The Hanover Advisor

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Retiring in a Down Market

The longest bull market run finally came to an end in April 2020 as the coronavirus pandemic upended the global economy. While it was difficult for anyone to watch their 401(k)'s and investment accounts lose value, it was particularly gut-wrenching for retirees. In retirement, your savings become your primary source of income, and watching an account meant to sustain you for the rest of your life lose 20% or more in a matter of days can cause panic. Though the markets quickly recovered, no one can predict where they will be 5, 10, or 20 years from now, so it is important for those nearing retirement to prepare for what it will mean if they retire in a down market.

Having a severe market shock, like the pandemic or the 2008 financial crisis, or even just a run of a few years of underperformance occur early in retirement exposes a retiree to what is known as sequence of return risk. What this means is that when a retiree withdraws assets while the market is down, those losses become locked in. The value that was removed is not only diminished, but no longer has the opportunity to increase as the market recovers. This lowers the value and future earning potential of the remaining portfolio and increases the possibility that a retiree will outlive their savings.

Luckily, retirees do not need to rely on good timing and pure chance to ensure that their savings will last through their retirement. Implementing a dynamic spending strategy can help retirees navigate market downturns. The most common spending strategies for retirees are to withdraw a flat percentage of their portfolio—4% is the general rule of thumb—or using a dollar plus inflation strategy, wherein the retiree determines a set dollar amount to withdraw each year and adjusts annually for inflation. The problem with these static, rigid approaches is that they ignore the changing market conditions, and they can often lead to retirees taking more than their portfolio can bear or less than they need to cover expenses.

A dynamic spending strategy, conversely, adapts to constantly changing market conditions and increases the likelihood that a retiree's nest egg will last for the entirety of their retirement. In a dynamic spending strategy, a retiree sets a ceiling and floor for how much to take from their portfolio each year, for example taking 5% more than the previous year when the

market is up or taking 1.5% less when the markets are down.

Economists at Vanguard tested the various retirement spending strategies. They created a model portfolio that had $1 million in assets at the time of retirement, but was reduced to $800,000 following a market crisis. They then ran this model portfolio through 10,000 potential simulations to see how they would fare over a 30-year period. If the portfolio used a dollar plus inflation spending strategy, it had a success rate of 88.6%. While this is respectable, it means that there is an 11.4% chance that a retiree would deplete their savings. Using a dynamic spending strategy had a 97.8% success rate, which leaves far less chance for the retiree to outlive their savings.

A dynamic spending strategy means that a small reduction in annual spending during down years can significantly increase the chances of a retiree's portfolio lasting for the rest of their lifetime. It also provides the flexibility to allow them to spend more during up years, affording them the ability to make the most of their golden years. Bear markets are inevitable, and it is impossible to accurately predict when downturns will occur, so it is important to be aware of sequence of return risk and plan ahead to make sure that you minimize the impact they can have on your retirement.

Perhaps the best benefit of adopting a dynamic spending strategy is that it requires you to reassess your finances every year. Financial planning is most successful when it is treated as an ongoing relationship instead of a fixed product. Things like inflation, taxes, and market volatility change year to year, and they can have a big impact on your finances. Because of this, it is important to meet with an advisor at least once every 12 months to ensure you are still on track to meet your financial goals, even as economic conditions change.

Understanding Risk Tolerance

The uncomfortable reality that all investors must accept is that all investments carry some degree of risk. Stocks and bonds can lose value, substantial value even, if market conditions turn negative. Even guaranteed or insured investments like a certificate of deposit with a bank carry inflation risk, meaning that they may not earn enough to keep up with the rising cost of living. Aside from economic factors like market conditions and inflation, investments can carry business risk, meaning that the decisions a corporation makes, such as merging with or acquiring another company or expanding into a new market, can impact the value of that corporation's stock. International investments carry political risk based on the actions of the

nation's government and currency risk based on the fluctuating value of the nation's currency when compared to U.S. dollars.

