Can we (really) time the market? (Part 2 of 3)

By Darren Burns, Head of Investment Solutions at Glacier Invest

Part 1 of this article outlined how significant timing can be to the overall value of your nest egg. It also illustrated how important market performance is the closer you are to retirement. But do these risks still exist post-retirement?

To re-cap - the assumed lifespan of a collective investment scheme is infinite and therefore with no end-point, it is managed very differently to individual portfolios. When a portfolio manager purchases a stock, he does so with the intention that there will be a positive return at some future date. This future date is undefined and is mostly in direct contrast to the thinking required when managing individual client portfolios. Individual portfolios can have a number of predefined events and some of these events can be so significant in the life of the investor that they may result in the need for a complete revaluation of the overall investment strategy. Retiring and ceasing to receive a monthly salary is one of these key events.

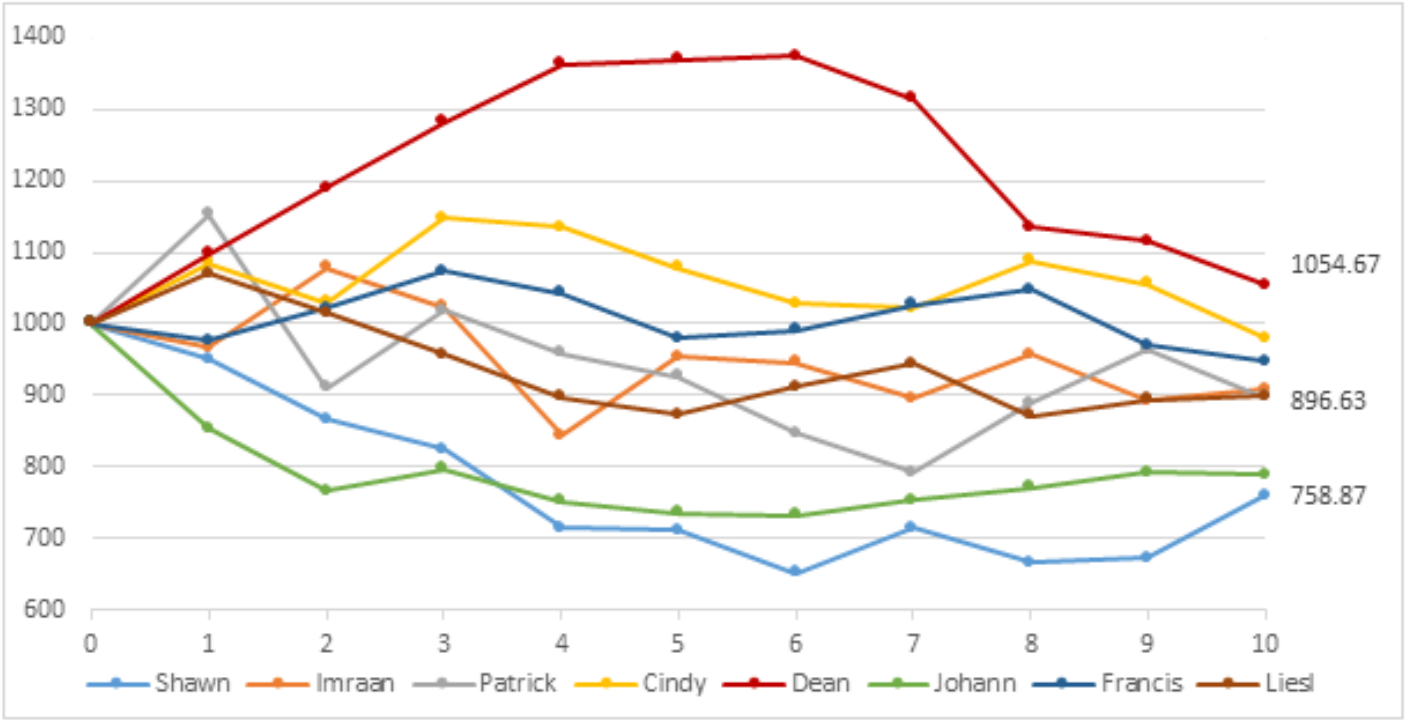
Sequence risk

Sequence risk is defined as “the danger that the timing of withdrawals from a retirement account will have a negative impact on the overall rate of return available to the investor”[1]. This is a similar problem to the issue discussed in *Part 1* of this article, however this time the situation involves regular withdrawals from an investment. Once again let’s use a practical example to demonstrate this. Table 1 shows calendar year portfolio performances of eight different random investors over ten years. Please note from the table that regardless of the differing calendar year returns, all eight investors achieved the same compounded annual growth rate (or average return) of 6.00% over a 10 year period.

