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FOCUSED ON WHAT MATTERS MOST.

Volatility and Retirement

There's an interesting dynamic at work as one approaches retirement. On one hand, there's frequently an urgency and in some cases desperation to get good returns in order to make up for lost time. People often feel like they need to boost their nest egg to that next level in order to be more comfortable making the transition. On the other hand, there can be big problems with taking on too much risk at such a critical point.

First, a full market cycle entails both an upward and downward phase. Although over the long term markets tend to trend higher, over shorter periods of time an investor who stays the course will have to endure the downward part of the market cycle at some point. When times are good, people often view the markets as low-risk, when in fact they're probably much closer to this downward part of the cycle than one would imagine. This can have nasty consequences when it comes to making the retirement transition.

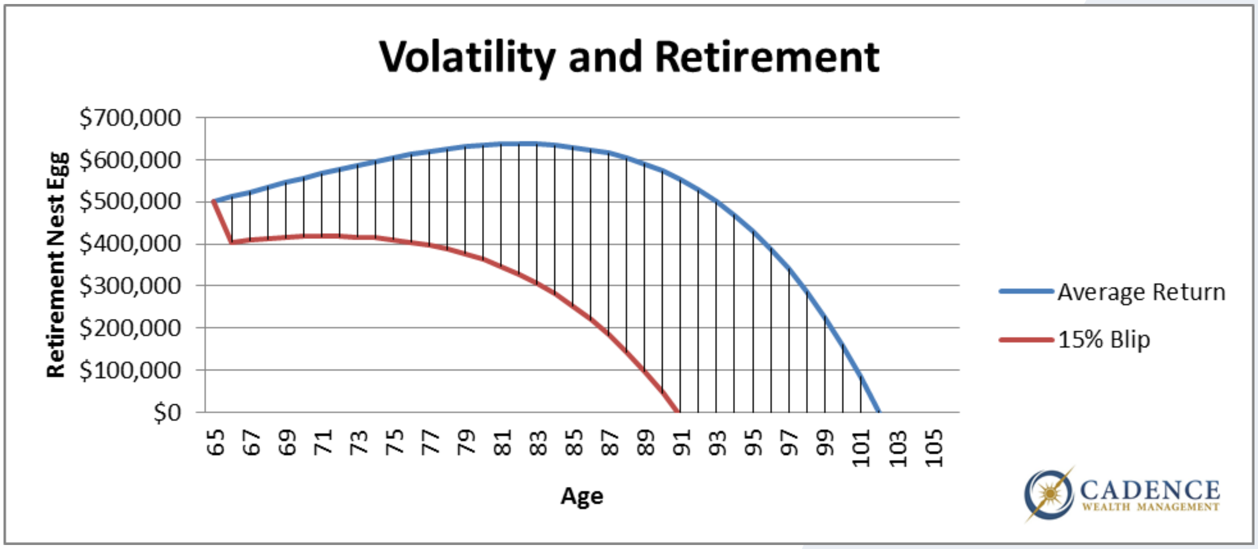
Second, the laws of math don't work in favor of retirees who are drawing income from their portfolios when balances start to really bounce around. When markets are rising and returns are good, all is well. The story quickly changes however once portfolio levels begin to decline. If a retiree is thinking about taking on risk, which inherently means more volatility in their returns, they'd better not be doing so near the top of a market cycle. This could result in their enduring poor and variable returns for a longer period than their portfolio could endure.

