# How 'sequence of returns' risk can wreck your retirement

Find out how to protect your nest egg from negative returns in the years before or after you quit work.

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Imagine you pencil in a reasonable 12% rate of return on your investments towards your nest egg. Years later, when retirement looms, your portfolio matches this return, but your corpus falls well short of the target. Why? A hidden risk has foiled your plans.

Chances are that you did not account for the exact pattern of gains or losses, or the order in which your investment returns occur. This is what is referred to as 'sequence of returns' risk. It is the risk of negative returns occurring later in your working years and/or early in your retirement life. It particularly comes into play during the five years before and five years after retirement—the 'fragile decade'. Investors in this phase of their lives are most vulnerable to sequence of returns risk.

Why is this risk a killer? Let us see with an example. Suppose two investors, A and B, start their retirement years with the same corpus of ₹1 crore. They avoid withdrawals for the initial 10 years. Two different market scenarios play out for A and B, where the returns are identical, except that they occur in reverse order. A's portfolio witnesses higher returns in the initial years, but lower returns than B's portfolio in later years. In both scenarios, the ₹1 crore initial pot would fetch the same amount of ₹1.75 crore at the end of 10 years, with the market averaging 7.3% return annually. Both are on an even footing, despite a contrasting pattern of market returns.

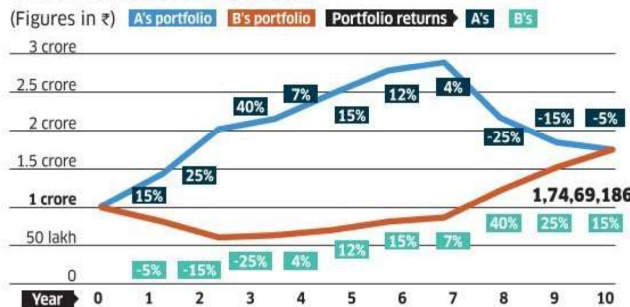
Now, let us compare how the two scenarios would play out if both A and B make regular withdrawals during this period. If ₹6 lakh is withdrawn at the start of each year, A's pot will grow to ₹1.15 crore at the end of 10 years. B, on the other hand, will be left with a sum of ₹50 lakh. Despite fetching the same average market return, A has about ₹65 lakh more than B owing to the sequence of returns. B's savings are severely depleted despite fetching higher-than-average returns in later years. B now faces uncertainty in the remaining years of his retirement as his portfolio longevity is severely crunched. What hurt B was not just the lower market return initially, but also the concurrent withdrawals from the corpus. Dev Ashish, Founder, StableInvestor, observes, "For retirees, the sequence of returns is a bigger risk as there is no fresh money to be added. A market drawdown at this stage, when they are dipping into the corpus, is a double whammy."

Imagine another scenario, where this specific pattern of market returns coincides with the five years before and after retirement for both A and B. They begin withdrawing from the corpus only from the sixth year onwards. In this scenario, A begins his second innings at 65 years, with a meaty corpus of about ₹2.48 crore. B, on the other hand, can only start his retirement with a whittled sum of about ₹70 lakh. After regular withdrawals, A still has ₹1.52 crore at his disposal at age 70, while B is left with ₹1.19 crore—₹33 lakh less than A. In this scenario, B didn't withdraw amid the initial market correction. Yet, he is left at a significant disadvantage. Meanwhile, despite A's withdrawals coinciding with a falling market, superior returns towards the end of his accumulation phase gives him an edge.

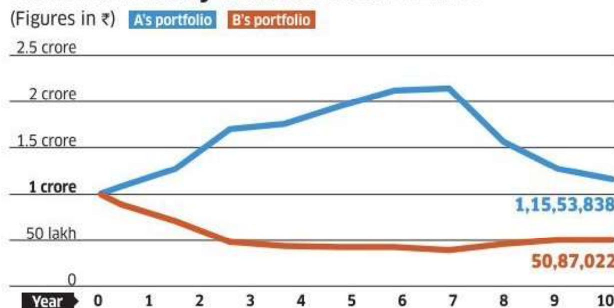
## Negative returns at critical periods can dent your retirement corpus

Poor returns, combined with withdrawals in retirement, will act as a double whammy.

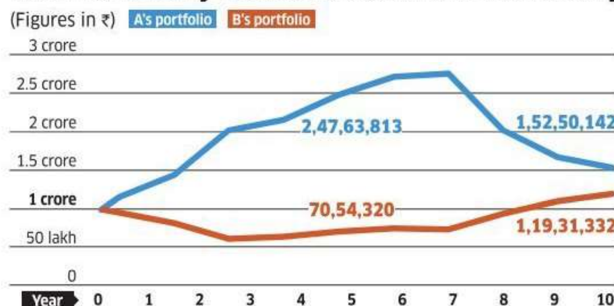
### Scenario 1: No withdrawals




### Scenario 2: Yearly withdrawals of ₹6 lakh




### Scenario 3: Yearly withdrawals of ₹6 lakh from sixth year




**Note:** Value of initial corpus for A & B: ₹1 crore; withdrawals are assumed to occur at the start of every year.

## What should retirees do?

One cannot know in advance how a sequence of market returns will play out. "You don't get to decide what sequence of market returns you get in future," asserts Dev Ashish. However, there are a few steps you can take to be better prepared for any eventuality. The central pillar is to have adequate diversification in the portfolio. If your investments are spread across asset classes, it can cushion losses in a specific segment of the portfolio.

Next, chalk out a glide path for your investments at least two-three years before your retirement. This involves a gradual shift from a volatile asset class like equities to a safer avenue like fixed income. Kirtan Shah, Founder and CEO, Credence Wealth Advisors, says, "The last two years before retirement are extremely critical. Returns generated via SIPs over 15-20 years can be whittled down to a pittance if the market tanks in this period. Start moving this money to a safer avenue like fixed income 12-24 months earlier." The idea is to protect your accumulated corpus from a bad sequence of returns occurring not just in later years of working life, but also during initial years of withdrawal, contends Ashish. After this critical phase is over, equity exposure can be moderately ramped up again. Not having any equity-linked exposure can also severely hurt the longevity of your savings.

Further, try and reduce the depletive impact of withdrawals during sharp market declines. There are two ways to achieve this. First, carve out a portion of your retirement savings in a liquidity bucket—liquid funds or FDs—intended to cover living expenses for the next two-three years. When the stock market nosedives, stop withdrawing from your core market-linked portfolio. "Use your fixed income bucket to withdraw during market declines," suggests Shah. Ashish insists, "Having this additional buffer gives your equity-linked portfolio enough runway to recover." Second, try to adjust your withdrawal rate according to market circumstances. Moderate living expenses by 10-15% during market declines to preserve savings.

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