Quadrant
Private Wealth

Unspoken Risk…

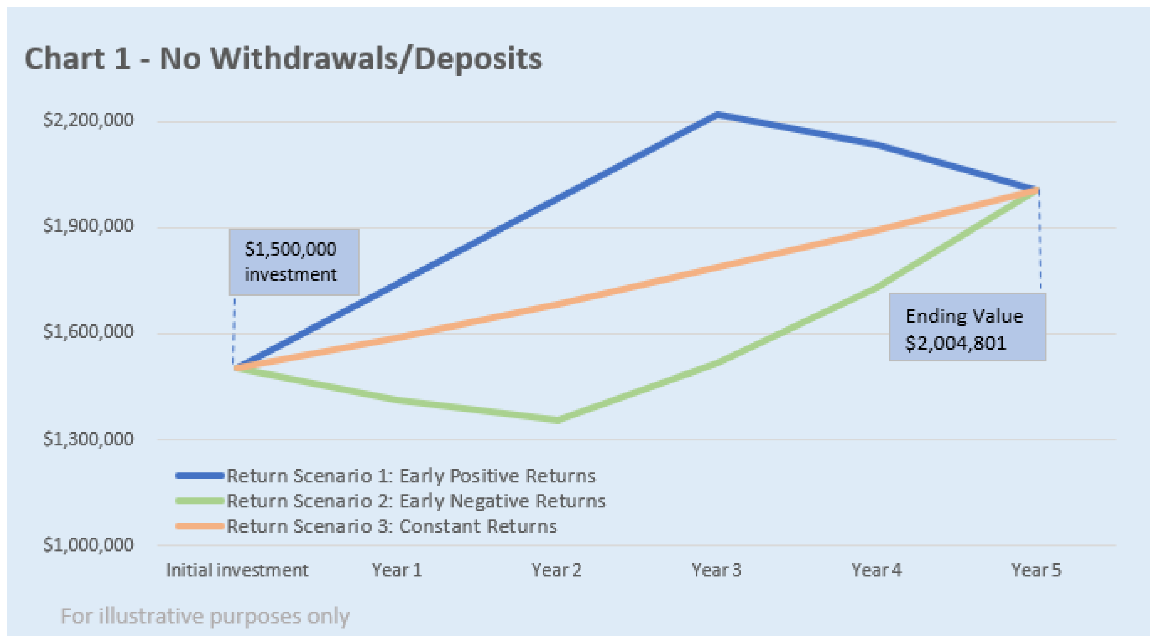
The word "average" is embedded in many of our vocabularies. Typically, it is a reference to a single number taken as representative of a list or collection of numbers. Oftentimes, it is casually interpreted as what is "normal" or "expected". In day-to-day usage, few of us stop to think about the prescriptive mathematical calculation behind a particular average and the potential positive or negative conclusions one could reach (or be led to reach) by accepting the "average" at its face value.

We have all read or heard about the importance of having a long term time perspective in portfolio management. Notwithstanding the long term average return of an investment portfolio, returns in shorter periods of time can be substantially below (or above) the long term average return. By choosing to invest in assets that do not have a contractual guaranteed return (i.e. bank GICs) we accept the risk of low or even negative returns in shorter periods with the expectation of enjoying higher average returns over the long term. Given a long time horizon and the discipline to remain invested during low or negative return periods, these short periods of "return disappointment" have no tangible long term financial consequence.

By way of a simple numerical example that does not consider inflation or income taxes, following are three 5 year portfolio return scenarios. Scenario 1 ("Early Positive Returns") and Scenario 2 ("Early Negative Returns") have the same annual returns in opposite sequence with Scenario 1 being highest to lowest and Scenario 2 being lowest to highest. Scenario 3 ("Constant Returns") has a constant return each year equal to the 5 year average.

Year	Return Scenario 1 *Early Positive returns*	Return Scenario 2 *Early negative returns*	Return Scenario 3 *Constant returns*
1	16%	-6%	6%
2	14%	-4%	6%
3	12%	12%	6%
4	-4%	14%	6%
5	-6%	16%	6%
Total Return	34%	34%	34%
Average Annualized	6%	6%	6%

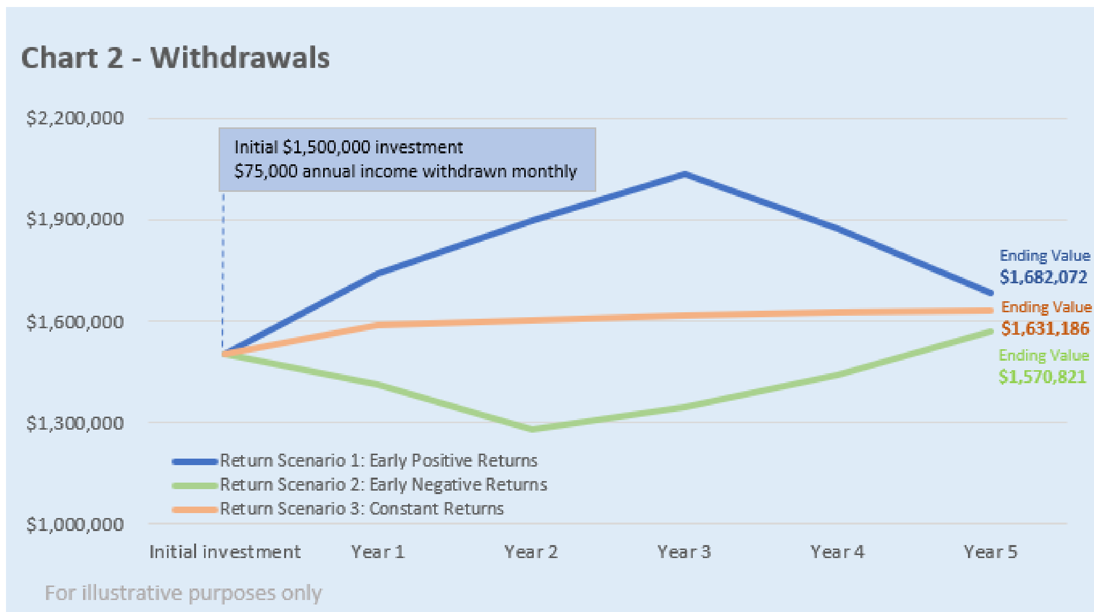
Despite very different portfolio returns year by year, each scenario ends up with the identical total and average annual returns over the 5 years. Given an equal amount invested in year one (say $1,500,000) and no deposits or withdrawals throughout the 5 years, the annual sequence of returns has no bearing on portfolio results at the end of the 5 year period.



