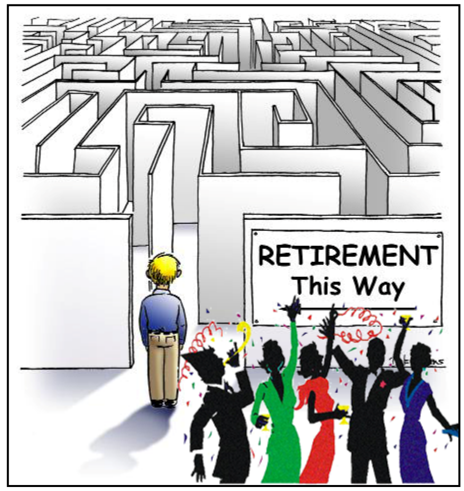
Leaving The Party Early

Navigating the Retirement Maze



"There are no safeguards that can protect the emotional investor from himself."

- J. Paul Getty

Thus far in 2013, the U.S. stock markets have been having a party at the expense of fixed income investors. The S&P 500 is up 15% for the year, and the financial media continues to cheer the averages higher. Beginning in January, many investors moved from bonds into stocks, as they grew tired of the paltry yields available from Treasuries. Why settle for 2% on a 10-year T-bond when many stocks are offerings 3% yields?

Well, in a word: risk. While you are waiting for the market gods to bestow more wealth on your portfolio, ask yourself a few key questions that will help determine how you ought to be investing, which should have less to do with current market exuberance and more with your long-term goals. Forget for the moment how much your portfolio has made this year, and focus instead on where you need to be ten or twenty years from now. Retirement investing isn't a sprint. It's a marathon.

What Goes Up…

The biggest risk in getting back into the stock market after having sat out the past four years is that you've already missed most of the run-up following the 2008-09 market collapse. As of January, the S&P 500 had already recovered nearly all of its earlier losses. When you hear market prognosticators state: "The market is still undervalued…", you need to know that the rest of the sentence should read: "… when compared to current low interest rates." The Federal Reserve has been artificially suppressing interest rates for several years now. When there are signs that this might come to an end, so will the rally in stocks. Observe what happened in early June when Bernanke implied that the Fed's current stimulus policies might soon taper off. The market dropped 2% in two days.

A key measure of risk tolerance is how much you are willing to lose in a market downturn. From its peak in 2007, the S&P 500 sank by more than half by 2009. If you're in your 40s, you have another 20-plus years to recover from a loss of that magnitude. If you're retired, though, each dollar that you withdraw after a market crash would represent a higher percentage of your retirement savings.

In Diversification We Trust

Put all of your eggs in the S&P 500 basket, and you risk losing much of the basket. Diversifying across a range of asset classes gives you a better chance of reducing your downside risk. Diversification means more than just stocks and bonds. Other asset classes – real estate, oil and gas, non-US stocks and bonds, and even precious metals – will help mitigate some of your downside in the event of a market downturn. Even holding some of your funds in that anathema of up-market assets – cash – isn't a bad idea. In fact, if you're planning to spend it within the next year, that's the best place to keep it.

Beware the Bear

Right now, the stock market party is going full blast, with the band playing "Happy Days Are Here Again." At times like this, emotions can override logic and it's difficult to remember that we're still in a secular (i.e., long-term) bear market. So don't start believing that you're in the early stages of a longer term bull market. Treat your returns in 2013 as a gift from the Fed, and start thinking about protecting some of your gains before the party ends. No one likes to be the last person out the door, especially at the stock market party.

If You've Already Won the Game

If you have been a diligent retirement saver, and have invested prudently so that your nest egg is large enough to carry you through retirement, congratulate yourself. You've already won "The Retirement Game." In this situation, you should heed the words of investment author William Bernstein: "When you have won the game, stop playing." In other words, why put your retirement assets at risk in a volatile market just to gain a few extra dollars that you don't need? This is when you should focus on creating a conservative income-generating portfolio, and leave growth stocks to the youngsters. As for the rest of you, get on with saving aggressively for your retirement. Don't stay at the stock market party too long, or you may not have as much to invest when the next one begins.

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