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Noel Swain: Sequence of Returns and Your Bottom Line

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Most people believe that if they can average a 6 percent to 8 percent return over a 15- to 30-year retirement, no matter the order of the individual returns, they will be just fine. But that may not be true.

The sequence in which an investor's returns are produced is vitally important to the health of his or her retirement nest egg once they start taking income from it.

This is why: If a retiree starts a sustainable income of 4 percent a year from his or her assets, then loses 50 percent of the asset base the first year, then that same income will represent an unsustainable 8 percent of assets in year two.

So once we start taking an income from our retirement assets, the sequence in which we receive our returns can make a huge difference to our bottom line.

Now you may say, "Noel, the sequence of returns is an interesting concept, but since no one knows what the actual stock market returns will be in the future, how does that affect me?"

This is how: At the beginning of this century, the stock market lost 37 percent over a 30-month period before it started going back up. In 2007, the stock market lost 57 percent over a 17-month period before it again started rising for good.

Those are periods of what we call "Maximum Drawdown," which is the amount an investment can go down — from the very top of its value to the very bottom — before it starts going back up. Investors need to pay very close attention to maximum drawdown, and work to keep it as low as possible. For example, if the stock market goes down 20 percent and they can keep their losses to only 10 percent, we believe two things may happen. One, they may be more likely to stay invested if their losses are not as great as the stock market as a whole; and, two, they will be in a much better position to benefit from the next bull market because they will still be in the market, starting it at the beginning, and from a higher position.

So how does one avoid the extreme volatility of the full stock market?

One way is by diversification. If you have a broad array of different investments like stocks, bonds and money market instruments in your portfolio, your returns are likely to be smoother than if they are invested in just one way.

The second way is by employing an active management strategy in which the investor trades according to the momentum of the different sectors of the market. Active investing is more difficult and time consuming than a diversified buy and hold strategy, but when done correctly, it can be a meaningful and successful way to invest.

If you feel uncomfortable investing on your own, there are several experienced, credentialed financial advisors in the Upstate. One place to find a Certified Financial Planner is at the CFP Board's website, www.letsmakeaplan.org. That should be a good start.