Pomegranate Financial

Refresh & Simplify
Your Financial Life

Newsletter

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Sequence of Returns | Planning For & Through Retirement

Sequence of returns is the year over year investment return you receive. Specifically the term refers to the first year of retirement up through until the last year of retirement.

Sequence of returns can have a dramatic effect on your retirement. Of course, in an ideal world you would always want the returns to be positive. However, in the real world, return on investment fluctuates in the stock market. The average return (S&P 500) from the past 30 years is 10.7% or from the past 50 years, 9.4%. Yet the actual return each year is rarely ever actually 10%, but rather has fluctuated between ~-37% (2008) to ~34%.

As you can imagine, starting retirement in a year like 2008 or 2022 might seem daunting. Say you start with $1MM invested and it has dropped by 16% to around $840,000 (2022 ~YTD). To get it back up to $1MM you would then need to see a return of 19%! If you start retirement with two straight years of losses, then the choice of retirement might appear to be a bad idea. However, it all depends on how you are invested and how you are not invested.

Typically, the approach is to be more conservative as you approach and are in retirement. Meaning, you gradually switch from a portfolio of stocks to a larger portion of bonds. In fact, if you look at the chart below you'll find the last 15 years of return for the S&P 500 and US Aggregate Bond Index.

Year	Bloomberg US Aggregate	S&P 500	Difference
2006	4.12%	15.61%	11.49%
2007	6.97%	5.48%	1.49%
2008	5.24%	-36.55%	41.79%
2009	5.93%	26.94%	21.01%
2010	6.54%	14.82%	8.28%
2011	7.84%	2.10%	5.74%
2012	4.21%	15.89%	11.68%
2013	-2.02%	32.15%	34.17%
2014	5.97%	13.52%	7.55%
2015	1.14%	1.38%	0.24%
2016	3.25%	11.77%	8.52%
2017	3.54%	21.61%	18.07%
2018	0.01%	-4.23%	5.23%
2019	8.72%	31.21%	22.49%
2020	3.76%	18.02%	14.26%
2021	-1.5%	28.47%	29.97%

Source: The Balance Money

You'll see that even in 2008 when the S&P 500 was down a negative ~37%, bonds were up 5%.

Typically bonds are positive, but not by much, especially if you factor in inflation.

2022 has been a down year for most assets thus far. Year-to-date the S&P 500 is down -21.5%. The unique factor of this year is the US Aggregate Bond is down -15%!

The 60/40 stock to bond portfolio typically helps retirees balance out the good & bad years, but this year it has been proven wrong.

