Strategies for Managing Sequence of Return Risk in Retirement

10.25.2023 | Schwab

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Chief Financial Planning Nerd. Kitces.com
Co-Founder. XY Planning Network, AdvicePay, fpPathfinder, New Planner Recruiting

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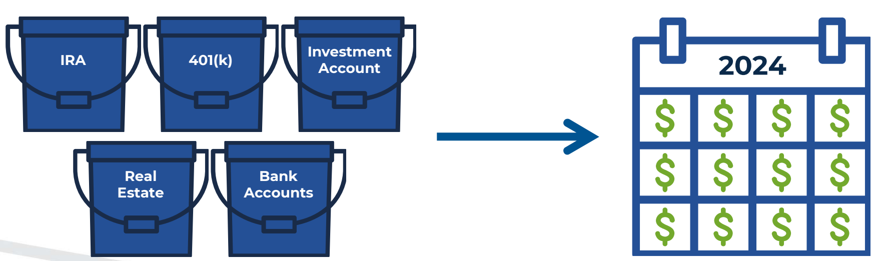
Basics of Safe Withdrawal Rates

- Fundamental client questions:
  - How much can I safely spend from this portfolio without needing to worry about the markets?



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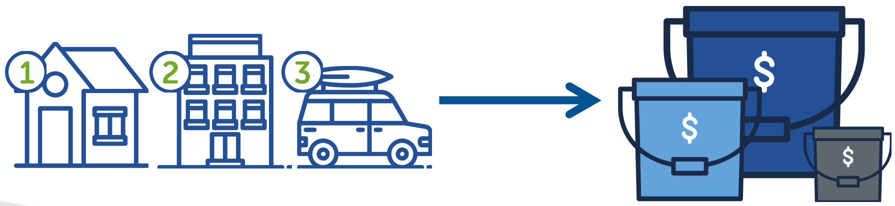
Basics of Safe Withdrawal Rates

- Fundamental client questions:
  - If I want to spend $XXX, how much money do I need in the account to safely retire?



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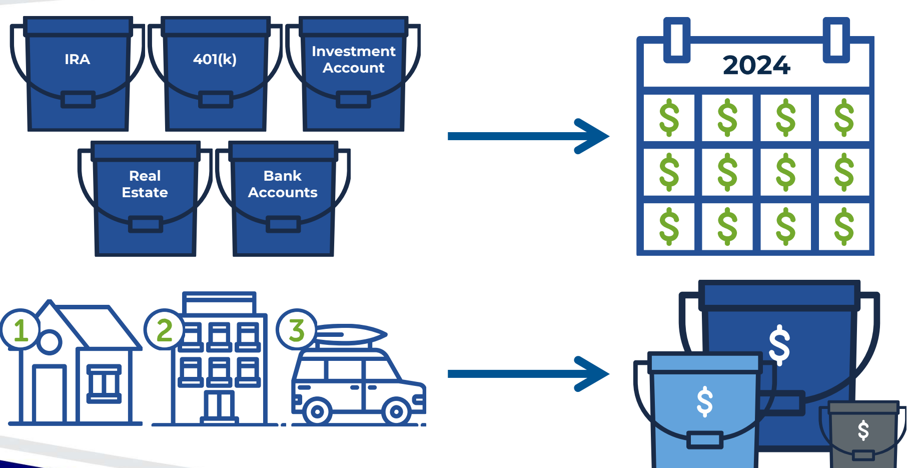
Basics of Safe Withdrawal Rates



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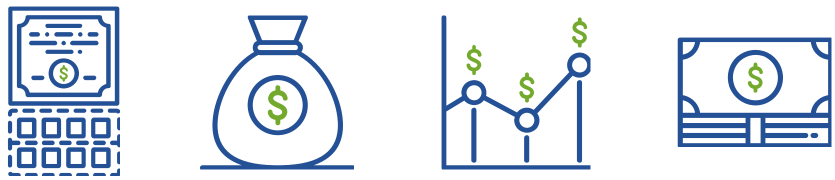
Basics of Safe Withdrawal Rates



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Linear Projections & Safe Spending

- Case example:
  - 65-year-old retiree for 30-year retirement
  - Inflation assumed to be 3%
  - 60% stocks, 40% bonds
    (rebalanced annually)
  - Stocks assumed to earn 10% (real 7%)
  - Bonds assumed to earn 5% (real 2%)
  - Average portfolio return 8% (real 5%)
  - Initial portfolio of $1,000,000

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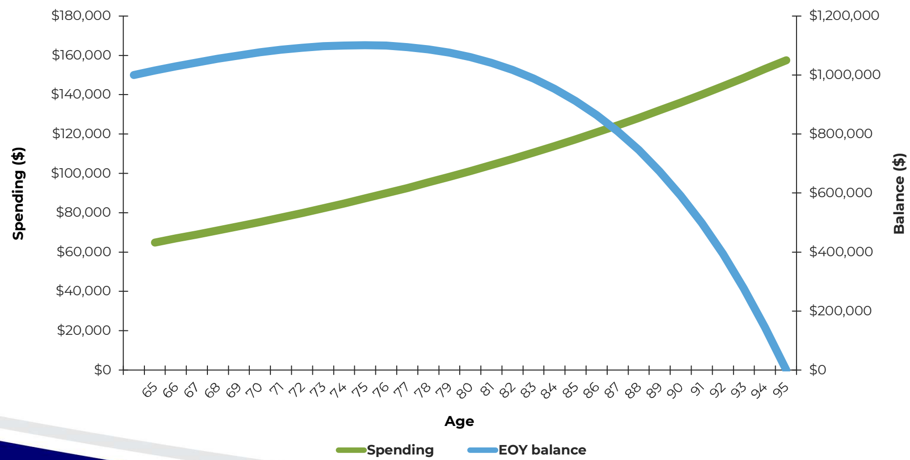
Linear Projections & Safe Spending



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Linear Projections & Safe Spending

- Question: How much can be safely spent?
- Answer: $65,895, or about 6.6%
- Is 6.6% the "safe withdrawal rate"?
  - Safe withdrawal rate versus Initial withdrawal rate
- Primary Challenge:
  - Assumes returns are the same each and every year

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Return Sequencing

- Consequences of return sequencing:
  - What happens if the *average* return of stocks is 10%, but the returns vary from year to year?
  - What if the first two years are 0%, and the last two are 20%?
  - What if the first two years are 20%, and the last two are 0%?

