Retirees Need to Face the High Cost of Bad Luck

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When you're working and the stock market plunges, it's a temporary problem. But if you've just retired, or are about to, then it could devastate your retirement savings. It's called "sequence of returns risk."

It makes me a little nervous when investors talk about "average rates of return" as though those numbers are something you can blithely base much of their retirement income plan on.

In reality, once you start withdrawing money from the nest egg you worked so hard to build, it's the sequence of those returns, not the averages, that can have a major effect on your wealth.

Down markets are little more than a distraction when you're young and still adding to your retirement savings. No one likes to see them, but with time — and continuing contributions — you can usually make back your money and then some.

If you're in the first five or so years of retirement when a market downturn happens, though, the loss could be devastating. If the market drops 50%, you'll need to make a 100% gain just to get back to even ... or more, since you'll likely be drawing money from that account while you're waiting for the market's recovery.

Think a 50% drop can't happen? The U.S. has seen two in the last 15 years: In October 2002, the Nasdaq dropped to as low as 1108.49 — a 78.4% decline from the all-time intraday high of 5132.52 it established in March 2000. On Oct. 9, 2007, the Dow closed at 14,164.43, and by March 5, 2009, it had dropped more than 50% to 6594.44.

The problem, of course, is that the market is unpredictable. There's no tracking system you can count on to alert you that trouble is coming.

Which means it's up to you to change your investing mindset from accumulation to preservation before you give up your paycheck and start tapping into your life savings. In the distribution phase, the focus is no longer on what you can earn on your money; it's about what you can keep. Losses are far more impactful than gains.

And while you don't have control over the market, and whether it will thrive or dive in the years after you retire, you do have some say over the different asset classes into which you allocate your money.

To try to protect yourself of sequence of returns risk, you simply can't have all your eggs in the growth basket anymore — which is what most people have when they come to our office, as though life exists in a vacuum and there's never going to be another market downturn.

You also should talk to your financial adviser about the pecking order of how and when you're going to take your income. Should you start with your IRA, your Roth or your after-tax money? There is no one-size-fits-all answer.

If you don't have an adviser and you're five to 10 years away from retirement, it may be time to get one — someone who can help you draw up a proper plan for your retirement goals. And one of the priorities of that plan should be to position you in a way that reduces the chances that bad timing in the market could harm your future.

Kim Franke-Folstad contributed to this article.

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