Balancing the Desire for Diversification with Retirement Security

Two severe bear markets during the past decade have made many investors wary about how much of their portfolio should be devoted to stocks. This is particularly true of retirees who need to depend on their savings for income.

Caution is understandable, but most investors are likely unable to generate sufficient income for retirement without including stocks in their portfolio. The long-term growth potential of stocks remains an important ingredient to long-term financial security, even in retirement. How can one balance the need for stocks while protecting against the risk of down markets?

Understanding Sequence Risk

An important but little talked about issue that retirees should to consider is sequence risk. This concept relates to the timing of stock market returns and how it can affect a portfolio.

The sequence of returns has little effect on a portfolio that is held over an extended period of time with the goal of accumulating wealth rather than generating income. For example, consider what happens with Bill and Betty, two individual investors, who experience exactly the opposite returns in a portfolio over two hypothetical five year periods. Bill's returns for five consecutive years were: +20% in year one, +6% in year two, 0% in year three, -6% in year four and -20% in year five. Betty's investment experience was exactly the opposite: -20% in year one, -6% in year two, 0% in year three, +6% in year four and 20% in year five.

If both invested $100,000 at the outset of this five-year period and let the money continue to grow throughout the period without additional investments or any withdrawals, both would end up with $95,654 at the end of five years. While this isn't likely the return they'd hoped for, the sequence of returns had no impact on their end result.

Unfortunate Timing Can Take a Toll

The concern is magnified for those taking withdrawals from an equity portfolio. Weak market returns occurring at the wrong time could more quickly deplete their nest egg. When withdrawals are made at the same time investments are losing value, the decline in portfolio value can be dramatic, which could jeopardize long-term financial security.

Let's consider what happens to Bill and Betty, two investors who retire during two completely different market cycles and experience returns exactly the opposite of each other. For Bill, returns were strong early on, but in later years, performance declined. For Betty, returns were poor in the early years, but improved over time. In this case, each withdrew $5,000 per year in income from their $100,000 portfolio. Here is how their portfolios performed combining the different sequence of returns with steady withdrawals:

Year	Bill's Portfolio Returned:	Value At Year End:	Betty's Portfolio Returned	Value At Year End:
1	+20%	$114,000	-20%	$ 76,000
2	+ 6%	$115,540	- 6%	$ 66,740
3	0%	$110,540	0%	$ 61,740
4	- 6%	$ 99,208	+ 6%	$ 60,144
5	-20%	$ 75,366	+20%	$ 66,173

As the numbers show, even though Bill was taking money out of the account each year, the value of his savings grew in the first two years. As returns deteriorated, the value of the account declined more significantly. Still, he ended the five years with considerably more money in the account than Betty. The negative returns Betty experienced in the first two years, combined with her taking money out of the account for income, greatly reduced the value of her account.

A Solution – Split Your Nest Egg

One way to overcome sequence risk is to split retirement savings into different "buckets":

Bucket #1 – put enough money aside in cash-equivalent investments where principal is secure to pay one to two years of current expenses.

Bucket #2 – set aside enough money in investments subject to little or no volatility to meet income needs for the subsequent two to three years.

Bucket #3 – allocate remaining money in a diversified portfolio that can include stocks (as well as bonds and other types of assets). This money can be allowed to grow with no immediate withdrawals required.

Growing portfolio value is important to help a retiree maintain an income level over time that can keep pace with increases in the cost of living. There is no easy fix for unpredictable market volatility, but an individual with savings split in this way may be better protected from the potential impact of sequence risk. Consider working with a financial advisor who can help

you determine how to balance your portfolio in the most effective way that works for you – whether you're already retired or still accumulating savings.

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Cheryle Brady is a Financial Advisor with Ameriprise Financial Services, Inc. in Quincy, MA. Cheryle specializes in fee-based financial planning and asset management strategies and has been in practice for 25 years. To contact her, you may call her office number #617 691 2167, at 859 Willard Street, Quincy, MA 02169; Cheryle.Brady@ampf.com;
http://ameripriseadvisors.com/cheryle.brady