SWAN GLOBAL INVESTMENTS

Fixing Fixed Income

The Case for Systematic Withdrawals

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The Case for the Defined Risk Strategy as a Systematic Withdrawal Vehicle

In a previous blog post, we compared the risk-return characteristics of the Swan Defined Risk Strategy (DRS) against traditional and alternative bond strategies. The idea was to illustrate how the DRS, with its focus on capital preservation, has performance metrics similar to the multi-sector and non-traditional bond funds that have been making their way into investor portfolios.

But beyond capital preservation, what about the other role bonds have traditionally performed within a portfolio, that of producing income? Since the Financial Crisis, it has been the lack of yield in traditional fixed income that had pushed investors to multi-sector and non-traditional bonds in the first place.

Reconsidering Ways to Generate Income or Cash-Flow

We live in a low-yield environment spawned by a “new normal” of worldwide monetary policy focused on stimulating with ultra-low or even negative interest rates and massive liquidity injections into the financial system. Consequently, bonds will be hard pressed to provide the same return streams going forward as they have over the past 35+ years. In this new investment landscape, savers and retirees are starved of yield (income). This will require investors and advisors to reconsider how to generate the necessary cash flow in retirement.

Systematic withdrawals are an option, provided investors minimize exposure to major losses in bear markets, as explained in our post "Suffering from Withdrawals." However, an investment strategy that can minimize large losses and generate consistent returns over market cycles may sustain systematic withdrawals. While investors and advisors alike may also struggle with the notion of actively withdrawing funds versus clipping a coupon, the reality of our low-yield environment is necessitating a change in perceptions for how to generate sustainable cash-flow in retirement.

So How Does the Swan DRS Perform as a Systematic Withdrawal Vehicle?

Because the DRS has historically been limited to single-digit losses in its worst years and has had meaningful participation in up markets, one could make the case it fulfills the role of a distribution vehicle in a portfolio.

To be clear, the DRS does not generate yield like a traditional bond fund with a monthly distribution. Instead, the DRS can be used within a systematic withdrawal plan.

Historically, one could have safely liquidated a percentage of their DRS holdings to generate cash and yet not endanger principal. In fact, if someone implemented a systematic withdrawal plan with the DRS at its inception, the principal value of a *DRS investment still grew*.

Setting the Scene

Let us walk through a simple, hypothetical scenario:

- Our initial investment of $1 million dollars invested is made on January 1st, 1998.
- We have three investment options: the DRS, the S&P 500, and a balanced portfolio of 60% S&P 500 and 40% Barclays US Aggregate.
- We take out $5,000 on a monthly basis with an initial annual withdrawal rate of 6%
- We compound the withdrawals by an annual inflation rate of 2%.

Due to inflation, the original $60,000 withdrawal grows to $87,409 by the end of 2017.

At the end of the simulation on December 31st, 2017, an aggregate $1,457,842 had been withdrawn from each option. However, the ending values were quite different:

Scenario	Total Withdrawal	Ending Value
DRS*	$ 1,457,842	$ 1,452,335
60/40	$ 1,457,842	$ 568,369
S&P 500	$ 1,457,842	$ 393,447

Source: Zephyr StyleADVISOR and Swan Global Investments. *Based on historic performance of the Swan DRS SMA Select Composite, period from January 1998 through December 2017. Indices are unmanaged and cannot be invested into directly. Past performance is no guarantee of future results.

