WELLS FARGO Advisors

Why sequence of returns risk matters for your retirement

Investment losses can have an outsized impact at certain times in the retirement journey. Your advisor can help you manage volatility in your retirement portfolio.

Downturns are an inevitable part of long-term investing. Although there's never a good time to lose money, large declines are a bigger problem at some points than others. A bear market late in your career, when retirement account balances are typically high—or early in retirement, when you're preparing to start withdrawals—can be especially challenging.

Your Financial Advisor can help you manage sequence-of-returns risk so you can feel more confident about your potential for a secure retirement.

What sequence-of-returns risk is

Sequence-of-returns risk is the chance of experiencing low or negative returns very late in your career and/or early in your retirement years. When investing for retirement, the sequence—or order—of investment returns has the biggest impact in the years immediately before and after you retire. Here's why:

- **Your assets probably are higher than they ever have been.** You may be investing more money than you were earlier in your career—so if the market falls, you're likely to lose more dollars.
- **You may not have much time (if any) to contribute more to your investment portfolio.** When you're close to or in retirement, the time horizon for recouping losses is typically very short.
- **You may need to withdraw from your retirement portfolio.** Withdrawals can magnify the impact of investment declines. That's because withdrawals can effectively lock in losses, leaving less money to benefit from any future gains.

Sequence-of-returns risk is least problematic early in your career or late in retirement. A big downturn at the beginning of your career may feel frightening, but it likely won't have a big impact on your long-term results: The dollar value of your losses might be minor, you have decades ahead to contribute to your retirement portfolio, and you probably won't need to withdraw from it for many years. And late in retirement, people have a decreasing need to prepare for many years of future withdrawals.

Investment and Insurance Products: ▸ NOT FDIC Insured ▸ NO Bank Guarantee ▸ MAY Lose Value

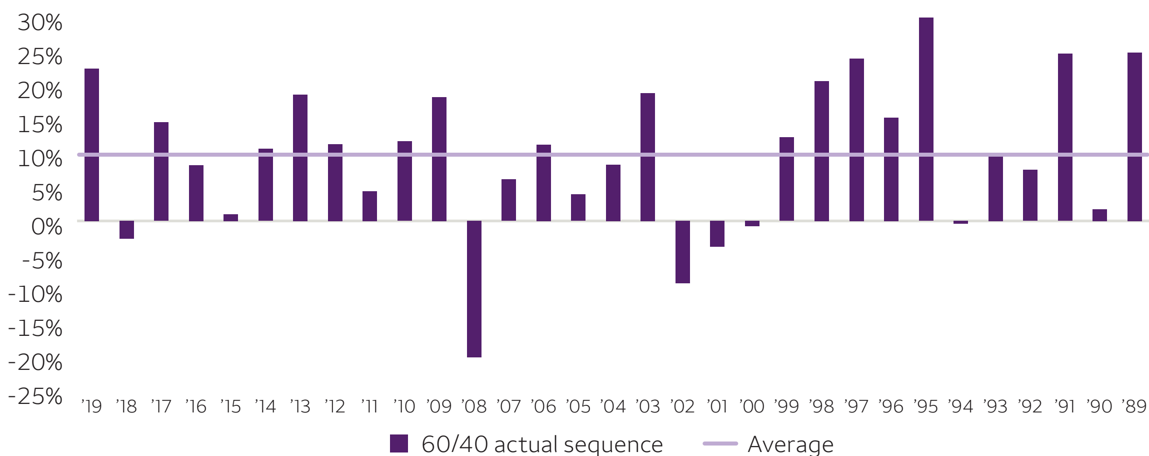
Why the average return doesn't tell the whole story

Many investors are either continually contributing to, or withdrawing from, their retirement portfolios. Because of this, the timing of investment returns has a surprisingly large impact on overall results—even if the average annual return over a given investment horizon remains the same. Let's explore why this is:

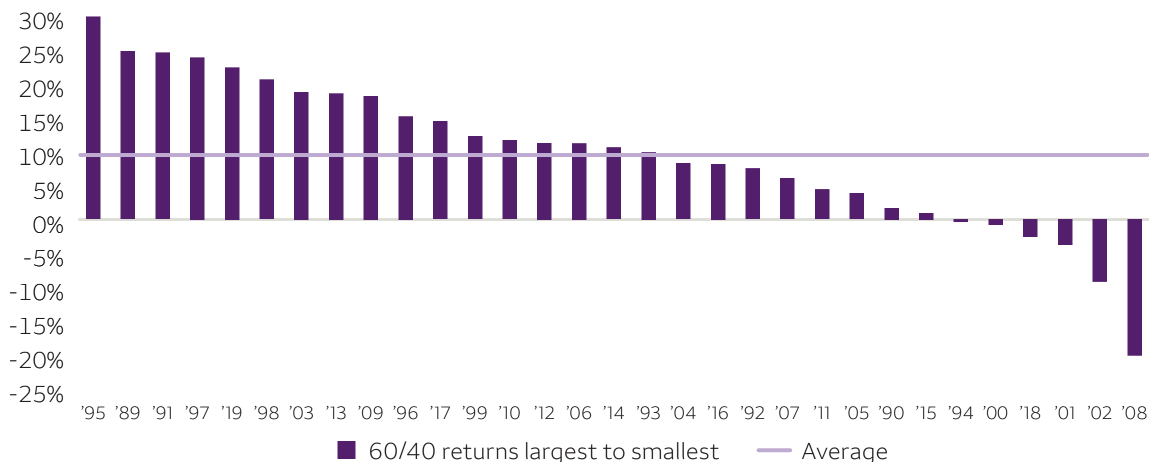
From 1989 to 2019, a portfolio of 60% stocks and 40% bonds returned 9.8% on average. Some years were better than others, however. In 1995, a 60/40 portfolio returned 29.9%, whereas in 2008, the return was –20.1%.

