
A Dynamic Approach to Sequence Risk

By Editor Test Sun, Jul 18, 2010

A new scholarly claims that sequence risk demands attention throughout retirement, not just during the years immediately before and after the retirement date.

Writing in the *Journal of Financial Planning*, Larry R. Frank, CFP, and David M. Blanchett, CFP, argue that the withdrawal rate should reflect the current risk of portfolio failure, and that the current risk should be recalculated every year during retirement.

Their paper, "The Dynamic Implications of Sequence Risk on a Distribution Portfolio," ran in the June issue. It claims that sequence risk exists throughout retirement, not just for several years before and after the retirement date.

"Unlike past research, which has suggested sequence risk only exists for a certain period, the authors contend that a 'spectrum' of *exposure* to sequence risk exists, and that sequence risk is always present, regardless of how long distributions have been occurring," the authors write.

"This paper will discuss this exposure to sequence risk and argue that sequence risk is *always* present to *some degree* when there are cash flows out of the portfolio. This paper will also demonstrate that the *degree* of exposure can be determined through evaluation of the current probability of failure of the portfolio's value being depleted during the remaining distribution period."

Frank's work was the subject of a June 16, 2009 story in *Retirement Income Journal*, entitled, "A Smarter Form of SWiP."

The paper also asserts that it's safer for retirees to raise their spending rate later in retirement rather than earlier. Although the desire to spend is greatest during the early years of retirement, that's also when long-term portfolio sustainability is still potentially fragile.

"The temptation is to withdraw more early with thoughts of withdrawing less later, that is, consumption 'smoothing.' However, sequence risk exposure suggests this is a risky strategy because it essentially entails an increased probability of failure, when portfolio values decline, with an already increased probability of failure through a higher withdrawal rate resulting from an attempt to smooth withdrawals over time," Frank and Blanchett write.

The authors suggest that advisors do the following for their retired clients:

- Adjust WR% as market return trends suggest.
- Adjust portfolio allocation to mitigate exposure to negative market returns as market trends suggest.
- Start with a reduced WR% to reduce exposure to the impact of declining markets on the probability of failure.

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