

PIABA BAR JOURNAL

VOLUME 21, No. 3 • 2014

**FINRA SIX YEAR ELIGIBILITY RULE, STATUTE OF LIMITATIONS
AND THE PROSPECTUS DEFENSES – THE DEATH KNELL OF
INVESTORS’ CLAIMS?: EXPLORING CRITICAL DIFFERENCES
AMONG NEW YORK, FLORIDA, CALIFORNIA AND TEXAS**

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a publication of

Public Investors Arbitration Bar Association

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**EXPERT’S CORNER:
“LATE-TERM” INVESTORS, MONTE CARLO
SIMULATION AND “SEQUENCE-OF-RETURN RISK”**

Frederick W. Rosenberg

We’ve all seen these cases, a Client, an early-retiree anticipating another 30-35 years who needed a steady lifetime income out of investments. His adviser made recommendations to retire and go long the market actuarially, setting objectives to “Long-Term Growth” with “moderate risk,” which meant a substantial if not total allocation in S&P growth stocks. Recommended distributions were 5%, \$50,000 per year before fees and costs. Ten years later, the Client is virtually penniless after following the adviser’s recommendations and continuing advice.

So, is this Client with 30 years of retirement ahead really a “Long-Term” investor? Unlike younger “Long-Term” investors who are working and accumulating wealth, retired investors no longer have the capacity to replace market losses or cushion portfolio depletion with earned income no matter how long they live in retirement. The Client’s investment objective is not “accumulation” but “distribution” with monthly income for 30 years, a *long term* for sure. Does the portfolio allocation typically assigned to “Long-Term Growth” actually conform to this Client’s objectives despite his life expectancy?

Retirees are not “Long-Term” but “Late-Term” investors with unique risks and the primary concern about the sustainability of distributions, a distinction too often ignored. Regardless of life expectancy, for every Late-Term Investor the financial risk horizon is four to five years at best. Were the portfolio to decline, either due to market performance or withdrawals during this period, it could be nearly impossible for the distributions to be sustained. How many four-year periods in the past 85 years has the market been flat, or even performed well below its historical average? Should a portfolio decline 20% from \$100,000 to \$80,000, \$5,000 in annual withdrawals grows from 5% to 6.25%, a pre-fee rate that is corrosive and unsustainable by every measure. But, even if the market remained flat, a \$5,000 (5%) annual liquidation will deplete assets by 15% in three years before management fees and costs, and would require double that rate of growth simply to restore the equity. That does not even take into consideration the continued withdrawals during the three-year period.

“*Sequence-of-Return Risk*” is the acute problem Late-Term investors must manage even when they own long-term growth stocks. It means that for

accounts taking fixed distributions the sequence of the returns is critical, specifically because early account losses or portfolio declines substantially impair sustainability and vice versa. Search “Sequence-of-Return Risk” and you’ll find dozens of articles addressing this very problem. Importantly, Monte-Carlo simulation, so present in sales presentations, is totally missing in retirement account management; the failure to update simulations may be directly linked to Client loss when updated simulations are not used.

Fooled by Averages.

A Monte Carlo Simulation is a respected and widely adopted method of forecasting outcomes and risk. Inputting known variables, such as a principal amount, standard deviation, average growth rate, and a time series such as days, months or years, produces a Bell Curve of outcomes over thousands or millions of iterations. The Investment Advisory industry has employed Monte Carlo Simulation in its presentations to financial planning clients for years. Monte Carlo Simulations have been used in litigation by claimants to prove that negative outcomes were predictable and foreseeable at the time of the recommendation, while respondents have used them to illustrate their recommendation was sound. Importantly, there is still much debate about whether the variables used in simulations reflect the real risks or provide false security, ideas expressed clearly in recent PIABA Bar Journal articles.¹

But it is often the failure to use Monte Carlo Simulation effectively that leaves Late-Term Investors in dire financial straits. Every simulation is only a point-in-time forecast based on specific variables. Over time, those variables change, the time horizon shortens, the standard deviation changes, and the portfolio value changes; however, withdrawals remain constant. In my years as an expert I cannot recall a case where new simulations were run to determine if the portfolio’s distributions were still sustainable following declines in portfolio value. Instead, investors stayed the course on recommendations that ignored “Sequence-of-Return Risk” in reliance essentially on out-of-date, stale forecasts.

