Seed Weekly

Sequence Risk & Drawdown Rates

seed investments

At Seed, we always encourage our investors to focus on the long term, with 'time in the market' ultimately much more important than 'timing the market'. Over the last 25 years, the typical local balanced fund, as represented by the ASISA SA Multi Asset High Equity category average, has produced significant inflation-beating returns. However, as most of us know, this performance did not all come in a straight line.

This is not a concern during the accumulation phase of retirement, when a buy-and-hold strategy is preferable. By remaining invested, weak returns in earlier years can be offset by higher returns in later years, and vice versa, eventually arriving at the same net result.

During the drawdown phase, however, the order of returns is crucial and can even determine whether a specific drawdown rate is sustainable or not. This brings us to the concept of sequence risk, which is the risk of weak or negative investment performance during the first years of retirement.

As an example, **Investor A** retiring on 2003/04/30 achieved a return of +23.7% pa over the next five years in the average balanced fund, whereas **Investor B** retiring on 2015/04/01 had to be content with only 0.9% pa for the first five years. For **Investor A**, the effective real drawdown rate would decline dramatically over the first 5 years, and for **Investor B** it would increase, probably leading to a much worse overall outcome.

To understand the effect of sequence risk on sustainable drawdown rates, we performed 1,000 simulations of the ASISA MA High Equity peer group returns over a 25-year period. These simulations assume that the risk and return characteristics of the typical balanced fund remains intact, but that monthly returns are achieved in randomised order. This gives us 1,000 different return series, but each with the same overall return (+11.7% pa) and risk (10.9% standard deviation) measures as the actual experience from October 1996 to September 2021.

The results over the analysis period are illustrated in the chart below. The actual outcome (blue) is displayed along with the 1,000 simulations. Although the simulations all deliver the same 11.7% pa return over 25 years, the order of monthly returns and 'path' is unique for each. The line at 10 years after retirement represents a snapshot at that point, and we have highlighted the best (green), average (black) and worst (red) outcomes by that stage.

