SEQUENCE RISK: THE BIGGEST INVESTMENT RISK YOU'VE NEVER HEARD OF?

Andrew Craig, Founder, Plain English Finance

Webinar

Monday, 17 May 2021, 15:30 BST

A Word From Today's Chairman

Dr Ariel Sergio Goekmen-Davidoff

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Today’s Agenda

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- 15:30 – 15:35 Chairman’s Introduction
- 15:35 – 16:00 Keynote Presentation – Andrew Craig
- 16:00 – 16:15 Questions & Answers

Today's Speaker

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Andrew Craig

Founder

Plain English Finance

FS Club

The biggest investment risk you’ve never heard of…?

Monday, 17th of May 2021

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An Opening Poll

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Are you familiar with sequence risk and the damage it can wreak on your portfolio by retirement?

a) Yes
b) No

Important information

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Setting the scene

Two huge problems for investors in 2021:

1. Interest rates are at record lows.

2. Many other financial markets are at or near record highs (equities, property).

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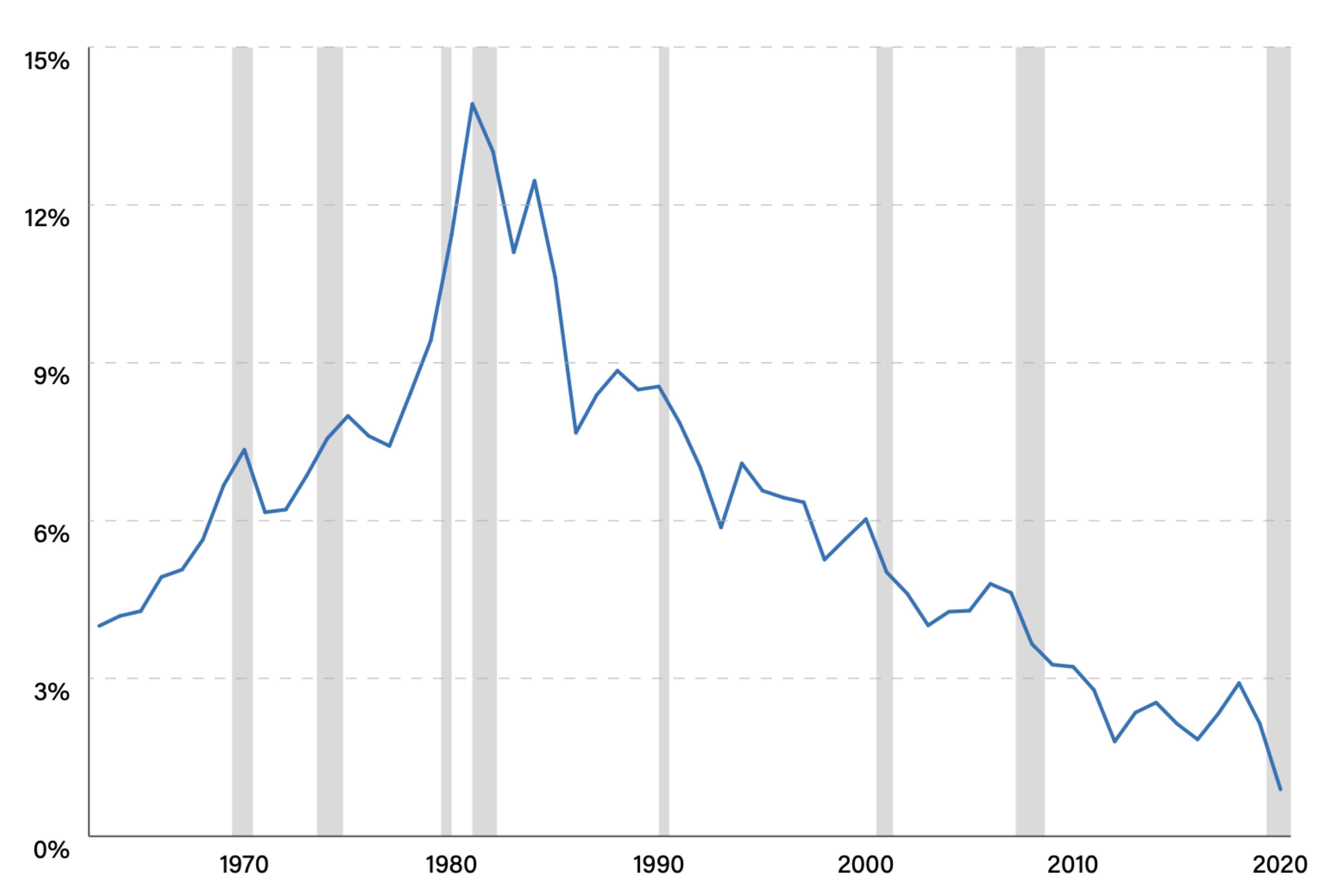
Interest rates all over the world are at all-time lows

This means that:

- Returns on “lower risk” / “balanced” portfolios are too low in the accumulation phase.
- “Risk free” income at retirement is too low. (6% of £1m = £60,000 a year. 1% of £1m = £10,000).
- Investors are forced to chase equity market returns for sufficient capital growth in accumulation and sufficient income at retirement.