When confronted with so many risks, the knee jerk reaction of many investors is to reduce risk as much as possible. Doing so, however, ignores the relationship between risk and reward. Anyone who has spent time in a casino knows that you can quickly double or triple your money while playing at a high stakes table, but you can just as easily bust out entirely after a few bad hands. Conversely, you could spend the entire evening playing penny slots, and while you are unlikely to lose all your money immediately, hitting the jackpot generates a relatively paltry return. When considering something as important as a retirement investment account, understanding the interplay between risk and reward is paramount.

There is no right or wrong amount of risk, but it is key that every investor understands their personal level of risk tolerance, meaning how comfortable they are with variability in their returns and their willingness and ability to handle large swings in the value of their investments. Age is traditionally a key factor in risk tolerance. Young investors have long time horizon before they will need to rely on their investments, so drastic swings matter less, because there is more time for the portfolio's value to recover. For an investor nearing retirement, a bout of volatility could be much more detrimental. It is not just age, however, but a variety of factors like future earning capacity, Social Security benefits, assets like real estate, and potential inheritance that must be considered when determining an investor's risk tolerance.

To help investors understand their risk tolerance, financial advisors have traditionally relied on risk tolerance questionnaires, wherein a client answers a series of questions about how they would respond to hypothetical scenarios and assigns them a risk profile accordingly. Research has shown this process to be highly unreliable, with one study finding that the use of such questionnaires typically explains less than 15% of the variation in risky assets between investors. Such questionnaires typically do not factor in an investor's level of financial literacy and cannot account for an investor's unconscious biases based on things like previous investment experiences and the influence of family and friends.

There is an issue not just with the questionnaires, but also with how their results are implemented. Traditionally, investors are assigned one of three risk tolerance levels: conservative, moderate, or aggressive. There is no industry standard for how advisors view these levels, and research has shown that asset allocation for the same level of client can vary widely from

advisor to advisor. Moreover, the use of generalized buckets such as these fails to take into account the nuanced financial situation of each investor and their specific goals.

At Hanover, we use a system called Riskalyze to determine our clients' risk profile. This system uses a proprietary formula to assign a specific risk score, providing a much more specific target than just the standard risk tolerance levels. It also presents clients with a range of expected returns over a six-month horizon based on their current risk score and asset allocation. This helps clients go beyond just understanding their risk tolerance, but demonstrates their risk capacity, meaning the level of risk that must carried or avoided to ensure that they are on track to meet their financial goals. We also perform sensitivity analysis to show investors how their portfolio would perform during outlier events—like the 2008 financial crisis—that fall outside the standard market conditions covered in most modeling scenarios.

It is impossible to accurately predict the future of the financial markets, but properly informed investors can predict how they will respond to the market's fluctuations. Understanding your personal risk profile will help weather downturns without resorting to panic and ensure that you will remain on track to meet your financial goals.

Hanover Advisor Bulletins
Special Reminders to all Hanover Clients

- Pershing will be implementing a new fee of $2 for mailed hardcopies of monthly statements and $1 for trade confirmations. We recommend that all clients switch to electronic copies of these documents to avoid this fee. If specific statements are needed, Hanover can provide them at no cost, upon request. If you have any questions or concerns about this, please contact us.
- We invite all clients to schedule an online portfolio review. Because we respect your time, we offer three different meeting formats that vary in length and level of specificity. For more information or to schedule a meeting, please contact us.
- Since the start of the pandemic, Hanover employees have been working remotely, conducting meetings online or over the phone. However, we would like to remind our clients that we still have our main office in Greenville, SC and conference facilities in Atlanta, GA. We are happy to hold in-person meetings at either of these locations or any other that works for you.
- The Hanover Advisors website can be accessed at hanoveradvisorsinc.com. There you will find our latest newsletter and investment commentary, articles, our blog, and videos. You can also learn more about our services, access both the Black Diamond performance reporting system and your Pershing brokerage account(s).
- All Hanover clients have free access to our internet-based reporting system known as Black Diamond. This robust system provides comprehensive performance reporting, asset allocation and risk assessment on clients' portfolios. Our office is available to assist in accessing and utilizing the Black Diamond system.

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