Market Cycles and the Retirement Risk Zone

Rethinking Retirement Planning

managed by CI Investments Inc.

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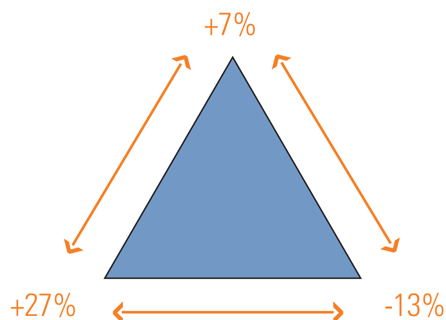
Market cycles and the sequence of returns

There's no way of knowing what stage of the market cycle your clients will retire into, or what sequence of returns they will receive before or during their retirement. Short term, equity markets may move up or down, but ultimately the long-term trend has always been up. A complete market cycle is the period between two market peaks.

The sequence of returns is the order in which an investor receives their investment returns. Think of it as a triangle, with each side representing a different annual return. The simple average of all three is 7%. But the returns can be received many different ways.



When clients are building their portfolio, the order of their investment returns is not as critical because they are not withdrawing money for income and any losses may be recouped over the long term. But, once they hit the retirement risk zone, the sequence of returns becomes extremely important, because time is not on their side.

If poor returns are received just prior to retirement it may mean they are unable to achieve their retirement goal. This could delay their retirement, or cause them to have a lower retirement income.

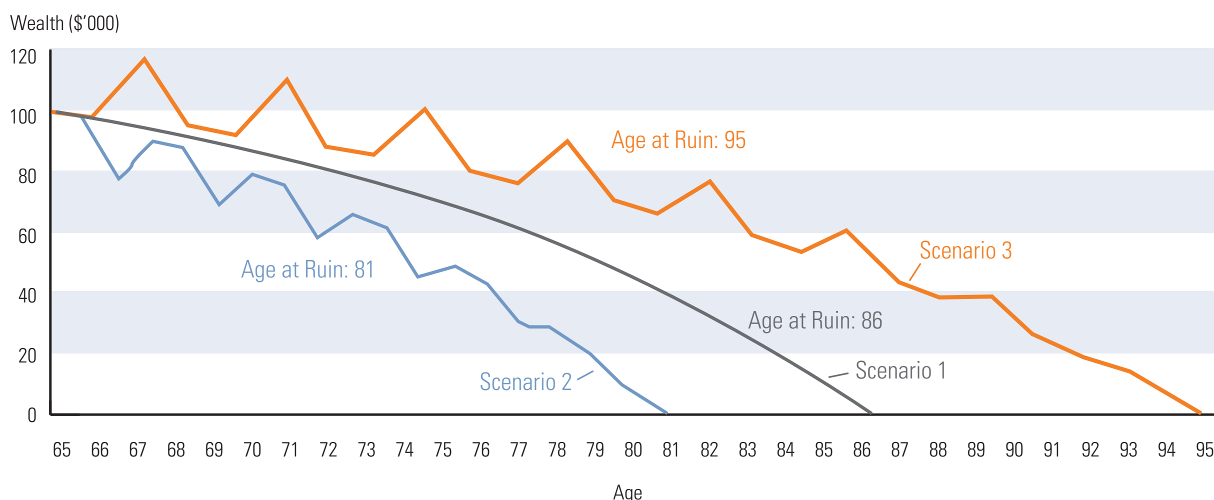
When poor performance occurs early in retirement, the decline is magnified because money is also being withdrawn for income. For example, imagine a negative 10% return in a year when there's a need to withdraw 10% of the assets for income. The assets would decline 20% in just one year and it would take a 25% increase the following year just to get back to where the portfolio started.

The disparity between receiving good or poor performance early in retirement can make a big difference when it comes to how long clients' money will last or how well their income keeps up with inflation.

The difference can mean years

This shows the impact of the sequence of returns. It assumes a $100,000 portfolio with an annual withdrawal of $9,000. Here are three scenarios:

Scenario 1, with a constant 7% annual return, the money will last until age 86
Scenario 2, if the portfolio experiences the poor return early (-13%, followed by +7% and +27%), the money will last until age 81.
Scenario 3, if good returns are achieved at the beginning (+27%, followed by +7% and -13%), the money will last until age 95.



