Mark Hulbert

Opinion: Is sequence risk really a big deal for retirees?

Published: Sept. 25, 2020 at 11:01 a.m. ET

By Mark Hulbert

Subjecting sequence risk to a reality check

Sequence risk seems scary, but you shouldn't obsess over it. GETTY IMAGES/ISTOCKPHOTO

SPX +1.61%

News flash: Sequence risk is not a huge threat to your retirement after all.

This is big news, since this kind of risk has received outsize attention in recent years from financial planners (including me, I must confess). Some commentators have even deemed it to be the biggest single risk faced by retirees and soon-to-be retirees.

Read: Americans' love affair with pickup trucks might be derailing their retirement plans

Sequence risk, of course, refers to the possibility of running out of money in retirement because of the order in which the markets' best and worst years occur. This risk exists even if the markets'

overall returns during your retirement are every bit as good as in those of others who don't run out of money.

That certainly seems scary enough. But just-completed academic research concludes that sequence risk, while real, is far too often exaggerated—leading retirees to pursue unnecessarily conservative strategies and reduce their standard of living.

The research, by Javier Estrada, a professor of finance at IESE Business School in Barcelona, is entitled: "Sequence Risk: Is It Really a Big Deal?" His conclusion is that "retirees should be informed, but not obsess, about sequence risk."

To illustrate both the existence of sequence risk and how it's exaggerated, imagine that the stock market's return in each year of your retirement will be equal to what it actually was in any calendar year picked at random from all years since 1900. Imagine further that you utilize a standard 4% withdrawal strategy.

Read: Kevin O'Leary says investing $100 a week will make you a millionaire

On the one hand, Estrada concedes, it's theoretically possible in this scenario that you will run out of money less than 10 years into retirement. That would be the case if the worst stock market years of the last 120 years all occur in the first years of your retirement.

On the other hand, Estrada is quick to point out, an unbroken sequence of 10 horrible years is an unrealistic assumption. Bad years are typically interspersed with good years. So to assume the very worst years, all in a row, goes too far.

A specific example can help to make this clearer. Consider the worst 10 calendar years for the S&P 500 **SPX**, +1.61% since 1900. Though these years did not occur in sequence, if they were to have occurred all in a row the stock market's annualized real-return over that 10-year period would be minus 11.0% annualized. If your retirement portfolio were substantially invested in equities, and this return occurred over the first 10 years of your retirement, your portfolio would very likely run out of money.

But no actual 30-year period in U.S. stock market history has ever begun with an annualized real loss of anything close to minus 11.0%. In fact, the worst actual 10-year performance for the stock market since 1900 was a loss of 4.4% annualized—which occurred from 1911 through 1920, the decade that encompassed World War I. While certainly not great, that's a lot better than minus 11.0% annualized.

Just because no 30-year period has ever come close to beginning with an annualized real loss of 11.0% doesn't mean it couldn't happen, needless to say. But the theoretical possibility of its occurrence is not the same as it's being likely. Estrada draws the following analogy: "Being attacked by a shark is a scary prospect, but the fact that shark attacks rarely happen should be a factor in an individual's decision about whether or not to go for a swim."

According to Estrada, a 4% withdrawal strategy actually failed just 4.4% of the time since 1900. And when analyzing the particular sequence of bad annual returns that led to those failures, he found that a different sequence of those same returns would have prevented those failures more than 90% of the time. So the odds of sequence risk sabotaging your retirement are quite low.

Estrada concludes: "Rational individuals consider both the impact of an event and the probability of its occurrence; hence advisers that highlight the dangers of sequence risk but do not discuss its probability of occurring are not really helping retirees."

A flexible withdrawal strategy

In any case, notice that the already-low failure rate assumed in these simulations assume a constant inflation-adjusted withdrawal from your retirement portfolio each and every year. This failure rate can be lowered even further if you're willing to reduce the amount you withdraw after particularly bad years in the market.

To be sure, reducing the amount you withdraw is an unpleasant prospect, since it means reducing your retirement standard of living. But, Estrada emphasizes, in most cases a very modest reduction is all that's needed to preserve the financial sustainability of your portfolio. In 41% of the simulations he ran, in fact, a reduction of less than 10% was all that's needed.

It's also worth emphasizing that a flexible withdrawal strategy can also work to your benefit. It allows you to take out more than originally planned following years in which the market has done particularly well, for example. You could always put that extra amount in a rainy-day fund to support your retirement following years of poor market returns.

I devoted a Retirement Weekly column a year ago to Estrada's research on these so-called "dynamic" withdrawal strategies, so I won't go into the subject in great depth here. The point I want to make in this column is that sequence risk, which is already quite small, is rendered even smaller by employing a dynamic withdrawal strategy.

The bottom line? Once you subject sequence risk to a reality check, you are likely to conclude that this is one thing you can, if not check off your worry list entirely, put far down that list.

Mark Hulbert is a regular contributor to MarketWatch. His Hulbert Ratings tracks investment newsletters that pay a flat fee to be audited. He can be reached at mark@hulbertratings.com.

This is one task everyone in their 50s should consider before it's too late

Mark Hulbert

Mark Hulbert is a columnist for MarketWatch. His Hulbert Ratings service tracks investment newsletters that pay a flat fee to be audited.