But – equities bring significant risk, particularly with markets at all-time highs.

10 Year Treasury Rate - 54 Year Historical Chart
Source: MacroTrends.net



Grey bars show recession years. Data as of: 06/12/20

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A “Triple Threat” of Equity Market Risks

1. Psychological risk…

The risk that an individual gives up on investment entirely during a large crash (1999/2000 and 2007 to 2009 for example)

2. The break-even fallacy

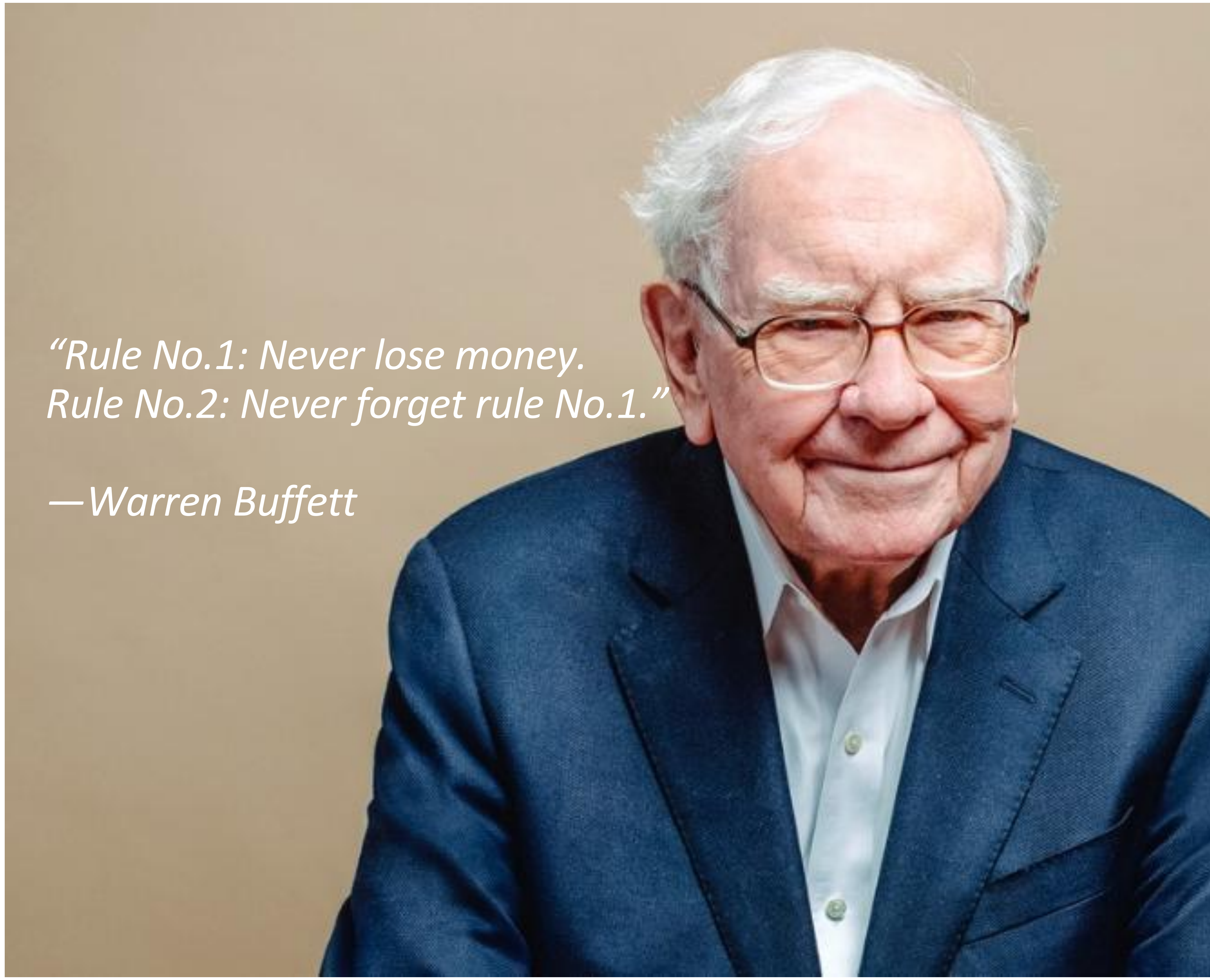
A 100% gain is required to recover a 50% loss. Stock markets crash 50% or more every few years.

Downside protection is PARAMOUNT.