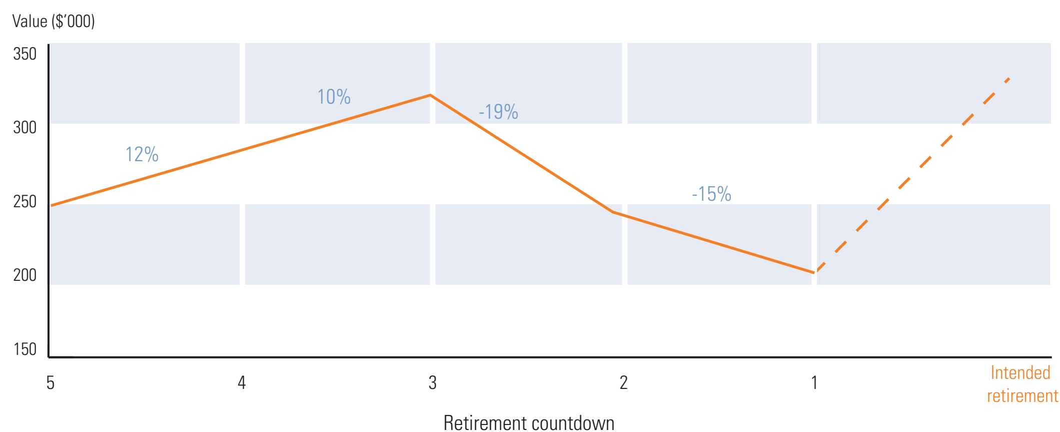
Source: Asset Allocation and the Transition to Income, Milevsky & Salisbury, September 2006.

Catching up is difficult in pre-retirement years

Market losses during the five to 10 years just before retirement can be difficult to recoup. In the example below, an investor is five years away from retirement. In the fifth year before retirement, they receive a return of 12% and in the fourth year a return of 10%. But the next two years are unkind, with losses of 19% and 15%, respectively. It would require a return of 45% the following year to recoup the loss – from the peak – and 65% to reach the original goal of $350,000 by the intended retirement date.

How realistic is that? More likely, it will take several years at a more reasonable rate of return.

Will poor performance in the retirement risk zone change your client's plans?



← How long and how much would it take to recover?

# Years	Average annual return
1	45%
2	21%
3	13%
4	10%
5	8%

From 2000 to 2002, the S&P/TSX Composite Index fell 45%. It didn't fully recover until the end of 2005.

During the same period, the S&P 500 Index fell 42%. It had barely recovered by mid-2007, when another round of volatility hit the markets.

When retiring in a down market, it's hard to recover early losses

Hypothetical $250,000 Portfolio

Withdrawals begin at age 62*	Hypothetical annual rate of return	Negative early returns	Hypothetical annual rate of return	Positive early returns
Beginning value		$250,000		$250,000
Age 62	-0.80% (A)	$235,490	(C) 16.02%	$277,550
Age 63	-10.83%	$197,109	15.61%	$308,006
Age 64	-13.79%	$156,663	11.68%	$330,723
Age 65	7.24%	$154,346	16.07%	$370,224
Age 66	4.10%	$146,611	9.05%	$389,657
Age 67	4.95%	$139,381	8.37%	$407,773
Age 68	10.38%	$138,917	16.55%	$460,333
Age 69	16.69%	$146,726	3.63%	$461,675
Age 70	-4.56%	$124,202	13.33%	$507,391
Age 71	4.25%	$113,172	-9.95%	$440,601
Age 72	19.43%	$118,366	7.15%	$455,300
Age 73	-3.38%	$97,066	7.76%	$473,342
Age 74	9.00%	$87,984	1.72%	$463,648
Age 75	12.54%	$80,656	18.69%	$531,956
Age 76	1.91%	$63,291	24.99%	$645,958
Age 77	24.99%	$59,629	1.91%	$638,834
Age 78	18.69%	$50,717	12.54%	$698,853
Age 79	1.72%	$30,927	9.00%	$741,117
Age 80	7.76%	$12,047 (B)	-3.38%	$694,809
Age 81	7.15%		19.43%	$807,912
Age 82	-9.95%		4.25%	$819,680
Age 83	13.33%		-4.56%	$759,057
Age 84	3.63%		16.69%	$861,778
Age 85	16.55%		10.38%	$926,526
Age 86	8.37%		4.95%	$946,997
Age 87	9.05%		4.10%	$959,690
Age 88	16.07%		7.24%	$1,002,214
Age 89	11.68%		(D) -13.79%	$836,223
Age 90	15.61%		-10.83%	$717,052
Age 91	16.02%		-0.80%	$681,830 (E)
Average annual rate of return for 30 years	7.26%	(F)	7.26%	
	Negative returns early deplete savings		**Positive returns early extend savings**	

** The $12,500 annual withdrawal is adjusted 3% each year for inflation.*

Sequence risk during the early retirement years

Suppose an investor retires at age 62 with retirement savings of $250,000. He plans to withdraw 5%, or $12,500 annually, adjusted for inflation of 3% each year.

