IT'S ALL IN THE TIMING

If you quit work right before a bull market, your portfolio will thrive. But retire before a downturn and you risk outliving your money. Here's what you can do now to protect your savings from the risk of bad timing

BY DAVID ASTON ILLUSTRATION BY PAUL GARLAND

When you were younger, you may have focused on beating the market. But when you reach retirement, you need to ensure the market doesn't beat you.

Retirement fundamentally changes the way you should approach your finances. When you're young and adding money to your portfolio every year, you should welcome market downturns, because they offer an opportunity to buy more stocks at low prices. But if you encounter a severe bear market immediately after retirement, you may be forced to sell beaten-down stocks to provide the means to live on. While those stocks should bounce back eventually, by then your portfolio may be too depleted to fully recover.

"If you're taking money out it means you can't endure those downturns as well as someone who is still putting money in. People have to get their heads around that," says Malcolm Hamilton, fellow with the C.D. Howe Institute and a retired actuary.

LUCK OF THE DRAW (DOWN)

Consider the example of a retiree with $500,000 who needs to withdraw $22,500 a year. (We'll ignore inflation for simplicity's sake.) As long as the portfolio is still worth $500,000, the drawdown is only 4.5%, which means investment returns stand a good chance of offsetting the withdrawals, and maybe even adding growth. But say the portfolio is suddenly hit by a 25% decline and is now worth just $375,000. Now the same $22,500 drawdown represents 6% of the portfolio's value, and that makes it harder for investment returns to keep pace.

It's simple math: in percentage terms, fixed drawdowns take an increasingly large bite out of a diminishing portfolio. And if returns fall short for several years, the portfolio shrinks further and creates a vicious circle. It may never be able to bounce back, even if you eventually get a period of exceptionally high returns. This is called "sequence-of-returns risk," and in extreme cases it can mean the difference between ending up wealthy or depleted.

ONE RETIREE SAW HIS NEST EGG GROW TO $2.2 MILLION, THE OTHER LOST IT ALL

The first seven years of retirement are when the risks are particularly high, says Moshe Milevsky, professor of finance at York University's Schulich School of Business in Toronto. "Once those first seven years are over you can breathe a sigh of relief."

Let's apply the 4.5% withdrawal to historic examples. Compare the fortunate senior who retired at the end of 1981 (just before a bull market) with the less fortunate one who retired at the end of 1968, just

prior to a dismal period for stocks. Let's assume each started with the equivalent of $500,000 in today's dollars. Say that money is invested in 50% large-cap stocks and 50% intermediate government bonds, and each retiree withdrew the 4.5% of the initial portfolio annually (a little more aggressive than many experts recommend), plus inflation adjustments. (We used U.S. dollars and returns data for this example.)

As it turns out, Lady Luck smiled on the 1981 retiree: after 30 years, that investor's nest egg would have grown to almost $2.2 million in today's dollars, despite all those withdrawals (see "Retire Like It's 1999" on page 30). Meanwhile, our 1968 retiree would have run out of money before 30 years were up. Remember, the 1968 retiree was still around to enjoy the bull market of the 1990s. But those high returns came near the end of retirement rather than the beginning, and that made all the difference.

Fortunately there are several ways to reduce sequence-of-returns risk. These include both lifestyle changes and adjustments to your investments. It's important to consider these options while markets are performing well, because you may not have time to react if markets stumble. Once you retire, "losses become more painful, hence you want them to be less likely," advises Hamilton.

While it's tempting to think of this primarily as an investing issue, look first at other aspects of your finances. Start by assessing your potential to reduce discretionary spending. Retirees tend to spend more on travel and other activities during the first few years after ending their careers, for example, since that is when they're most likely to be in good health. Are you prepared to give up or delay some of those leisure plans? If you earn a decent wage at a job you enjoy, are you willing to work longer? Consider whether there are other realistic options, like renting out a downstairs apartment or selling a cottage to take some of the pressure off your investments.

If these options don't provide enough leeway, then consider adjustments to your portfolio. You probably still need at least some allocation to stocks: with today's low interest rates, only the wealthiest investors can sustain their portfolios with high-quality fixed income only. So the key is looking for sensible ways to contain the risks inherent in stocks.

