Controlling Risk When Investing Near Retirement

Investors should know their tolerance for investment risk and learn how to protect their retirement savings as they approach retirement.

Managing investment risk takes on added importance for retirement investors as the day of their retirement draws ever closer. If you are within a few years of the date you plan to retire, you'll want to pay close attention to the different types of investment risk you face and develop approaches for protecting your retirement nest egg from large losses that would adversely affect your retirement. As a long-term investor, you likely have an asset allocation strategy and a diversified portfolio. That means that you can potentially weather volatility in the financial markets since stocks and bonds have traditionally delivered positive returns over the long haul. However, the long-term record does not offer much comfort if your retirement plan portfolio declines 15% and you cannot retire on the date you planned. So, your goal should be to find a way to reach your retirement goal with the least amount of risk possible.
To do that, you'll need to understand your tolerance for investment risk.

Assess Your Comfort Level

Risk tolerance is the ability to handle the chance of losses from an investment in exchange for the possibility of higher returns. You can gain a fairly good understanding of your comfort level for risk by answering these questions:

When will you need the money?
Making investment decisions based on the number of working years you have ahead of you is a key to successful retirement investing. If you are planning to retire in five years or less and your retirement plan portfolio is heavily invested in stocks, it may make sense to realign your investments. That could mean cutting back on stocks and increasing the percentage of your portfolio allocated to bonds and cash. You are, essentially, moving away from a largely growth-focused strategy to one that seeks to preserve any gains you may have made.

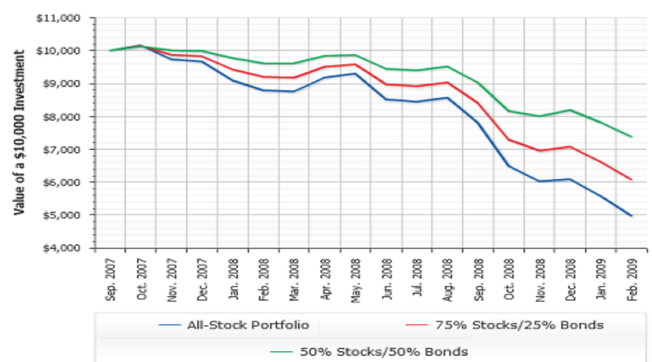
How honest are you about your capacity to handle loss?
Many investors overestimate their capacity to handle portfolio losses. Remember, to recover from an investment loss, you need to earn more than the percentage you lost. And, it may take months or even years to regain a large loss. The 2007-2009 bear market lasted almost a year and half (as measured by the S&P 500 index), and the market downturn that began in January 2022 lasted about ten months before bottoming out in October. A bear market is a decline of 20% or more, generally lasting 60 days or longer, in any broad equity index. Recovering a large investment loss could take many years -- possibly longer than you could afford to wait.

Will a big loss have a big impact on your future plans?
The impact of a loss is greater when that loss affects your future purchasing power. You'll get a better idea of your capacity to absorb losses if you view a loss in concrete terms. For example, would a loss of 15% or 20% force you to postpone plans to move to a new location? Would such a loss mean that you couldn't build that sunroom or redo your kitchen?

Manage Investment Risk

Once you have answered these questions, you will have a better understanding of how you should be investing your retirement plan money at this stage of your life. Aim to invest your plan assets in a way that can help you reach your goal of a financially secure retirement without sacrificing your emotional well-being and your ability to sleep soundly at night. The chart below demonstrates how an allocation to bonds would have reduced losses during the most recent bear market. As you can see, portfolios that were composed of a mix of stocks and bonds might have fared better than all-stock portfolios during that period. Of course, past performance is not a guarantee of future results.

Bonds Might Have Helped



Source: ChartSource®, DST Retirement Solutions, LLC, an SS&C company. For the period from September 30, 2007, through February 28, 2009. Stocks are represented by the S&P 500 index. Bonds are represented by the Bloomberg Barclays U.S. Aggregate bond index. Assumes that the bear market ended on March 9, 2009. It is not possible to invest directly in an index. Index performance does not reflect the effects of investing costs and taxes. Actual results would vary from benchmarks and would likely have been lower. Past performance is not a guarantee of future results.

Your financial professional can help you determine an appropriate asset allocation as your retirement nears.

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How Economic Cycles Impact Investing

It’s helpful for investors to understand the impact of economic cycles on investments.

It’s a certainty in investing that you cannot predict movements in the stock market on any given day, week, or month. They are unpredictable over the short term. However, the reality is that stock markets generally follow identifiable patterns over the long term. These patterns, or cycles, are closely tied to economic, social, and political factors, since some factors encourage investment and other factors make investors unwilling to risk their capital.

Understanding the positive and negative factors that impact investment and how economic cycles occur can be beneficial to all investors as they develop and refine their investing strategies.

The Four Stages in an Economic Cycle

There are four primary stages in the economic cycle -- recovery, expansion, slowdown, and recession. Investor sentiment, interest rates, corporate earnings, and employment numbers tend to be different at each stage.

1 The Recovery Stage

Job losses, declines in corporate earnings, and investor caution are the hallmarks of an economy in a tailspin. As the economy begins to regain its footing after an economic downturn, there are signs of an evident improvement in economic fundamentals. The Fed, which typically cuts interest rates during an economic downturn, begins to reevaluate the need for further cuts during the recovery stage of the market cycle. Investors also begin to reconsider investing once again in the stock market as they start to believe the worst of the downturn is over. In addition, the unemployment rate reaches bottom and businesses start hiring again during the recovery stage.

2 The Expansion Stage

Once the recovery begins to take hold, the economy begins a growth trajectory. All economic fundamentals display strength. Businesses see earnings growth and profit margins begin climbing during the expansion stage. Strong earnings growth results in an increased rate of hiring. It also drives stock prices upward. Investor sentiment is positive, and investors are no longer as fearful of risk as they were. While economic growth is healthy, the Fed typically dislikes signs that the economy is overheating. In particular, the Fed will keep a close eye on inflation. If it has any concerns, it may start to tighten monetary policy at this stage.

3 The Slowdown Stage

Late in the economic cycle, some weaknesses become evident. When the Fed hikes interest rates in order to control inflation, it results in raising the cost of borrowing. Higher interest rate payments make it harder for businesses to find the money to fund their expansion plans. Consumers pay higher interest rates on their credit cards, and higher interest rates on mortgages can shut many consumers out of the housing market.

During the slowdown stage of the economy, consumers tend to rein in spending since they are worried about job security and are dealing with higher borrowing costs. That more cautious consumer behavior, in turn, has an impact on business's sales. Since corporate earnings are likely to decline, investor sentiment may also turn more cautious. In general, investors may feel less confident about making money from investing in equities.

4 The Recession Stage

Shrinking demand within the broad economy results in lower corporate earnings. Businesses deal with shrinking demand and declining earnings by cutting back on expansion plans and hiring. Severely impacted businesses reduce employee count. Stocks and bonds in multiple segments of the markets generally decline in price and keep declining until signs of the recession ending start to appear. Generally, the economy starts climbing out of recession when the Fed's interest rate cuts begin stimulating economic activity.

Investing Strategies During Economic Cycles

Understanding the impact of economic cycles on investments can be helpful for most investors. But before making any changes a portfolio in response to a shift in the economy's direction, investors should first take the time to discuss the issue with their financial professionals.