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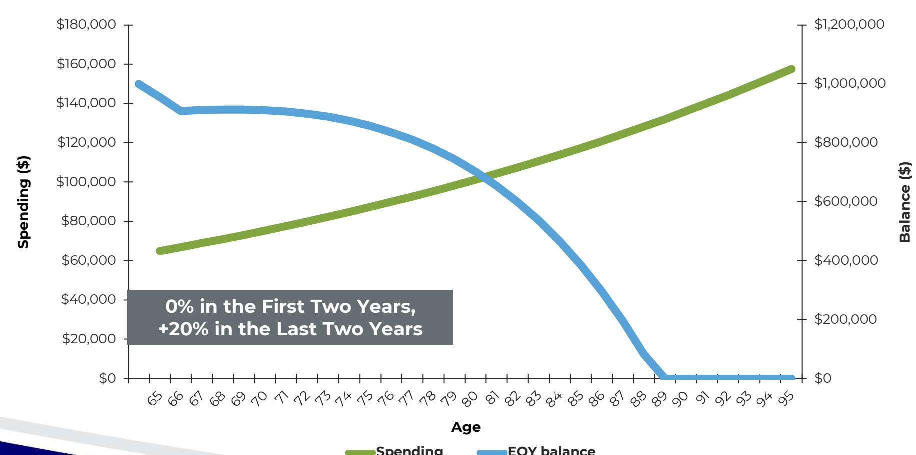
Linear Projections & Safe Spending



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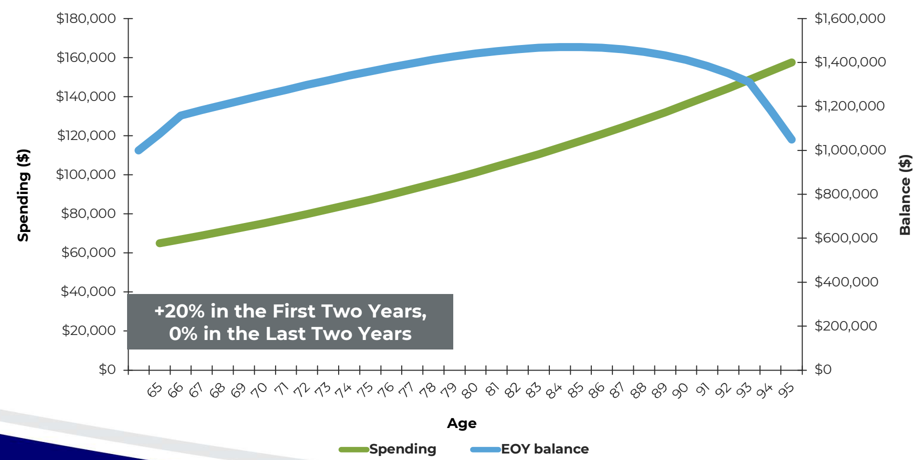
Linear Projections & Safe Spending



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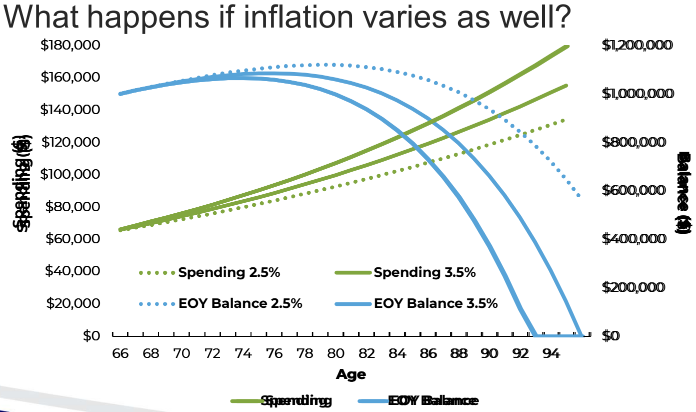
Return Sequencing

- Consequences of return sequencing:
  - What happens if inflation varies as well?



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Return Sequencing

- Retiree environment from 1969 to 1999

Asset Class	Return	Real Return
Equities	13.4%	8.1%
Bonds	8.6%	3.3%
Inflation	5.3%	

- What is the (linear) safe withdrawal rate?
  - 60% equities, 40% fixed portfolio
  - Average portfolio return: 11.5%

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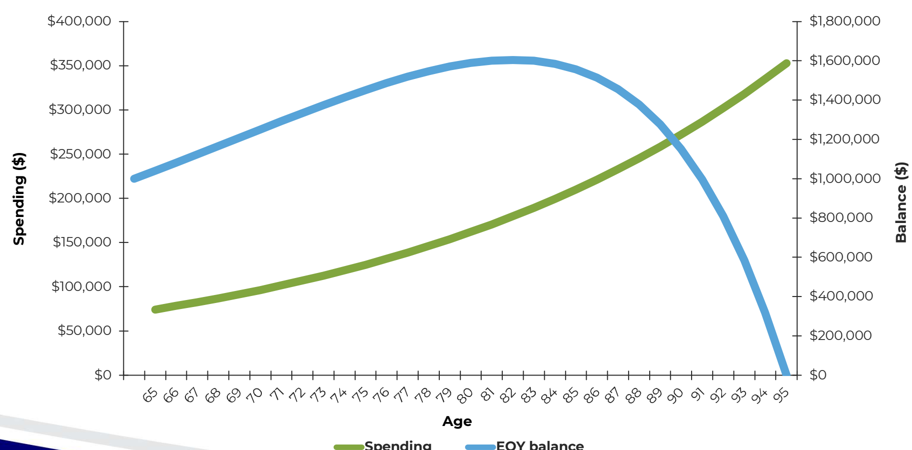
Linear Projections & Safe Spending



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Linear Projections & Safe Spending

- Question: How much can be safely spent with 1969-1999 returns?
- Answer: $74,308, or about 7.4%!
- What happens when we take into account the order of returns and inflation?