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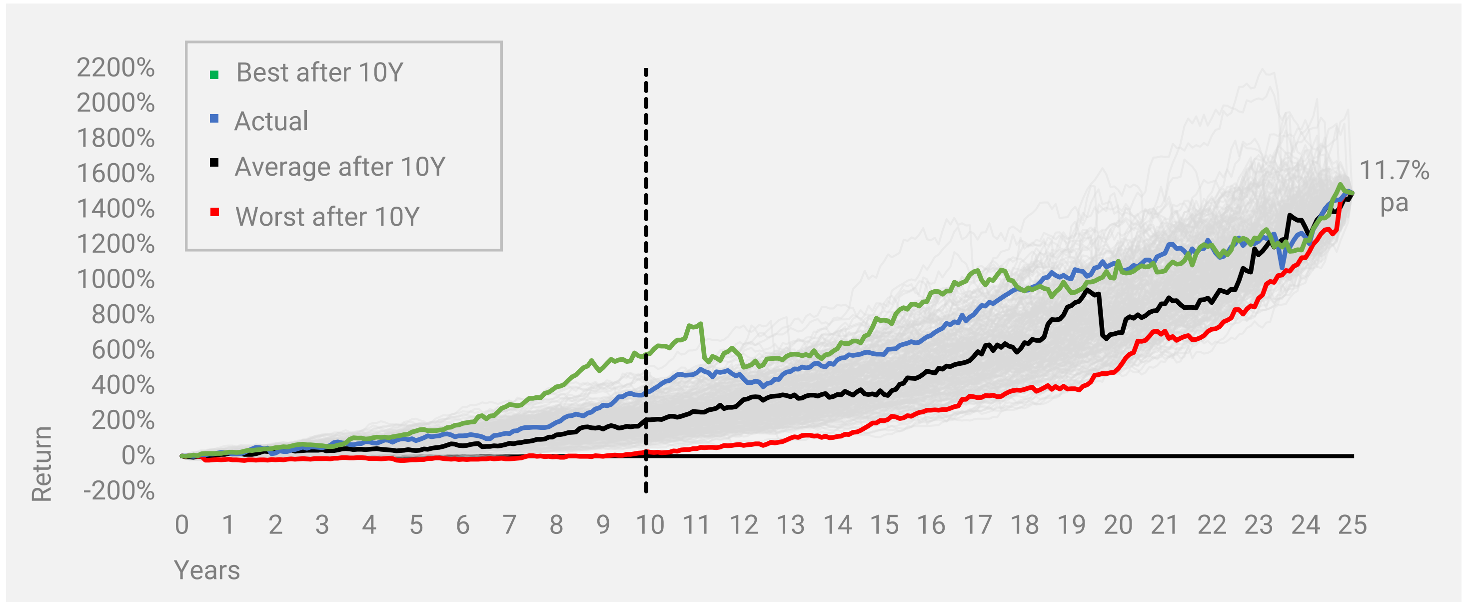
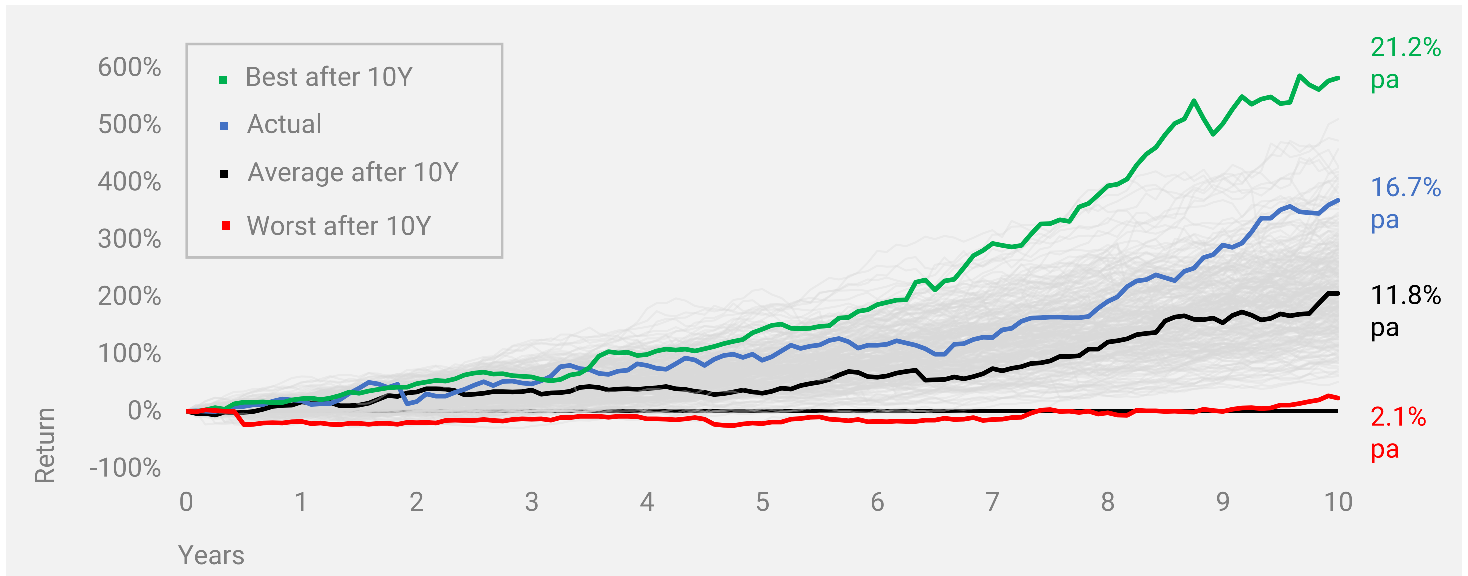


The 10-year snapshot is illustrated in more detail in the chart below. At this stage, the annualised returns vary from +21.2% pa to only +2.1% pa, and naturally the experience over the first 10 years of retirement would have an influence on the sustainable drawdown rate for that scenario. The actual experience (blue) over the last 25 years was much better than average at the 10 year mark, with two significant drawdowns (2008,2020) coming in the last 15 years rather than in the first 10 years.