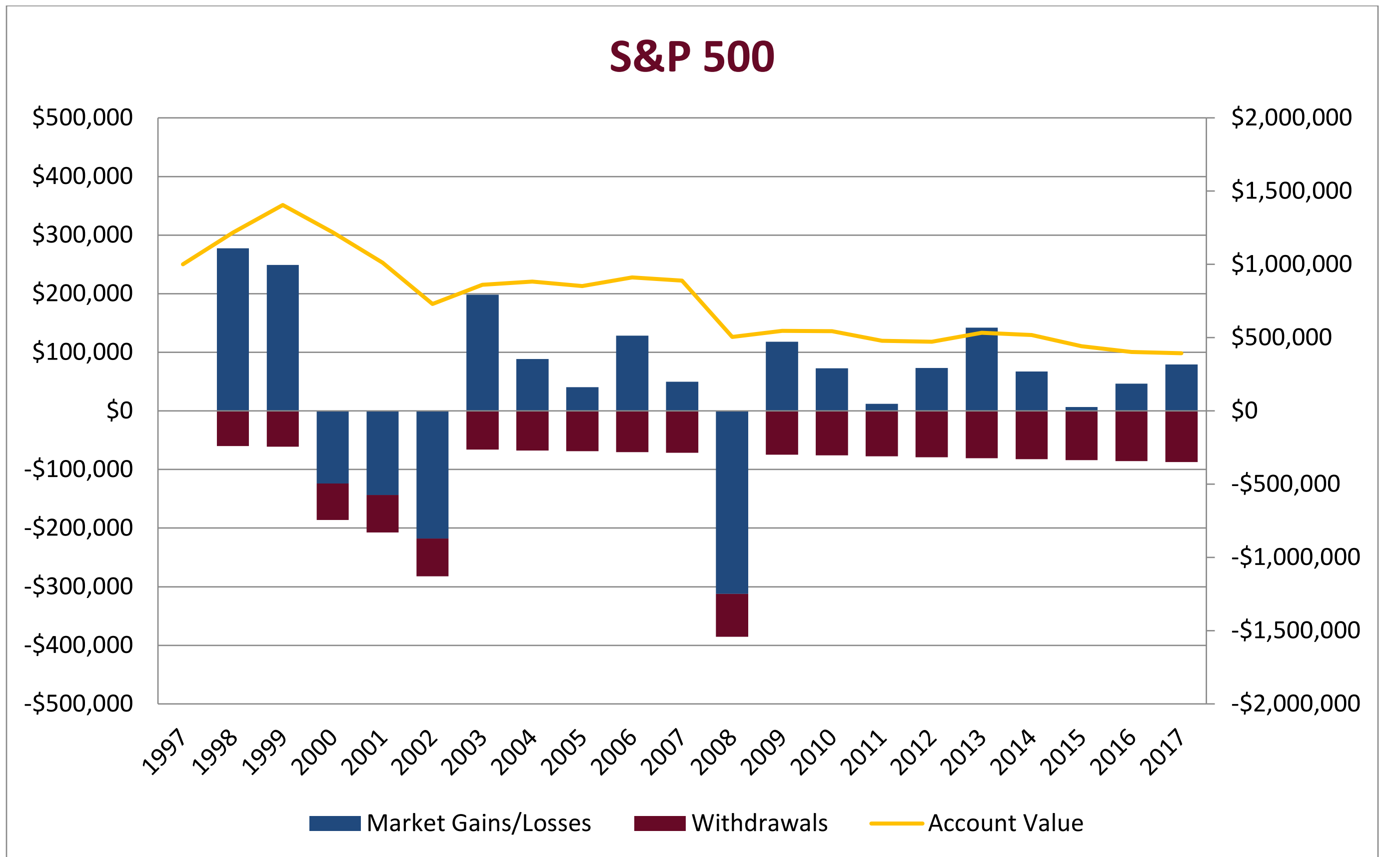
How is this possible? How can the ending values be so different? Let's take a look at each investment broken out on a year-by-year basis starting with the S&P 500.

Withdrawals and the S&P 500

In the graph below, the red/burgundy lines represent the yearly systematic withdrawals of $60K, compounded by the 2% annual inflation rate. These will always be negative. The blue bars represent the unrealized gains and losses of the account.

While usually stated in percentage terms, here we see gains and losses stated in terms that most people care about: dollars gained or dollars lost.