3. Sequence Risk

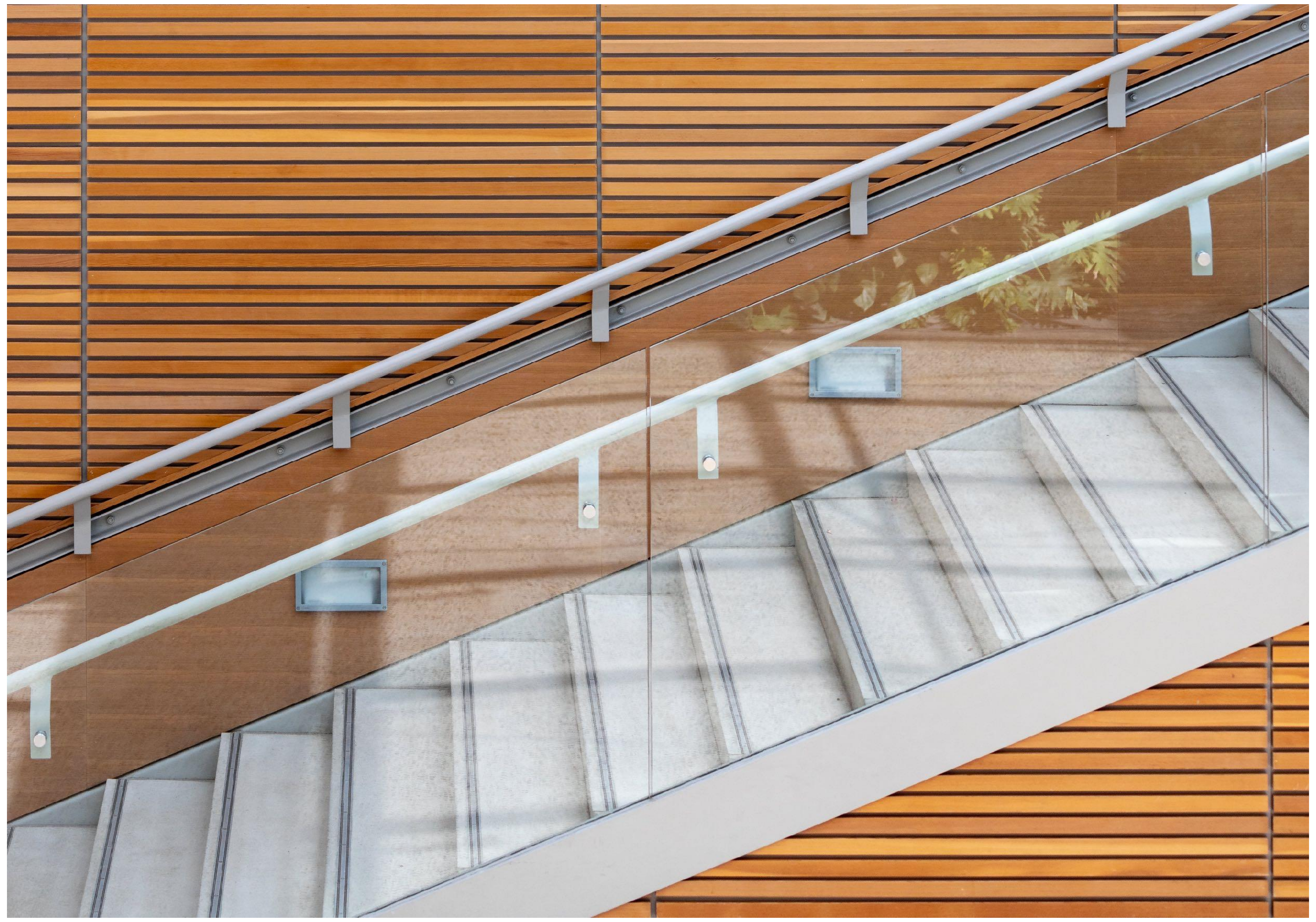
…the biggest investment risk most people have never heard of.

