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OPINION

Market timing and your retirement: Understanding the impact

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With the S&P/TSX, S&P 500, Dow Jones Industrial, Russell 3000, Nasdaq and MSCI EAFE indexes recently reaching all-time highs, there are discussions of valuations being too high and the markets correcting. People within one to two years of retirement (or anyone about to withdraw money from their investment portfolio) should be mindful of the impact that large losses can have on portfolios, and a concept called reverse dollar cost averaging.

Portfolio losses occurring early in retirement can lead to a far different outcome than if the losses occurred later in retirement. When the losses occur early, less money is compounding. Further, when minimum RRIF and additional withdrawals are removed from the portfolio, the problem is compounded.

To demonstrate this, we can compare two 1 million dollar portfolios that have the same returns for the last 20 years with a small exception - in the third year of retirement, portfolio A has a loss of -20% and portfolio B has a gain of 1%. The result is a difference of $421,000 at the end of 20 years. The differences compound when we examine the results of withdrawing from the portfolio. When $50,000 per year, indexed to inflation, is withdrawn from each portfolio, the difference is that Portfolio A ran out of money in year 20, while there is

$337,000 remaining in Portfolio B at the end of 20 years. The cause of this damaging effect is referred to as reverse dollar cost averaging.

Dollar cost averaging is a well-known strategy that involves a regular purchase of a fixed dollar amount of a stock, or mutual fund, on a consistent basis with price as the primary consideration. When prices drop, more shares or units are purchased. When prices rise, fewer shares or units are purchased. Over time, dollar cost averaging enhances portfolio returns.

The opposite of this is referred to as reverse dollar cost averaging, where regular withdrawals occur on a consistent basis, regardless of price. It works well when portfolios are rising, however, it is detrimental if withdrawals occur when portfolios are declining. Less capital is available for compounding to recover from market declines. Overtime, this leads to an accelerated loss of capital available for retirement income.

Incurring loss early in retirement can be offset by spending less, increasing returns by taking on more risk and postponing retirement. None of these options are ideal for individuals that worked and saved for most of their lives and happen to retire just as the markets produce a large loss. This unfortunate timing is a reality, and investors are wise to prepare for it. There are strategies that can be implemented in advance to help mitigate timing risk.

Proper Diversification

The first line of defense in preventing large losses is to have a properly diversified portfolio. Over the last few decades, correlations between equities and fixed income are rising, negating the diversification benefits that these asset classes previously offered. A 60% equity, 40% fixed income portfolio does not offer meaningful diversification as it is an outdated simplified estimate of a balanced portfolio. Further diversification is available by style, sector, geography, capitalization, maturity, rating, and class. Despite this, the asset classes have not changed as equities and fixed income remain.

What is required to fully diversify portfolios is the use of alternative asset classes such as private equity, private debt, real estate, natural resources, precious metals, hedge funds, and infrastructure. Allocating to this complete range of asset classes is referred to as the Endowment Model. Institutional and high net worth investors have adopted this model because the managers of these asset classes are less constrained and the markets are more inefficient. They also provide adequate returns during periods of low and negative real interest rates, while offering a low correlation to public markets. As a result, volatility can be smoothed, resulting in less intense losses. While the upside and downside capture will not be as great, allocators of capital are typically fine with this trade-off given they are structuring portfolios to last 25 to 35 years with retirement in mind.

From July 2014 to December 2018, a portfolio, comprised of 60% S&P 500 and 25% U.S. Bond Index, returned 22.09%. In restructuring the portfolio, by adding 15% Canadian Senior Private Debt and 15% U.S. Mid Market debt, while reducing the S&P 500 to 45% and the U.S. Bond index to 25%, performance increased to 33.42%, over the same period. Additionally, there was less volatility as standard deviation was 1.42% compared to 1.93% for the 60/40 portfolio. In the months where stocks and bonds experienced negative returns and greater volatility, the private debt asset classes acted as a stabilizer. We recognize that 4.5 years is a relatively short time period. Yet, this illustrates the potential benefits of having asset classes with low correlation to public investments.

Alternative Income

Bond yields are currently very low. Dividends are a good option… however, they are ultimately equities. With an Endowment Model asset allocation, private debt and real estate provide the additional benefit of being income producing investments. This reduces the dependency on capital appreciation to provide gains for income withdrawal, while alleviating the effects of reverse dollar cost averaging on non-yielding investments.

With a proper diversified portfolio in place that contains alternative income, poorly performing investments do not have to be sold to create income, thereby protecting the long-term future value of the income stream.

Strategic Reserve Account

Once a portfolio is properly diversified, the use of a strategic reserve account is a powerful strategy to prevent selling retirement assets during, or after, large losses. The consequences for selling investments during a bear market have long-term consequences, which can take many years to recover. It involves setting aside three years of income in laddered investments, to mitigate the damaging effects of withdrawing investments during an untimely market correction. One year's worth of retirement income is held in a high interest savings account. Income for year two and three are held in short-term instruments. This permits the remainder of the portfolio to recover from the losses while the income for the next three years has been accounted for. Profits from the remainder of the portfolio are moved into the strategic reserve account to provide income for years, four, five and six. This process is repeated throughout retirement.

Trusted Investment Advisor

It is fine to be hopeful at graduations and weddings, but it's not an effective retirement planning strategy. An independent, trusted wealth advisor can help provide clarity to make critical decisions for those in, or approaching, retirement. The direction of the investment winds cannot be controlled, but with careful investing, you can certainly adjust the sails. The strategies discussed in this article provide an outline that can help mitigate the negative effects of large losses and reverse dollar cost averaging.

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Editor's note: An earlier version had incorrect references to the two portfolio examples cited. Also, a correction from the originally published Globe and Mail article changes the word "efficient" to inefficient in the enclosed article. The article can be seen in its original version online.