Finally, the gold line represents the value of the account.



Source: Zephyr StyleADVISOR & Swan Global Investments. Indices are unmanaged and cannot be invested into directly. Past performance is no guarantee of future results. The charts and graphs contained herein should not serve as the sole determining factor for making investment decisions.

When someone says the S&P 500 lost 37% in 2008, what does that really mean?

In the context of this scenario, the $312,352 losses in the account in 2008 represents over four years of spending. The three-year bear market of 2000-02 was arguably worse since it lasted longer and the market took longer to recover. The unrealized losses were $485,097 and withdrawals of $191,042 were taken out over those three years.

Although markets did rally between 2003 and 2007, the portfolio had been seriously impaired by the long bear market.

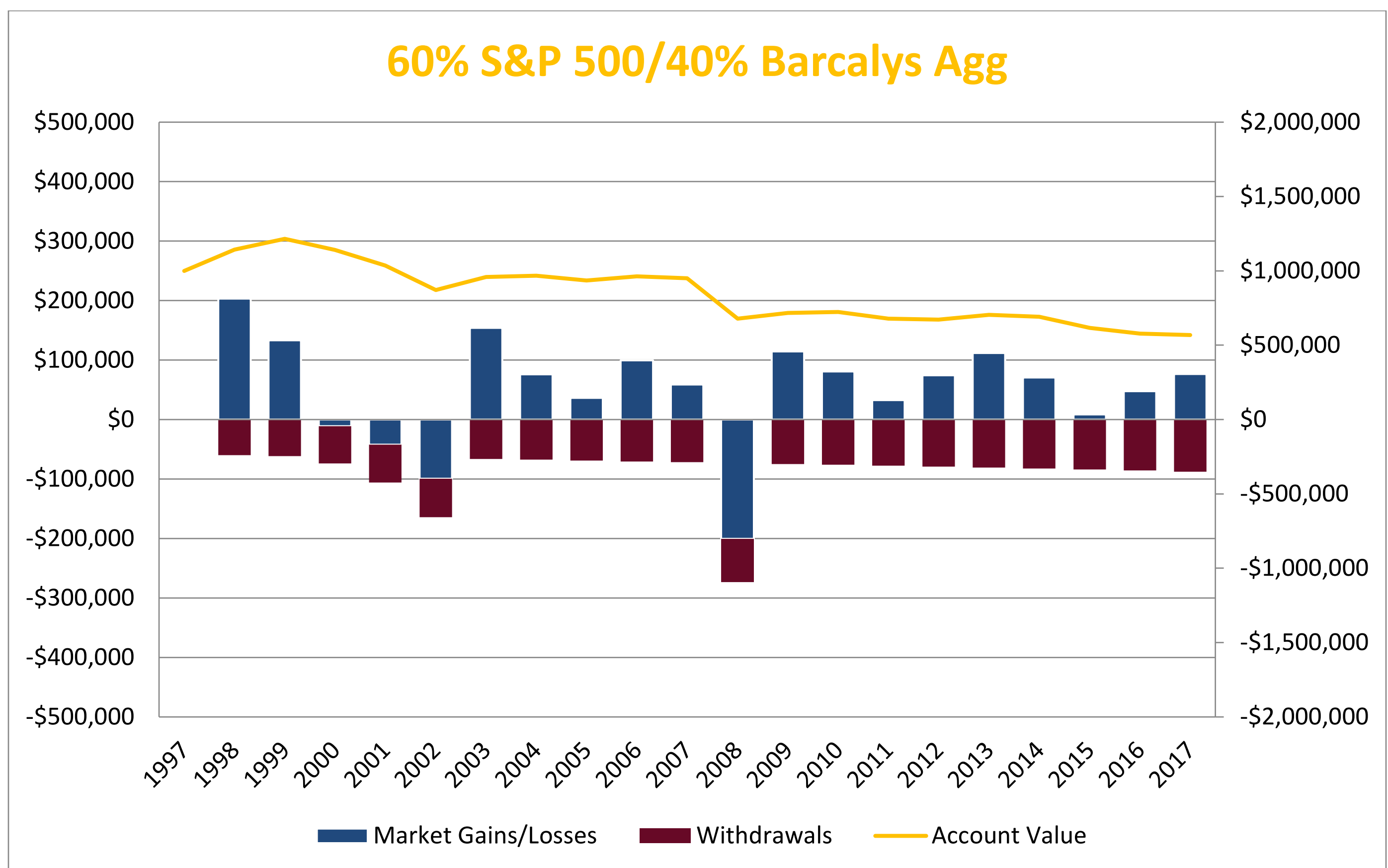
Is a bull market enough to cover these losses?

