The Investment Risk No One's Ever Heard Of

Knowledgeable investors are aware that investing in the capital markets presents any number of risks, including interest rate risk, company risk, and market risk. Risk is an inseparable companion to the potential for long-term growth. Some of the investment risks we face can be mitigated through diversification.[1]

As an investor, you face another, lesser-known risk for which the market does not compensate you, nor can it be easily reduced through diversification. Yet, it may be the biggest challenge to the sustainability of your retirement income.

This risk is called the sequence of returns risk.

The sequence of returns risk refers to the uncertainty of the order of returns an investor will receive over an extended period of time. As Milton Friedman once observed, you should, "never try to walk across a river just because it has an average depth of four feet."

Sequence of Returns

Mr. Freidman's point was that averages may hide dangerous possibilities. This is especially true with the stock market. You may be comfortable that the market will deliver its historical average return over the long-term, but you can never know when you will be receiving the varying positive and negative returns that comprise the average. The order in which you receive these returns can make a big difference.

For instance, a hypothetical market decline of 30% is not to be unexpected. However, would you rather experience this decline when you have relatively small retirement savings or at the moment you are ready to retire – when your savings may never be more valuable? Without a doubt, the former scenario is preferable, but the timing of that large potential decline is out of your control.

Timing, Timing, Timing

The sequence of returns risk is especially problematic while you are in retirement. Down years, in combination with portfolio withdrawals taken to provide retirement income, have the potential to seriously damage the ability of your savings to recover sufficiently, even as the markets fully rebound.

If you are nearing retirement or already in retirement, it's time to give serious consideration to the "sequence of returns risk" and ask questions about how you can better manage your portfolio.

1. Diversification is an approach to help manage investment risk. It does not eliminate the risk of loss if security prices decline.