The sequence of returns that make up the average long term return of a portfolio can have an impact on long term wealth when regular deposits or withdrawals are being made into/from the portfolio. Where an investor is making regular withdrawals from their portfolio, this introduces "Sequence of Returns Risk". This often "unspoken risk" is particularly relevant to retired investors who are relying on their investments to fund lifestyle costs over the balance of their lives.

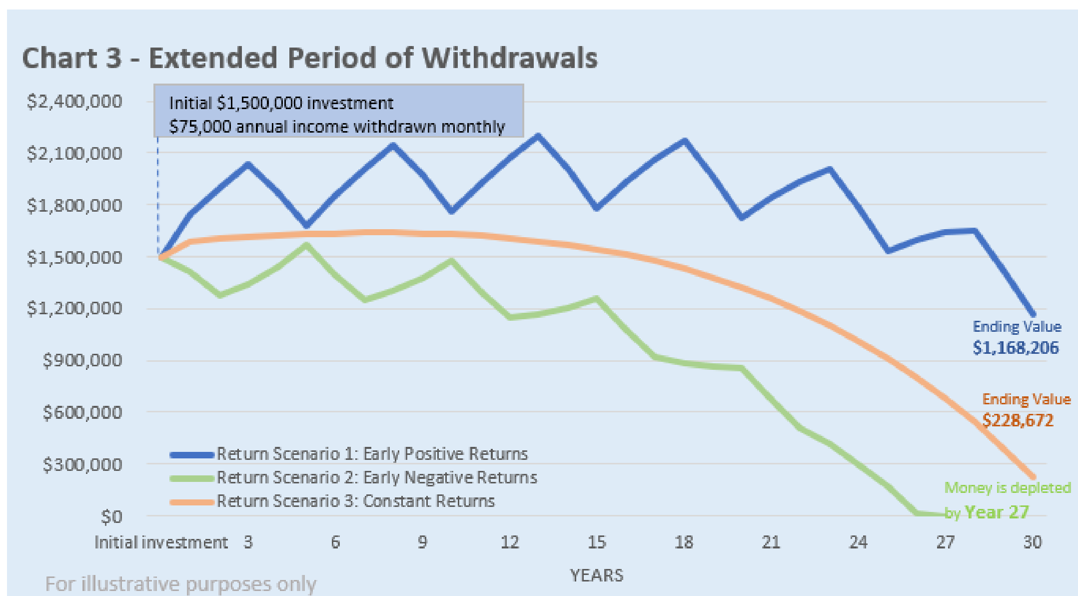
When investing in the capital markets, it is inevitable that there will be periods where a balanced portfolio underperforms the average long term return, and some periods may include negative returns. If this happens earlier in retirement it can have a permanent negative effect on the ability to fund lifestyle costs over the balance of a retired investor's lifespan.

Extending the original numerical example (Early Positive, Early Negative and Constant Return), the same opening value of $1,500,000; we introduce an annual withdrawal of $75,000 (5% of the opening value).



In this case, the Early Negative Portfolio illustrates the impact of Sequence of Returns Risk over just 5 years. The difference in portfolio values from lowest to highest ($111,251) represents 7.5% of the original portfolio value.

If we assume that the same return sequences repeat themselves over 30 years (often a typical retirement span) the impact is more dramatic.



Even though all three scenarios over this period would have earned an average annualized rate of return of 6%, the dollar ending value of each portfolio would differ dramatically. The Early Negative Portfolio would be exhausted by the 27th year. The other two portfolios would have ended with a positive dollar value and would have been able to continue providing retirement income.

Without a disciplined and deliberate wealth planning process to allow for and manage Sequence of Returns Risk specific to each investor, long term portfolio management can fail that investor.

At Quadrant, we take the time to understand this risk in the context of each client's circumstances on a continual basis. Our portfolio management process integrates a comprehensive and personalized wealth planning process alongside traditional portfolio management elements.

Markets are always on the move and 2019 has been no exception! It has been a year with ups and downs, surprises and shocks. However, at the end of the day, we have not changed our process for managing our clients' portfolio, nor is there a need to.

> *"Small disciplines repeated with consistency every day lead to great achievements gained slowly over time".* John C. Maxwell

Quadrant is always here to help you with your financial plans based on the proven investment tenets of diversification, discipline, long-term focus and capital preservation.

We thank all of our clients for their continued support and trust. We wish you a healthy, peaceful and prosperous 2020.

About Us

Disciplined. Compassionate. Effective.

Quadrant Private Wealth is an independent, comprehensive, integrated wealth management firm committed to your financial well-being and peace of mind. We take the time to understand your complete financial picture. We tie all of your information together, including tax planning, to paint a picture of what your financial future could look like. And we aim to earn your complete confidence in the process.

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