

RETIREMENT • RISK MANAGEMENT

Sequence of Return Risk

The Retirement Risk Almost Nobody Talks About, and How to Protect Yourself

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Key Takeaways

- Two retirees with identical savings and identical average returns can end up in completely different places depending on when the down years arrive.
- During accumulation, a bad early year is survivable. Once you are withdrawing, an early downturn forces you to sell shares at depressed prices, permanently shrinking the portfolio.
- The five years before and after retirement are the highest-risk window, sometimes called the retirement red zone.
- Practical defenses exist: a cash buffer, a distribution-focused portfolio structure, flexible withdrawals, and attention to valuations as you approach retirement.

Why This Matters

Imagine two people, same age, each retiring with a million dollars, and over twenty years they earn the same average market return. One runs out of money at 79. The other is still comfortable at 90. The only difference between them is when the market fell. That is sequence of return risk, and for anyone in their fifties or sixties it may be the single most important retirement concept they have never fully understood.

What Sequence of Return Risk Actually Is

Most people plan retirement around average returns. The market averages roughly 7% a year, the thinking goes, so I will be fine. During the decades you are accumulating, that logic mostly holds. A bad year early on is something you ride out, because you are not withdrawing; the market recovers and so does your balance.

The moment you start pulling money out, the math changes completely. Think of it like a campfire. While you are adding wood, saving every month, a rainstorm slows you down but does not stop you; you just add more. But once you stop adding wood and start drawing on the fire for warmth, that same rainstorm can put it out. If the market drops 30% in your first two years of retirement while you withdraw to live on, you are selling shares at depressed prices. Those shares are gone. They cannot recover for you because you no longer own them.

Even if the market roars back in years three through ten, the portfolio is now permanently smaller. The compounding that was supposed to carry you through your eighties and nineties has been quietly gutted. It is not about what the market does on average. It is about what it does in the years right around your retirement date.

Why Right Now Matters: The Retirement Red Zone

There is a window I call the retirement red zone: the five years before retirement and the five years after. It is the most financially dangerous decade of your life, for three reasons. You are at peak savings, so a market drop costs more real dollars than it ever did in your thirties. You are beginning withdrawals, so selling at depressed prices locks in losses permanently. And you have less time to recover, because you need the money soon.

The 2000 dot-com crash and the 2008 financial crisis devastated retirement accounts for people who happened to retire into those storms. Some were forced back to work; others cut their standard of living for years. Not because they failed to save enough, but because of when the crash hit. Timing, not discipline.

Three Conditions That Make It Worse

Not every retirement carries the same exposure. But three conditions, when they appear together, should make any pre-retiree stop and think carefully.

- Large distributions. The more you withdraw each year, the faster a downturn depletes the portfolio. If your lifestyle depends on significant withdrawals because Social Security will not cover the gap and you have no pension, your exposure is amplified.
- An aggressively allocated portfolio. Heavy equity exposure can drive great long-term growth, but it also means steeper drops in a correction. Being 80% or 90% in stocks made sense in your thirties; in the red zone it becomes a loaded risk.
- Retiring into an overvalued market. When valuations are stretched and the market has had an unusually long run, the probability of a significant correction rises. If it hits in year one or two, you are forced to sell low at the worst possible time.

When all three are present, the margin for error is razor-thin.

Four Ways to Protect Yourself

The good news is that this is a manageable risk. Here is how thoughtful pre-retirees address it.

Build a Cash Buffer Before You Retire

Keep one to two years of living expenses in cash or short-term bonds. If the market drops in year one, you draw from that buffer instead of selling equities at a loss, giving the portfolio time to recover before you have to touch it. It is not glamorous, but it works.

Get the Portfolio Structure Right Before You Retire

A well-structured retirement portfolio does two things at once: it protects the assets you will need in the short term and keeps enough growth-oriented investments working so you do not outlive your money. That means shifting from an accumulation mindset, focused on maximizing growth, to a distribution mindset, focused on protecting what you have built while keeping it growing.

Keep Withdrawals Flexible

Plans that allow you to trim spending modestly in a down year, rather than withdrawing a fixed amount regardless of conditions, dramatically reduce the damage from a bad early sequence. Flexibility is itself a form of protection.

Mind Valuations as You Approach the Red Zone

You cannot control when a downturn arrives, but you can take less risk into a stretched market as you near retirement, rather than carrying maximum equity exposure into the most vulnerable window of your financial life.

The Bottom Line

Sequence of return risk is not about being pessimistic. It is about recognizing that the order of returns, not just the average, determines whether your money lasts. The most dangerous decade is the one straddling your retirement date, and it is precisely the period most worth planning for in advance. The strategies that address it are straightforward; the key is having them in place before the storm, not after.

You cannot choose when the market falls. You can choose whether your plan is built to absorb a bad start without breaking.

References and Sources

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