Managing Sequence-of-Returns Risk
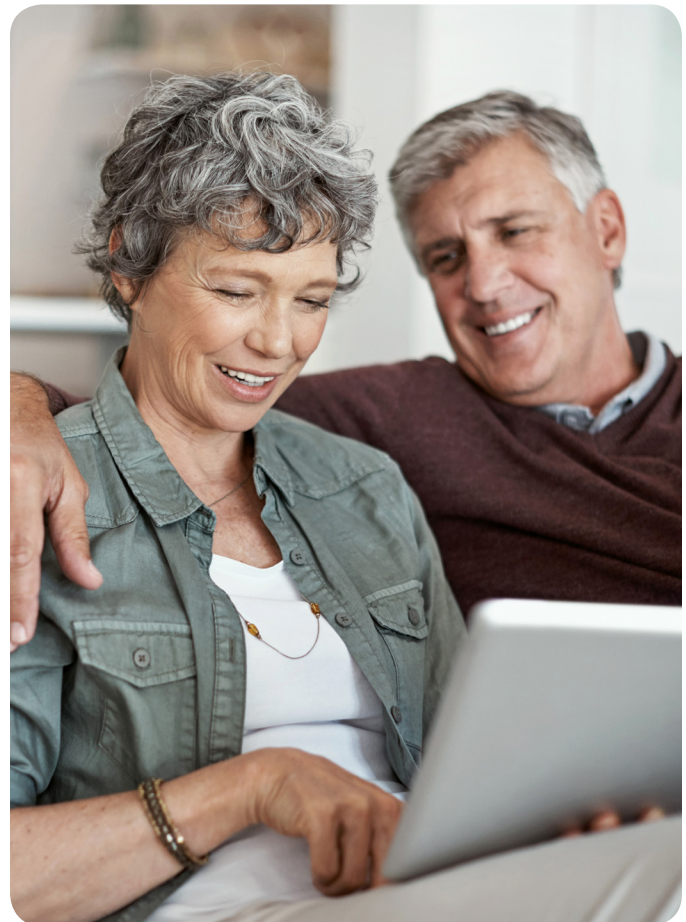
USING WHOLE LIFE INSURANCE

Once you start taking withdrawals, the sequence of annual returns on your retirement savings can be critical to how long your income lasts. A strategy using whole life insurance may help preserve assets.

Investment returns are variable and, unfortunately, unpredictable. When planning for income, the sequence of positive and negative annual returns can have a significant impact on how long a portfolio will last – particularly if the portfolio is in the distribution stage and a set amount is being withdrawn from the portfolio every year. Low or negative returns in the first few years of retirement can significantly add to the possibility of portfolio ruin.

SEQUENCE OF RETURNS MATTER

Let's take a look at a hypothetical example over two 15-year income scenarios and consider how the sequence of annual returns could impact the value over time — and learn about a strategy using whole life insurance that may help manage risk and preserve the portfolio's value.

In the illustrations that follow, both Jane and Jim started with a balance of $500,000. Beginning at age 66, each took out $20,000 per year adjusted for inflation as part of their retirement income plan. No other actions were taken to manage income withdrawals. Each scenario yielded the same average annual rate of return on the underlying investment for the 15-year period, but the only difference is the sequence of the annual returns. The outcomes are dramatically different.

Scenario 1: Early negative returns can deplete a portfolio.

CLEARLY DIFFERENT OUTCOMES

Jane's portfolio is worth $500,000. At age 66, she began taking out $20,000 per year (adjusted by 2.5 percent for inflation). For this example, let's assume she has invested in an index fund that mirrors the performance of the S&P 500 from the time period of 2000 through 2015.

Over the 15-year period, her portfolio had a 3.77 percent average annual rate of return. Her ending portfolio balance would be $74,300.

Jim's portfolio is also worth $500,000. Let's assume he invested in the same index fund with the same average annual rate of return on the underlying investment, but we reverse the order of the hypothetical rates of return. His ending portfolio balance would be $344,290.

In this example, there is a difference of approximately $270,000! The bad outcome for Jane illustrates the impact of negative returns in the early years in conjunction with a set distribution pattern from a portfolio.

