

## SEQUENCING RISK

# THE SECRETS OF SEQUENCING RISK

When markets are volatile, helping clients to manage their sequencing risk may prove to be the most valuable advice a planner can provide, writes **Rob Lavery**.

Financial planning involves a lot of discussion of risk – the risk of injury or illness, market risk, credit risk, liquidity risk, legislative risk, clients completing risk profiles, and institutions creating fancy tools to explain to clients how risk and return are linked. Risk, and the mitigation of risk, is ever present.

There is one type of risk that is often missed in all the discussion, tools and processes – sequencing risk.

In a nutshell, sequencing risk is the likelihood that a client's investments will experience sharply negative returns at just the wrong time. Unexpectedly, it was an encounter with an Uber driver that brought the importance of minimising sequencing risk into sharp focus.

### THE STORY OF UBER PETER

Friday night had gone a bit longer than planned and I needed to get home quickly. Peter picked me up in his immaculately maintained Prius and we got chatting.

Peter does security work during the day and had taken up Uber driving in the evenings. He was only too keen to share his reason for taking on a second job – Peter was saving to buy the new, affordable Tesla due to be released in 2019, the Model 3. Peter's enthusiasm was obvious as he showed me the laminated Model 3 promotional card he kept in his car's map pocket.

Peter had been saving for two years. He reckoned it would be another six months or so until he had enough. I asked him where he kept his savings and he replied that he used an online savings account. I started to say that there were more fruitful ways to build your wealth and then I caught myself.

The reality was that Peter was so close to his goal, he could almost feel the smooth

acceleration of his much-desired electric dream. To expose Peter to additional risk at this point in his savings would be unacceptable. A poorly timed market correction could set Peter back months, or even a year. He would be devastated. This was sequencing risk at its most fundamental.

Perhaps if I had met Peter at the start of his savings, a more aggressive form of savings vehicle may have been more appropriate. A correction wouldn't have eroded his accrued capital as badly and good returns could have jump started him on the road to his goal.

As it was, I can only assume Peter continued on his way and, when he picks up his new Tesla some time next year, he will be delighted with the results of his work and discipline.

### BIGGER FISH

Of course, Peter's situation is a scaled-down version of one faced by planners and their clients every day – saving for retirement.

Sequencing risk peaks as a client approaches retirement. Clients who were heavily exposed to shares in 2007, anticipating a comfortable retirement in 2009, were incensed when their retirement savings were halved, or worse, during the GFC.

That said, corrections need not be as dramatic as the GFC to make a material difference to a client at a time when their invested capital is at its peak.

### ERIN'S CLIENTS

In 2014, four individual clients of financial planner, Erin, were all approaching retirement. All four were in a similar situation – they had to save and invest aggressively towards the end of their working lives in order to meet their goal of retiring with \$900,000 to fund retirement. These four clients had different planned



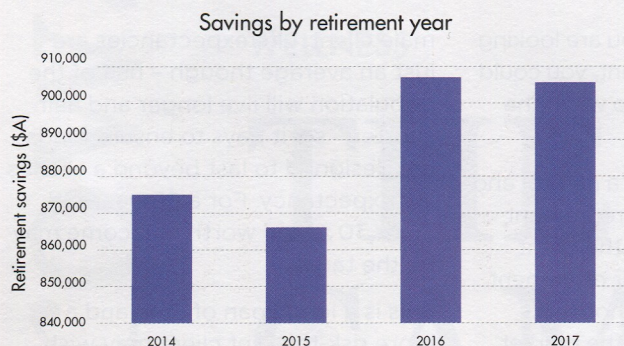


Chart 1: Savings by retirement year

retirement dates – at the end of 2014, 2015, 2016 and 2017 respectively.

Each of these clients had retirement savings of \$850,000 entering their final working year and were invested in the same portfolio of index funds:

- 45% Australian shares;
- 20% International shares;
- 5% Australian property trusts;
- 20% Australian fixed interest; and
- 10% International fixed interest.

They each contributed \$25,000 in pre-tax contributions to super in their final year of work.

Chart 1 (below) shows each client's savings at retirement.

Taken as a percentage, the difference in retirement savings does not seem that significant. The client who retired in 2015 has about 95 per cent of the savings of the client who retired in 2016.

That said, in dollar terms, the client who retired in 2015 had \$42,000 less in savings than the client who retired in 2016. What's more, the client who retired in 2015 did not meet their retirement savings goal and would have faced some tough choices. They may have chosen to work for a further year to build their savings

up or they may have reduced their planned budget in retirement. They may have had to scale down planned holidays or put off making major lifestyle changes.

the two approaches outlined above.

*Indices used:*

- Australian shares – S&P ASX300.
- International shares – MSCI World ex Australia.
- International Fixed Interest – S&P Global Leveraged Loan Index AUD Hedged (where available).
- Australian property trusts – S&P ASX AREIT.
- Australian fixed interest – S&P Australian Fixed Interest Index.
- Cash – RBA 90 Day Bank Bill Rate.

## ACKNOWLEDGING THE ISSUE

As with all risk mitigation, the first step in addressing a client's sequencing risk is for the client to acknowledge that sequencing risk is an issue. This requires planners to both educate clients and ensure they take ownership of the issue. This is crucial if the client is to minimise their fear of missing out.

## FEAR OF MISSING OUT

As the need for retirement income becomes more evident to clients, how their savings are invested becomes a more prominent concern. What's more, it is likely that clients approaching retirement have friends in the same stage of life.

The upshot of these two factors is that talk of investments at dinner parties, on the golf course or tennis court, and in other social situations, ramps up. Clients hear from friends who have invested in a sure-fire winner that will solve all their retirement savings issues. And they want in.