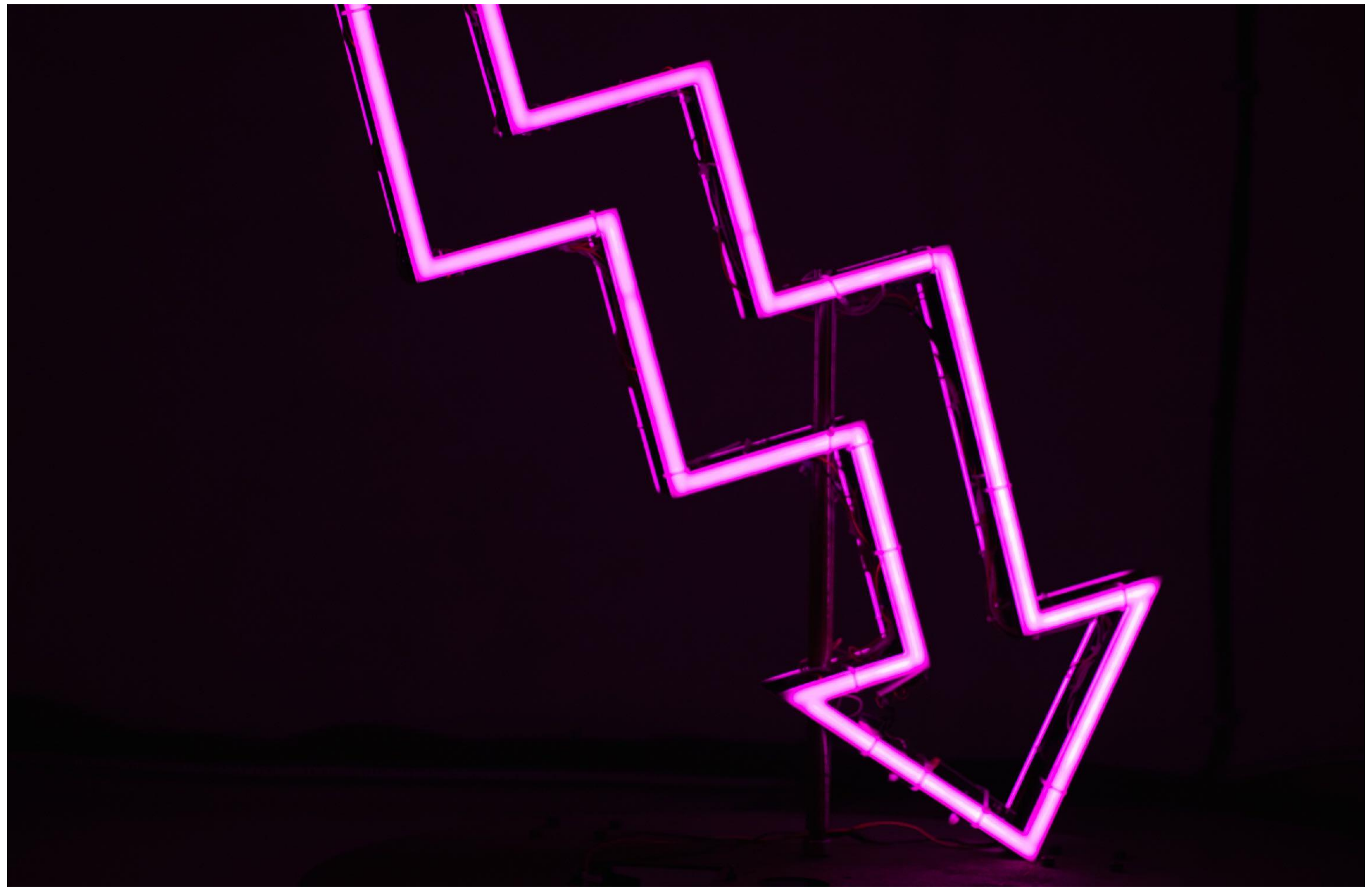
Two assets with *identical annualised returns* and *volatility* give entirely different real-world outcomes depending on *when* in their life an individual experiences an equity market crash.



01.
Sequence Risk

Sequence Risk… On the way "up" …and on the way "down"





"Accumulation" versus "decumulation"

In the real-world, there are two key investment phases in your life:

"Accumulation":
The period in which you attempt to build wealth by saving and investing. We might think about this being your focus from roughly the age of, say, 30 to the age of 60.

"Decumulation":
The period in your life when you will want to live on the wealth you have built in the accumulation phase. We might think about this as, say, roughly from the age of 60 to the age of 90 (with apologies to anyone over the age of 90 watching this presentation!)…

The crucial point: is that in both of these phases…

…the ORDER in which you make returns can be more important for real-life outcomes than the SIZE or VOLATILITY of those returns.

The importance of ORDER on the way “up”

Let us take the example of a thirty-year-old who has managed to save £10,000 in their 20s.

Let us also assume:

- …they can save and invest £500 a month into a stocks and shares ISA account.
- they can make roughly equity market returns from the age of 30 to the age of 60 (7.5%).

So - they are starting with £10,000, saving £6,000 a year and making 7.5% returns.

The really interesting bit:

Now let us assume that **one year** in those 30 years, they suffer a big stock market crash.

The S&P 500 fell 38% in 2008, so we are going to use that number for the purposes of illustration.

The importance of ORDER on the way "up" – II

Accumulation table. Large loss occurs in 'orange years'.

Source: Plain English Finance

AGE	30	39	49	59	NO LARGE LOSS
30	£10,000	£10,000	£10,000	£10,000	£10,000
31	£12,200	£16,750	£16,750	£16,750	£16,750
32	£19,115	£24,006	£24,006	£24,006	£24,006
33	£26,549	£31,807	£31,807	£31,807	£31,807
34	£34,540	£40,192	£40,192	£40,192	£40,192
35	£43,130	£49,207	£49,207	£49,207	£49,207
36	£52,365	£58,897	£58,897	£58,897	£58,897
37	£62,292	£69,314	£69,314	£69,314	£69,314
38	£72,964	£80,513	£80,513	£80,513	£80,513
39	£84,437	£92,551	£92,551	£92,551	£92,551
40	£96,769	£63,382	£105,493	£105,493	£105,493
41	£110,027	£74,136	£119,405	£119,405	£119,405
42	£124,279	£85,696	£134,360	£134,360	£134,360
43	£139,600	£98,123	£150,437	£150,437	£150,437
44	£156,070	£111,482	£167,720	£167,720	£167,720
45	£173,775	£125,843	£186,299	£186,299	£186,299
46	£192,808	£141,282	£206,271	£206,271	£206,271
47	£213,269	£157,878	£227,742	£227,742	£227,742
48	£235,264	£175,718	£250,822	£250,822	£250,822
49	£258,909	£194,897	£275,634	£275,634	£275,634
50	£284,327	£215,515	£176,893	£302,307	£302,307
51	£311,652	£237,678	£196,160	£330,980	£330,980
52	£341,026	£261,504	£216,872	£361,803	£361,803
53	£372,603	£287,117	£239,138	£394,938	£394,938
54	£406,548	£314,651	£263,073	£430,559	£430,559
55	£443,039	£344,250	£288,803	£468,851	£468,851
56	£482,267	£376,068	£316,464	£510,014	£510,014
57	£524,437	£410,273	£346,198	£554,265	£554,265
58	£569,770	£447,044	£378,163	£601,835	£601,835
59	£618,502	£486,572	£412,525	£652,973	£652,973
60	£670,890	£529,065	£449,465	£410,843	£707,946

