INSIGHT

THE GREATEST WEALTH IS **YOUR PEACE OF MIND...**

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Understanding and managing ‘sequence risk’

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Most investors are concerned about the future returns of their portfolio, despite the expectation that a well-structured, globally diversified balanced portfolio should yield positive returns after inflation over most 10- and 20-year periods.

When an investor withdraws money from their portfolio regularly, such as to fund their retirement lifestyle, the sequence of portfolio returns they experience can significantly impact financial outcomes, even if the average return is as expected. This phenomenon is known as 'sequence risk'. However, if no withdrawals are made, the order of returns does not affect the outcome, because 3 X 2 X 1 yields the same result as 1 X 2 X 3.

Why does withdrawing money from a portfolio make a difference? Simply put, withdrawing money early in retirement, especially during market downturns, can swiftly and significantly deplete the pot needed to generate many years of future expenses. A clear example is a £1 million global equity portfolio invested from 2000 to 2023, with annual withdrawals of £50,0001. This period, which began with the tech-driven crash of 2000-2003, would have seen the portfolio rapidly depleted and eventually exhausted. Conversely, reversing the sequence of returns (from 2023 to 2000) would leave an investor with roughly the same amount of money as they started with. The same average return, but with a different sequence, yields a very different outcome.

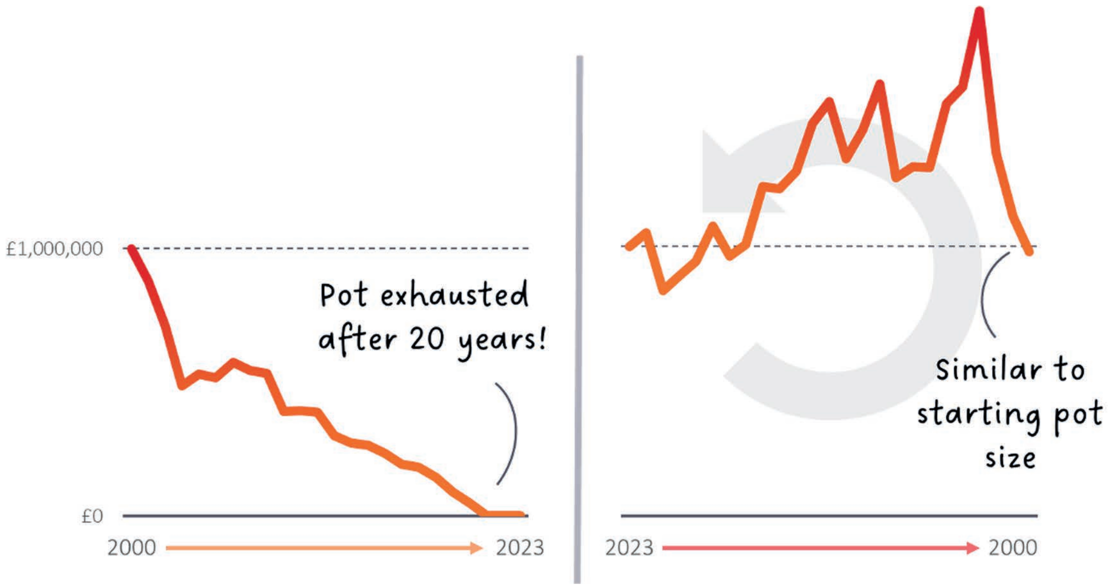

Figure 1: Sequence risk matters

Source: Albion Strategic Consulting[1].

Although this example is quite extreme—featuring a 100% equity portfolio that experiences a significant market decline at the outset, a 5% initial withdrawal rate, and no plan to adjust the amount of cash withdrawals—it effectively highlights the risk involved.

So, what is the solution?

The solution is a combination of two key elements of the service that a good financial planning firm provides.

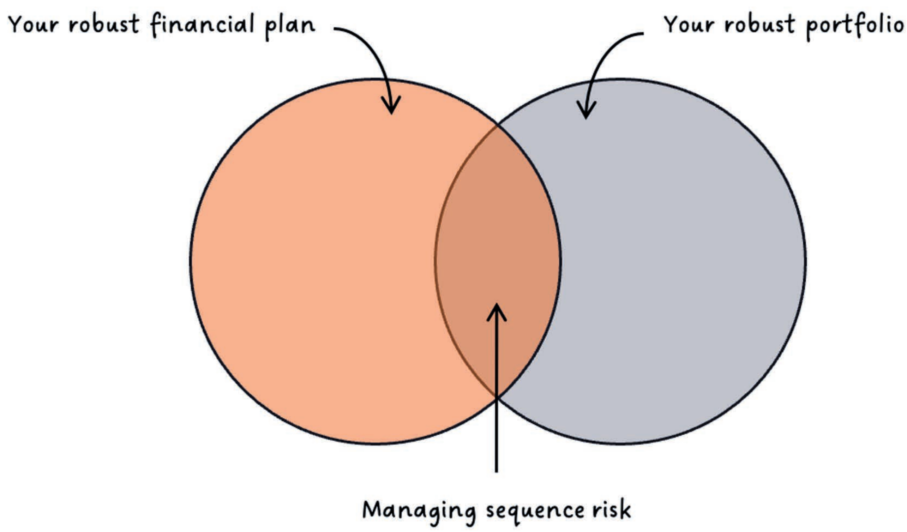

Figure 2: Managing sequence risk through process

Source: Albion Strategic Consulting

Your robust financial plan

Creating a robust financial plan involves stress-testing your financial goals against various negative market scenarios (and sequences of returns) to grasp the potential downside impact. This process enables informed discussions about what mitigating actions can be taken if such events were to occur. Understanding your flexibility regarding your spending needs is crucial, as reducing withdrawals during market downturns can significantly enhance outcomes. Our regular progress meetings, where these decisions can be made, are essential for managing this risk effectively.

Your robust portfolio

No financial planner can control market returns. However, we can build robust portfolios grounded in a sound investment philosophy: acknowledging that markets are difficult to beat and emphasising diversification across markets, sectors, companies, and well-evidenced risk factors to help smooth portfolio-level returns. The objective is to capture as much of the market's return as possible. Additionally, minimising both financial and emotional costs associated with investing is crucial for achieving successful outcomes.

By combining these two elements with regular progress meetings with you, financial planners, like us, can help to significantly mitigate the sequence risk their clients face.

End notes.

1.

Data: Albion World Equity Index (https://smartersuccess.net/indices), annual returns in GBP. Adjusted for UK CPI. 2000-2023. £1,000,000 portfolio drawing £50,000 at the start of each year

Other notes and risk warnings

Use of Morningstar Direct© data

Risk warnings

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