INCOME INVESTING PAYS DIVIDENDS

If you're able to meet most or all of your income needs with the interest from high-quality fixed income and reliable dividend stocks, then a market decline won't necessarily have a major impact—as long as your stocks don't cut their dividends. First, the dividends themselves can provide much of your cash needs, which lessens the likelihood you'll need to sell stocks at inopportune times. Secondly, reliable dividend stocks are usually less susceptible to market downturns than non-dividend-paying stocks. That means you probably won't be hit as hard if you do end up selling equities in a down market.

However, most people won't be able to meet all their cash-flow needs from dividends and bond interest unless they take on extra risk and "chase yield." Experts say you can generally withdraw about 4% of the value of your initial portfolio each year (plus annual inflation adjustments) with little risk of outliving your money. That assumes you retire at 65 and invest in a balanced portfolio that earns market returns. But these days you can probably expect to generate only about 3% in yield using a mixture of reliable dividend stocks and investment-grade fixed income. And that's before accounting for adviser fees and taxes.

The bottom line is you will probably still need to draw on capital if you're trying to maximize the amount you can safely withdraw. That means you will probably need another strategy to generate the rest of your cash flow.

TWEAK YOUR ASSET ALLOCATION

The classic approach to curtailing market risk early in retirement is simply to reduce your allocation to equities and increase your holdings in investment-grade bonds, GICs or cash. You'll still need to maintain a ➤

THE GLIDE PATH LESS TRAVELLED

A common retirement strategy is to gradually increase your portfolio's bond allocation as you get older (or at least maintain it at a conservative level). But new research puts a twist on how to manage your asset allocation "glide path."

A recent article by academic Wade Pfau and financial planner Michael Kitces in *The Journal of Financial Planning* suggests you can increase the odds of sustaining your nest egg by starting with an unusually high fixed-income allocation when you retire, and then gradually lowering it as you get through the danger zone.

The suggestion that you should increase your equity allocation as you age—and therefore increase your risk of major losses—has stirred controversy in financial planning circles. But Pfau provides a commonsense interpretation: "You can get more downside protection starting at 30% stocks and then working your way back to 60% stocks, rather than staying at 60% stocks and 40% bonds the whole time," says the professor of retirement income at the American College in Bryn Mawr, Pa. You never have a higher equity allocation than you would otherwise have had, Pfau says. But you get very conservative in the first several years of retirement, "and you work your way back up from a lower level."

Moshe Milevsky, professor of finance at York University's Schulich School of Business, says this research is provocative, though it shouldn't be considered conclusive. Note that you would need to be prepared to put up with the lower expected return during those years, and you may find it emotionally unappealing to increase your equity exposure later in retirement.

balance: most experts advise keeping both stocks and fixed income (including cash) between 40% and 60% if you're moderately conservative. However, you could go down to 30% equities or even lower if you're extremely risk-averse. Some advise keeping a consistent asset allocation as you get older, while others advocate gradually reducing equities as you age. (See "The Glide Path Less Travelled" on the previous page.)

A variation on this idea is to ensure you have plenty of cash and short-term fixed income so you can cover near-term cash flow needs without having to sell stocks or bonds at the wrong time. Consider a simple "bucket strategy." If you know you'll need $20,000 in annual cash flow, you might hold that amount in cash, in a 1-year GIC and a 2-year GIC. That would let you wait out a stock downturn for at least three years. (If you want protection for longer, you can extend the GIC ladder farther.) As time passes, you add to the end of the ladder when conditions are favourable.

There are other ways to achieve similar results, points out Jim Otar, a financial planner and retirement researcher at retirementoptimizer.com. You can adopt a balanced asset mix and ensure you have sufficient cash and fixed income to cover short-term needs. Then draw your cash flow from the part of the portfolio that is doing the best, he advises. If stocks have a good year or two, you sell some shares to help meet your monthly expenses. When they've done poorly, you instead draw from the cash and fixed income. This is just part of normal portfolio rebalancing, Otar says.