%	1	2	3	4	5	6	7	8	9	10	CAGR
Shawn	0.23	-2.91	1.79	-5.94	8.31	1.01	20.67	3.56	12.56	24.95	6.00%
Imraan	1.89	17.28	0.23	-11.63	20.76	6.19	2.02	15.23	1.31	10.84	6.00%
Patrick	20.55	-16.32	18.25	0.16	3.25	-1.25	1.66	21.71	17.13	1.48	6.00%
Cindy	13.76	0.00	17.12	4.08	0.73	1.47	6.17	13.81	4.08	0.51	6.00%
Dean	14.94	13.49	12.56	11.12	5.14	5.20	0.82	-8.05	5.14	1.85	6.00%
Johann	-9.34	-3.77	11.38	1.94	6.45	8.57	12.64	12.02	12.87	9.88	6.00%
Francis	2.82	10.29	10.78	2.81	0.00	8.04	10.78	9.23	0.00	6.01	6.00%
Liesl	12.25	0.00	0.00	0.00	4.45	12.25	11.26	0.00	11.62	9.52	6.00%

The table shows calendar year portfolio performances of eight different random investors over ten years.
Source: Glacier Research & Morningstar

The question is, how will the final portfolio values differ should the investors withdraw an income from their investment? Will the differing sequence of returns have an impact on the end portfolio value and if so, how significantly? Using the same information from the table above let's assume each investor has an initial investment of R1000 and is withdrawing R50 (5%) per annum (increasing at an inflation rate of 5% per year over a 10 year period). The results can be seen in the chart below.



The chart above shows is the impact that the volatility of returns can have when investors are withdrawing from their portfolios.
Source: Glacier Research & Morningstar

What the chart above shows is the impact that the volatility of returns can have when investors are withdrawing from their portfolios. We therefore do not only need to be cognisant of the overall average return but also the consistency with which these returns are achieved.

For example, Dean's final portfolio value is almost 40% greater than that of Shawn's, who is the worst performer. (Importantly, remember that they both achieved the same average annual return of 6% over the 10 years). This makes sense when we look back at the sequence of returns. Dean achieved most of his positive returns in the early years of his investment whereas Shawn only saw his portfolio make a major comeback late in its investment's life. This latter performance was preceded by initial poor performance.

However, this does not only apply to theoretical situations. In recent years we have seen real-world examples of how sequence risk has negatively impacted investors' portfolio values. The poor local equity market returns experienced in 2015, 2016 and 2018, which would previously have helped offset withdrawals, provided little support to the overall portfolio values of those drawing down on their investment. In addition, any withdrawals greater than the overall return of the relevant portfolio would have resulted in backward moving values. This will now require significantly higher future returns in order to accommodate future withdrawals.

So finally - can we manage sequence risk, or is it simply a matter of luck? Part 3 of this article will address ways in which we can reduce the effect of this risk as well as increase the potential to provide more consistent overall returns.

> It's not the destination, it's the journey – Ralph Waldo Emerson

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[1] Julia Kagan, Sequence Risk, Investopedia, https://www.investopedia.com/terms/s/sequence-risk.asp

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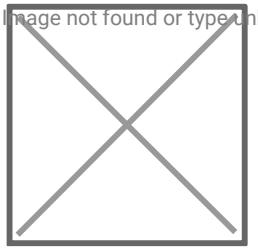

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Darren is a CFA charterholder and holds a degree in Investment Management (University of Stellenbosch) and a BCom (Hons) in Financial Analysis and Portfolio Management from the University of Cape Town. He has completed RE 1, 3 and 5 and has the relevant experience as a representative and key individual for both Category I and Category II licences. Darren joined Glacier from Secure Wealth, where he worked as a director, financial adviser and analyst for seven years. He joined Glacier as a discretionary fund manager in October 2016.

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