To elaborate, assume a Client with \$1 million portfolio withdraws 5% per year (\$50,000), but experiences a 20% decline in the portfolio by the end of three years to \$800,000. A new investor retiree with \$800,000 portfolio and a 5% withdrawal rate would be advised to take no more than \$40,000 per year

1. See Michael B. Engdahl, *Computer Model Illustrations in Securities Arbitration Cases*, 19 PIABA B.J. 45 (2014), and Jeffery Schaff & Michele Schaff, *Gamed By Monte Carlo*, 19 PIABA B.J. 237 (2012).

to assure sustainability. An adviser's recommendation to "stay the course" and maintain the withdrawal rate based on the stale 3-year old simulation is now, in fact, unsuitable and unsustainable.

In the cases I have seen, the common advice to retirees taking distributions during recent market declines was to "stay-the-course" — advice based not on an updated Monte Carlo Simulation, but upon unfounded reliance on out-of-date projections and market optimism. This led to unsustainable portfolios even after markets were in recovery. Had the Client been provided a revised simulation based upon new variables (\$800,000, a \$50,000 withdrawal rate, and a 27 year time horizon), the sustainability risk would have become immediately apparent calling for action. Without the updated simulation, no action was taken or additional risks discussed and the Client is now destitute.

Late-Term Investors suffer most from Sequence-of-Return Risk and cannot wait for market recoveries by blindly continuing to take distributions and riding out the bumps, nor can they even sustain periods of non-growth if they occur early in the plan. How many recessions has the country experienced where market declines and recoveries consumed approximately 36 months and how many 3-4 year periods has the S&P 500 suffered a loss or remained unchanged? These conditions are normal bumps for Long-Term investors accumulating wealth, but can spell disaster for Late-Term Investors relying on sustained distributions for the balance of their lives. All Late-Term Investors must be prepared to reduce risk pro-actively and to react precipitously to contain loss and premature account depletion that threatens income sustainability over a life expectancy. Updated Monte Carlo Simulations provide real guidance when used for retirement accounts in distribution. The question in litigation is where were the Monte Carlo Simulations when the Client needed them?

Below is a table illustrating "Sequence of Return" risk. The Illustration assumes an 8% return over 25 years with a standard deviation of 14.4% and a withdrawal rate of \$50,000 per year. The left side illustrates the impact of modest losses in the first three years while the right side simply reverses the returns to place the gains first.

Sequence of Returns Risk-25 Year							
Year		1,000,000	(50,000)	Year		1,000,000	(50,000)
1	-18.0%	770,000	6.5%	1	22.0%	1,170,000	4.3%
2	-5.0%	681,500	7.3%	2	8.0%	1,213,600	4.1%
3	-12.0%	549,720	9.1%	3	30.0%	1,527,680	3.3%
4	10.0%	554,692	9.0%	4	18.0%	1,752,662	2.9%
5	14.0%	582,349	8.6%	5	24.0%	2,123,301	2.4%
6	12.0%	602,231	8.3%	6	9.0%	2,264,398	2.2%
7	-9.0%	498,030	10.0%	7	28.0%	2,848,430	1.8%
8	6.0%	477,912	10.5%	8	16.0%	3,254,179	1.5%
9	-10.0%	380,121	13.2%	9	-9.0%	2,911,303	1.7%
10	16.0%	390,940	12.8%	10	16.0%	3,327,111	1.5%
11	5.0%	360,487	13.9%	11	-6.0%	3,077,485	1.6%
12	-12.0%	267,228	18.7%	12	17.0%	3,550,657	1.4%
13	30.0%	297,397	16.8%	13	30.0%	4,565,854	1.1%
14	17.0%	297,954	16.8%	14	-12.0%	3,967,952	1.3%
15	-6.0%	230,077	21.7%	15	5.0%	4,116,349	1.2%
16	16.0%	216,890	23.1%	16	16.0%	4,724,965	1.1%
17	-9.0%	147,370	33.9%	17	-10.0%	4,202,468	1.2%
18	16.0%	120,949	41.3%	18	6.0%	4,404,617	1.1%
19	28.0%	104,814	47.7%	19	-9.0%	3,958,201	1.3%
20	9.0%	64,248	77.8%	20	12.0%	4,383,185	1.1%
21	24.0%	29,667	168.5%	21	14.0%	4,946,831	1.0%
22	18.0%	(14,993)	-333.5%	22	10.0%	5,391,514	0.9%
23	30.0%	(69,491)	-72.0%	23	-12.0%	4,694,533	1.1%
24	8.0%	(125,050)	-40.0%	24	-5.0%	4,409,806	1.1%
25	22.0%	(202,561)	-24.7%	25	-18.0%	3,566,041	1.4%
Avg Retn		8.0%		Avg Retn		8.0%	
Standard Deviation		14.4%		Standard Deviation		14.4%	

The conclusion is crystal clear. Early losses in accounts under distribution can dramatically alter outcomes and sustainability, a foreseeable fact routinely ignored in recommendations to “stay the course.”