



SEQUENCE OF RETURN RISK

THE RETIREMENT THREAT HIDING IN PLAIN SIGHT

Picture two neighbors retiring at the same age. Each has saved \$1 million, each plans to withdraw \$50,000 per year, and each earned an average return of 7% over their working years. By every conventional measure, they are in identical financial positions. Yet despite sharing the same numbers, one neighbor may eventually run out of money in retirement while the other remains financially secure for life.

This isn't a trick question or a hypothetical anomaly, it's a real and surprisingly common outcome, and it points to one of retirement planning's most misunderstood risks. Most investors spend decades focused on a single metric: average returns. It's a natural instinct. We're conditioned to believe that if the long-run numbers are strong, the plan is sound. But that logic has a critical blind spot. Once you retire and begin drawing down your savings, average returns alone can no longer tell the whole story.

What matters just as much, and sometimes

more, is the order in which those returns arrive. A portfolio that suffers significant losses in the early years of retirement faces a fundamentally different fate than one that experiences the same losses later on. This phenomenon is known as **Sequence of Returns Risk**, and understanding it is essential for anyone building a retirement income strategy.

What Is Sequence of Returns Risk?

Sequence of returns risk occurs when negative investment returns hit at the worst possible time, right as you are nearing or entering retirement, or early in your withdrawal years. When you're forced to sell investments during market downturns to fund living expenses, you lock in losses and leave fewer assets available to participate in future market recoveries. This creates a mathematical problem that even strong returns later may not fully resolve. During your working and growth years, market volatility is less

threatening. In fact, downturns can possibly work in your favor through dollar-cost averaging, or buying more shares when prices are low. But once withdrawals begin the math reverses. Now you're selling shares when prices are low, which permanently reduces the number of shares left to grow when markets recover.

The Critical Difference:

It's not volatility alone that creates the risk, it's volatility combined with income withdrawals during retirement

Why the First Decade Matters Most

Financial planners often call the first 5-10 years of retirement the "retirement red zone", and for good reason, this is when sequence risk hits hardest.

Consider this hypothetical scenario: You retire with \$1 million and plan to withdraw \$50,000 annually (5% withdrawal rate).

- **Scenario A:** The market drops 20% in year one. Your portfolio falls to \$800,000. After your \$50,000 withdrawal, you're left with \$750,000.
- **Scenario B:** The market gains 10% in year one. Your portfolio grows to \$1.1 million. After your \$50,000 withdrawal, you have \$1,050,000.

That \$300,000 difference created in just one year compounds over time. Assuming both portfolios experience identical returns going forward, Scenario A may never catch up because there are fewer dollars left to grow. The damage isn't just from the loss itself, it's from the required

selling during the loss to pay for living expenses.

Who Faces Greater Risk?

Sequence of returns risk doesn't affect everyone equally. You may be particularly vulnerable if you:

Just retired or are within 5 years of retirement- The transition period carries maximum exposure because your portfolio is largest relative to future needs, and you have the least time to recover from early losses.

Hold a high percentage in stocks- Equities offer growth potential but bring volatility. A portfolio heavily weighted toward stocks during the withdrawal phase amplifies sequence risk, not because stocks are bad, but because the timing of their inevitable downturns becomes critical.

Depend on portfolio withdrawals for essential expenses- If your mortgage, healthcare, groceries, and utilities come primarily from investment withdrawals rather than guaranteed income sources like pensions or Social Security, you have limited ability to "wait out" a downturn. You must keep withdrawing, even when markets are down.

Expect a long retirement- Living into your 90s is wonderful but it extends your portfolio's job. The longer your money needs to last, the more damaging early losses become, because there's less time and fewer assets to make up the difference.

Interesting Fact: Americans who reach age 65 can expect to live roughly 20 more years on average, well into their mid-80s. (CDC / RetirementLiving)

The Real-World Consequences

When sequence risk strikes, the effects ripple far beyond spreadsheets and projections. Financially, portfolios can deplete years earlier than planned, even when long-term average returns look "fine" on paper. This may force difficult choices such as downsizing homes, eliminating travel, reducing gifts to family, or cutting back on healthcare expenses. The emotional toll can be equally significant. Watching your portfolio shrink while taking withdrawals creates anxiety that can lead to panic-driven decisions like abandoning your investment strategy at the worst possible moment or moving entirely to cash just before a recovery. In severe cases, the loss of financial independence may require dependence on family support, part-time work in later years, or difficult conversations about financial help, all outcomes that can erode both dignity and peace of mind. These interconnected consequences underscore why understanding and managing sequence risk is essential not just for portfolio longevity, but for maintaining quality of life throughout retirement.

Common Misconceptions

Myth 1: "Average returns are all that matter."

Reality: A 7% average return over 20 years can produce wildly different outcomes depending on when the good and bad years occur. Averages hide timing risk.

Myth 2: "The market always eventually recovers"

Reality: Markets do tend to recover but if you're forced to sell during the downturn, your portfolio doesn't get to participate fully in that recovery. You've locked in losses.

Myth 3: "This only affects aggressive investors."

Reality: Sequence risk arises from the combination of volatility and withdrawals, not just your risk tolerance. Even moderate portfolios face this challenge once distributions begin.

Strategies to Consider when Managing Sequence Risk

No single approach eliminates this risk entirely, but thoughtful planning can significantly reduce exposure. Listed are general strategies that may be discussed with your financial professional:

1. **Adjust Asset Allocation Strategically.** Gradually shift toward less volatile investments as retirement approaches but don't abandon growth assets entirely. The goal is fewer sharp swings in the early withdrawal years, while preserving long-term growth potential.

2. **Build Multiple Income Streams.** Social Security, pensions, annuities, or rental income reduce your dependence on portfolio withdrawals during downturns. Let guaranteed income cover essentials; use portfolio withdrawals for discretionary spending.

3. Stay Flexible with Withdrawals. Spend a little more in strong markets, pull back in weak ones. Even modest adjustments delaying a major purchase or skipping a discretionary expense can meaningfully extend how long your portfolio lasts.

4. Use a Bucket Strategy. Divide your portfolio by time horizon: near-term cash (years 1–3), moderate fixed income (years 4–10), and long-term growth assets (years 11+). This prevents forced selling during downturns and gives each bucket time to do its job.



5. Keep a Cash Cushion. Holding 1–3 years of expenses in liquid reserves means you can draw on cash, not stocks, when markets are down, giving your investments time to recover.

6. Explore Risk-Managed Solutions. Certain products can provide contractual income, reduce volatility, or transfer specific risks. They aren't right for everyone, but when properly integrated, they can address gaps a traditional portfolio may leave.

The Challenge - Sequence risk isn't purely mathematical, it's emotional. Watching your balance drop early in retirement can trigger fear-based decisions: moving to cash and locking in losses, abandoning a sound strategy, or cutting spending unnecessarily. A well-designed plan with clear guidelines helps you stay the course when markets get turbulent. Managing this risk requires proactive planning before retirement, not reactive adjustments after losses occur. It demands ongoing coordination between your investment strategy and income needs, revisited regularly as markets shift and life evolves.

To conclude, sequence of returns risk is one of retirement planning's most underappreciated challenges. Proper planning reframes your portfolio not as an investment account, but as an income-producing system, one that's vulnerable to timing. Understanding who is most exposed, why the consequences can be severe, and how to manage the risk puts you in a far stronger position heading into retirement. The goal isn't to eliminate all risk, that's impossible. The goal is to create a plan resilient enough to weather the inevitable storms while supporting the retirement you've worked so hard to build. Please feel free to inquire anytime with questions or for discussion.

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