The Impact of Sequence of Returns on Your Retirement Portfolio

As you accumulate assets and grow your money for retirement - known as the “accumulation phase of investing” – market volatility is generally more tolerable. Since you have a longer time horizon before you plan to use your money you take comfort in knowing your investments have time to recover from any short term volatility in the market.

As you begin drawing down on assets during retirement and create an income stream – known as the ‘de-accumulation phase’ of investing – market volatility takes on greater significance, especially if your portfolio is subject to this volatility at the beginning of retirement. More specifically, market fluctuations and the order in which positive and negative investment returns occur, or ‘the sequence of returns,’ can have a detrimental effect on your retirement savings.

Timing of retirement can have an impact

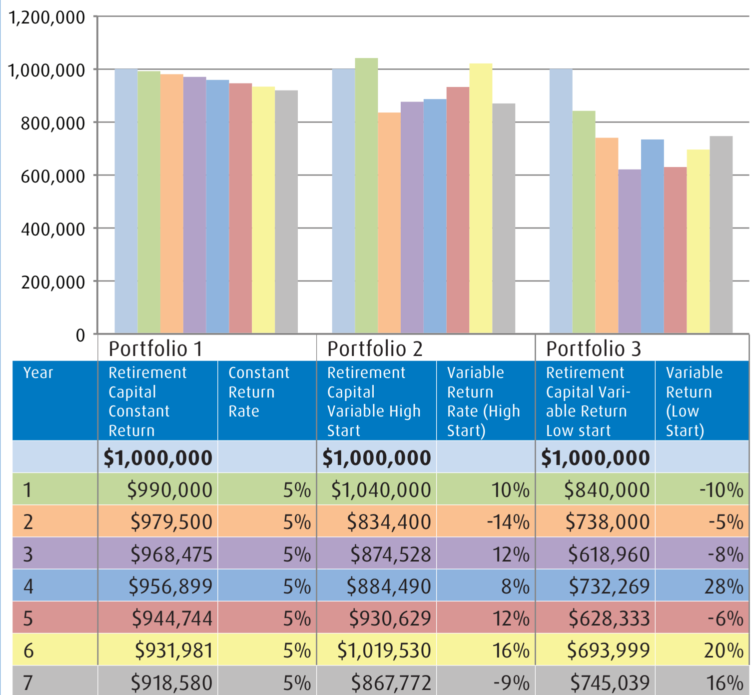
Looking more closely at sequence of returns risk and the timing of retirement, if negative returns happen near the beginning of retirement, overall capital will decrease more quickly compared to a portfolio with positive returns at the beginning of the retirement withdrawal period. This is why the first years of retirement are so important; what happens during that period may determine whether or not you’ll outlive your savings or if you’ll have to lower your desired standard of living later in retirement to extend these savings.

As seen in **Figure 1**, three similar retirement portfolios can end up having very different outcomes, depending on the market conditions they’re under and the sequence of returns. In each scenario, the portfolio earns an average annual 5% per year return over the seven years and assumes a $60,000 withdrawal per year from an initial capital investment of $1 million. We can see that Portfolio 3, with a negative variable rate of return at the beginning, faces a greater depletion of capital and is left with a considerably lower balance compared to Portfolio 1 and Portfolio 2, at the end of year seven.

Figure 1

Capital accumulation and depletion over a 7-year period

Each scenario has an average annual 5% per year return and assumes a $60,000 withdrawal at the end of every year. Initial capital investment is $1,000,000.



Year	Portfolio 1 Retirement Capital Constant Return	Constant Return Rate	Portfolio 2 Retirement Capital Variable High Start	Variable Return Rate (High Start)	Portfolio 3 Retirement Capital Variable Return Low start	Variable Return (Low Start)
	$1,000,000		**$1,000,000**		**$1,000,000**	
1	$990,000	5%	$1,040,000	10%	$840,000	-10%
2	$979,500	5%	$834,400	-14%	$738,000	-5%
3	$968,475	5%	$874,528	12%	$618,960	-8%
4	$956,899	5%	$884,490	8%	$732,269	28%
5	$944,744	5%	$930,629	12%	$628,333	-6%
6	$931,981	5%	$1,019,530	16%	$693,999	20%
7	$918,580	5%	$867,772	-9%	$745,039	16%

For illustration purposes only

Source: BMO Financial Group

Mitigating sequence of returns risk

Knowing the significance of sequence of returns risk on retirement portfolios, how can investors planning for retirement defend or mitigate this risk? After all, market volatility is not something you or your investment professional can control.

Luckily, there are a number of important steps you and your investment professional can take.

- **De-risk your retirement portfolio** – You can reduce sequence returns risk by decreasing the risk itself within your portfolio. One way of doing this is by reducing your exposure to riskier investments, such as equities, perhaps at the outset, when you begin retirement.
- **Diversify across asset classes** – Diversification is generally a key principle when investing, but perhaps is even more important during retirement, to ensure more stable, consistent returns.
- **Flexible spending** – Those who want upside in their savings, should be flexible with their spending and willing to make adjustments. In particular, spending on 'big ticket' items should be carefully planned during retirement.
- **Plan ahead** – In general, it's important to map out your utilization of retirement savings with your investment professional. Understand what your objectives are for retirement and what your expected spending will be to ensure ample income to live comfortably.

Integrate BMO Retirement Portfolio's investment approach with your retirement

BMO Global Asset Management's approach focuses on more consistent returns, while providing some capital protection and potential for growth, to ensure your retirement portfolio is as healthy and active as you are in your retirement.

- Moving beyond traditional asset classes to reduce volatility and provide capital protection
- Multi-asset strategy that is flexible, diversified and hedged against significant market declines
- Realize more consistent growth potential to fund your retirement lifestyle

For more information on BMO Retirement Portfolios, please call your investment professional or visit bmo.com/mutualfunds.

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