The importance of ORDER on the way “up” – £260,000 poorer!

- A 38% crash @ 31 = pot of £670,890.
- …at 59 = £410,843 - a **£260,000 difference.**
- 40% worse off – **yet with SAME average annual returns and volatility!**
- Of course - they will be even better off if they manage to avoid having a big down year at any point on the (right most column).
- The bigger these numbers are, the bigger the difference.

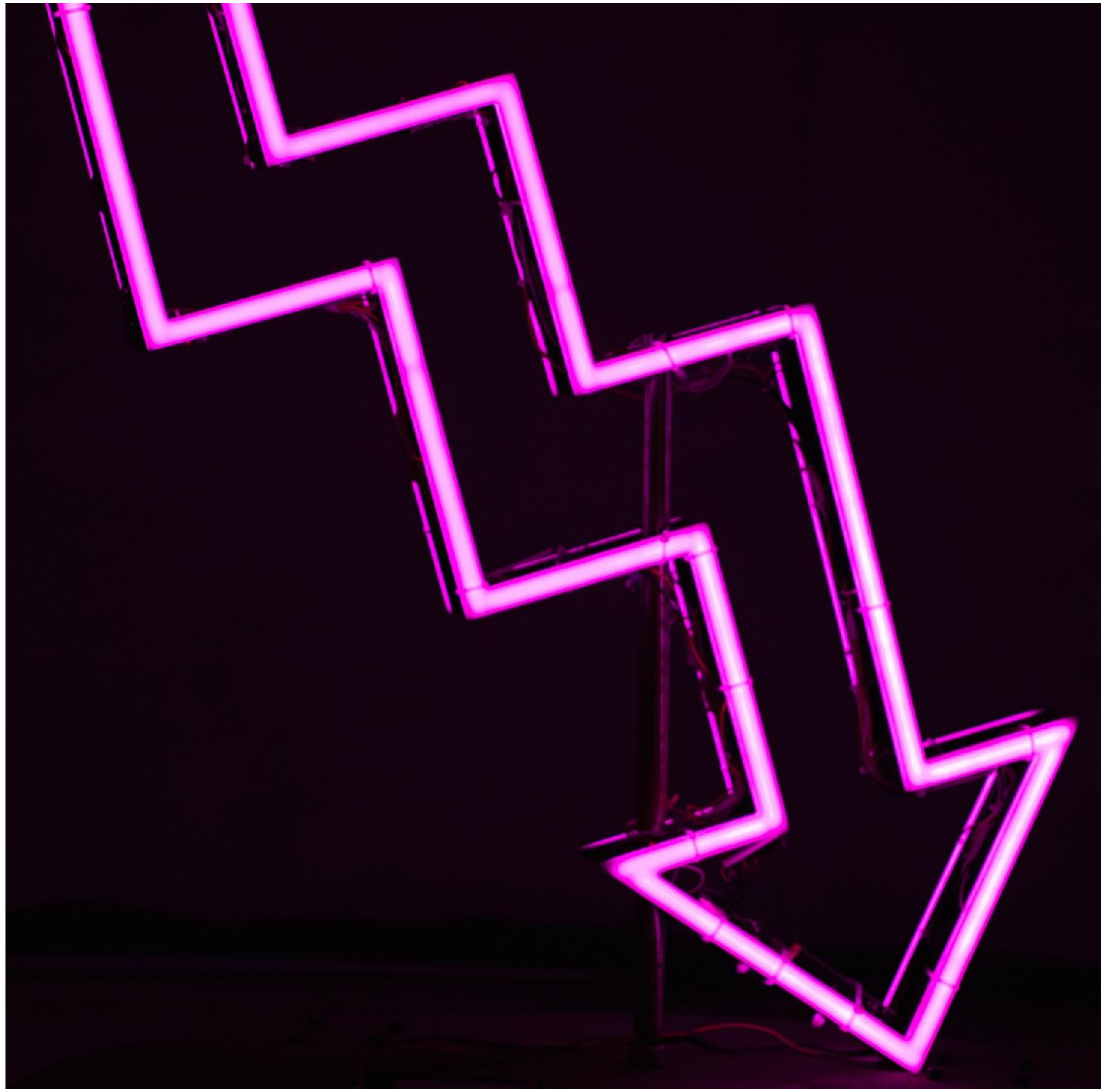
For a highly paid professional, “sequence risk” can make a large six- or even seven-figure difference. Hence why it is SO important to understand.

