SEQUENCE MATTERS

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Of all the tools at the disposal of investors, few people recognize the financial significance of sequencing. Sequencing has the potential to add great value, but when ignored can be a devastating mistake for those seeking financial security and independence. In fact, when it comes to financial decisions, proper sequencing is as important as the benign task of putting socks on before tying your shoes – to complete this exercise in any other order would seem illogical to most. As it relates to our personal finances, this is similar to speculating in markets before building the necessary emergency fund.

In the real world people face sequencing decisions all the time:

- Would it be smart to take on the cost of two significant mortgages if the old house hasn't sold before buying the desired new house?
- Should you purchase a boat with your current cash surplus one year before sending your child to college?
- With three years left on a mortgage, should you purchase a new vehicle or wait and use that money to speed up repayment on the mortgage?
- While interest rates are low do you finance a purchase or pay cash?
- If a worker reaches the goal of retiring early at 55, well before Medicare coverage kicks in, how do they afford adequate health insurance to meet their surely rising health care costs and not jeopardize their nest egg?

Sequence risk can also rear its head for savers and retirees when market returns are below average for a protracted period of time. While market returns are out of an investor's control, choosing to delay savings and thus depending on a higher return later on is a common sequence risk, which can have profound and lasting long-term effects.

According to Investopedia and many scholarly posts, "the order or the sequence of investment returns is a primary concern for retirees who are living off the income and capital of their investments."

Additionally, the magnitude of sequence risk has been amplified as of late, since we believe there is little doubt that the seemingly guaranteed high returns of 1982-2000 are giving way to a lower return environment for the foreseeable future. Any investor counting on above average investment returns to finance retirement is likely heading for a rude awakening. This is underscored with the explosion of *negative* government bond yields throughout the developed world.

A recent analysis by McKinsey & Company titled "Diminishing Returns: Why Investors May Need to Lower their Expectations" is no exception. "Buoyed by exceptional economic and business conditions, returns on US and Western European equities and bonds during the past 30 years were considerably higher than the long-run trend," the report stated. The reasons for the remarkable boom are numerous: historically low inflation and interest rates, favorable demographic trends, strong global GDP, productivity gains, the emergence of China as an economic force, and dramatic advances in automation that reduced global supply chain costs.

And, "some of these conditions are weakening or even reversing," the report also said. "Our analysis suggests that over the next 20 years, total returns including dividends and capital appreciation could be considerably lower than they were in the past three decades." The McKinsey & Company report suggests equities returns could drop to 4 to 5 percent, down from the 1985-2014 average of 7.9 percent while fixed income yields are estimated to drop to "0 to 1 percent" which is down considerably from the 14% yields common as one of us began his career.

In practical terms, this could require working longer and saving more. It can also mean a realignment of attitudes about expectations, and a greater emphasis on the importance of sequencing. Without the benefit of double digit returns, sequencing risks are likely to be unmasked. Its critical investors practice financial self-reliance, understand their strengths and vulnerabilities, and ask tough questions about their goals and themselves when they make decisions on investments, retirement age or major acquisitions.

Over the years we have found that our most successful clients seek counsel regarding sequence and transitional decisions, thereby lessening their dependence on markets while also reducing their risk exposure. They understand how professional and personal changes can impact a portfolio far more than seeking maximized returns by attempting to time market whims. Ideally, this self-reliant mindset of learning what we can control should begin early, but it is never too late. We advise any investor to have at least a six-month cash nest egg put aside

for emergency expenses before they even begin to think about retirement saving. This type of planning is a helpful tool in confronting the reality of sequence risk. When an investor adds a level-headed attitude about market fluctuations along with proper tax planning and asset location, they'll be better prepared for the expected lower returns in the future.

So remember: when you see folks walking around with boxer shorts over their pants or seniors working at a fast food franchise, you can bet that sequence risk played a part.

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