## A MORE DEFENSIVE PORTFOLIO

How would Erin's clients have fared had she recommended that they mitigate their sequencing risk in their final year before retirement by taking a more defensive investment approach? Chart 2 compares the four clients' retirement savings if they held an aggressive portfolio in their final year, as compared to if they held a portfolio split as outlined below:

- 10% Australian shares;
- 5% International shares;
- 5% Australian property trusts;
- 35% Australian fixed interest;
- 25% International fixed interest; and
- 20% Cash.

The more defensive investment approach doesn't cure all Erin's clients' investment ills – a bad year is still a bad year – but the variation in results is less. The highs are a bit lower but the lows are not as impactful.

## TO THE EXTREME

The most extreme recent years in terms of investment returns were 2008 and 2009. Chart 3 shows how clients in the same position as Erin's would have fared in those years using

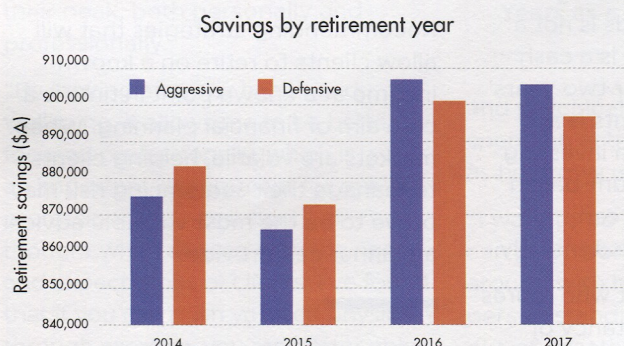


Chart 2: Savings by retirement year

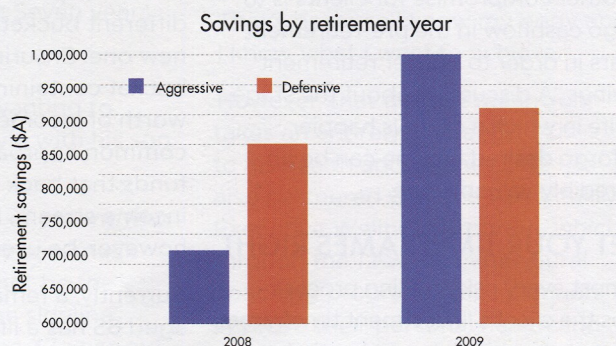


Chart 3: Savings by retirement year

*Continued overleaf*





Clients' fear of missing out is something planners need to manage on a regular basis. If a more defensive approach is recommended, the fear of missing out may increase. Ensuring clients understand the reasoning behind managing sequencing risk, and are comfortable with the potential drawbacks, is crucial in keeping them engaged and on track.

## MAKING COMPROMISES

Mitigating sequencing risk is not a one year process; it is something to be implemented gradually, as clients approach retirement. It's also not as straightforward as the examples provided above make it out to be.

Some clients may have expectations of living standards in retirement that just won't be met by taking a more conservative investment approach. In these circumstances, the potential benefits of a more aggressive investment approach need to be weighed against the associated risk of the client falling significantly short of their goal. What will the client need to sacrifice if they fall \$200,000 short of their retirement goals, rather than \$100,000?

Taking a more aggressive approach is not the only solution. Clients who have expectations greater than their means may need help adjusting their expectations. Downgrading retirement expectations can help reduce the risk of falling significantly short of them. That said, it is not an easy conversation to have, particularly with a new client.

Another compromise for clients is to forgo cashflow in the pre-retirement years in order to bolster retirement savings. A discussion about the stage of life in which a client is happier to forgo desired income can be an incredibly valuable one.

## GET YOUR TIMEFRAMES RIGHT

Almost every risk profiling process uses the client's 'investment timeframe' as an element in determining their risk appetite. So, when does that

timeframe end? When you are looking at funds held for retirement, you could argue they will be used up when the client exhausts them.

In actuality, retirement is a natural end point for the client's pre-retirement investment timeframe. If the client wants certainty over their retirement income, they may even choose to remove their funds from the market entirely at retirement and use guaranteed income products instead.

There is a middle ground between these two extremes, and one way to access it is through the use of buckets.



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## THE BUCKET APPROACH

The concept of a client having different buckets of funds is not a new one. Ensuring there is a cash bucket containing one or two years' worth of income payments is a common approach when investing funds that back an account-based income stream. Buckets can, however, be used more extensively.

Currently, a female client who retires aged 65 has a life expectancy of 22 years. This drops to 20 for a

male client. Life expectancies are just an average though – half of the population will live longer and half shorter – so, it pays to ensure funds are designed to last beyond a client's life expectancy. For a 65-year-old, 25 or 30 years' worth of income may be the target.

This is a long span of time and a more risk-tolerant client may wish to see greater returns on the capital invested for later retirement. As such, their retirement savings may be split into two buckets – one for the first half of retirement, and one for the second half.

The capital in the bucket for the first half of retirement will need to be protected as the client approaches their retirement date. At this pre-retirement stage, mitigating sequencing risk on this portion is important.

The portion for the client's second half of retirement may not be accessed for 10 or 15 years after retirement, and has the time to weather any short-term setbacks. Managing the sequencing risk on this portion need not be a priority until some time after the client retires.

There is nothing to prevent a client's retirement savings portfolio being split into more than two buckets if they have more sophisticated needs.

## BRINGING IT ALL TOGETHER

Ultimately, the length of time over which a more conservative investment approach needs to be adopted in order to minimise sequencing risk will depend upon many factors. These include the other strategies, such as employing buckets, that have been used to isolate and avoid the risk.

Recommending strategies that will allow clients to retire on a known income at a known point in time is a core aim of financial planning. When markets are volatile, helping clients to manage their sequencing risk may prove to be the most valuable advice a planner can provide.

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