With all these strategies you need a few years' worth of cash and short-term fixed income in the portfolio so you can wait out an extended downturn in stocks, should one occur. As a result, you should be prepared to accept lower returns than you might otherwise have expected.

RETIRE LIKE IT'S 1999

We've seen how your portfolio's fortunes can change dramatically based on your chosen retirement date. That begs the question of how the current generation of retirees is faring. Since many financial plans assume a retirement portfolio needs to last 30 years, we looked at the situation for someone who is almost halfway there.

The last decade and a half has been challenging for stocks, although bonds have done better. The year 1999 was a particularly unfavourable date to retire: many stocks were trading at extremely high levels during the dot-com bubble, and the bear market that followed was a prime example of an unlucky sequence of returns. It's too soon to answer conclusively whether a retiree's nest egg will be sustainable over a full 30-year period, but it's looking iffy based on a 4.5% withdrawal rate. If you had retired in 1999 with the equivalent of $500,000 in today's money, you would still have a portfolio worth about $314,000 at the end of 2013. That's significantly ahead of where the unfortunate 1968 retiree was after 14 years (see below), but not enough to be confident the money will last the full 30 years.

To be fair, however, it's important to acknowledge that many people who retired in 1999 were in their peak earning years during the longest bull market in history (from 1987 to 2000) and probably benefitted from the massive gains in stocks during those years. That would have enabled them to build a retirement portfolio substantially bigger than it might have been. So the fortunes of the 1999 retiree have probably averaged out to some degree.

WILL FORTUNE SMILE ON YOUR RETIREMENT DATE?

How three portfolios would have held up during the first half of a 30-year plan

	Down and Out: the 1968 retiree	Shot the Lights Out: the 1981 retiree	The Jury's Out: the 1999 retiree
Initial value of portfolio in today's dollars	$500,000	$500,000	$500,000
Value of portfolio after 14 years in today's dollars	$171,000	$1,312,000	$314,000
Value of portfolio after 30 years in today's dollars	$0	$2,165,000	?

Notes: Retirees from each period were assumed to have retired at the end of the year in question. All portfolio starting values are adjusted for inflation so they are equivalent to $500,000 in today's dollars. The assumed annual withdrawal rate is 4.5% of the original portfolio value plus inflation adjustments. Data and portfolio values are in U.S. dollars. Portfolios are assumed to be 50% large-cap U.S. stocks and 50% intermediate government bonds, rebalanced regularly. Source for returns and inflation is the *Ibbotson SBBI Classic Yearbook 2014*, published by Morningstar.

BUYING YOUR PERSONAL PENSION

An annuity is a product that works like a traditional company pension, providing reliable cash flow for life in exchange for a lump sum. Annuities aren't for everyone, but they provide excellent protection from sequence-of-returns risk, since your income is guaranteed, regardless of market conditions. (They also protect you from the "longevity risk" of living to a ripe old age.) If your finances are tight and you're particularly concerned about outliving your wealth, it makes sense to include annuities in your retirement income strategy. One good approach is to buy enough annuities so that along with government pensions you have essential expenses covered. That way sequence-of-returns risk would impact only your discretionary spending.

A major disadvantage is that once you buy an annuity, the money is committed (although some annuities have guarantee periods). Another problem these days, with interest rates so dismal, is annuity payouts are low. But the payouts increase with age, so you can get a better deal by waiting and gradually annuitizing in your early 70s. While that strategy makes sense, most people retire earlier—if you stop working in your 60s, you'll need a "bridge" strategy to protect yourself in the interim. Or you can choose to live with low payout rates and annuitize immediately after you retire.

If you have ample wealth relative to your income needs, annuities don't make as much sense and you have more leeway to adopt whatever approach appeals to you. In that case, if you end up with a bad sequence of returns, there may be little or no impact on lifestyle. Instead, the impact may primarily be borne by your heirs.

Ultimately, you can't escape sequence-of-returns risk entirely, but there is plenty you can do to contain it. If you address that risk carefully, you should be able to ensure a long and prosperous retirement. M

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