



When Not Investing Could Make You More Money than a 6% Average Annual Return

Description

If I told you that with the same principal investment, the same taxes, the same rate of withdrawal, the same accounting and calculation methods, and the same time frame, I could give you more money with a 0% average annual return, which would leave you with more money in ten years than an investment with a 6% average annual return, would you believe it?

Read on.



from xkcd.com

One of the key facts one must keep in mind when planning for economic confidence is that sequence of returns matters. At the decumulation stage, the sequence of returns on your investment is critical and will have a multiplier effect on your overall asset values. Let me explain.

When you are accumulating assets, provided there are no withdrawals, the sequence of returns doesn't matter. So, if you invested \$100,000 for 10 years, whether the returns were high early on and low later, or low early on and high later, would not make a difference.

Year	Rate of Return (Starts High)	Annual Gain or Loss	Value at end of the year	Rate of Return (Starts Low)	Annual Gain or Loss	Value at end of the year
1	30%	\$ 30,000.00	\$130,000.00	-30%	-\$30,000.00	\$ 70,000.00
2	20%	\$ 26,000.00	\$156,000.00	-20%	-\$14,000.00	\$ 56,000.00
3	10%	\$ 15,600.00	\$171,600.00	10%	\$ 5,600.00	\$ 61,600.00
4	10%	\$ 17,160.00	\$188,760.00	10%	\$ 6,160.00	\$ 67,760.00

5	10%	\$ 18,876.00	\$207,636.00	10%	\$ 6,776.00	\$ 74,536.00
6	10%	\$ 20,763.60	\$228,399.60	10%	\$ 7,453.60	\$ 81,989.60
7	10%	\$ 22,839.96	\$251,239.56	10%	\$ 8,198.96	\$ 90,188.56
8	10%	\$ 25,123.96	\$276,363.52	10%	\$ 9,018.86	\$ 99,207.42
9	-20%	-\$ 55,272.70	\$221,090.81	20%	\$ 19,841.48	\$119,048.90
10	-30%	-\$ 66,327.24	\$154,763.57	30%	\$ 35,714.67	\$154,763.57

When there are no withdrawals the sequence of returns doesn't make a difference

At the end of 10 years your average annual rate of return is 6% for both (i.e. $[(30 + 20 + 10 + 10 + 10 + 10 + 10 + 10 + (-20) + (-30)) / 10 = 6\%$ and $[(30 + 20 + 10 + 10 + 10 + 10 + 10 + 10 + (-20) + (-30)) / 10 = 6\%])$ and in both cases you have \$154,763.

However, what happens if you need to use some of this money for other investments or you're retired and using it for an income? Let's look at the same scenario again only now we are going to withdraw \$6,000 at the end of every year. How different do you think the end result will be?

Year	Rate of Return (Starts High)	Value at beginning of year	Value at end of the year	Rate of Return (Starts Low)	Value at beginning of year	Value at end of the year
1	30%	\$ 100,000.00	\$124,000.00	-30%	\$ 100,000.00	\$ 64,000.00
2	20%	\$ 124,000.00	\$142,800.00	-20%	\$ 64,000.00	\$ 45,200.00
3	10%	\$ 142,800.00	\$151,080.00	10%	\$ 45,200.00	\$ 43,720.00
4	10%	\$ 151,080.00	\$160,188.00	10%	\$ 43,720.00	\$ 42,092.00
5	10%	\$ 160,188.00	\$170,206.80	10%	\$ 42,092.00	\$ 40,301.20
6	10%	\$ 170,206.80	\$181,227.48	10%	\$ 40,301.20	\$ 38,331.32
7	10%	\$ 181,227.48	\$193,350.23	10%	\$ 38,331.32	\$ 36,164.45
8	10%	\$ 193,350.23	\$206,685.25	10%	\$ 36,164.45	\$ 33,780.90
9	-20%	\$ 206,685.25	\$159,348.20	20%	\$ 33,780.90	\$ 34,537.08
10	-30%	\$ 159,348.20	\$105,543.74	30%	\$ 34,537.08	\$ 38,898.20

Even with the same 6% average annual return the difference between an early high return vs an early low return is \$120,450.

What is more, if you started with low rates of return in the early years, you would have had \$1,101.80 more if you hadn't invested anything at all.

In fact, if you invested in a GIC that paid just 2% a year for 10 years, you'd have \$21,664.04 more, with no volatility, than you would have had with a market investment that returns 6% on average annually.

Please note: I am not suggesting that market investments are bad, but rather that you need a plan and to do things in the right order to maximize your economic effectiveness.

CATEGORY

1. Financial Planning
2. Wealth Creation & Economic Confidence

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