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When Is Market Volatility Most Dangerous?

Though a market downturn generally isn't fun for most people, its timing can have a greater impact on some investors than on others. For example, a market downturn can have greater significance for retirees than for those who are still accumulating assets. And it has the most impact if it occurs early in retirement.

Why--Because of something known as the "sequence of returns"--basically, the order in which events affect a portfolio.

For retirees, timing is everything

To understand the importance of the sequence of returns, let's look at two hypothetical retirees, both of whom start retirement with a $200,000 portfolio.

Each year on January 1, Jim withdraws $10,000 for living expenses; so does Pam. During the first 10 years, each earns an average annualized 6% return (though the actual yearly returns fluctuate), and both experience a 3-year bear market. With the same average annual returns, the same withdrawals, and the same bear market, both should end up with the same balance, right?

They don't, and here's why: though both portfolios earned the same annual returns, the order in which those returns were received was reversed. The 3-year decline hit Jim in the first 3 years; Pam went through the bear market at the end of her 10 years.

	Jim's Return	Jim's Balance	Pam's Return	Pam's Balance
Year 1	-5%	$180,500	15%	$218,500
Year 2	-2%	$167,090	12%	$233,520
Year 3	-1%	$155,519	14%	$254,813
Year 4	3%	$149,885	8%	$264,398
Year 5	7%	$149,677	9%	$277,294
Year 6	9%	$152,247	7%	$286,004
Year 7	8%	$153,627	3%	$284,284
Year 8	14%	$163,735	-1%	$271,541
Year 9	12%	$172,183	-2%	$256,311
Year 10	15%	$186,511	-5%	$233,995

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As you can see, Pam's account balance at the end of 10 years is more than $47,000 higher than Jim’s. That means that even if both portfolios earned no return at all in the future, Pam would be able to continue to withdraw her$10,000 a year for almost 5 years longer than Jim. This is a hypothetical example for illustrative purposes only, of course, and doesn’t represent the results of any actual investment but it demonstrate the timing challenge new retires can face.

Weighing income and longevity

If you’re in or near retirement, you have to think both short term and long term. You need to consider not only your own longevity, but also whether your portfolio will last as long as you do. To do that requires balancing portfolio longevity with the need for immediate income.

The math involved in the sequence of returns dictates that if you’re either withdrawing money from your portfolio or about to start, you’ll want to pay especially close attention to the level of risk you face. After the 2008 market crash many individual investors fled equities and invested in bonds. Along with actions by the Federal Reserve, that demand helped push interest rates to all time lows.

However, when interest rates begin to rise, investors will face falling bond prices. And yet if you avoid both stocks and bonds entirely current super-low interest rates might not provide enough income. Achieving the right combination of safety, income and growth is one of the key tasks of retirement investing.

Seeking Balance

You obviously can’t control the timing of a market downturn, but you might have some control over its long term impact on your portfolio. If your timing is flexible and you’re unlucky enough to get hit with a downturn at the wrong time, you might consider postponing retirement until the worst has passed. Any additional earnings obviously will help rebuild your portfolio, while postponing withdrawals might help soften any impact from an unfortunate sequence of returns. And reducing withdrawal amounts, especially in early retirement years also could help your portfolio heal more quickly

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Let’s start the conversation!

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