Pandemic a case study in sequencing risk for retirees

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One of the most common forms of risk for retirement portfolios is sequencing risk, and with the COVID pandemic creating volatility in financial markets, you don't have to look far to see the impact of sequencing in action.

Sequencing risk sounds complex but it really can be summed up in two words: bad timing. It's the risk of having bad timing at the start of an investment period such as retirement. This also happens to be when the portfolio amount is at its highest level, so more can be lost for any percentage decline.

Understanding sequencing risk is important because it helps frame the way portfolios are constructed for retirees. A poor sequencing risk event like a severe market decline can have a devastating impact on the amount and longevity of a retirement nest egg. Generally, mitigating the level of sequencing risk should play an active role in the choice of investments in a retiree's portfolio, especially if savings need to last a long time on a relatively small balance.

Take equities for example. A traditional equity fund may be able to generate high long-term capital growth, but it may also include high sequencing risk, which stems from its high volatility.

However, there are a small number of equity funds that are designed for lower sequencing risk. These may be categorised as low risk equity funds and they may focus on reducing volatility, generating income, or often a combination of both.

Why sequencing risk matters can be demonstrated by comparing the differences in a retiree's nest egg depending on when they retired, and what happened in the subsequent months.

The table below shows that if a retiree couple retired with the average $640,000 balance on January 31 this year, and invested all of it in an Australian shares index fund or similar ETF, their balance would have fallen to $467,352 by the end of March.

How sequencing risk and investment strategy can impact a retirement portfolio[1]

	Index or ETF investment ($)	Vertium low-risk equity investment ($)
Starting balance - January 31 2020	640,000	640,000
Amount at March 31 2020	467,352	505,181
Starting balance - February 29 2020	640,000	640,000
Amount at March 31 2020	506,693	551,849
Starting balance - March 31 2020	640,000	640,000
Amount at June 30 2020	747,473	707,627

If instead of investing in the index or ETF fund, they invested in a low-risk equity income fund such as the Vertium Equity Income Fund, they would have fared much better, with a balance of $505,181. That's a $38,000 difference simply by choosing an equity fund that can better manage sequencing risk.

Now, let's change the scenario and assume they held off retiring for one month.

If they invested in an index fund or ETF on February 29 (instead of January 31), their end of March balance amounted to $506,693. So they saved over $39,000 by simply delaying investment by one month. And if instead they chose the more sequencing-risk friendly Vertium Equity Income Fund instead of the indexed or EFT fund, they would be further ahead with a balance of $551,849.

In this scenario, based on actual investment returns, the difference between the poorest timing and choice, and the best timing and choice, amounts to a whopping $84,000. And that's largely the impact of sequencing risk over just one month.

See why it's so important?

As you've probably worked out, the selection of months can have a big impact on the result and even if you assume these months are very selective and unlikely in the future, they can and do happen.

If the same couple held off investing until 31 March, their balance at the end of June would be $747,473 in the index or ETF option, while the Vertium Equity Income Fund would have delivered a lower amount of $707,627. So in these months, when markets recovered, loosening the sequencing-risk safety harness would have helped deliver a higher result.

This works out to be good timing. But why risk your retirement based on chance?

It's very difficult to time markets and to predict the level of sequencing risk insurance that needs to be employed in a retiree portfolio.

And while you can construe different results using different time periods and show advice clients a range of scenarios, the fact remains that outcomes *are* variable. Sequencing risk can devastate portfolio balances in a worst case scenario, as shown in the recent example.

Perhaps a more stable portfolio strategy is to blend low risk funds with higher risk strategies to match the risk profile of an investor. In the Australian equities space, that may mean blending a capital growth equity fund with a low risk equity income strategy, such as Vertium.

Hoping for the market to rise in retirement is not a strategy. Planning for adverse market conditions is a prudent strategy for retirement.

[1] Index or ETF based on the performance of the S&P/ASX 300 Accumulation Index for the relevant periods. Vertium performance based on the total return of the Vertium Equity Income Fund, after fees and assumes all distributions are re-invested.

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Jason founded Vertium Asset Management in 2017 and has around 20 years' Australian equity investment management experience. He leads Vertium's investment team and is responsible for the firm's investment philosophy, process and portfolio management.

Before establishing Vertium, Jason was a Senior Portfolio Manager at Investors Mutual. He was the architect of the Investors Mutual Equity Income Fund, which he successfully managed for almost six years. As the second-longest serving employee at Investors Mutual spanning over 16 years, he had a variety of roles including managing a share of the Investors Mutual Australian Share Fund and as an Equity Analyst and Senior Quantitative Analyst.

About Vertium Asset Management

Founded in 2017 by Jason Teh, one of Australia's leading equity income investors, Vertium is a specialist Australian equity income investment manager focused on delivering Australians better investment outcomes in the lead-up to and during retirement.

Vertium is a proud investment manager partner of Copia Investment Partners, an independent multi-boutique investment management group.

Copia provides the resources and infrastructure our team needs to prosper, including distribution, marketing, operations and compliance services, enabling us to focus solely on delivering our investors superior long-term investment outcomes.

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