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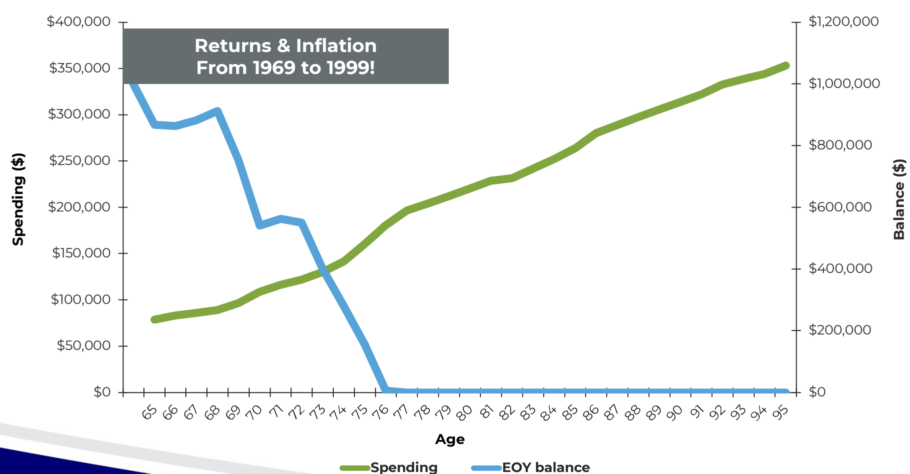
Linear Projections & Safe Spending



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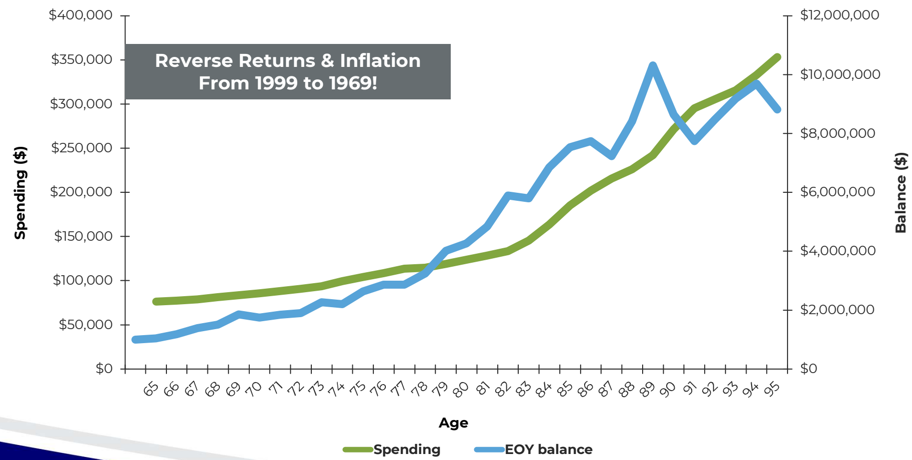
Linear Projections & Safe Spending



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Return Sequencing

- The sequences of returns matter, a lot!
- Disparities in the early years have a magnified effect over time!
- The extent of volatility matters too!
- It’s not just about early crashes…
  - But slow recoveries!
  - Or extended periods of low returns!

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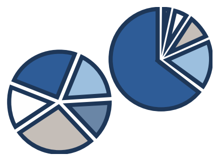
Managing Sequence Risk

- How do you manage sequence-of-return risk?

Safe Withdrawal Rates



Dynamic Asset Allocation

Dynamic Spending Strategies

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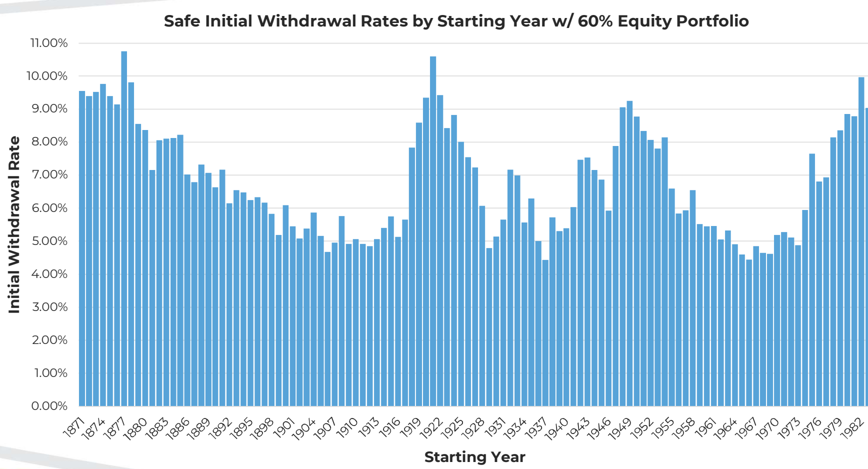
Current Research on Safe Withdrawal Rates



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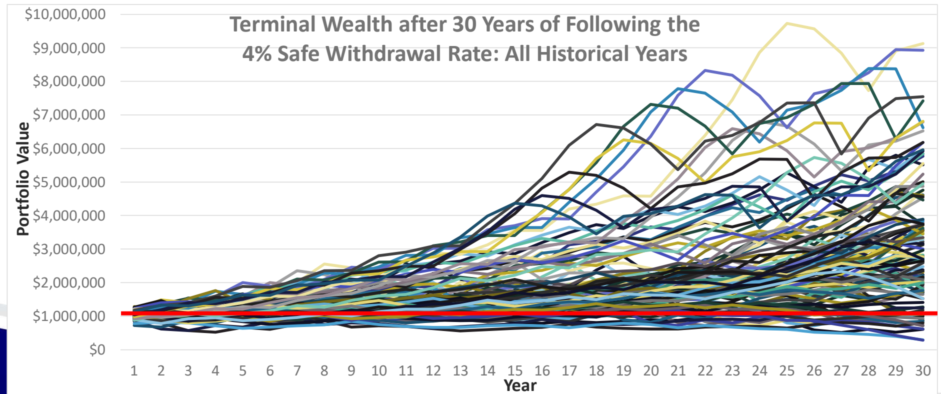
Safe Withdrawal Rates (SWR)

- Usually you don't need to be "this" conservative?
  – But you do it anyway, "just in case"!