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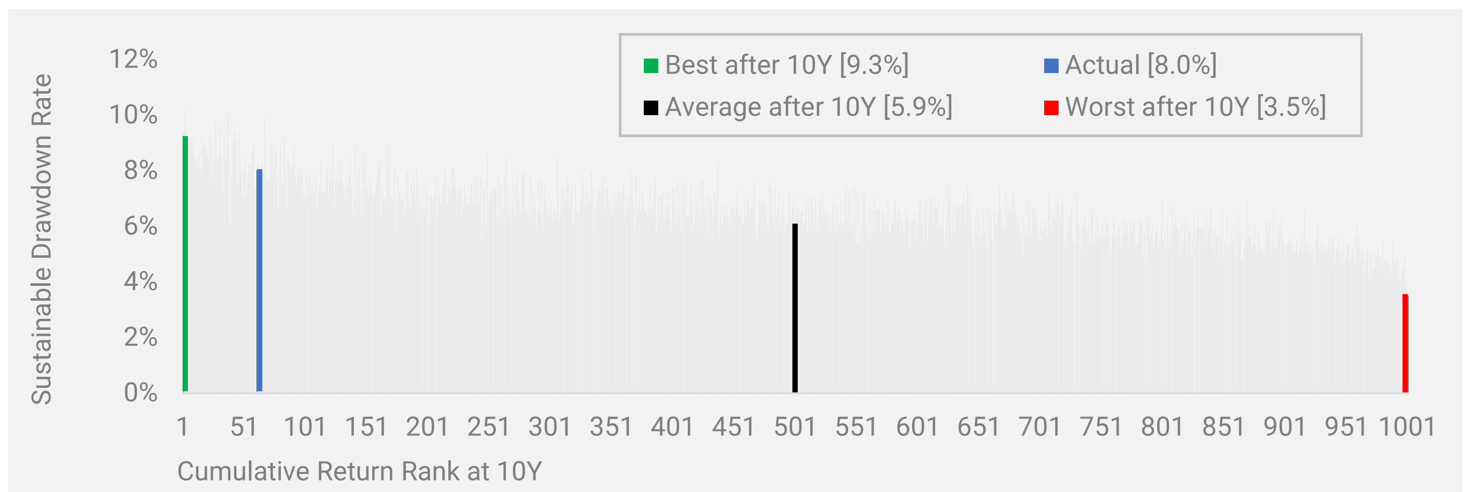
The final chart shows the sustainable drawdown rates for each of the 1,000 scenarios, ranked by the relative position after 10 years. The actual experience has sustained an 8.0% drawdown rate, which is very high, but reflects the fact that the ASISA MA High Equity category has delivered CPI + 6.1% over this period and that investors were fortunate that the performance was much better over the first 10 years (+16.7% pa) than over the last 15 years (8.5% pa).



Although the actual experience has been favourable over the last 25 years, clients must come to terms with the fact that a below-average sequence risk scenario would have resulted in a sustainable drawdown rate of between 3.5% and 5.9% only. Furthermore, future returns may well be lower than the CPI + 6.1% used in the simulation, and we have already seen real returns of only +3.9% pa and +2.9% pa over the last 10 and 15 years respectively from this category.

The Seed Wealth Management Team is well equipped to assist you in building a bespoke investment strategy that suits your needs, including a sustainable drawdown rate for your retirement portfolio. Please contact our offices on +27 21 914 4966 or send an email to wealthadmin@seedinvestments.co.za to speak to an Advisor. We are on the journey with you, and we always love hearing from you!

Kind regards,

Cor van Deventer *CFA, FASSA*
Portfolio Manager

Chart Data Source(s) : Seed Investments (31 October 2021)

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