Too Much Risk Near Retirement

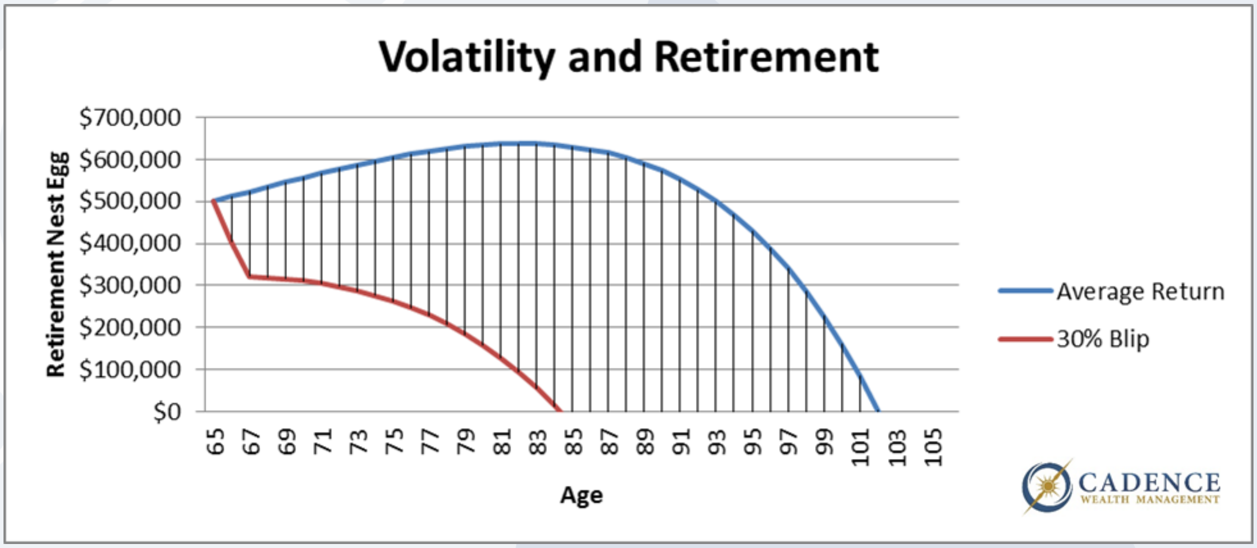
As investors come to learn in every full market cycle, taking risk doesn't just mean you get a higher return from your investments. The reason it's called "risk" is because there are in fact real losses that are incurred from time to time – some big, some small. As retirement nears, losses are the last thing one wants to experience in preparing for the transition from employment income to investment income – especially deep losses. Having a smaller nest egg than planned upon transitioning or in those early years of retirement can turn a seemingly secure financial plan into one that requires some sacrifices.

Let's first look at what one might consider a sound retirement scenario. This investor, we'll call her Susan, retires at 65 with $20,000 per year in fixed income through pensions and social security. Susan's expenses are $36,000 per year resulting in a shortfall that will be covered with a $500,000 retirement nest egg. When looking at an average return throughout retirement of 7%, things look good – the portfolio should last beyond Susan's 100th birthday. (Keep in mind that there really isn't any investment today that pays a steady 7% each year that we would recommend owning, but we use this illustration because most retirement calculators assume a fixed return between 6% and 10%.)

However, what happens if in an effort to pad her retirement scenario by taking more risk, Susan loses 15% just as she transitions from employment income to taking income from her portfolio? Well, Susan goes from running out of money at age 102 to running out at 90 - a blip in markets that shaves a full 12 years off her retirement portfolio.



Taken one step further, what would happen to Susan's retirement if rather than just experiencing a short-term correction she experiences a mild bear market with 30% losses over the first two years of her retirement? This scenario is an absolute game-changer. Susan now runs out of money at age 84. As if this isn't enough, Susan's situation could actually look worse if she responds to the loss in a counterproductive way. As we know from fund flow information at market peaks and valleys, she's now either very reluctant to take an appropriate amount of market risk going forward and exits the markets for an extended period of time or is compelled to take on too much risk in a desperate attempt to get back on track. Of course our advice would be to avoid making long-term decisions based on short-term results, but investor psychology and the resulting decision-making can get someone leaning in the wrong direction after such an experience.

