

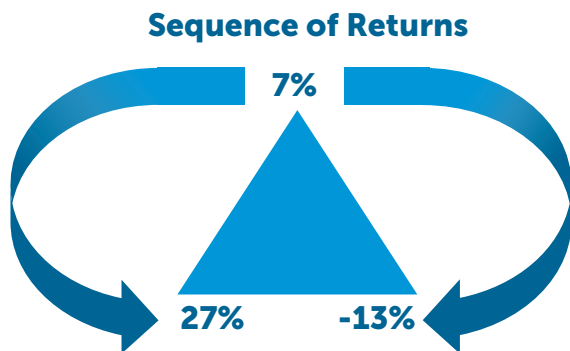
STEPUP

Sales Tax Estate Planning Underwriting & Product Newsletter

3rd in a series

We've gone through some of the mathematics comparing the same patterns of rates of return over times, both when saving for the long term and using that money to generate an income for the long-term. Does it matter when the pattern starts and someone is drawing an income?

When did you get on the rate of return cycle



Let's consider another example of your portfolio earning an average of 7% each year. Here again, we begin with \$100,000 from which the investor makes monthly withdrawals of \$750—which is \$9,000 annually—and is earning a nominal rate of 7% per year (0.5833% per month).

We know that the investor will run out of money because they are withdrawing more than what they are earning on average. What we want to know is when that will happen. Let's assume that the rate of return is exactly 7% each year. The average annual rate of return is the same as the three year average. On a positive note, recovery and average rates of return take comparatively little time to generate the target average in this set of examples.

This asset will be exhausted within month number 259. Put another way, if the investor started this withdrawal process at age 65, they will run out of money half-way through age 86.

Now what happens if the actual returns are not 7% each year, but merely average 7% every 3 years? There are a number of patterns that we will compare. This chart assumes that the rates of return in each scenario repeat themselves every three years.



Peter A. Wouters,
Director, Tax
Retirement &
Estate Planning
Services

Peter works with independent advisors and other professionals raising awareness on issues and concerns faced by affluent individuals, professionals and business owners. He supports efforts in researching and developing optimal solutions for clients aimed at improving their financial well-being and supporting their personal wishes and lifestyles. He has provided 1000s of workshops, seminars and technical support throughout the country on tax, retirement income and estate planning issues, concepts and strategies to both advisors and consumers. As an accredited Registered Financial Gerontologist, a good deal of his time is spent on building awareness and educating people of all professions who work with or specialize in the needs, expectations and issues of elders. Comprehensive lifestyle planning is an important element of these processes.

The Sales, Tax, Estate Planning, Underwriting & Product (STEPUP) team provides internal and broker support, including seminars, education, advanced concept illustrations & Client case technical consultations.

Peter can be reached at
peter.wouters@empire.ca

When did you get on the rate of return cycle?

Return Sequence (repeated)	Ruin Age	+/- Months	
+7%, +7%, +7%...	86.50		
+7%, -13%, +27%...	83.33	-38	
+7%, +27%, -13%...	89.50	+36	
-13%, +7%, +27%...	81.08	-65	14 yrs.
+27%, +7%, -13%...	94.92	+101	

Assuming \$9000 annualized spending/withdrawal beginning age 65

Source: Retirement Ruin and the Sequencing of Returns Moshe Milevsky

The table summarizes the impact of various sequence of return patterns on the "ruin age," the age at which the investor runs out of money. On a positive note, recovery and average rates of return take comparatively little time to generate the target average in this set of examples. The point is that it doesn't affect the results. You can see the difference in time it takes to spend all the money, measured in months between each sequence and a 7% level rate of return each and every year of retirement. This sequencing gap can get quite large. Look at what happens if we simply reverse the sequencing in the last two scenarios. There is a 14 year gap between repeating the sequence {-13%,7%,27%} versus {27%,7%,-13%}

Sequence of returns

The challenge is how advisors and investors can avoid or minimize the problems or pitfalls within the retirement risk zone. Both parties need to pay attention to the pattern of returns that make up the average rates over time. The patterns can dramatically impact the size of an investor's assets when they are withdrawing money to provide themselves an income to meet expenses, especially in the early years of retirement. Investors eat into their retirement nest egg when:

- they need to withdraw money and the markets are down, particularly experiencing negative returns, or
- what they take out is more than what their investment is earning

If investors avoid exposure to the sequence of returns risk by putting all monies into short term fixed-income products that do not fluctuate, the portfolio will show comparatively little growth over time. It will not likely keep up with inflation and the cost of living. If the retirement portfolio is comprised of equities, it's very likely that early negative returns will decimate the

portfolio and force the retired investor to reduce planned spending levels or put off retirement. We cannot predict the sequence of returns in the future. How can we deal with this dilemma?

"In sum, although conventional wisdom dictates that asset allocation explains the greater part of investment performance in the accumulation phase, we believe that product allocation will determine success in the retirement income phase."

Asset Allocation and the Transition to Income:

The Importance of Product Allocation in the Retirement Risk Zone

By: Moshe A. Milevsky¹ and Thomas S. Salisbury - September 27, 2006

I add to that this additional consideration. Income allocation becomes the third leg in the stool supporting sustainable income throughout the period of financial independence, something people still call retirement. The three legs of the sustainable income stool are: asset diversification/allocation, product diversification/allocation and income diversification/allocation, all connected by a comprehensive retirement income plan.

In the next article, let's focus on an alternative income source that can assist in dealing with sequence of return risk and the risk or worry of outliving one's income. Recognize that there are additional, complementary strategies that may help address sequence of returns risk.

Peter Wouters

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[GWB Order to Disorder series 2 of 7: Rate of Return and Impact on Accumulation vs. Withdrawal periods](#)

[GWB Order to Disorder series 4 of 7: What is a Guaranteed Withdrawal Minimum Benefit \(GMWB\)?](#)

[GWB Order to Disorder series 5 of 7: Investor behaviour](#)

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[GWB Order to Disorder series 7 of 7: Many Protective Features, Benefits & Advantages](#)

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259 King Street East, Kingston, ON K7L 3A8

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empire.ca info@empire.ca 1 877 548-1881

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