#69

Minimize Your Portfolio Risk

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You may be bearing down on retirement with a full head of steam. It's going to be a fast-paced schedule of skydiving, casino trips, and adventure travel for you, right? When it comes to your retirement nest egg, however, you may want to check some of that adventure mentality at the door. Without the right amount of risk in your portfolio and a clear idea of your needs, you may find yourself having to ratchet back your recreation plans — not because you're physically unable but because you can't afford them. In this strategy, you discover how to handle investment risks.

Assess Your Need for Income

You can't assess the risks to your portfolio if you don't know for sure what you need to live on. Therefore, your first step is to assess how much income you'll likely need in retirement.

Identify your basic needs foundation

If you were building a house, would you start by figuring out what kind of doorknobs and decorative lighting you wanted? Hopefully, your first concerns would be a solid foundation and structural design. The foundation of a solid retirement income plan involves knowing your basic living expenses, especially in uncertain times. Even if you're fortunate enough to have substantial savings, it's important to know at a detailed level your basic ongoing living costs.

The old rule of needing 70 to 80 percent of your current income during retirement may or may not apply to you. Do you pay significant job-related expenses like commuting costs, clothing, or professional fees? Yes, these will go down, but things like medical and long-term care insurance and travel and leisure costs will probably go up.

Accept the importance of a (yawn) budget

Fact is, everyone's needs are different, and needs differ from wants and luxuries. Thinking about what you could live without isn't fun, but it's worth taking the time to identify precisely what you need to live on so you can find a way to get a secure income stream or safe assets to support it.

This is where a budget comes in. Look through recent credit card and bank statements. Enter your must-have monthly expenses on a worksheet. Budget tools are available in most personal finance software, or you can do an online search for "budgeting terms." After you enter your current numbers, do a retirement version. Think through it item by item. If your monthly need is greater than your monthly income, the difference must come from your portfolio.

Assess Your Need for Liquidity

Having enough accessible liquid assets on hand when major needs arise is critical, not only to your mental stability but also to protecting your portfolio in uncertain markets. The last thing you want to do is to sell assets in a down market to cover living expenses or a vacation.

REMEMBER

Retirement budgeting starts with knowing what you need and when you need it. Basic expenses come first. Make sure you plan for other major expenditures outside your regular budget, such as car replacements, home maintenance projects, or maybe leisure travel. A goal tree that identifies these major liquidity events can help.

Make Sure the Funds Are There

When you know your needs, work on protecting the nest egg you've accumulated. This section explains how to limit investment risks and make sure the money will be available when you need it.

Increase returns while decreasing risk

TOUGH TIMES

In an uncertain market, the key to managing risk is diversification. By combining different types of investments, you can get the major benefit of diversification: a relatively high rate of growth, with smaller fluctuations in total value from year to year.

The most common measure of investment risk is called *standard deviation.* Standard deviation measures *volatility,* or how much annual returns deviate from average returns. High volatility means the security's value goes drastically up or down from one year to the next. Consider two baseball players: They have the same number of total bases, but one hits singles every time, while the other swings for the fences, striking out a lot, but also hitting more home runs. Same average, different standard deviation.

Standard deviation — and growth potential — differs for different types of securities:

- Stocks, which produce the highest long-term returns, have higher standard deviations than bonds.
- Small company stocks are more volatile but grow more than large company stocks.
- International company stocks, especially those from emerging markets like India and China, have even higher returns and standard deviations.

The neat thing for investors is that the returns produced by these different types of investments don't move in the same direction at the same time. Their returns aren't correlated. So when stocks are down, bonds may be up. When U.S. markets are in the doghouse, Asian companies' stocks may be booming.

Investing in non-correlated securities produces reduced volatility (or risk) *and* higher returns. Say you have half your money in a U.S. stock fund and the other half in a bond fund. Although the return on the portfolio is simply the average returns of the two funds, the standard deviation, or risk, of the two combined is *less* than the average of the two funds' individual standard deviations.

Manage other risks to your portfolio

In addition to volatility of individual securities, you also face risks related to your life span, market changes, and more. Table 69-1 explains how to minimize risks.

Table 69-1 Risk Management

Risk	***Definition***	***Management Techniques***
Longevity risk	The risk you'll outlive your money	Make sure you have a sensible withdrawal rate. Know what you need for big purchases and for basic expenses. Consider a no-load, low-cost immediate annuity to guarantee an inflation-adjusted lifetime stream of income, at least sufficient to cover basic needs that Social Security and any pension benefits don't cover.
Liquidity risk	The risk that you won't have the cash on hand when you need it, forcing you to sell assets in a down market	Assign chunks of your money to each major goal. Plan to have more accessible liquid assets, such as short-term bonds and cash, in those accounts as the time approaches.

Inflation risk	The risk inflation will outpace the return on your investments, reducing your purchasing power	Long-term inflation is close to 4%; underestimating the effect of price increases can put your portfolio and income stream at risk. Use a realistic inflation factor in your planning. Make sure you have enough equity in your mix to grow your long-term money faster than inflation.
Market risk	The risk that stock and bond markets as a whole will fall	Get a mix of stocks, bonds, and cash that make sense for your risk tolerance and time horizon.
Manager risk	The risk that you'll pick the wrong money manager, your manager will leave, or your actively managed mutual fund will do worse than the market on a risk-adjusted basis	Consider using index mutual funds or exchange-traded funds (ETFs) that attempt to match the performance of their given market sector. Be happy with what the markets give you and enjoy the lower costs.

Follow an investment strategy

When you know the amount for basic living expenses and major goals, use the technique in Table 69-2 to minimize the risk and ensure liquidity for the retirement-funds part of your portfolio.

Table 69-2 Balancing Risk and Liquidity

Account	***Amount***	***Invested In***		***Refill***
Your local bank or credit union	One year's living needs + any goals due this year	50% savings	50% CDs tied to goal dates	From cash reserve account annually
Cash reserve account	Two years' living needs + goals due in two and three years	25% money market	75% high-quality short-term bond fund	From investment portfolio when rebalancing
Investment portfolio	Remainder	Your targeted cash allocation*	Your targeted bond allocation*	From your targeted stock allocation*

**Allocations would be adjusted for bonds and cash held in bank and cash reserve accounts.*