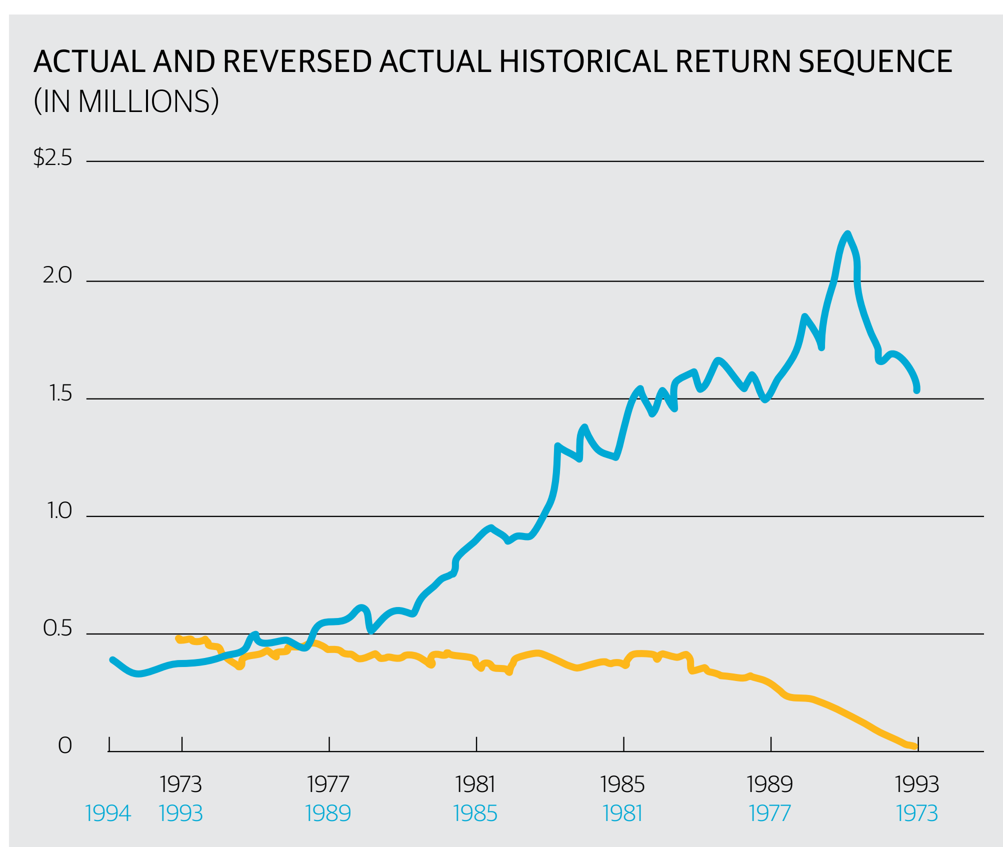
UNDERSTANDING HOW MARKET PERFORMANCE CAN INFLUENCE YOUR RETIREMENT

Market returns fluctuate over time, and future performance can best be described as unpredictable. One simple statement holds true for the market and almost anything in life: "Past performance is no indication of future results."

No one knows what the future holds, so a sound retirement plan needs to help manage risks through effective asset allocation, reducing withdrawal rates and spending, or sometimes deferring retirement.

This chart illustrates two hypothetical examples of how the sequence of market returns impacts portfolio growth while withdrawing necessary income during retirement.



Hypothetical case of portfolio starting retirement January 1, 1973, with monthly withdrawals (right before a bear market). The portfolio ran out of money by August 1994. A portfolio can be eroded simultaneously by a bear market and withdrawals during the early years of retirement. Even if good returns are experienced in later years, rebuilding wealth may not occur.

Hypothetical case illustrates the same portfolio, but historical returns now occur in the reverse chronological order. The returns from 1994 occurred before the returns from 1993, etc., with the returns from 1973 occurring last. By reversing the sequence of returns, the portfolio experienced high returns in the early years and low returns in the latter years. As a result, the portfolio increased substantially over time, more than tripling in value, despite the ongoing 5 percent withdrawals.

This hypothetical example is provided for illustrative purposes only and is not indicative of any investment. An investment cannot be made directly in an index. ©2014 Morningstar. All Rights Reserved.

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THE SEQUENCE OF RETURNS CAN SIGNIFICANTLY AFFECT YOUR RETIREMENT

The point in time that a person chooses to retire can also affect the ability of his or her portfolio to last throughout retirement.

The graph on page one demonstrates this by showing how the sequence of market returns affects how much a portfolio can grow while sustaining needed withdrawals in retirement.

The graph looks at a hypothetical 50 percent stock/50 percent bond portfolio with an initial value of $500,000 and assumes a withdrawal rate of 5 percent annually, adjusted for inflation.

The yellow line in the graph on page one assumes a person retired on January 1, 1973 (right before a bear market), and began making monthly withdrawals in January 1973. The result was that the portfolio ran out of money by August 1994. The blue line illustrates a hypothetical case where the historical returns occurred in reverse chronological order: The returns from 1994 occurred before the returns from 1993, etc., with the returns from 1973 occurring last. By reversing the sequence of returns, the portfolio experienced high returns in the early years and low returns in the latter years. As a result, the portfolio increased substantially over time, more than tripling in value, despite the ongoing 5 percent withdrawals.

This hypothetical example highlights that in the early years of retirement, a portfolio being eroded simultaneously by a bear market and withdrawals may not be able to rebuild wealth, even if good returns are experienced in later years. This is relevant because people who retired right before or during the bear market of the early 2000s experienced large declines in portfolio values early in retirement. The same reasoning applies to the 2007–2009 recession.

Unfortunately, no one can predict what the market might do in the critical years of retirement. This is why it is particularly important in the early years to manage this risk through effective asset allocation, reducing withdrawal rates and spending, or deferring retirement.

Government bonds are guaranteed by the full faith and credit of the United States government as to the timely payment of principal and interest, while stocks are not guaranteed and have been more volatile than the other asset classes.

About the Data:

Stocks in this example are represented by the Standard & Poor's 500®, which is an unmanaged group of securities and considered to be representative of the stock market in general. Bonds are represented by the five-year U.S. government bond and inflation by the Consumer Price Index. An investment cannot be made directly in an index.

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