Seed Global

In the context of retired investors navigating the drawdown phase, the challenge of preserving their capital while sustaining sufficient income growth becomes apparent. This delicate balance between stable income and capital returns, influenced by investment choices and yield considerations, underscores the need for vigilant monitoring to mitigate the sequence of return risk.

In this article Ian De Lange, Seed Chief Investment Officer delves into Yield, Drawdown, and Sequence Risk.

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Yield, Drawdown, and Sequence Risk

It is completely understandable that retired investors in the drawdown phase, "*never want to dip into the capital"*. This assumes that the income is not only sufficient at the start of the drawdown period, but also that it can grow each year to compensate for the inflation risk. However, this may not always be feasible, depending on the size of the overall portfolio and the percentage that needs to be withdrawn to meet income requirements.

If we break down the total return on investments, it comprises a **more stable income component**, and a **more volatile price or capital return** component. Investments with no yield, for example gold, tend to have high price volatility, while higher-income investments such as fixed income have lower price volatility.

The high-income yield from **bonds and fixed income** investments are favoured by retirees. However, not only is the annual income and lump sum payouts static, the income is also fully taxed, which erodes their real value over time. The current yield on the US 10-year bond is 4.3%.

Residential and commercial property has delivered strong total returns over the past two decades, primarily due to their stable and growing income. Direct real estate, real estate investment trusts (REITS), farmland, and timberland, have generated a compounded return of 8.9% over this period. The current yield on the top five US REITS averages at 3.8%.

On average, **shares in listed companies** have historically generated some of the highest returns across all asset classes. However, unlike bonds and property, a smaller portion of these returns comes from dividends. While US equities averaged almost 10% per year over the last 20 years, the dividend component of this was only around 2%, and has now dropped to approximately 1.5% on the back of higher prices.

The simple average yield for these three main investment classes therefore stands at 3.2%, and so for retired investors seeking a higher annual withdrawal rate of say 4%-5%, they may need to tap into the capital return portion of their growth assets. This is typically sustainable depending on the numbers but introduces an additional risk, known as **sequence of return risk**. In simple terms, this is the risk that the returns from growth assets are suboptimal for many years, while a retired investor requires withdrawals.

We observed this risk firsthand during the early 2000's when returns from developed markets, particularly US equities, remained stagnant for a decade. As we continuously assess various factors across all asset classes, including yield and future return prospects, it is evident that one of the most effective strategies for retired investors to manage this risk is to consistently monitor their drawdown rate relative to the yield of their overall portfolio.

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If you have any questions, please do not hesitate to reach out to Ian and our team directly on global@seedinvestments.co.za.

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