Keeping the annual returns over the 1989-2019 time period unchanged, but re-ordering their sequence, let's imagine two "alternative reality" scenarios—one in which the best returns all happened at the beginning, and one in which they all happened at the end:

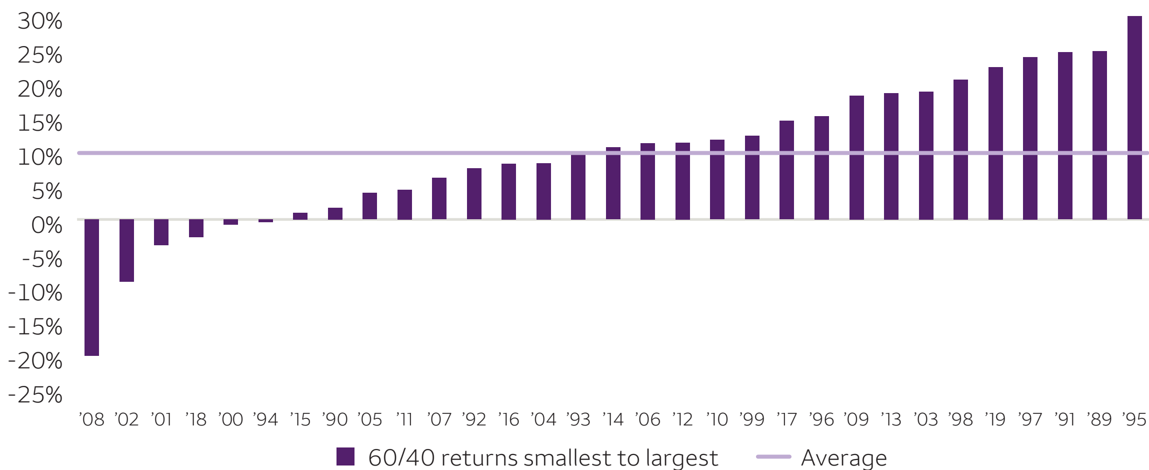
60/40 actual sequence



60/40 returns largest to smallest



60/40 returns smallest to largest



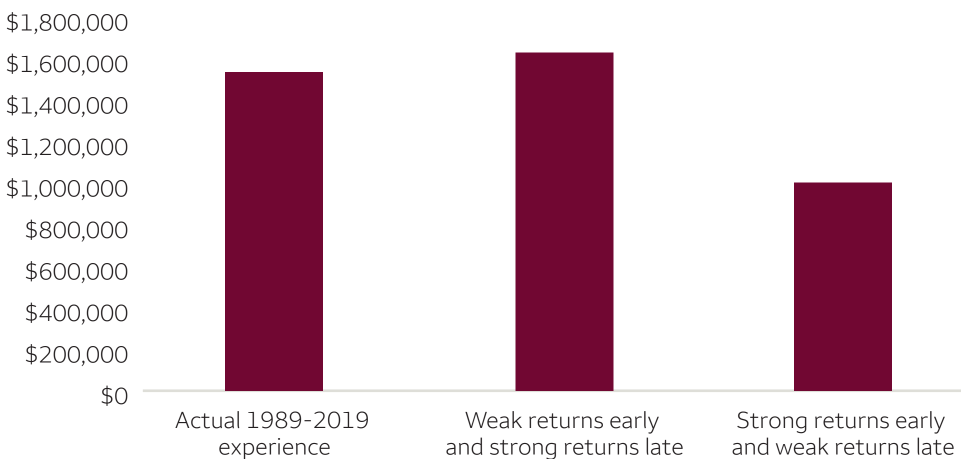
While the average return remained 9.8% in all three scenarios, the order of returns changed. How would each of these scenarios have impacted an investor's experience? Let's look at two examples:

Example 1: Saving for retirement

Consider a hypothetical investor named Ben who saved for retirement from 1989-2019. Each year, Ben contributed the employee maximum contribution to a tax-sheltered account at the beginning of the calendar year and invested 60% in stocks and 40% in bonds.

