

Sequence-of-Returns Risk: A Problem Retirees Can Overcome

Weak returns in early years can deplete your savings, but disciplined withdrawals may help.



The perfect retirement story we tell ourselves goes like this: We grow a sizable nest egg, we quit our jobs, and we head off into our golden years confident that our money will last as long as we do.

But the risk we may not see coming is a down market early in retirement that can permanently damage future portfolio income, even if the markets stage a recovery in later years. This risk is called “sequence-of-returns” risk.

Bull vs. Bear: Different Retirement Results

Imagine two retirees, Rita and Ron, who start retirement in remarkably similar financial situations: a nest egg of \$500,000, 5% withdrawals each year for income, and an identical 7.68% average return over 20 years. Their experiences differ in when they face a bear market.

To make our scenario more realistic, we used the S&P 500 Index’s actual returns from 2000-2019 for Ron and reversed those same returns for Rita (**FIGURE 1**). While some withdrawal strategies include adjustments to inflation, we have omitted those changes for the sake of simplicity.

Unlucky Ron

Ron’s stock portfolio experiences successive annual losses early on. He’s forced to sell some of his holdings at a loss to maintain his \$25,000 annual income target. Once sold, those stocks are unable to participate in the market turnaround that occurs later.

By maintaining that steady \$25,000 withdrawal rate, Ron sees his initial \$500,000 balance dwindle to \$135,658 in year 20, despite the market having bounced back strongly after the initial bear market.

Key Points

- Sequence-of-returns risk is the risk that poor market returns early in retirement can do lasting damage to a portfolio that’s being drawn down for income.
- Selling equities for income in retirement during a downturn can leave fewer dollars invested for a future recovery.
- A disciplined withdrawal plan and a thoughtful mix of investments can help reduce the impact of early market declines.

Lucky Rita

In our hypothetical example, Rita experiences the same annual market returns as Ron, except in reverse. Her portfolio begins with strong gains, so, when a bear market finally strikes later on, that decade plus of healthy overall returns allow Rita to keep withdrawing the same \$25,000 each year with little fear of running out of money. In year 20, Rita's account retains a balance of \$921,737 (vs. Ron's balance of \$135,658).

FIGURE 1

Sequence-of-Return Risk: Good Market, Bad Market

By Taking 5% of His Starting Balance Annually, Ron's Weak Portfolio Stumbles

Year	Unlucky Ron: Retiring into a Bear Market			Lucky Rita: Retiring into a Bull Market		
	Market Return (%) ¹	Ron's Withdrawals	Ron's Annual Balances	Market Return (%) ¹	Rita's Withdrawals	Rita's Annual Balances
0	—	—	\$500,000	—	—	\$500,000
1	-9.10	\$25,000	\$431,775	31.49	\$25,000	\$624,578
2	-11.89	\$25,000	\$358,409	-4.38	\$25,000	\$573,316
3	-22.10	\$25,000	\$259,726	21.83	\$25,000	\$668,013
4	28.68	\$25,000	\$302,045	11.96	\$25,000	\$719,918
5	10.88	\$25,000	\$307,188	1.38	\$25,000	\$704,508
6	4.91	\$25,000	\$296,043	13.69	\$25,000	\$772,532
7	15.79	\$25,000	\$313,841	32.39	\$25,000	\$989,658
8	5.49	\$25,000	\$304,698	16.00	\$25,000	\$1,119,003
9	-37.00	\$25,000	\$176,210	2.11	\$25,000	\$1,117,087
10	26.46	\$25,000	\$191,220	15.06	\$25,000	\$1,256,555
11	15.06	\$25,000	\$191,253	26.46	\$25,000	\$1,557,424
12	2.11	\$25,000	\$169,761	-37.00	\$25,000	\$965,427
13	16.00	\$25,000	\$167,923	5.49	\$25,000	\$992,057
14	32.39	\$25,000	\$189,215	15.79	\$25,000	\$1,119,755
15	13.69	\$25,000	\$186,696	4.91	\$25,000	\$1,148,508
16	1.38	\$25,000	\$163,928	10.88	\$25,000	\$1,245,745
17	11.96	\$25,000	\$155,544	28.68	\$25,000	\$1,570,855
18	21.83	\$25,000	\$159,041	-22.10	\$25,000	\$1,204,221
19	-4.38	\$25,000	\$128,170	-11.89	\$25,000	\$1,039,012
20	31.49	\$25,000	\$135,658	-9.10	\$25,000	\$921,737
Total		\$500,000	\$135,658		\$500,000	\$921,737

For illustrative purposes only. **Past performance does not guarantee future results.** Indices are unmanaged and not available for direct investment. ¹The S&P 500 Index returns found on the left side of FIGURE 1 represent actual sequential performance figures for the years 2000 to 2019. On the right side, the same identical return figures are applied in reverse order to illustrate a hypothetical reverse-sequence scenario for the same 20-year time span. The S&P 500 Index is a market capitalization-weighted price index composed of 500 widely held common stocks. Sources: Ned Davis Research, Inc. and Hartford Funds, 10/26.

