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Lexington Minuteman

COROMANDEL WEALTH MANAGEMENT

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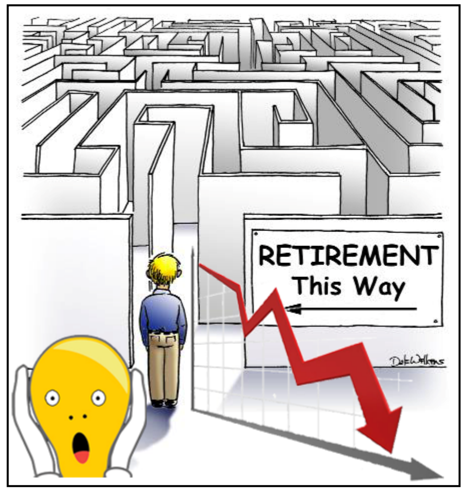
Rightsizing your portfolio risk

Navigating the Retirement Maze



"Risk comes from not knowing what you're doing."

-- Warren Buffett

Last month, I discussed how to manage a range of risks that could threaten your financial well-being. Now I'll address the one that is on most everyone's mind these days after last month's stock market roller coaster: portfolio risk.

We all have an end-of-career goal where our accumulated investments plus other income streams (Social Security, annuities, pensions) should carry us through our retirement years. Annuities and pensions represent known income streams, with the risks being inflation and the solvency of the entities making those payments. Investment portfolios are more problematic, as many asset classes can exhibit significant drops at exactly the worst times, like when you need to sell them to cover living expenses.

Portfolios will differ according to one's financial situation and age, but there are some common principles that can be applied to reduce portfolio risk while still achieving the returns needed to meet your financial goals.

What's your REAL risk?

The media seems to make a point to emphasize stock market risks. You may hear jargon such as VIX index, interest rates, sovereign defaults, exchange rate fluctuations and the like. Ignore them. You should focus on two major risks: permanent loss and falling short of the gains needed to meet your lifetime objectives. The former comes from taking too much risk at the wrong time, and the latter from a portfolio that has too little risk to achieve the gains you'll need to meet your goals.

It's about timing

Funds needed in the near term should not be invested in volatile assets like stocks. That's gambling, not investing. It can result in a permanent loss, where you're forced to sell depressed assets that you'll no longer own when their price eventually bounces back. It's money that's gone for good.

The same goes for funds that you'll need during retirement. If your spending plans next year require $40,000 from your investments, those funds belong in an investment that won't fall 20 percent, like a money market or short-term bonds. Using a "bucket" asset allocation strategy, which I described in a previous column, separates your short-term assets from your longer term ones, letting the latter grow over time while weathering market fluctuations.

No rewards without risk

You need to accept some volatility in order to get higher returns. If you only hold cash, you'll lose out to inflation over time, plus forego any market gains. Most people need a sizeable equity position in their portfolios during their working years in order to retire with sufficient assets. You may experience frequent fluctuations in value, but over long periods of time you should come out ahead.

Conversely, there's no reason to take more risk than required. Say you retire with a $3 million portfolio, and need to draw $25,000 a year to augment your other sources of income. If your only objective is to make sure that you don't outlive your assets, then most of your portfolio should be in TIPS (Treasury Inflation-Protected Securities), because you can easily achieve your goal that way with minimal risk. The key is to take the right amount of risk required to produce the needed gains over the relevant time frame.

Managing portfolio risk

Following a few basic rules will help keep your portfolio, along with your self-esteem, from total meltdowns:

- Diversify – Your portfolio should include domestic and international equities, bonds, real estate, energy, and even some precious metals. A good blend will dampen price fluctuations and lead to solid long-term returns.
- Don't time the market – Time is your financial friend if you'll let it work for you. Numerous studies have shown that individual investors are terrible at trying to time market movements, and pay the price with lower returns. Stop continually adjusting your portfolio, and let time and the markets do their thing.
- Develop "risk tolerance" – Too much effort goes into determining the degree to which a person can tolerate portfolio risk. More important is the level of risk that you need to take in order to meet your financial goals. Do you look at your portfolio every day and lose sleep over market corrections? Get a hobby. Still can't tune out daily market movements? Then consider hiring a professional to manage your portfolio.

Once you have a well-diversified portfolio appropriate for your age and financial situation, leave it alone. Less is more when it comes to managing your investments, and it will produce better results for you over time.

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