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February 2020

The Sequence of Returns

A look at how variable rates of return do (and do not) impact investors over time.

THE MONTH IN BRIEF

Early January gains gave way to late January losses as the coronavirus emerged as a global health concern, and correspondingly, a concern for the investment markets. The S&P 500 ended up retreating 0.16% for the month. The coronavirus outbreak was just one of the big stories in January: President Trump signed one trade deal while Congress approved another, Brexit occurred, oil prices temporarily jumped as tensions between America and Iran heightened, and stocks hit record highs again.[1]

MARKET INDEX	Y-T-D CHANGE	1-MO CHANGE	2018
DJIA	+22.34	-0.99	-5.63
NASDAQ	+35.23	+1.99	-3.88
S&P 500	+28.88	-0.16	-6.24
YIELD	**1/31 RATE**	**1 MO AGO**	**1 YR AGO**
10 YR NOTE	1.51	1.92	2.63

Sources: wsj.com, barchart.com, treasury.gov – 2/2/2020,[21,22,23]
Indices are unmanaged, do not incur fees or expenses, and cannot be invested into directly. These returns do not include dividends. 10-year Treasury yield = projected return on investment, expressed as a percentage, on the U.S. government's 10-year bond.

Monthly Quote
"Whatever you do in life, surround yourself with smart people who'll argue with you."

JOHN WOODEN

Tip of the Month
If you are considering disability insurance, seek coverage with a benefit approximating 60% or more of your current income. Disability insurance is issued by participating insurance companies. Not all policy types and product features are available in all states. Any obligations are dependent on the ability of the issuing insurance company to continue making claim payments.

The Monthly Riddle
I am soft, and you can serve me indoors or outdoors, but you would not want to eat me. What am I?

Last month's riddle:
It is met by feet in the morning, and sees few feet in the night. It may shake as if it is angry, but it will never bite. What is it?

Last month's answer:
The ground

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The Sequence of Returns

A look at how variable rates of return do (and do not) impact investors over time.

What exactly is the "sequence of returns"? The phrase describes the yearly variation in an investment portfolio's rate of return. Across 20 or 30 years of saving and investing for the future, what kind of impact do these deviations from the average return have on a portfolio's final value?

The answer: no impact at all.

Once an investor retires, however, these ups and downs can have an effect on portfolio value – and retirement income.

During the accumulation phase, the sequence of returns is ultimately inconsequential. Yearly returns may vary greatly or minimally; in the end, the variance from the mean hardly matters. (Think of "the end" as the moment the investor retires: the time when the emphasis on accumulating assets gives way to the need to withdraw assets.)

An analysis from BlackRock bears this out. The asset manager compares three model investing scenarios: three investors start portfolios with lump sums of $1 million, and each of the three portfolios averages a 7% annual return across 25 years. In two of these scenarios, annual returns vary from -7% to +22%. In the third scenario, the return is simply 7% every year. In all three situations, each investor accumulates $5,434,372 after 25 years – because the average annual return is 7% in each case.[1]

Here is another way to look at it. The average annual return of your portfolio is dynamic; it changes, year-to-year. You have no idea what the average annual return of your portfolio will be when "it is all said and done," just like a baseball player has no idea what his lifetime batting average will be four seasons into a 13-year playing career. As you save and invest, the sequence of annual portfolio returns influences your average yearly return, but the deviations from the mean will not impact the portfolio's final value. It will be what it will be.[1]

When you shift from asset accumulation to asset distribution, the story changes. You must try to protect your invested assets against sequence of returns risk.

This is the risk of your retirement coinciding with a bear market (or something close). Even if your portfolio performs well across the duration of your retirement, a bad year or two at the beginning could heighten concerns about outliving your money.

For a classic illustration of the damage done by sequence of returns risk, consider the awful 2007-2009 bear market. Picture a couple at the start of 2008 with a $1 million portfolio, held 60% in equities and 40% in fixed-income investments. They arrange to retire at the end of the year. This will prove a costly decision. The bond market (in shorthand, the S&P U.S. Aggregate Bond Index) gains 5.7% in 2008, but the stock market (in shorthand, the S&P 500) dives 37.0%. As a result, their $1 million portfolio declines to $800,800 in just one year.[2,3]

If you are about to retire, do not dismiss this risk. If you are far from retirement, keep saving and investing, knowing that the sequence of returns will have its most relevant implications as you make your retirement transition.

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ACR# 340676

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