The importance of ORDER on the way "down"

Now let us consider the same concept with respect to what may happen in retirement.

- Let us assume:
- …a £500,000 pot at 60 (entirely realistic as we've seen).
- …they have paid off their mortgage and can live reasonably well on, say, £25,000 a year.
- …so will want to take this amount out of their pot each year (they will "withdraw" £25,000 a year).

We will keep the average annual return and "terrible crash year" assumptions the same at 7.5% and -38%.



The importance of ORDER on the way "down" – II

Decumulation table. Large loss occurs in 'orange years'.

Source: Plain English Finance

AGE	60	70	80	NO LARGE LOSS
60	£500,000	£500,000	£500,000	£500,000
61	£294,500	£510,625	£510,625	£510,625
62	£289,713	£522,047	£522,047	£522,047
63	£284,566	£534,325	£534,325	£534,325
64	£279,033	£547,525	£547,525	£547,525
65	£273,086	£561,714	£561,714	£561,714
66	£266,692	£576,968	£576,968	£576,968
67	£259,819	£593,365	£593,365	£593,365
68	£252,431	£610,993	£610,993	£610,993
69	£244,488	£629,942	£629,942	£629,942
70	£235,950	£650,313	£650,313	£650,313
71	£226,771	£387,694	£672,211	£672,211
72	£216,904	£389,896	£695,752	£695,752
73	£206,296	£392,263	£721,059	£721,059
74	£194,894	£394,808	£748,263	£748,263
75	£182,636	£397,544	£777,508	£777,508
76	£169,458	£400,484	£808,946	£808,946
77	£155,293	£403,646	£842,742	£842,742
78	£140,065	£407,044	£879,072	£879,072
79	£123,695	£410,697	£918,128	£918,128
80	£106,097	£414,625	£960,112	£960,112
81	£87,179	£418,846	£579,770	£1,005,246
82	£66,842	£423,385	£596,377	£1,053,764
83	£44,980	£428,264	£614,231	£1,105,921
84	£21,479	£433,509	£633,423	£1,161,990
85	£-	£439,147	£654,055	£1,222,265
86	£-	£445,208	£676,234	£1,287,060
87	£-	£451,723	£700,076	£1,356,714
88	£-	£458,728	£725,707	£1,431,593
89	£-	£466,257	£753,260	£1,512,087
90	£-	£474,351	£782,879	£1,598,619

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The importance of ORDER on the way "down" – Dog food vs millionaire…

- If someone is unlucky enough to experience a big crash year when they have just retired – they will then run out of money before they turn 85 (left hand column).
- If the crash doesn't happen until they are 80, they will still have £782,897 by the time they turn 90 – what a difference!
- Most significantly, if they never suffer a big crash year at all, they will power into their nineties with more than £1.5 million!

Again – it is important to stress that the three scenarios on the left have the **SAME average annual returns and volatility…**

…but there is a very significant difference in the real-world impact on the individual's wealth (as you can see!).

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No-One Talks About This Stuff!

It is vanishingly rare ever to see this utterly crucial reality presented to you by the finance-industry.

Why?

- Perhaps because there is no statistic or measure that easily summarises this aspect of investing.
- Fund managers and financial advisers can market what they do with respect to percentage returns and (at the more sophisticated end of the market, “risk” or volatility-adjusted returns).
- …but there is no “league table” for master of the universe fund managers to compare each other based on their ability to deal with sequence risk.
- Perhaps another reason for this is that the comparison would need to be made over very long periods of time. The industry tends to focus on 3 or 5-year performance…

This does not change the fact that reducing the possibility of big drawdowns (falls or losses) is arguably THE key ingredient in devising successful long run investing strategies…

02.
What to do?

Part 1

Make use of “100 minus your age”…

- This idea has been around for decades to help people work out the percentage they should hold in “low risk” bonds vs. “high risk” equities.
- The idea is that you should own “100 minus your age” in equities.
- Or – put another way – you should *“...own your age in bonds...”* (John Bogle).
- This idea was the main focus of my second book: “Live on less, invest the rest…”
- But - bonds vs equities doesn’t work so well with bond rates at 0.5% and equites at ATHs!

- A better way is to think about “aggressive” vs “defensive”…
- Aggressive could be lots of things: S&P, small caps, biotech, even crypto…
- …and for the “defensive” bit – we believe in using two powerful investment techniques…

Part 2

The combination of two key investment techniques.

1. TRUE diversification

- All major asset classes in all major regions of the world.
- The main assets classes: Shares, bonds, cash, property and commodities, respond differently to the various stages of an economic cycle: Growth, deflation, inflation, stagnation, and so on.
- Diversifying by geography and by asset class significantly reduces risk and maximum draw down.