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Safe Withdrawal Rates (SWR)

- Current research summary:

Base Withdrawal Rate	4.0% - 4.5%
Adjustments:	
Fees/Alpha	-1% to 1%
Taxes	-0.25% - 0.75%
Legacy/Longevity Hedge	0% to -0.4%
Time Horizon	-0.5% to 1%
Diversification	0.5% to 1%
Spending Flexibility	0% to 1%
Risk Tolerance	0% to 1%
Valuation Environment	0% to 1%
Tactical Asset Allocation	0% to 0.2%
Standby Reverse Mortgage	1% to 2%
Final Withdrawal Rate:	**Sum Total of Adjustments**

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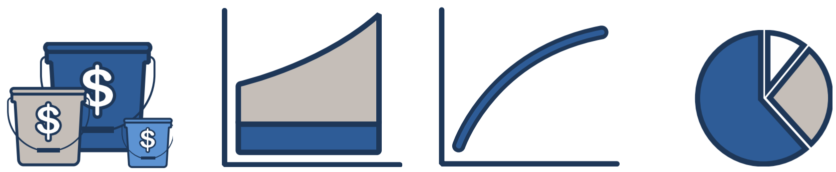
Dynamic Asset Allocation

- Managing sequence risk via asset allocation strategies



Bucket Strategies | Annuitization Floor | Rising Equity Glidepath | Valuation-Based Asset Allocation

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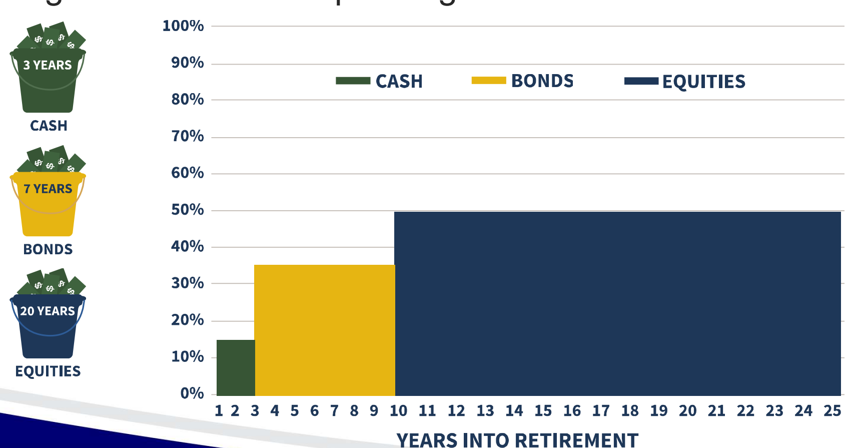
The Retirement Bucket Approach

- Segment retirement spending needs into three buckets



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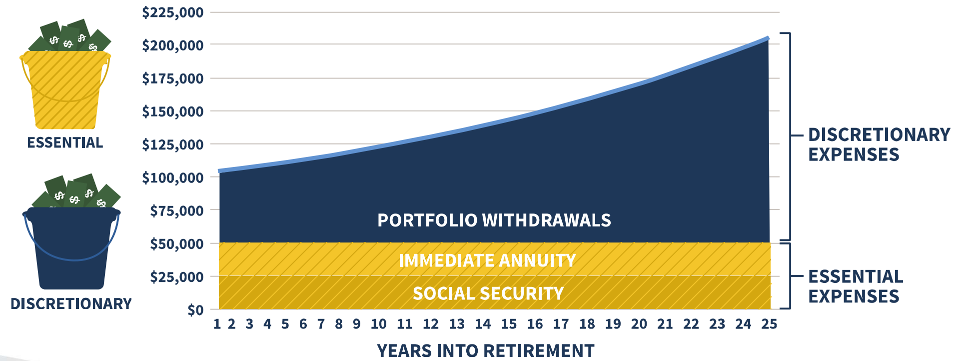
The Annuity Bucket Approach

- Annuity alternatives to the “traditional” bucket strategy



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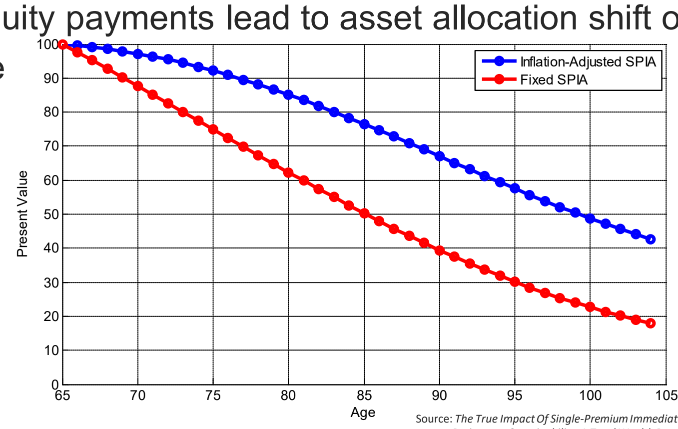
The Annuity Bucket Approach – Over Time

- Annuity payments lead to asset allocation shift over time



Source: *The True Impact Of Single-Premium Immediate Annuities On Retirement Sustainability: A Total Wealth Perspective* by Michael Kitces & Wade Pfau