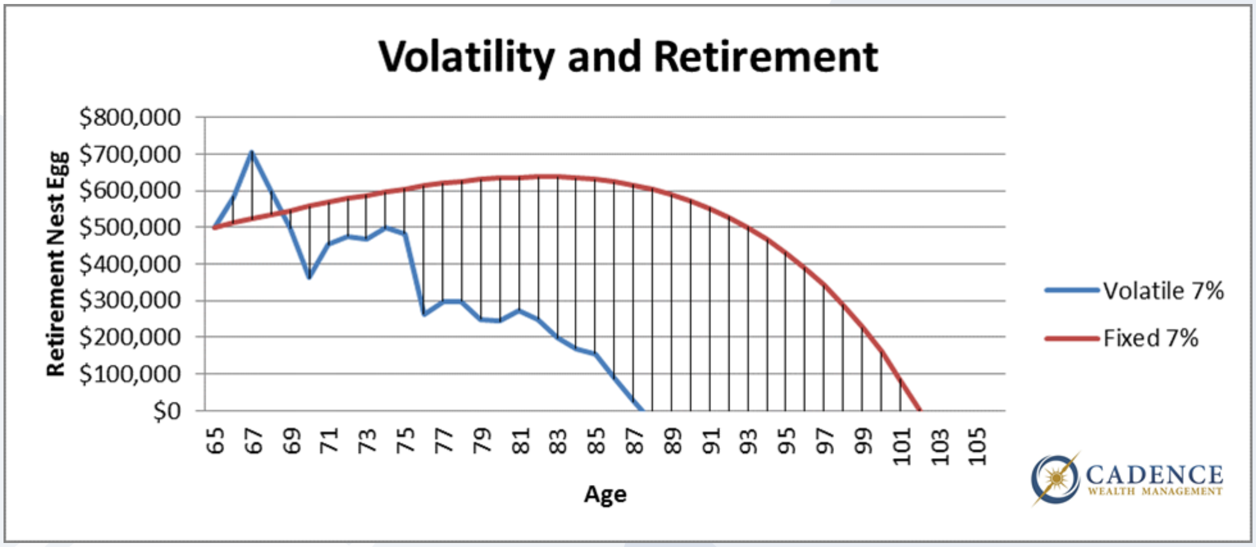


The point here is that taking too big of a loss early on in retirement can have negative long-term consequences. Taking risk should be weighed very carefully regardless of how well that risk-taking has been rewarded in the recent past. At some point the definition of risk actually manifests.