The above analysis is sobering. Please keep in mind that the current U.S. bull market is the second longest on record, and the S&P 500 is up over 308.5% since March 9, 2009 to August 6, 2018. However, if one were to look at the gold line through that period, it is essentially flat. From 2009 to 2017 the unrealized gains were $617,179 while withdrawals were $727,719.

Through this amazing bull market, the portfolio was essentially treading water.

Withdrawals from the 60/40 Balanced Portfolio

The story isn't much different with the balanced 60/40 portfolio. Although the highs aren't as high, and lows aren't as low, the general picture remains the same.

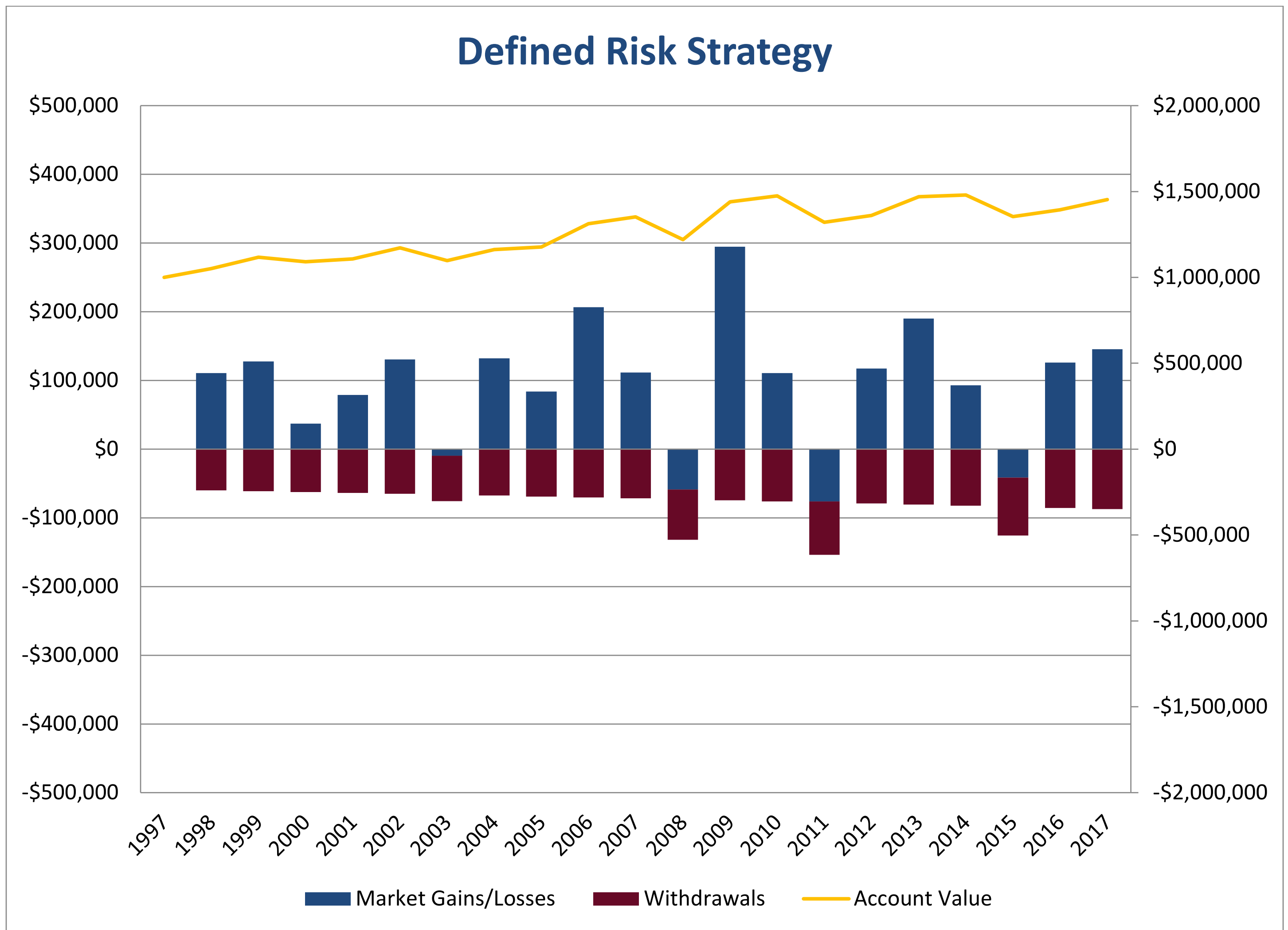


Source: Zephyr StyleADVISOR & Swan Global Investments. Indices are unmanaged and cannot be invested into directly. Past performance is no guarantee of future results. The charts and graphs contained herein should not serve as the sole determining factor for making investment decisions.

A "glass-half-full" optimist would argue that the portfolio has maintained a fairly aggressive level of withdrawals and is holding up well during the distribution stage. Conversely, a "glass-half-empty" pessimist would wonder how many more years of spending the portfolio could maintain and would be rightfully frightened of another bear market sell-off.

Withdrawals with the Defined Risk Strategy

Finally, we see the same scenario using the Defined Risk Strategy. In the 20 years of this study, the DRS Select Composite has only had four years of losses and the average unrealized loss during those years was $46,499.