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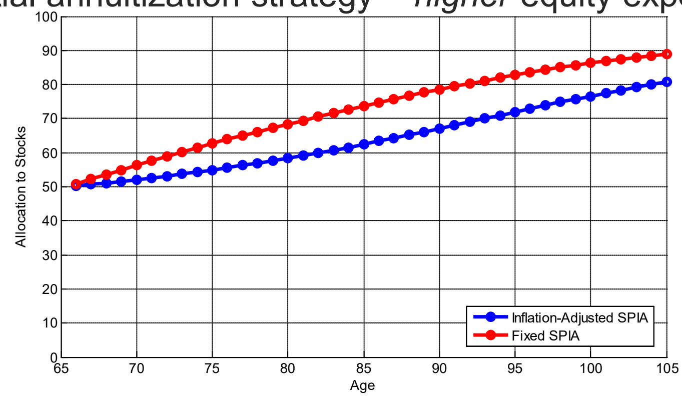
The Annuity Bucket Approach – Over Time

- Partial annuitization strategy = *higher* equity exposure!



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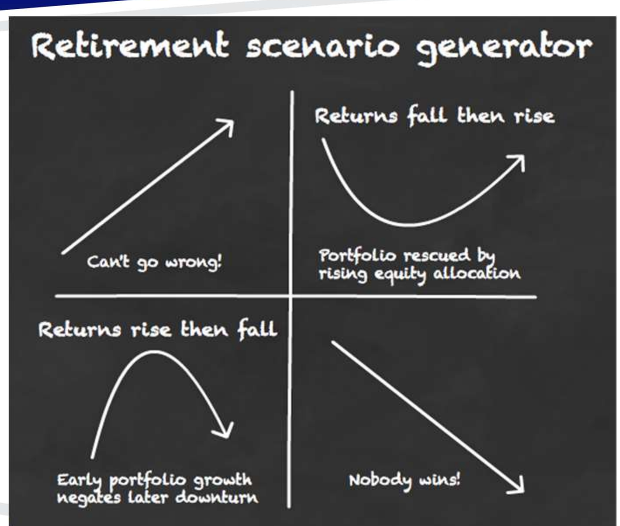
Rising Equity Glidepaths



Source: Monevator blog - http://monevator.com/buy-shares-in-retirement/

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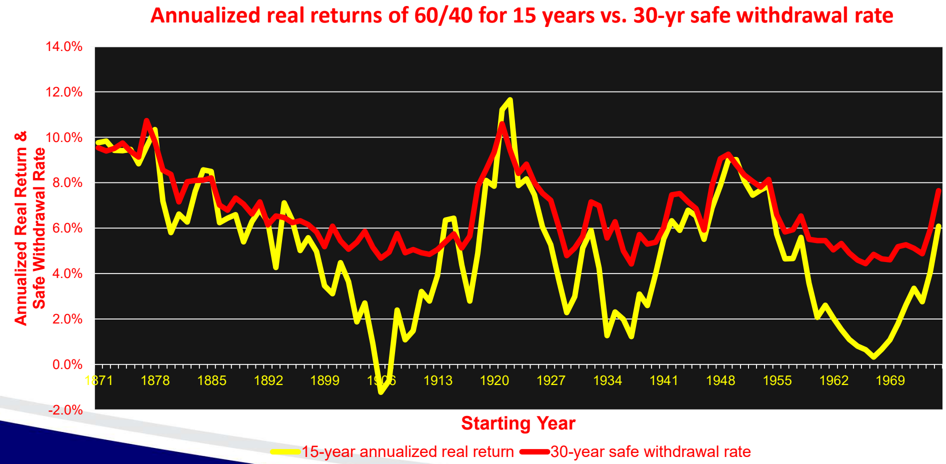
Early Returns & SWR

- The SWR is heavily influenced by early returns



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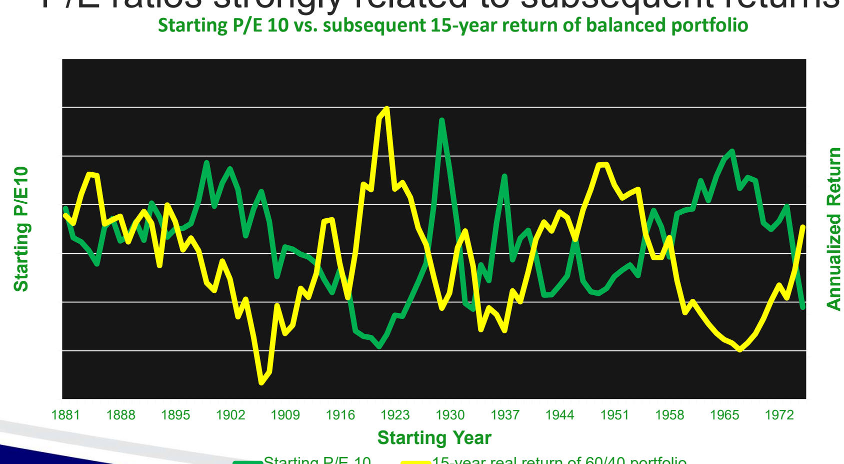
Forecasting Market Returns

- P/E ratios strongly related to subsequent returns



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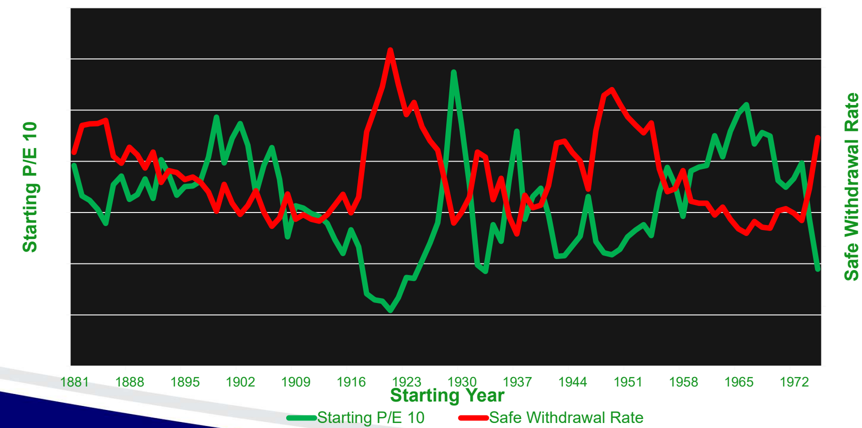
Forecasting Safe Withdrawal Rates