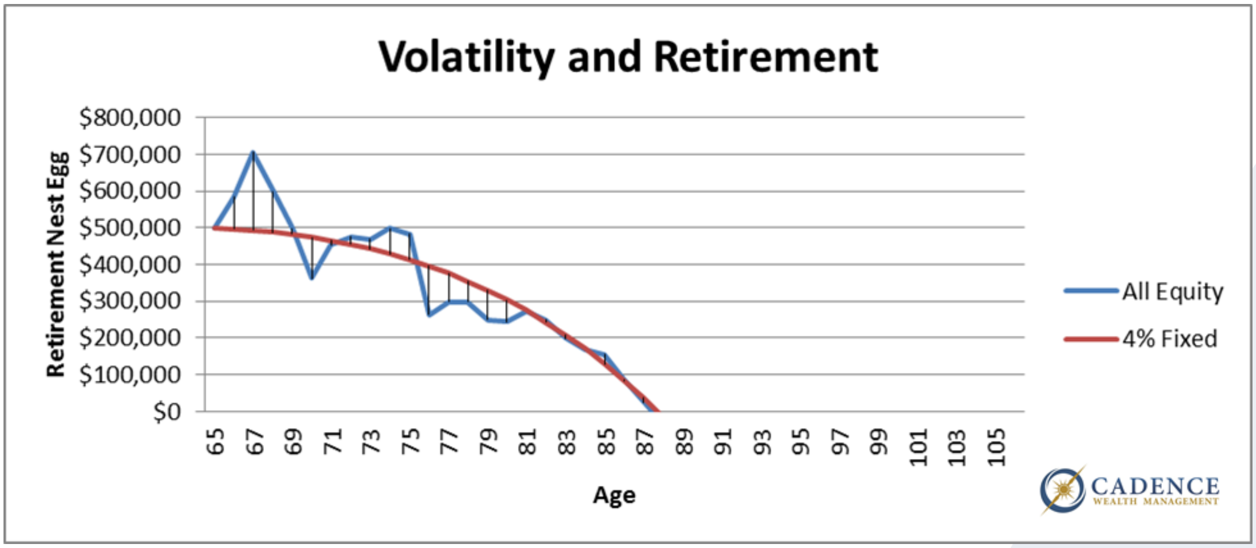
Too Much Risk Throughout Retirement

As we saw with Susan, taking losses early on in retirement can change the long-term outlook significantly. But what if we take a series of large losses throughout retirement that are followed by large gains? In other words, what if we invest aggressively along the way and experience a lot of volatility? For those who have more than enough saved for retirement and don't need to take too much from their portfolio, this may not necessarily be a bad thing. Similar to waiting out bad periods during the accumulation years, these retirees could simply ride out any losses until they are recovered.

However, if as in Susan's case there isn't a tremendous amount of wiggle room, this excessive volatility over the years could have very nasty consequences. If Susan retired on January 1, 1998 with a diversified stock portfolio, today at age 84 she would be down to $156,000 from $500,000 and three years from running out of money. Although she would have averaged 7% over the last 19 years after all the ups and downs, she would be significantly behind the initial projection that assumed a fixed 7% every year. As unlikely as a fixed 7% return is from year to year, that initial "projection" indicated she would have $630,000 left in retirement savings. That's $474,000 less money even with the same average annual return due to the excessive volatility that Susan would have experienced over the last 19 years!



Put another way, that volatile 7% return that Susan earned over the last 19 years in her all-equity portfolio would be the equivalent of a roughly 4% fixed return. As we mentioned, taking large losses can be psychologically difficult to bear, especially when one's retirement is in jeopardy. When investors are experiencing losses in real time, emotions can compel them to do things that ultimately hurt their retirement picture further. Whether this is jumping out of markets and missing out on recoveries or taking excessive risks to try and get back to where they were, the more volatility (in the form of losses) one experiences, the less likely a particular projection is to play out. What this means is that the 4% fixed return scenario for Susan would likely turn out to be much more attractive in actuality than the volatile 7% return. It's a much safer and less emotionally taxing course of action.



Conclusion

Clients often comment to us that their 401(k)'s always seem to be performing better than their other accounts, all else being equal. Upon hearing this we quickly remind them that it's usually because they are saving into it on a regular basis. The investment could be losing value, but the contributions give the appearance that it's growing. This steady savings rate goes a long way toward offsetting short-term losses.

Well this phenomenon gets thrown into reverse when one retires. Losses get exacerbated when money is steadily coming out of accounts to support one's lifestyle. This makes volatility a formidable adversary for retirees that needs to be grappled with very carefully. Not enough risk and we don't get the investment returns needed to extend our portfolio beyond our life expectancy, but too much and the volatility can start us on a downward slope that has us outliving our investments. It's a delicate balance.

Not all volatility is bad however. It's the downward volatility or losses that really hurt us, while we're more than happy to accept the upward variety. Given that, investors should pay close attention to where we are in the market cycle. Our examples with Susan had her taking excessive risk and experiencing losses early on. What we know from history is that when markets are excessively valued or expensive, returns going forward tend to be significantly lower than average. The same is true on the flip side. When market valuations appear more average or below average, returns over time tend to be higher since a good chunk of the downward volatility is already behind us. Had Susan altered her risk level based on how attractive or expensive market valuations were from 1998 to present, the end result may have been different.

The point is this: Taking less risk to dampen volatility as one approaches and enters into retirement is generally a good idea. In addition to this, being aware of where we are in the market cycle, valuation levels, and losses that are likely to follow based on history can further help you minimize the big downward volatility that can negatively affect your retirement outlook. In the end, sometimes a lower return that has fewer ups and downs can in fact be better than a higher average return that's more volatile and emotionally taxing.

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