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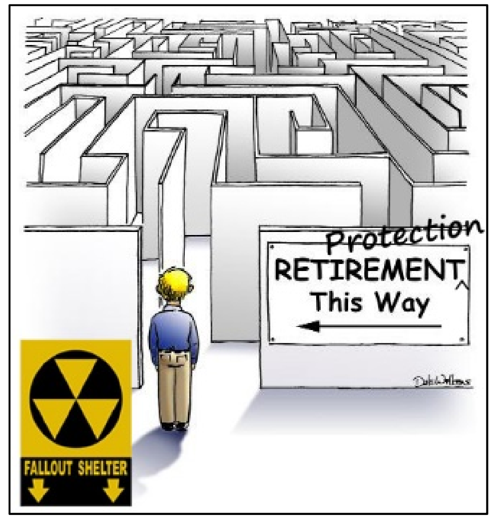
Building your financial fallout shelter

Navigating the Retirement Maze



"The Federal Reserve is not currently forecasting a recession."

– *Ben Bernanke, Federal Reserve Chairman, on January 10, 2008. The S&P 500 lost 47 percent over the next 14 months.*

Ben Bernanke's pronouncement in early 2008 can be viewed in hindsight as either incredibly naive or supremely deceptive. Either way, the financial carnage that resulted from the real estate crash of 2008-09 was a shock to most people who thought that "real estate always goes up." (Post-crash caveat: Except when it has become a "bubble.") Some people foresaw the impending train wreck – go watch the movie of Michael Lewis' book *The Big Short* if you want proof – but many people were caught off-guard, including most of the financial industry.

The resulting stock market crash and subsequent recession were devastating to companies, families, and the US economy. Even worse, many people bailed out at the bottom and didn't fully get back into stocks until four or five years later, after the market had recovered all its losses. Considering that we are into the tenth year of one of the longest bull markets, and recent market volatility has spooked even the professional investors, how should you proceed? Do nothing and hold on? Sell everything and move to cash? Something between the two? As I typically point out to clients, it all depends on your personal situation and how your portfolio assets are currently allocated.

Ray Dalio has been generous enough to distribute his firm Bridgewater Associates' extensive research on debt bubbles, *Principles for Navigating Big Debt Crises*, for free. For that, I'll nominate him for my 2018 Cassandra Award. Namely, advice that is available to all but will be ignored until it is too late. Are you ready for what the market might bring in 2019? If not, then read on.

Are you diversified? Are you sure?

When I look at the holdings of consulting clients who come to me for a portfolio review, invariably I see an excessive concentration of US stocks. This is known as "home bias." In hindsight, this has been a great strategy for the past nine years, as US markets have significantly outperformed non-US markets over that time. Going forward, though, US markets are projected to have almost zero average return the next ten years based on relative valuations and macroeconomic factors. Non-US markets are projected to outperform US markets over that time period.

Much of the problem of overconcentration on US stocks comes from the fact that most 401(k) and 403(b) retirement plans are laden with US stock fund offerings and try to appear diversified by offering growth and value funds, along with small-, mid-, and large-cap offerings. In reality, these funds tend to be correlated to each other by over 90 percent, meaning that when one falls, most of them fall.

The most robust portfolios are those that are truly diversified among their asset holdings because they have low correlations to one another, and thus can offer some ballast to your portfolio when stock markets tank. Consider making some allocations to real estate investment trusts (REITs) and oil and gas master limited partnerships (MLPs), commodities, different types of debt, and even precious metals. If you need some guidance on how much of these alternative assets you should allocate to your portfolio, check out funds that that are called "multi-asset" funds. Make sure that they are truly diversified by asset class, not just by name.

Assess your cash needs

“Buy and hold” is usually a superior strategy to market timing, as most market timers tend to get the timing wrong and end up significantly underperforming those who do nothing during market downturns. The only flaw with B&H is if your financial situation dictates that you will need cash sometime in the next several years. This can result in selling assets at or near the bottom of a market dip, and you can’t recover from a depressed asset that you have sold.

I tell my clients that they need to assess their cash requirements over the next three to five years, and to hold those assets in lower-volatility assets like money markets or short-term Treasury bonds, which are unlikely to be affected by market downturns. Another approach is to use the “bucket strategy” (which I addressed in my November 2011 column). Using this approach, cash needed within the next three to five years is held in money market accounts or similar, assets needed in five to ten years are invested in low volatility/higher yield securities, and those not needed for ten years or more – the time period during which most markets recover from crashes –are in equities.

Your “Crash Survival Kit”

The best portfolio for you is one that results in the SWAN effect: it lets you “Sleep Well At Night,” regardless of how the markets are performing, and meets your long-term financial goals. Thus, the best asset allocation model is the one that is appropriate for your personal situation: age, years to retirement, cumulative assets, risk tolerance, ability to tolerate financial volatility.

There are numerous resources available to the individual investor for assembling appropriately diversified portfolios. Unfortunately, most of the major brokerages and fund families seem to think that stocks and bonds are adequate diversification. Fidelity and T. Rowe Price are better than most in this regard, along with mutual fund family American Funds. As always, pay attention to fund fees, as high fees are a drag on returns. If you want to get more sophisticated about diversification, Google “Craig Israelsen” and “7Twelve” to read about how he diversifies portfolios, and the returns that they have achieved.

Now breathe deeply… and ignore the market

Once you have a portfolio that passes the SWAN test and addresses your long-term financial needs, here is an exercise guaranteed to save you time, angst, and money: ignore the market. Stop watching CNBC, don’t tune in to Jim Kramer (unless you are entertained by people who bite the heads off of toy bulls and bears), and skip the Markets section of your newspaper. Look at your portfolio performance quarterly, rebalance annually, and every few years revisit your asset allocations to ensure that they are still appropriate for your current situation.

I can promise you that markets will go up or down each day and that countless millions of investors will stare at the market ticker as though it was an EKG of their financial survival. Let them. If you have addressed your near-term cash needs and have a well-balanced portfolio appropriate to your situation, the market’s daily gyrations are irrelevant to you. The time you save here could be better spent reading a good book, watching a movie, or hugging a loved one.

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