JANE'S PORTFOLIO
WITH EARLY NEGATIVE RETURNS

Beginning Balance $500,000

Age	Return	Annual Withdrawal	Growth	Ending Value
66	-10.14%	$20,000	$(48,672)	$431,328
67	-13.04%	$20,500	$(53,572)	$357,256
68	-23.37%	$21,012	$(78,580)	$257,664
69	26.38%	$21,537	$62,290	$298,417
70	8.99%	$22,075	$24,843	$301,185
71	3.00%	$22,627	$8,357	$286,915
72	13.62%	$23,193	$35,919	$299,641
73	3.53%	$23,773	$9,738	$285,606
74	-38.49%	$24,367	$(100,551)	$160,688
75	23.45%	$24,976	$31,825	$167,537
76	12.78%	$25,600	$18,140	$160,076
77	0.00%	$26,240	———	$133,836
78	13.41%	$26,896	$14,341	$121,281
79	29.60%	$27,568	$27,739	$121,452
80	11.39%	$28,257	$10,615	$103,810
81	-0.73%	$28,963	$(546)	$74,300

Ending Balance $74,300

JIM'S PORTFOLIO
WITH LATE NEGATIVE RETURNS

Beginning Balance $500,000

Age	Return	Annual Withdrawal	Growth	Ending Value
66	-0.73%	$20,000	$(3,504)	$476,496
67	11.39%	$20,500	$51,938	$507,934
68	29.60%	$21,012	$144,129	$631,051
69	13.41%	$21,537	$81,736	$691,250
70	0.00%	$22,075	———	$669,175
71	12.78%	$22,627	$82,629	$729,176
72	23.45%	$23,193	$165,553	$871,537
73	-38.49%	$23,773	$(326,304)	$521,459
74	3.53%	$24,367	$17,547	$514,640
75	13.62%	$24,976	$66,692	$556,356
76	3.00%	$25,600	$15,923	$546,679
77	8.99%	$26,240	$46,787	$567,226
78	26.38%	$26,896	$142,539	$682,869
79	-23.37%	$27,568	$(153,144)	$502,157
80	-13.04%	$28,257	$(61,797)	$412,104
81	-10.14%	$28,963	$(38,850)	$344,290

Ending Balance $344,290

The examples shown are hypothetical in nature and used for illustration purposes only.

Scenario 2: A strategy that may help preserve a portfolio.

A POTENTIAL STRATEGY FOR JANE

When Jane was 45, she purchased a whole life insurance product from The Lafayette Life Insurance Company to provide protection for her family during her working years. Since then, the policy has built up cash value that could be used to supplement Jane's retirement income.[1]

In order to try to preserve her portfolio, Jane decides to take a loan from her life insurance policy in the year following a negative performance year in her portfolio. The amount of the loan is identical to her inflation-adjusted withdrawals in scenario one.

Note: The amount of the loan could potentially be less than the withdrawal from the portfolio if the amount needed from the portfolio was increased to cover any income tax liability on the amount distributed. Life Insurance policy loans are considered nontaxable distributions.

With this strategy, Jane's ending hypothetical portfolio balance in year 2015 is now $249,974. This is a difference of $175,673 when compared to the first scenario.

As you can see in this hypothetical example, by strategically taking withdrawals from Jane's life insurance policy to supplement her retirement income in the year following a year of negative performance in her portfolio (especially in the early years), she may help preserve her portfolio.

JANE'S PORTFOLIO USING LIFE INSURANCE TO MANAGE SEQUENCE-OF-RETURNS RISK

Beginning Balance $500,000

Age	Return	Annual Withdrawal	Growth	Ending Value
66	-10.14%	$20,000	$(48,672)	$431,328
67	-13.04%	———	$(56,245)	$375,083
68	-23.37%	———	$(87,657)	$287,426
69	26.38%	———	$75,823	$363,249
70	8.99%	$22,075	$30,672	$371,845
71	3.00%	$22,627	$10,477	$359,695
72	13.62%	$23,193	$45,832	$382,334
73	3.53%	$23,773	$12,657	$371,218
74	-38.49%	$24,367	$(133,503)	$213,348
75	23.45%	———	$50,0300	$263,378
76	12.78%	$25,600	$30,388	$268,166
77	0.00%	$26,240	———	$241,926
78	13.41%	$26,896	$28,836	$243,866
79	29.60%	$27,568	$64,024	$280,322
80	11.39%	$28,257	$28,710	$280,775
81	-0.73%	$28,963	$(1,838)	$249,974

Ending Balance $249,974

1 This strategy assumes that Jane's income, as well as her assets, will enable her to fund the required life insurance premiums and still end up with a $500,000 investment portfolio at age 66. While this strategy assumes Jane will use the life insurance to supplement her retirement income, the life insurance premium also pays for a death benefit that could contribute to the eventual portfolio balance in the event of a premature death.

Example assumes Contender 2020 Whole Life Policy, female, age 45, Preferred Non-Tobacco.

THE ADDED VALUE OF WHOLE LIFE

Whole life insurance is one of the few instruments where the premiums, cash value and death benefit are guaranteed.

In addition to the guaranteed values offered in your policy, whole life insurance also gives you the potential to receive dividends annually, which can increase the value of the policy when the insured is living or provide an increased death benefit for your beneficiaries.

Note that policy loans are available when the policy has accumulated Net Cash Value. Dividends will not be reduced by loaned amounts. Loans and interest will reduce the death benefit if not repaid.

For more information about this strategy, talk to your financial professional.

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