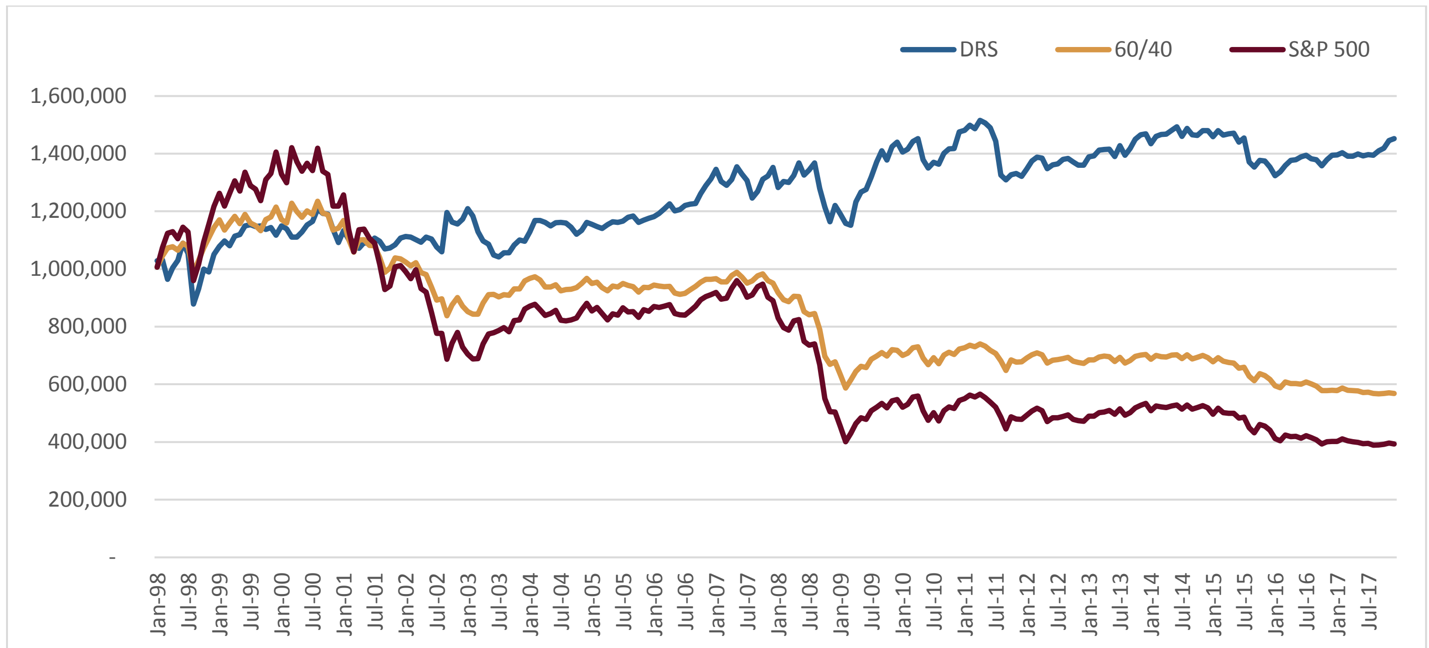


Source: Zephyr StyleADVISOR & Swan Global Investments. Indices are unmanaged and cannot be invested into directly. Past performance is no guarantee of future results. DRS results are from the Select Composite, net of fees, as of 12/31/2017. The charts and graphs contained herein should not serve as the sole determining factor for making investment decisions.

The worst calendar year in the DRS's history was 2011 when it was down -5.4%. During that year, the unrealized loss ($76,154) was roughly equal to one year of spending ($77,616).

Most importantly, the DRS was able to grow its account value throughout the course of this simulation while maintaining the same levels of withdrawals as the S&P 500 and the 60/40.

The final graph below compares the account value of these three options against each other.



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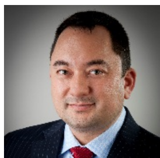
Continuing the Conversation

The Swan DRS can serve various roles in a portfolio. We have made the case for how this unique investment approach can serve investors looking to accumulate wealth and those needing cash-flow or distributions to live on in retirement. We will continue the Where the DRS Fits blog series in future posts examining how the Swan DRS can be applied to multiple asset classes.

About the Author



Marc Odo, CFA®, CAIA®, CIPM®, CFP®, Client Portfolio Manager, is responsible for helping clients and prospects gain a detailed understanding of Swan's Defined Risk Strategy, including how it fits into an overall investment strategy. Formerly, Marc was the Director of Research for 11 years at Zephyr Associates.

Important Disclosures

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nonqualified discretionary accounts invested in since inception, July 1997 and are net of fees and expenses. All data used herein; including the statistical information, verification and performance reports are available upon request.

The benchmarks used for the DRS Select Composite are the S&P 500 Index, which consists of approximately 500 large cap stocks often used as a proxy for the overall U.S. equity market, and a 60/40 blended composite, weighted 60% in the aforementioned S&P 500 Index and 40% in the Barclays US Aggregate Bond Index. The 60/40 is rebalanced monthly. The Barclays US Aggregate Bond Index is a broad-based flagship benchmark that measures the investment grade, US dollar-denominated, fixed-rate taxable bond market. The index includes Treasuries, government-related and corporate securities, MBS (agency fixed-rate and hybrid ARM pass-throughs), ABS and CMBS (agency and non-agency). Indexes are unmanaged and have no fees or expenses. An investment cannot be made directly in an index. Swan's investments may consist of securities which vary significantly from those in the benchmark indexes listed above and performance calculation methods may not be entirely comparable. Accordingly, comparing results shown to those of such indexes may be of limited use.

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