GYROSTAT
CAPITAL MANAGEMENT

# A Retiree Shouldn't Be Asked to Behave Their Way Out of a Portfolio Construction Problem

**Why behavioural coaching should complement, rather than substitute for, prudent retirement portfolio construction**

**By Craig Racine – Managing Director & CIO, Gyrostat Capital Management**

## Executive summary

Behavioural finance has significantly advanced our understanding of how investors respond to market uncertainty. Financial advisers therefore perform an important role in helping clients remain disciplined during periods of market stress and avoid decisions that may permanently impair long-term investment outcomes.

Retirement, however, changes the nature of the problem. Once investors begin drawing upon accumulated savings, market declines are no longer solely a behavioural challenge. Withdrawals continue regardless of market conditions, capital becomes increasingly difficult to replace, and adverse return sequences can permanently affect retirement outcomes.

This creates an important distinction between behavioural coaching and portfolio risk management. **Behavioural coaching can help an investor respond to risk, but it does not manage the underlying portfolio risk itself. For retirees, behavioural coaching should therefore sit beneath an umbrella of substantive retirement portfolio construction.**

Prudent retirement stewardship begins by considering the different functions the portfolio needs to perform: **Growth, Defensive, Retirement Income and Retirement Portfolio Resilience**. Each addresses a different retirement requirement. Together they provide a framework for considering the distinct portfolio functions required throughout retirement.

**A retiree should not be asked to behave their way out of a portfolio construction problem.**

## Behavioural finance introduced the human investor

Traditional investment theory has often begun with a rational investor making decisions based upon available information, risk and expected return. Behavioural finance introduced a more human perspective.

The work of Kahneman and Tversky demonstrated that investors do not necessarily experience gains and losses symmetrically, while subsequent behavioural research examined how loss aversion, framing and the frequency with which investors observe portfolio outcomes can influence financial decisions.

These insights have important implications for financial advice. Advisers do more than construct portfolios; they also help investors understand uncertainty, maintain perspective during difficult markets and avoid unnecessary decisions driven by fear.

For accumulation investors, this behavioural support operates alongside several natural sources of recovery capacity. Employment income continues, regular contributions can be maintained, lower asset prices may allow additional capital to be invested and there may be decades available for markets and earnings to recover.

## Retirement changes the capacity to recover.

As investors transition from accumulation to decumulation, employment income and regular contributions generally reduce or cease while portfolio withdrawals begin. Capital accumulated over a working lifetime becomes increasingly difficult to replace.

The existing Retirement Portfolio Resilience research describes this transition simply:

**Natural recovery capacity declines while loss-aversion sensitivity rises.**

A retiree's concern following a significant market decline should therefore not automatically be regarded as an irrational behavioural response. **A falling portfolio combined with continuing withdrawals can represent a genuine deterioration in the range of future retirement outcomes.**

This is the mathematical foundation of sequence-of-returns risk. Two retirees can experience identical average investment returns but materially different retirement outcomes simply because those returns occur in a different order.

The distinction between accumulation and retirement is therefore not simply that retirees may feel losses more acutely. **The financial consequences of those losses can also be different.**

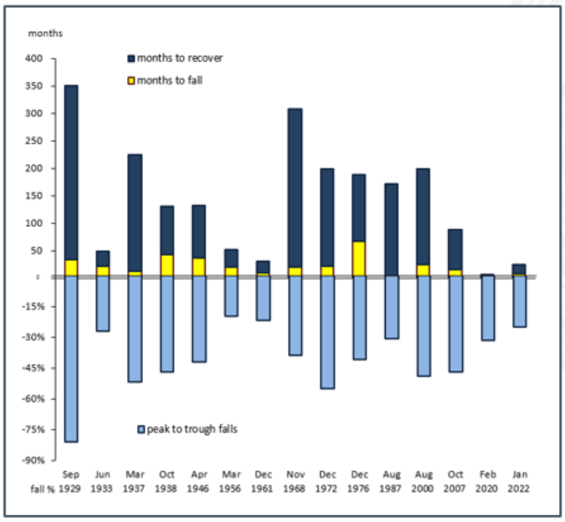
## The retiree experiences one market path

Retirement modelling can examine thousands of possible future market paths and provide valuable information about the range and probability of potential outcomes. This remains an important part of retirement planning.

The retiree, however, does not experience the average of those possible paths. They experience one uncertain path through time while continuing to fund their retirement.

This distinction becomes particularly important when considering market recovery. Major equity markets have historically recovered from significant declines, **but the time required has varied considerably.** A review of major S&P 500 declines over approximately 90 years demonstrates that significant falls are a recurring feature of long-term markets, with recovery periods varying materially across market cycles.

## *Investment cycles – major sell offs a regular feature*




S&P 500 Index - 90 Year Historical Chart: Peak to trough falls > 20%, duration of falls, time to recover to pre fall levels

The graph shows the extent of falls from peak to trough S&P 500, the duration of the fall, and time taken to recover to pre fall highs.

*Source: http://www.macrotrends.net/2324/sp-500-historical-chart-data*

The relatively rapid recoveries following the most recent major declines have been historically favourable. However prudent retirement stewardship should not assume that future recoveries will necessarily occur as quickly.

For a retiree, this distinction matters because withdrawals continue throughout the recovery journey. Cash spent during that period is no longer invested when markets subsequently rise. The market returning to its previous high therefore does not necessarily mean that the retiree's capital has recovered to the same position.