While Ben's average return in all three scenarios was the same, his ending portfolio value would have been much higher if the worst returns all occurred early in his career—or much lower if they all happened late in his career.

Ben's portfolio value after 30 years

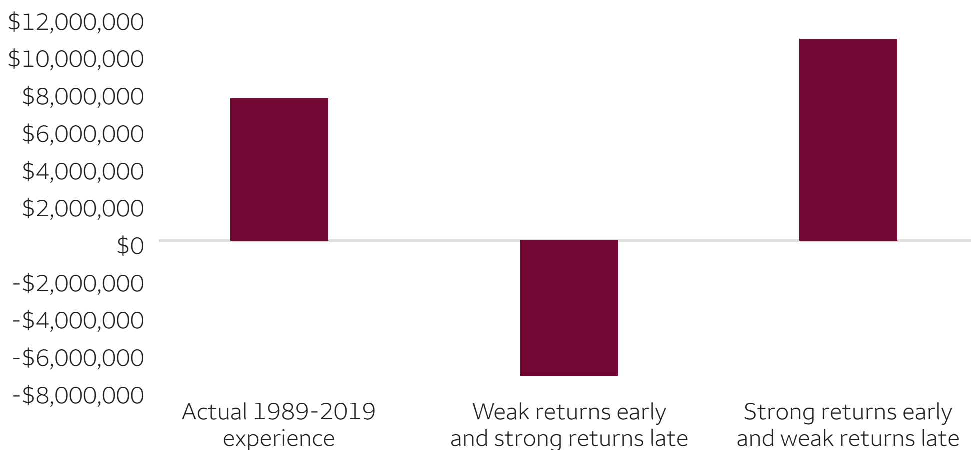


Example 2: Spending in retirement

Sequence-of-returns risk also can affect retirees. Imagine a hypothetical investor named Ann, who retires with an initial retirement account balance of $1 million that's invested 60% in stocks and 40% in bonds. At the beginning of her first year of retirement, Ann withdraws $40,000 for retirement income (4% of her account balance). At the beginning of each subsequent year, the amount Ann withdraws equals the previous year's withdrawal amount plus a cost-of-living adjustment (COLA) based on inflation. (For the entire period, the COLA means that Ann's distribution increased, on average, 2.5% per year.)

While Ann's average return in all three scenarios was the same, her ending portfolio value would have been much higher if the worst returns all occurred late in her retirement—or much lower if they all happened early in her retirement. In fact, Ann would have run out of money 15 years into retirement if all the worst returns happened early. The deficit shows how Ann would have needed to reduce her withdrawals or rely on an additional source of income to sustain her distribution plan.

Ann's portfolio value after 30 years



The bottom line for both Ben and Ann is that even though the annual returns didn't change, and the average return was the same in all three scenarios, the sequence of those returns had a major impact on their outcomes.

Solutions for sequence-of-returns risk

Although you can't control how the markets will perform, a number of tools and strategies can help manage sequence-of-returns risk. Here are five common approaches:

1. **Reduce a portfolio's market risk** as you draw closer to retirement. Increasing the allocations to fixed income and cash and decreasing allocations to equities can help manage the impact of market declines during this pivotal period.

2. **Maintain an ample cash reserve.** For example, reserving enough cash to fund 12 to 24 months of expenses can help ensure that you won't need to sell investments at depressed levels in order to meet your cash needs.

3. **Develop an adaptable spending plan.** Consider whether you have the flexibility to withdraw less—or not at all—in a down year.

4. **Emphasize typically less volatile equity investments,** such as shares of large, high-quality, financially stable companies that pay consistent dividends. Adjusting the equity allocation to focus more on generally less volatile stocks may help manage the risk of a downturn while maintaining exposure to the growth that's needed to support withdrawals throughout a retirement that could last three decades or more.

5. **Annuities** can help mitigate sequence-of-returns risk as well. Annuities can provide income regardless of fluctuations in the financial markets.

Your Financial Advisor can help you manage sequence-of-returns risk

Your Financial Advisor can help you evaluate your investment portfolio's exposure to sequence-of-returns risk and determine if these tools make sense for you. Understanding your risk factors can help you make adjustments along the way as life—and the markets—continue to change.

Call your Wells Fargo Advisors Financial Advisor today to learn more about the benefits of creating diversified income sources, a dynamic spending strategy, a cash reserve, and a written retirement strategy.

This information is hypothetical and is provided for informational purposes only. It is not intended to represent any specific return, yield, or investment, nor is it indicative of future results.

Wells Fargo Advisors is a trade name used by Wells Fargo Clearing Services, LLC and Wells Fargo Advisors Financial Network, LLC, Members SIPC, separate registered broker-dealers and nonbank affiliates of Wells Fargo & Company.

© 2020 Wells Fargo Clearing Services, LLC. All rights reserved. CAR-0520-00285 IHA-6742418