2. Formula-based trend following:

- More than a century of evidence.
- Looking at financial data as far back as practicably possible, and across essentially all markets, academic research and real experience has shown that the positive or negative direction of any market is statistically more likely to continue than to reverse.
- Because of this, formula-based trend following improves returns and reduces volatility.

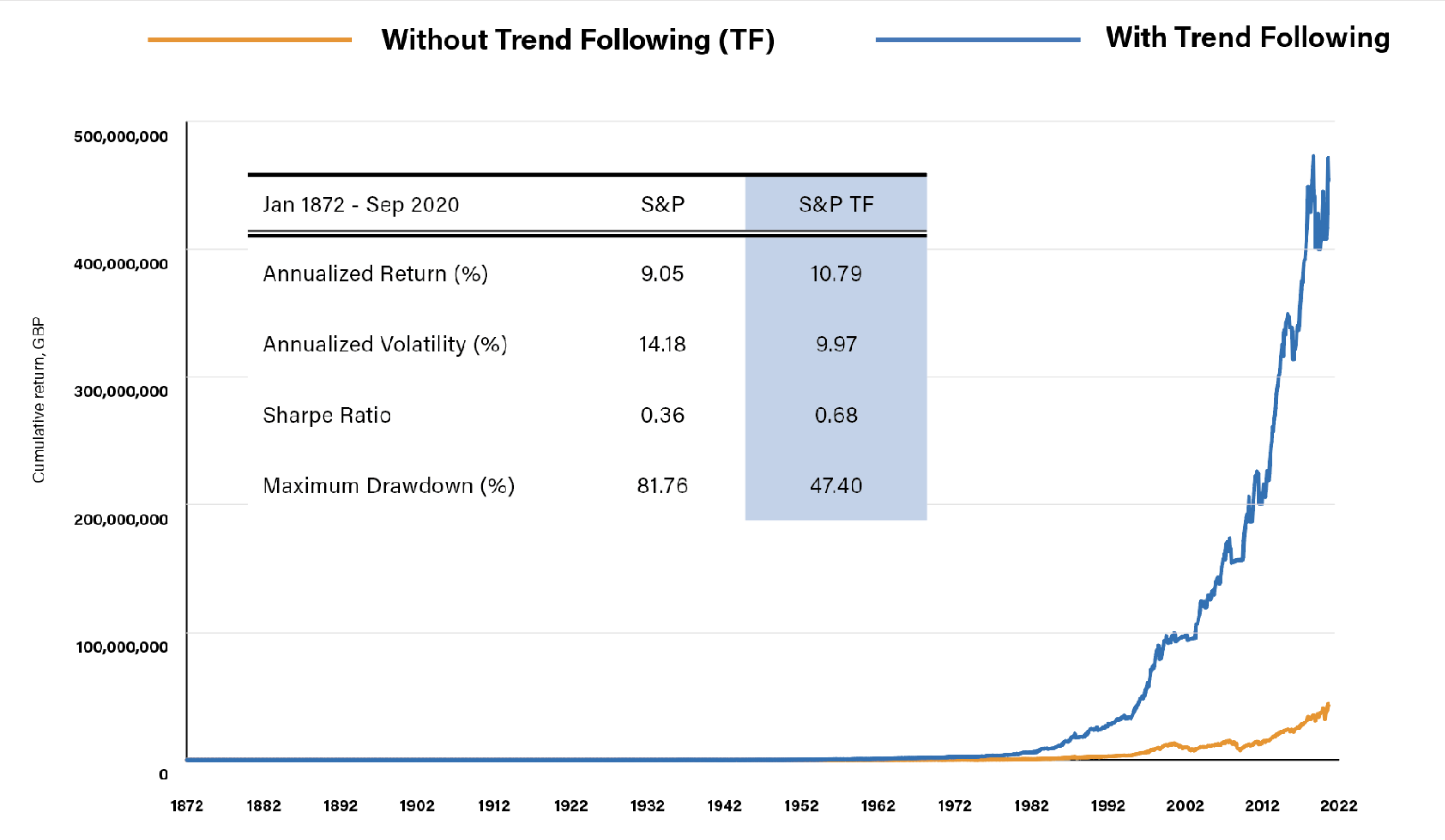
Evidence for Trend Following (TF)

Historical evidence for the efficacy of basic TF is powerful…

The chart here shows the use of simple trend following going all the way back to 1872. This has:

- improved annual performance by more than 2% a year
- reduced volatility by over 4%
- and reduced the maximum drawdown from 81.76% to 47.40%
- similar results were achieved for other asset classes (e.g. commodities and property)*

S&P 1872-2020
Source: Professors Andrew Clare, Steven Thomas & Dr.James Seaton



Jan 1872 - Sep 2020	S&P	S&P TF
Annualized Return (%)	9.05	10.79
Annualized Volatility (%)	14.18	9.97
Sharpe Ratio	0.36	0.68
Maximum Drawdown (%)	81.76	47.40

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*Please refer to pages 25 and 26 of the Fund Overview document…

Disclaimer: Simulated past performance is not necessarily a reliable indication of future performance.