**“Markets eventually recover” is an observation about markets. It is not a retirement risk-management strategy.**

**A cash reserve or retirement-income bucket can provide valuable time. History shows recovery has sometimes taken longer than that reserve lasts.**

**If the recovery outlasts the reserve, the retiree remains exposed to sequence-of-returns risk.**

## Portfolio construction comes before behavioural coaching

Prudent retirement portfolio construction already recognises that retirement requires different functions to be addressed. Growth assets can support long-term capital growth and purchasing power. Defensive assets, including cash and fixed interest, can provide stability and liquidity, while bucketing can help fund near-term expenditure without requiring growth assets to be sold during adverse markets. Retirement Income addresses how sustainable income will be delivered throughout retirement.

Each performs an important function. The question is whether the portfolio has also intentionally addressed the distinct risks created when withdrawals continue through an adverse sequence of returns and when the investor must remain committed throughout the market path.

## Retirement Portfolio Construction Checklist

- ☐ **Growth**
  How will long-term capital growth support purchasing power throughout retirement?
- ☐ **Defensive**
  How will capital stability, liquidity and cash reserves help manage market uncertainty?
- ☐ **Retirement Income**
  How will sustainable retirement income be delivered throughout retirement?
- ☐ **Retirement Portfolio Resilience**
  How will sequencing risk and behavioural survivability be addressed so investors remain financially and emotionally invested throughout their retirement journey?

**Where a Retirement Portfolio Resilience allocation is being considered, the framework then moves from portfolio function to construction and evidence.**

**Five Pillars of Retirement Portfolio Resilience**

1. Sequencing-Risk Awareness
2. Behavioural Survivability
3. Risk-Pricing Discipline
4. Retirement Portfolio Construction
5. Resilience Across Market Environments

**Two objective evidence tests**

1. How has the allocation actually performed during significant market falls?
2. How dependent have outcomes been on the direction of equity markets across different market environments, including through measures such as beta?

## From Sequencing Resilience to Retirement Portfolio Resilience

Sequencing Resilience addresses an important mathematical problem: whether a retirement portfolio can withstand an adverse sequence of returns while withdrawals continue.

Retirement Portfolio Resilience is broader.

Retirees do not experience a mathematical model. They experience one uncertain market path, through time, while continuing to fund their retirement. The path may include a major decline, a prolonged recovery, repeated rallies and reversals, extended sideways markets or periods of strong investment returns.

This introduces a human dimension alongside the mathematics.

**Sequencing Resilience asks whether the mathematics can survive an adverse path. Retirement Portfolio Resilience asks whether the portfolio and the person can remain resilient throughout whatever path markets take.**

This distinction explains why Behavioural Survivability forms part of Retirement Portfolio Resilience alongside Sequencing-Risk Awareness, Risk-Pricing Discipline, Retirement Portfolio Construction and Resilience Across Market Environments.

## Behavioural coaching needs an umbrella of substance.

Behavioural coaching remains an important part of financial advice. Even appropriately constructed retirement portfolios will experience uncertainty and periods of negative returns, and advisers play an important role in helping clients understand their strategy and avoid unnecessary decisions during those periods.

The question is what sits behind that coaching.

**Behavioural coaching should not be expected to compensate for portfolio risks that should reasonably have been considered through retirement portfolio construction.** The portfolio should first address the risks that can reasonably be managed through portfolio construction. Behavioural coaching can then help the investor remain committed to that substantive architecture.

Put simply:

**Do not ask the investor to supply through behaviour what the portfolio should reasonably have supplied through construction.**

This does not mean that retirement portfolios should avoid all losses, nor does it prescribe a particular asset allocation or investment strategy. **It means that prudent stewardship should consider the financial consequences of adverse market paths before asking the investor to withstand those consequences behaviourally.**

## Behavioural Survivability begins before markets fall

Behavioural Survivability should therefore not be understood simply as teaching investors not to panic.

The existing educational series defines Behavioural Survivability as **the capacity of both the investor and the retirement portfolio to endure the full path of market decline and recovery without decisions that permanently impair the retirement strategy**.

The inclusion of both the investor and the portfolio is important. Retirement portfolio construction can influence the financial experience the investor is subsequently asked to tolerate, while behavioural coaching can help the investor remain committed to an appropriately constructed strategy.

This suggests a useful stewardship question. When markets fall and a retiree becomes concerned, an adviser may naturally ask how to help the client remain invested. Retirement Portfolio Resilience suggests another question should already have been considered:

**Was the portfolio constructed so that remaining invested would be a reasonable thing to ask of this client?**

**Conclusion**

Behavioural finance taught investment professionals to recognise that investors are human. Retirement requires portfolio construction to recognise that those human beings experience one uncertain market path while drawing upon finite and increasingly difficult-to-replace capital.

Sequencing Resilience addresses the mathematics of an adverse sequence. Retirement Portfolio Resilience is broader, bringing together mathematical and behavioural survivability within a portfolio-construction framework designed for retirement.

Growth remains necessary. Defensive assets and bucketing can provide stability, liquidity and time. Retirement Income can support the delivery of sustainable income. Retirement Portfolio Resilience complements these functions by reducing dependence on favourable market paths and helping investors remain financially and emotionally invested throughout retirement.

Behavioural coaching has an important role within that architecture, but it should complement substantive retirement portfolio construction rather than substitute for it.

**A retiree should not be asked to behave their way out of a portfolio construction problem.**