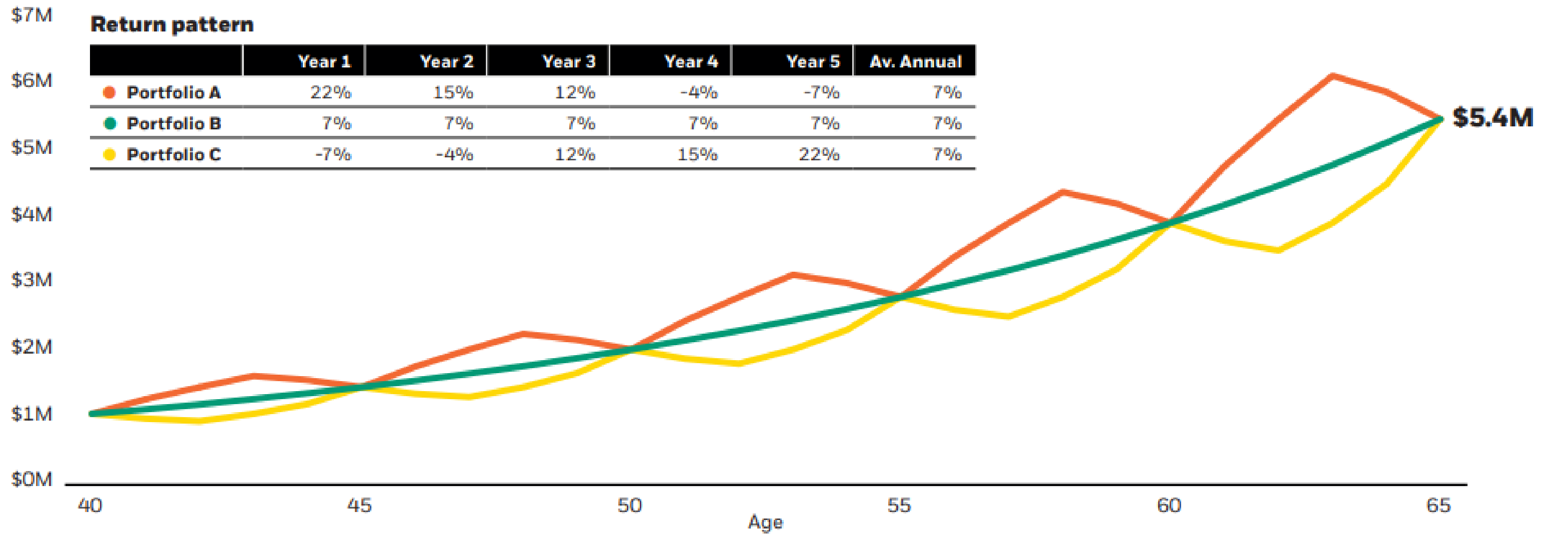
Planning For Sequence of Returns

The second worst time to withdraw money from the market is when the market is down.

The worst time is to withdraw it during retirement when the market is down.

Even with the year 2022 and a terrible return on bonds, bonds are still an important piece of the portfolio. They typically help generate income and provide stability.

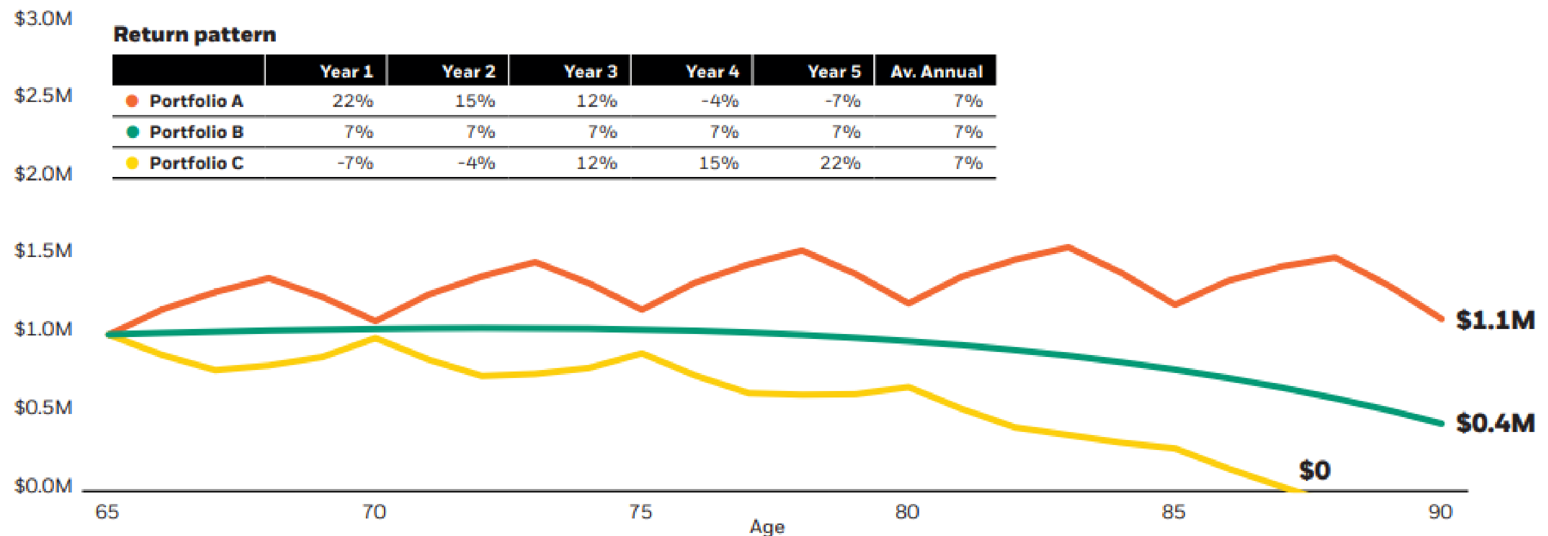
Sequence of returns actually does not matter too much before retirement years. But take a look at the charts below to see the effect of having to withdraw from your portfolio with a bad sequence of returns.