- Using P/E ratios to predict safe withdrawal rates

Starting P/E 10 vs. Safe Withdrawal Rate over subsequent 30-year period



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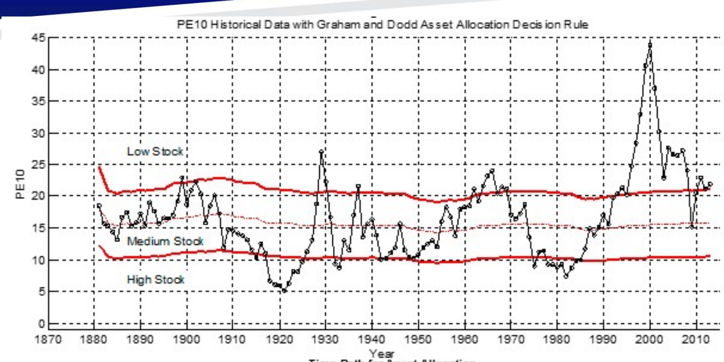
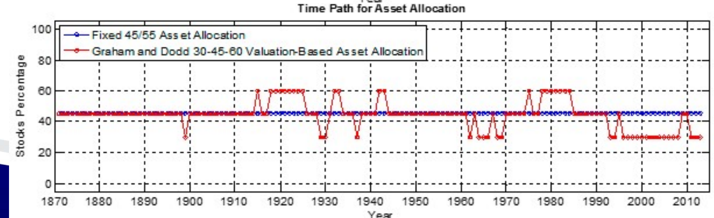
Valuation-Based Allocations





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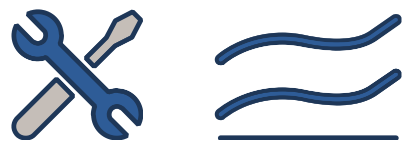
Dynamic Spending Strategies

- Managing sequence risk via dynamic spending



Spending Ratchets **Floor/Ceiling Guardrails**

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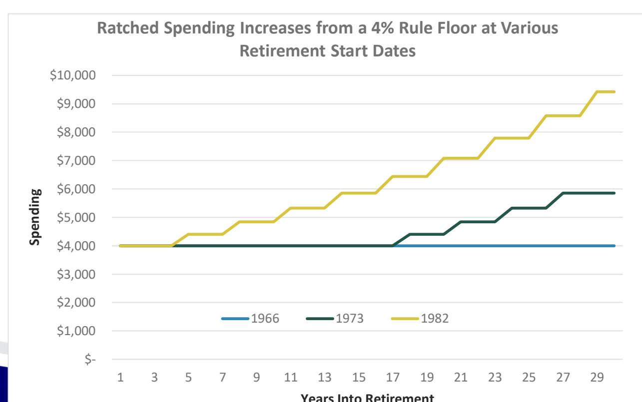
Ratcheted Spending

- Start with a “SWR base” but ratchet higher
  - Most years will do better, simply need a target threshold!