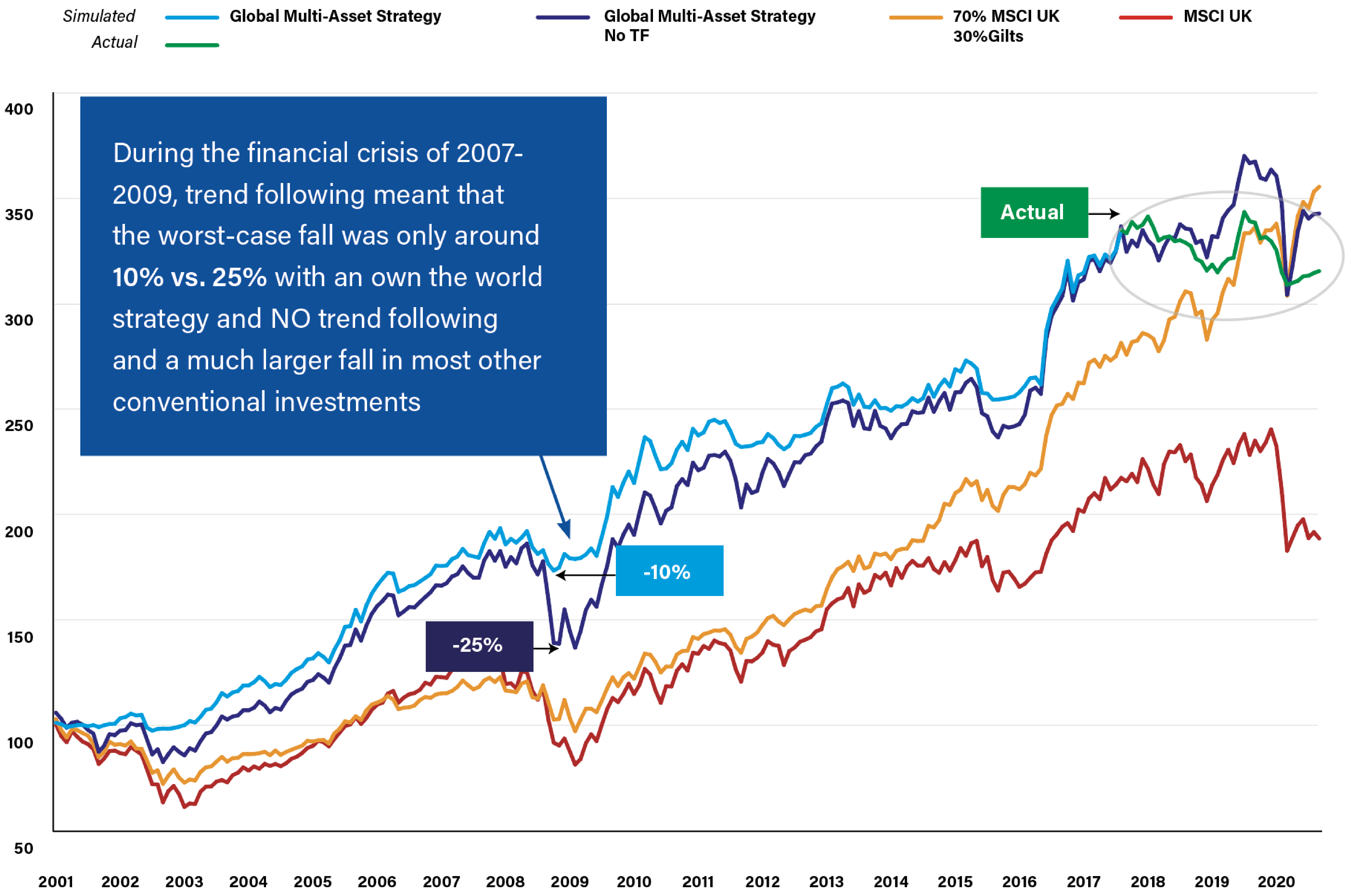
Some evidence…

Cumulative Return of the Model

Source: Professors Andrew Clare, Steven Thomas & Dr.James Seaton

Disclaimer: Simulated past performance is not necessarily a reliable indication of future performance.

Data as at 30/09/20



Closing Poll

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Having listened to this presentation, do you now feel more informed about managing your personal investments and avoiding sequence risk?

a) Yes
b) No
c) Still not sure

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1. Sign up to Andrew’s free, periodic email newsletter
2. Find out more about our Premium “How to Own the World Community”
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Andrew Craig
Founder & Investment Manager

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Thank You For Listening

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Forthcoming Events

- Tue, 18 May (10:00-10:45) Financial Centres Of The World 2021: Focus On Moscow
- Wed, 19 May (15:00-15:45) AI Made Inventions And AI Created Works In Europe. What Does This Have To Do With My Business?
- Thu, 20 May (09:00-09:45) UK-China-Europe Relationships And Co-operation After Brexit: Rewiring The Connections
- Fri, 21 May (14:00-14:45) On The Shoulders Of Giants: The Digital Exploration Of Newton’s Career At The Royal Mint

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