Return pattern

	Year 1	Year 2	Year 3	Year 4	Year 5	Av. Annual
Portfolio A	22%	15%	12%	-4%	-7%	7%
Portfolio B	7%	7%	7%	7%	7%	7%
Portfolio C	-7%	-4%	12%	15%	22%	7%

You notice that sequence of returns doesn't matter as much when accumulating assets. But when withdrawing from investments it can lead to running out quickly.



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What's the solution?

The solution is cash. Cash can mean a lot of things. Ideally not literal cash, but cash as in savings accounts, money markets, CDs, Treasury Bonds, etc.

I typically recommend retirees have 3 years worth of *expenses in cash like investments. Other financial planners say 1-3, some say 5. The longest bear market on record (over the last 100 years) was the Great Depression which lasted around 783 days (2 years and 53 days). The shortest was 32 days (Covid-19 in 2020).

Please Note

By having up to 3 years worth of cash, you can avoid withdrawing any money from your investments during the markets down years. So a retiree in 2022 doesn't have to make a decision on when and how much to withdraw to live on this year or next. They have cash that they can use to live on while the market is down.

This might seem fairly simple, and it is, but it is also hard. It is hard to accumulate three years of cash. It is hard to resist withdrawing money when you are afraid the market will continue going down. It is hard when times are good to see your cash earning nothing (think 2010 - 2021). It takes discipline to stick to the plan, to not chase returns, or follow your fears. It is hard not to think 'this time is different' and then make rash choices.

Here's how powerful strategizing around the sequence of returns can be for you:

By only withdrawing from your investments during positive years, you can help mitigate risk and help your money last longer.

IRA Value Without Systematic Withdrawals

Source: Northwestern Mutual

AGE	BALANCE AT BEGINNING OF YEAR	WITHDRAWAL FIRST OF YEAR	S&P 500 RETURN 73-87	BALANCE AT END OF YEAR
65	$2,000,000	$140,000	-14.7%	$1,586,766
66	1,586,766	0	-26.5%	1,166,749
67	1,166,749	0	37.2%	1,601,130
68	1,601,130	140,000	23.9%	1,809,609
69	1,809,609	140,000	-7.2%	1,550,065
70	1,550,065	0	6.6%	1,651,904
71	1,651,904	140,000	18.6%	1,793,270
72	1,793,270	140,000	32.4%	2,188,929
73	2,188,929	140,000	-4.9%	1,948,122
74	1,948,122	81,854*	21.6%	2,268,449
75	2,268,449	140,000	22.6%	2,608,627
76	2,608,627	140,000	6.3%	2,623,163
77	2,623,163	140,000	31.7%	3,270,822
78	3,270,822	140,000	18.7%	3,715,346
79	3,715,346	140,000	5.3%	$3,763,052

***A Clarification**

3 years of cash is based on your annual expenses. But if you have an annuity, pension, rental income, and/or social security, then the amount of cash you need may differ. For example, if you live on $100k/year but social security provides $50k/year, then you may want ~$150k of cash in retirement ($50k/year * 3).

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