portfolio construction forum

Reduce volatility to reduce sequencing risk?

Tim Farrelly | farrelly's | 17 March 2016

We've heard a lot about sequencing risk in recent years. Mainly, we've heard how big a problem it is. However, suggestions about how to protect against it are less plentiful. For the most part, we hear from providers of fixed interest and alternative asset funds suggesting that the answer lies in reducing volatility. It seems plausible – volatility at the start of retirement means a nest egg can be reduced severely to the point where recovery becomes impossible. Volatility late in retirement seems to be less of an issue.

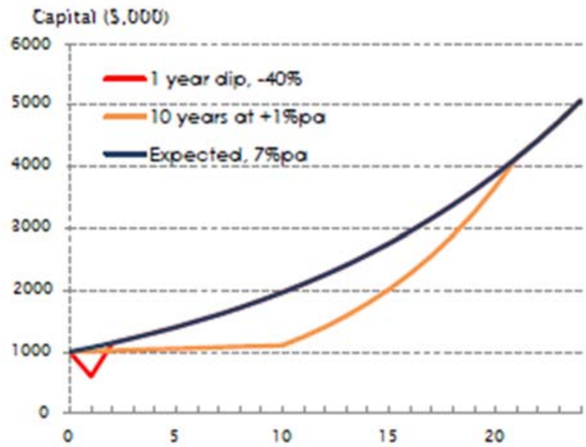
The argument seems plausible at one level – unfortunately, it's also nonsensical. How can sequencing risk be an issue for a 70-year-old who is about to retire, but not for a 70-year-old with an identical amount of capital, who retired at age 60?

More importantly, the maths just doesn't add up.

Figures 1 and 2 below show that return scenarios can have very different impacts on buy-and-hold investors on the one hand, and on investors in the drawdown phase on the other.

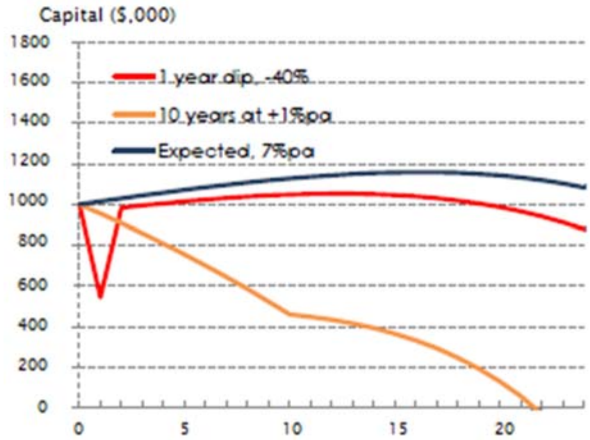
- the red line in both graphs represents a 40% downturn in year one, followed by a rapid recovery, and an overall return over 20 years of 7% per annum.
- the orange line in both graphs shows 10 years of returns at 1% per annum followed by a recovery so that, over the full 20 years, we again experience a 7% per annum return, on average.
- the blue line in both graphs represents consistent returns of 7% per annum.

Figure 1: Capital with no drawdown



Source: farrelly's

Figure 2: Capital with 5.5% drawdown



Source: farrelly's

For buy and hold investors (Figure1), the long-term outcomes of all three scenarios are the same - it doesn't matter how they get there, a 7% per annum return is a 7% per annum return. However, we see a very different picture for investors in the drawdown phase (Figure 2). All paths have the same average 20-year return, but one delivers dramatically worse results. And, it's not the volatile return path. It's the scenario of 10 years of low returns that delivers a terrible outcome for the drawdown investor. In other words, a prolonged period of poor returns is what should worry us, not volatility.

Sequencing risk is real and dealing with it is not straightforward. The solution lies with anticipating its possible impact and planning accordingly.

As for managing sequencing risk by locking into low volatility, low return strategies? It's nuts and you can clearly see it's nuts!

Tim Farrelly is principal of specialist asset allocation research house, farelly's Investment Strategy, available exclusively through PortfolioConstruction Forum. Tim is a member of PortfolioConstruction Forum's core faculty of leading investment professionals.