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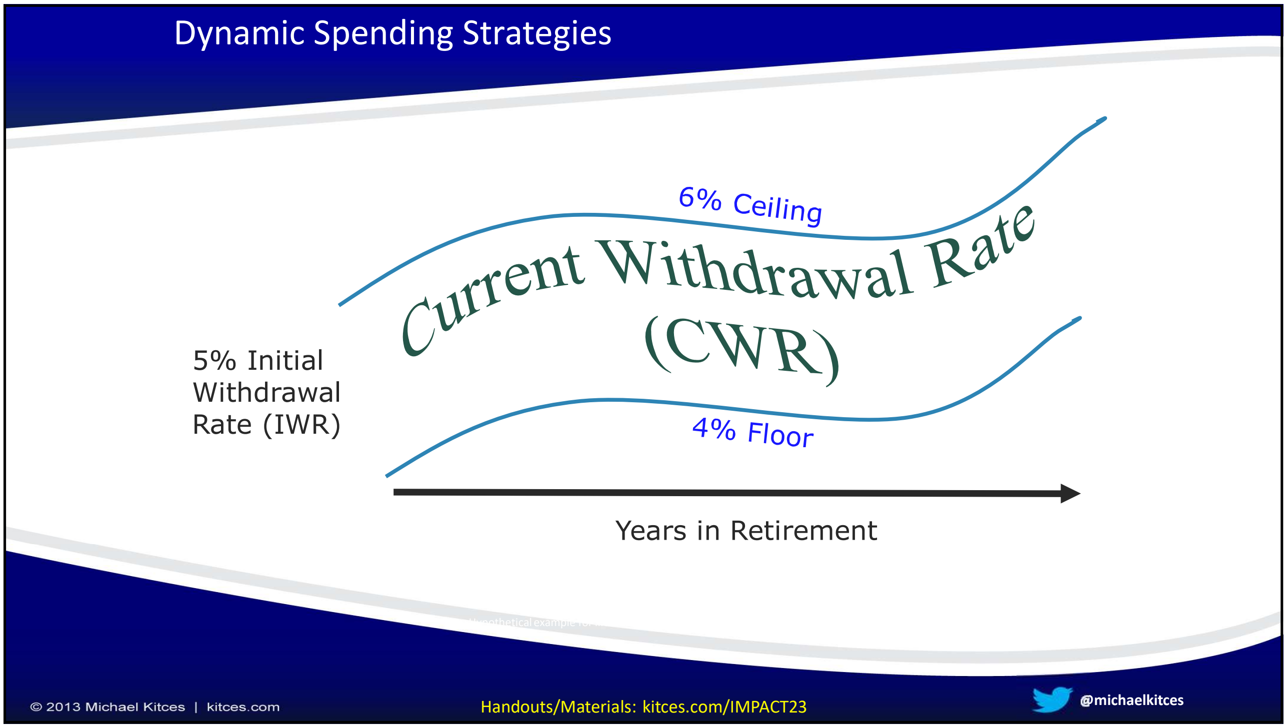
Dynamic Spending Strategies
6% Ceiling
Current Withdrawal Rate
(CWR)
5% Initial
Withdrawal
Rate (IWR)
4% Floor
Years in Retirement
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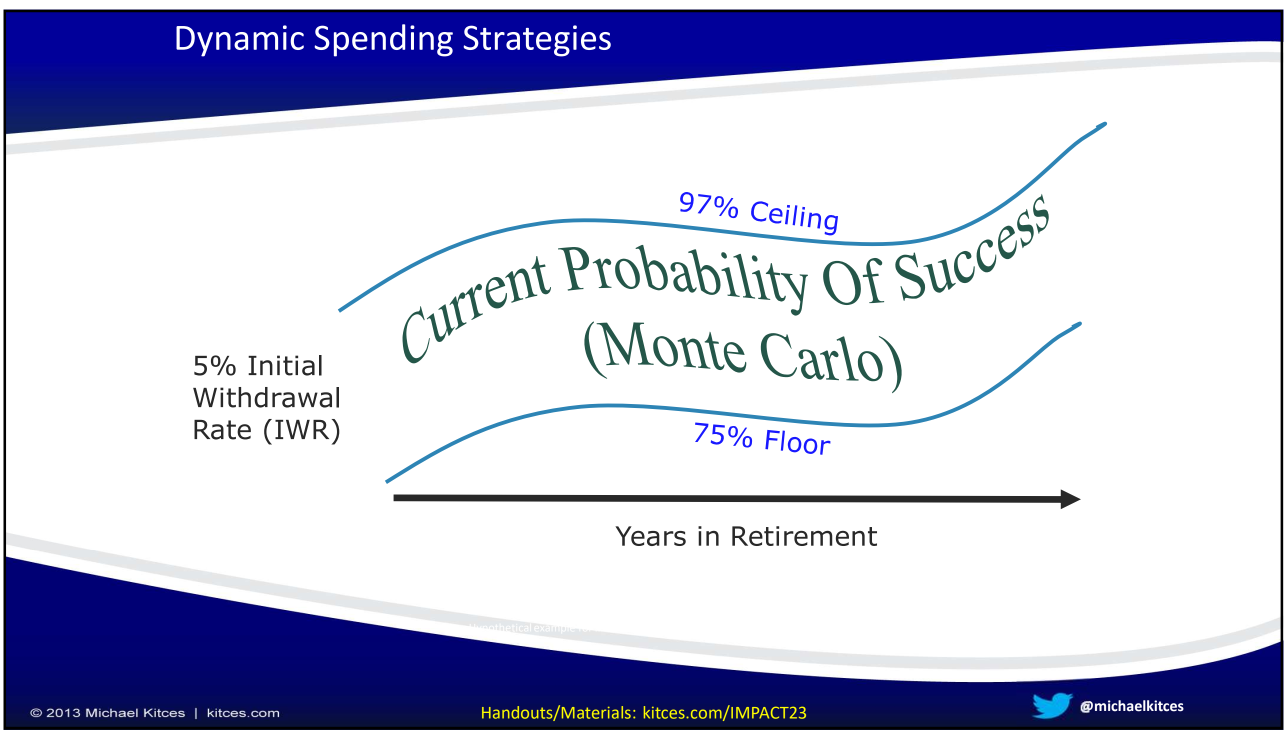
Dynamic Spending Strategies
97% Ceiling
Current Probability Of Success
(Monte Carlo)
5% Initial
Withdrawal
Rate (IWR)
75% Floor
Years in Retirement
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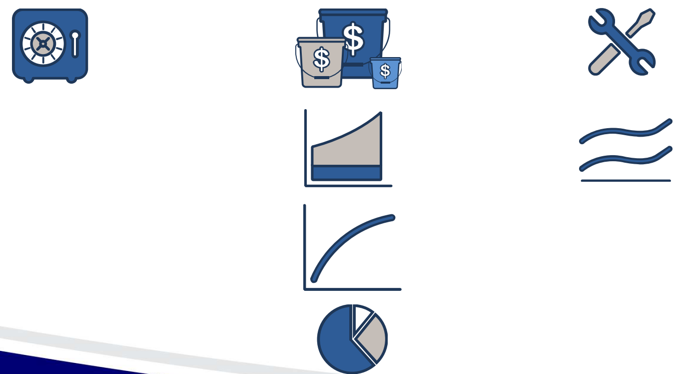
Strategies For Sequence Risk

- Setting A Strategy To Manage Sequence Risk

Safe Withdrawal Rates | **Dynamic Asset Allocation** | **Dynamic Spending**



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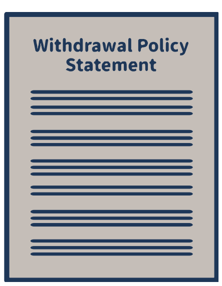
The Withdrawal Policy Statement

- Crafting A Withdrawal Policy Statement



1. Income goals (how much?)
2. Available assets (what will we use?)
3. The initial withdrawal rate;
4. Liquidation/sourcing methodology (interest/dividends/capital gains; account types)
5. Adjustment triggers (thresholds & magnitudes)

