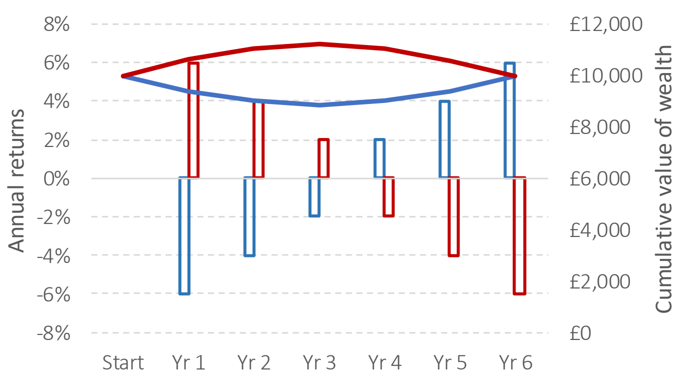
Alleviating sequence risk

What is sequence risk

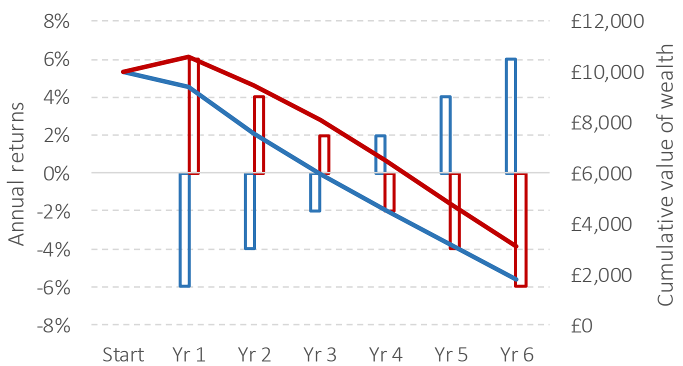
For an individual withdrawing money from an invested portfolio on a regular basis, the order (or sequence) of returns can have a material effect on their overall wealth. Take a simple example. The charts opposite show how a lump sum investment of £10,000 changes over time (the blue and red lines) depending on the returns achieved (the blue and red columns). In Chart 1 there are no withdrawals made and the investment is left untouched over time. The red shows when yearly returns start positive and end negative. While the blue are the same returns, but in the reverse order. Importantly, the final value is equal in both cases. The red and blue lines converge together at the end.

Chart 1 - When no withdrawals occur



Now look at what happens if a withdrawal of £1,500 is made at the end of each year, say to fund income in retirement. In Chart 2, the red and blue returns are the same as previously. This time, however, changing the sequence of the returns ends with different values. If a portfolio loses money early (like the blue) it will remain negatively affected from then on.

Chart 2 - When withdrawals are taken



For investors withdrawing money out of an invested portfolio, the order of returns will affect their overall wealth. This is known as sequence risk and requires careful management in the way a total financial plan is put together.

How can sequence risk be alleviated

Cashflow management is a key element in addressing the problems associated with sequence risk. This involves a structured plan that is easy to follow and can be implemented effectively. One such approach is the multi-pot strategy. This divides an investor's assets into three separate pots – Cash, Investment and Reserve, with an annual rebalancing. Although the structure can be nuanced for each individual, the likely starting point is to hold one and a half years' worth of desired income in cash. A further two to three years of 'rainy day' money in Reserve and the balance of the assets invested for longer-term growth to fund the projected withdrawals.

In a recent study by Indextus, this multi-pot structure was compared to a more traditional approach of holding two and a half years in cash with the rest invested in a mixed asset portfolio. Looking at returns over the past three decades, the research found the multi-pot strategy ended with more overall wealth than the standard approach. This is because the multi-pot's Reserve allows for a smoothing of how the Cash is topped up each year, avoiding sales of Investments in poorly performing years. This was only achieved, however, when a specific set of rules were applied annually. Determining the movement of assets between the pots and for funding the desired level of cash.

Important Information - Past returns may not reflect future performance. For information only. Not financial advice.