An Antidote to Early Bear Markets? Sensible Withdrawals

Bear markets are impossible to predict and can occur uncomfortably close to your retirement schedule. But Ron and Rita could have employed a possible mitigation strategy: taking a market-driven approach to withdrawals.

Instead of taking the same fixed 5% amount of their original balances every year, they could limit withdrawals to 5% of their *adjusted annual market balances* instead. Ron would experience a better ending value by year 20, and Rita could wind up with a richer income stream that can still withstand later-year market losses (FIGURE 2):

FIGURE 2

A Withdrawal Plan for Preserving Weakened Portfolios

By Taking 5% of Adjusted Year-End Balances, Hard-Hit Savings Can Be Salvaged

Year	Unlucky Ron: Retiring into a Bear Market			Lucky Rita: Retiring into a Bull Market		
	Market Return (%) ¹	Ron's Withdrawals	Ron's Annual Balances	Market Return (%) ¹	Rita's Withdrawals	Rita's Annual Balances
0	—	—	\$500,000	—	—	\$500,000
1	-9.10	\$25,000	\$431,775	31.49	\$25,000	\$624,578
2	-11.89	\$21,589	\$361,415	-4.38	\$31,229	\$567,360
3	-22.10	\$18,071	\$267,465	21.83	\$28,368	\$656,654
4	28.68	\$13,373	\$326,966	11.96	\$32,833	\$698,430
5	10.88	\$16,348	\$344,412	1.38	\$34,922	\$672,665
6	4.91	\$17,221	\$343,257	13.69	\$33,633	\$726,515
7	15.79	\$17,163	\$377,584	32.39	\$36,326	\$913,742
8	5.49	\$18,879	\$378,398	16.00	\$45,687	\$1,006,944
9	-37.00	\$18,920	\$226,471	2.11	\$50,347	\$976,781
10	26.46	\$11,324	\$272,076	15.06	\$48,839	\$1,067,690
11	15.06	\$13,604	\$297,398	26.46	\$53,384	\$1,282,690
12	2.11	\$14,870	\$288,489	-37.00	\$64,135	\$767,690
13	16.00	\$14,424	\$317,915	5.49	\$38,385	\$769,345
14	32.39	\$15,896	\$399,844	15.79	\$38,467	\$846,283
15	13.69	\$19,992	\$431,853	4.91	\$42,314	\$843,444
16	1.38	\$21,593	\$415,922	10.88	\$42,172	\$888,450
17	11.96	\$20,796	\$442,383	28.68	\$44,422	\$1,086,094
18	21.83	\$22,119	\$512,007	-22.10	\$54,305	\$803,764
19	-4.38	\$25,600	\$465,102	-11.89	\$40,188	\$672,787
20	31.49	\$23,255	\$580,985	-9.10	\$33,639	\$580,985
Total		\$370,037	\$580,985		\$815,595	\$580,985

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The chief takeaway is simple: Though a market downturn is out of your control in retirement, a willingness to reduce withdrawals modestly in down years can dramatically extend the life of a portfolio.

Other Considerations for Managing Sequence-of-Returns Risk

A frugal withdrawal plan can be a highly effective strategy for riding out an early bear market, but it's not the only strategy. Consider also:

Realistic Asset Allocation and Professional Help

A conservative, diversified portfolio in the years approaching and entering retirement can reduce the magnitude of early losses. A portfolio heavily tilted toward equities, much like those of Ron and Rita, will be far more vulnerable to a stock-market decline than one with a more balanced blend of equities and fixed income, for example.

Building a Cash Buffer

Keeping one to three years of expenses in cash or short-term bonds allows you to avoid selling equities during a downturn. You tap the buffer, give the market time to recover, and replenish the buffer in good years.

Rely on a Guaranteed Income Stream

Covering essential expenses with guaranteed income sources—Social Security, a pension, or a fixed and/or income annuity—reduces the dependence on portfolio withdrawals and removes the worst-case outcome from the equation.

Tax-Smart Withdrawal Order

Withdrawing from the right accounts in the right sequence—drawing taxable bond-fund accounts first, then tax-deferred accounts, for example—can preserve more of the portfolio's compounding power and extend the runway for long-term growth.

Bottom Line

Market downturns are always challenging, but they can be especially damaging early in retirement if you're taking regular withdrawals. A sensible, disciplined income strategy can help you avoid selling too much at the wrong time and give your portfolio a better chance to recover.

With assistance from a financial professional, a personalized income strategy built specifically around timelines, expenses, and goals can help you adjust your plan as markets, spending needs, and personal circumstances change.

Your financial professional can help you create a withdrawal strategy designed to support your income needs while managing the risks that come with retirement.

Important Risks: Investing involves risk, including the possible loss of principal. • Fixed-income security risks include credit, liquidity, call, duration, and interest-rate risk. As interest rates rise, bond prices generally fall. • Diversification does not ensure a profit or protect against a loss. • All annuities are subject to risk, including the possible loss of the money you invest.

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