A As he begins to withdraw income, his portfolio experiences three straight years of decline.

B Since the poor performance coincides with his withdrawals, it means he will run out of money in 18.5 years. At age 80, there is $12,047 remaining, about half his annual withdrawal.

Look at what happens if the sequence of annual returns is ***exactly reversed.***

C The investments do well in the early years of retirement.

D While the same declines came much later, they don't have the same impact.

E Not only would his money last for 30 years, but there would be substantial assets remaining at age 90.

F It's clear that even with the same average rate of return +7.26%, early losses can mean running out of money, while positive returns early in retirement can easily provide a lifetime of income.

There's no way to anticipate market cycles and know what sequence of returns your client will receive.

Can they afford to be at the mercy of market volatility and sequence of return risk?

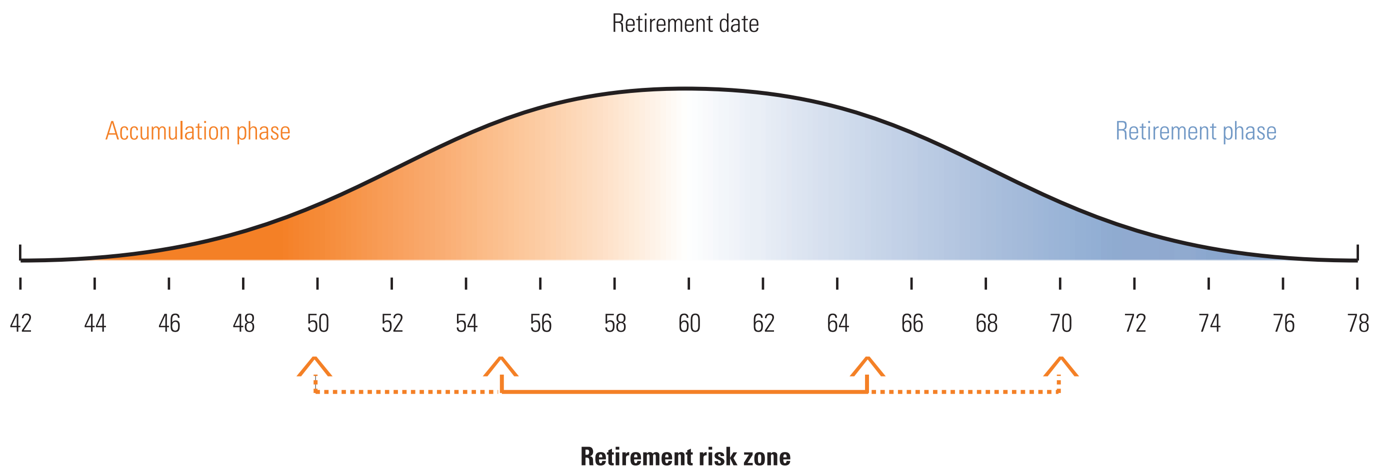
SunWise® Elite Plus

Rethinking Retirement Planning

Retirement risk zone

Your clients, can have a good plan in place, make regular contributions to their retirement fund and allocate their assets prudently, but they may still have the misfortune to experience a market downturn around their anticipated retirement date or early in their retirement.

The retirement risk zone is the five to 10 years just before and after your client retires. It's a critical time when short-term losses can have negative long-term effects because there's little or no time for their investments to recover.



No matter what sequence of returns your client receives, Sun*Wise* Elite Plus can provide a steady, reliable income for life.

It helps mitigate sequence of returns risk …..

> Prior to retirement, the 5% annual guaranteed income bonus, applied every year a withdrawal is not made in the first 15 years, can provide guaranteed income growth.

> During retirement, with guaranteed income for life – regardless of market returns.*

And, as their investment grows – so will their income.

*Subject to legislated minimums and maximums and certain conditions. Exceeding the 5% withdrawal may h*ave* a negative impact on future payments. The guaranteed income for life or Lifetime Withdrawal Amount is available after December 31 of the year the annuitant turns 65. Payments can continue until the death of the annuitant (LWA annuitant for joint contracts) or termination of the contract. For those who need income before age 65, Sun*Wise* Elite Plus guarantees a return of principal in the form of regular withdrawals of up to 5% annually for at least 20 years. Payments end when the Remaining GWB is nil; when the contract is terminated; on the contract maturity date or upon death of the last surviving annuitant.

Retirement illustration is based on poor early performance scenario, which can be found the in the Sun*Wise* Elite Plus Illustration tool at www.sunwiseeliteplus.com. It assumes a portfolio of 60% equity/40% income, after MERs and insurance fees.

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