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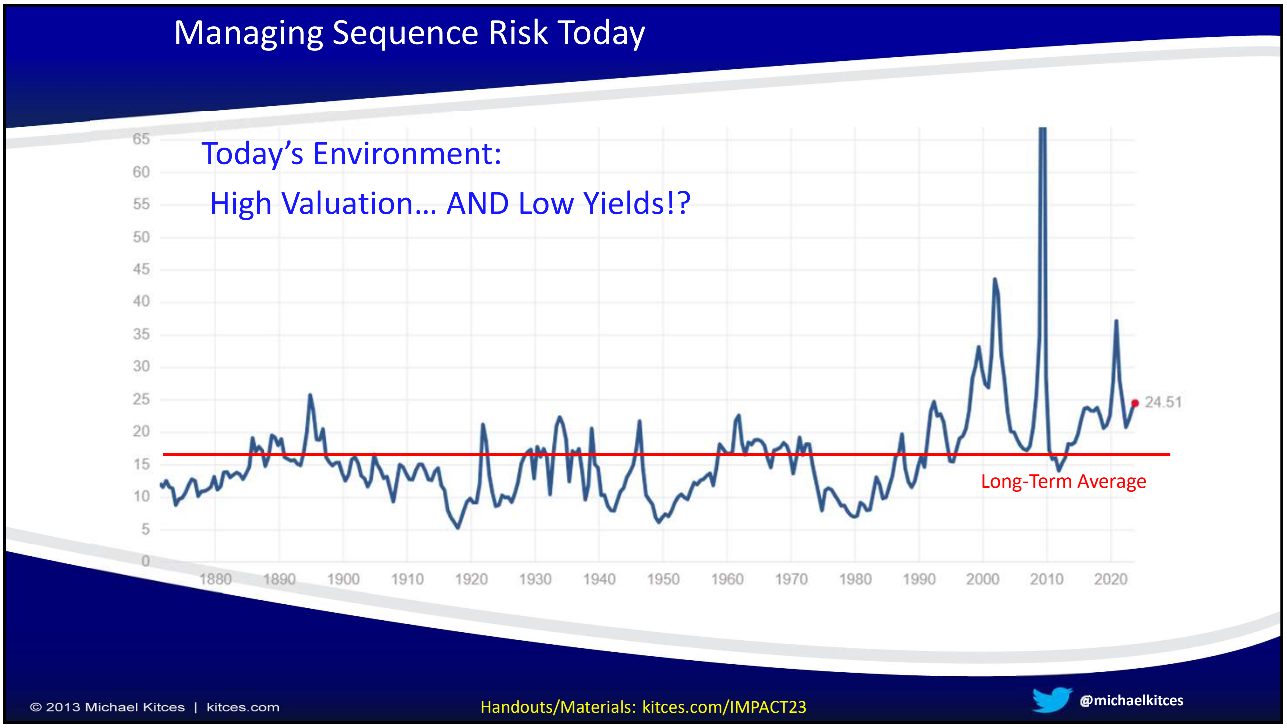
Managing Sequence Risk Today
Today's Environment:
High Valuation… AND Low Yields!?
65
60
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0
1880 1890 1900 1910 1920 1930 1940 1950 1960 1970 1980 1990 2000 2010 2020
24.51
Long-Term Average
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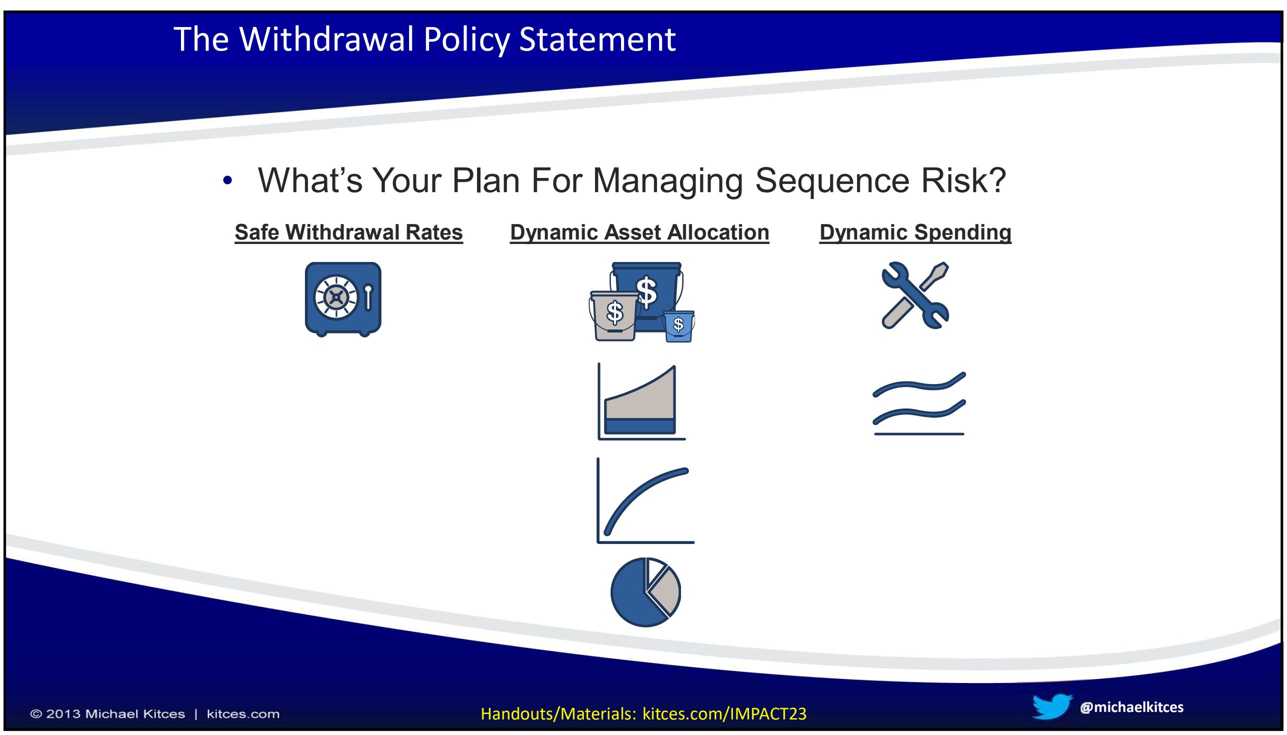
The Withdrawal Policy Statement
• What's Your Plan For Managing Sequence Risk?
Safe Withdrawal Rates
Dynamic Asset Allocation
Dynamic Spending
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