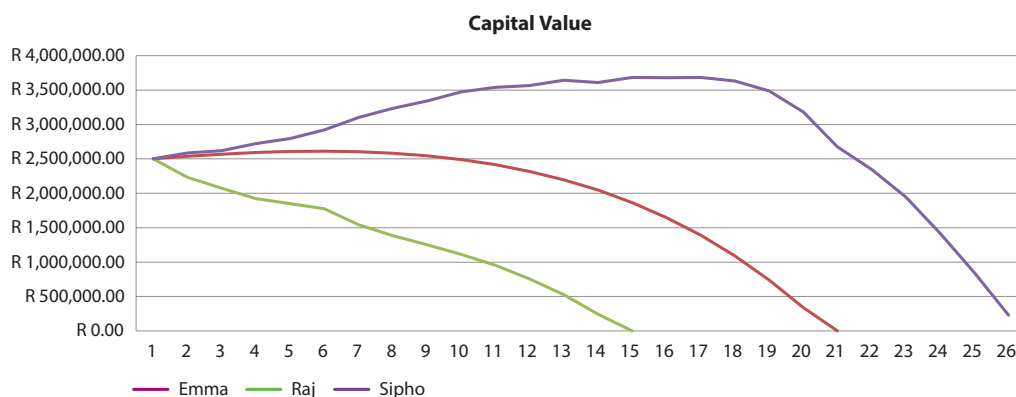
- They have the exact same birth date and retire at age 60. They plan for 25 years of retirement.
- They each have R 2,500,000 in retirement savings.
- They each require a gross annual income of R 150,000 and will increase this amount by 6% each year.
- Their investments grow at an annual average return of 8% over the 25 year period

Surely with all of these commonalities, the investors should have the same outcome? Not even close...and it's due to sequence risk.

Although each investor receives an annual average return of 8% on their investment, the following occurrences changed their individual outcomes:

- Raj received poor returns in the early years of his investment and strong returns in later years (Poor start scenario)
- Emma receives a consistent 8% annual growth (Consistent Scenario)
- Siphon receives strong returns in the early years of his investment and poor return in later years (Strong start scenario)

The sequence of returns has a dramatic effect on their retirement savings, illustrated below:



Fund value on the Y-axis and Years after retirement on the X-axis

Notice the vast differences in fund values for each investor as each year passes. Raj's scenario is a retiree's nightmare, one that becomes a reality all too often for South Africans. He has run out of money 15 years into his retirement, at age 75. At the same stage, Siphon's fund value has grown to R 3,683,241.67 and Emma's fund value sits at R 1,865,037.75. These key differences are attributed to sequence risk.

Raj faces the hard reality of relying on hand-outs from family and a measly government pension to get by from age 75.

How does GMI help clients to manage Sequence Risk?

In order to mitigate sequence risk, one has to aim for returns that are consistent with low volatility. In simpler terms, the investor should be invested in lower risk funds that provide more consistent returns. This usually means investing in income funds or moderately conservative funds that aim for a fairly consistent return.

Retirees generally have a long investment horizon, and simply can't afford investments that expose them to undue risk and volatility, however, they also require returns that will ensure their ability to maintain their lifestyles.

Focus should be placed on a well-diversified investment portfolio that targets funds with a consistent track record of good yield. Although the term yield and return are often used synonymously, they are different concepts. Yield is a component of return that is more consistent and predictable in nature, such as dividends and interest. Funds that give an attractive yield can help to satisfy the retiree's income requirement. A portion of the investment should be allocated to growth assets, whilst simultaneously managing risk.

Each individual case is different, and your retirement solution will depend on the amount you have saved for retirement, your income requirements and your risk profile etc.

A full retirement planning analysis at any stage pre- or post-retirement will allow you to take stock of where you are in your retirement journey. This will also give you the opportunity to make any necessary changes, if required.

Other solutions such as life annuities, investment-linked living annuities and hybrid annuities can also be explored.

Conclusion

Sequence risk presents a clear and present danger for people who have retired since 2014. The market has been in a sideways and volatile trend since September 2014.

GMI clients have largely experienced sector beating returns, and in most cases, inflation beating returns too. Our approach to downside risk management and cost mitigation has resulted in clients weathering the storm relatively well.