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Identifying Investment Risk And Coping With It

Are you a risk-taker? To realize rewards, you usually have to take some risks, especially when it comes to finances. But beyond understanding that investment risk and reward go hand in hand, it's important to know how they relate. What is the nature of risk, and how can you handle the different kinds of risk that could affect the performance of your investments?

What is the nature of risk? For many investors, risk is associated with the inherent volatility of the equities markets. You run the risk that your investments will perform worse this year than last year or worse than you anticipated or worse than the markets as a whole.

Risk means you have something to lose—the money you've put into a particular investment or the money you might have made if you had made different choices. You also could run the risk of throwing good money after bad, of buying more of something when the price is low only to see the value fall further.

Although risk and reward are related, there's no direct, predictable connection between the two. You could decide to take fewer risks and still lose money, or you might ratchet up your investment risk without cashing in on higher returns. Nevertheless, it's important to try to keep risk and reward in a balance that fits your situation.

What are the main types of risks? Financial experts often debate this question, but the pros generally agree that two significant risks facing investors are inflation and emotion.

1. Inflation risk. Essentially, this is the risk that money you earn will lose some of its purchasing power over time. For example, if you buy a five-year certificate of deposit (CD) from a reputable bank, there's relatively little risk that the bank won't live up to the terms of the CD. But there's a much bigger risk that the dollars you receive in five years won't buy as much as they would now.

If you're old enough to have experienced the 1980s, you might recall the days when money market funds paid interest at double-digit percentage rates. However, with double-digit inflation occurring at the same time, most savers barely stayed even.

Inflation risk can present problems to all investors, and especially to retirees. Someone who left work in 1978 might have felt pretty comfortable with a pension paying $40,000 a year. But that $40,000 was worth only about $12,200 in 2013, according to the Bureau of Labor Statistics. This represents a loss of almost three-quarters of the money's buying power.

One way to protect against inflation risk is to include an appropriate ratio of stocks and stock funds in your portfolio. Or, if you're more conservative, you might consider

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Planning Critical For Bike Trips... And Retirement

After 32 years devoted to my career, I'm taking a summer sabbatical to ride a bike across the United States with my son. It's a big goal. And it's a big challenge – but it's not impossible. Like retirement, big goals can be achieved with proper planning.

My cross-country goal started with a dream, but I didn't just jump on my bike and start riding without some serious thinking, budgeting, visiting with experienced cyclists, etc. My strategy was to visualize the process and calculate what it would take to be successful. I wanted to increase the odds of our success in every way possible.

I spent two years training to build my core strength. Every piece of equipment was evaluated for how it would help us accomplish the goal. How heavy? How large? How critical is it, given there is a limit to what we can carry?

Planning a tour on a bike is similar to planning for retirement. There is risk involved, but how can I reduce these risks to increase my odds of succeeding?

Nothing in life is guaranteed, but emotions and risk don't have to hold us back from enjoying a robust and enjoyable retirement. Or a bike trip across this magnificent country!

Ron Dickinson

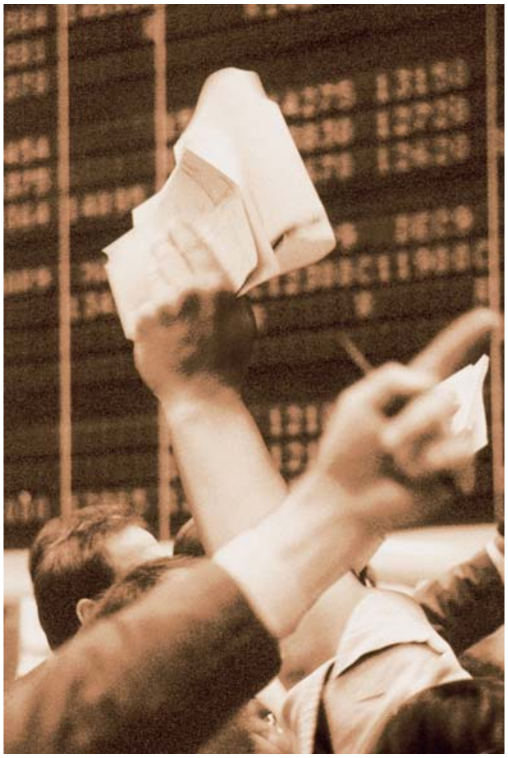
Don't Chase After The Market News

Did you read the newspaper today or check the news online? Invariably, the stock market will be heading up or down, with the movement triggered by anything from company earnings announcements to a change in economic indicators or even a political event such as the recent U.S. government shutdown. And, more often than not, financial pundits may respond by urging investors to buy or sell something.

But you can drive yourself crazy, if you haven't already, by making stock market decisions based on what just has occurred or what you think will happen next. In fact, chasing after the news is a common investment mistake. There are at least four good reasons to avoid this temptation like the plague:

1. The stock market usually moves ahead of the news.

There was no "all clear" signal that the severe stock market downturn of 2008-2009 had abated. But the market hit bottom on March 9, 2009, and embarked on a long, profitable climb even as other financial news remained dire. Typically, stocks move about six months ahead of economic developments, reflecting the collective knowledge, trends, and inclinations of investors. If you try to beat the market by reacting to the latest news, you'll probably be much too late to benefit.



2. You don't have all the necessary information.

Markets tend to move based on the decisions of mutual fund managers or professional analysts who monitor and interpret financial data for a living. They have a lot more information than you do, and they get it much sooner than you—and millions of others like you—who will hear it on television or find it on the Internet. That puts you at a decided disadvantage.

3. You can't believe all the hype.

In this electronic age, media reports are often prone to hyperbole, as the pressure to generate interest from a fickle public continues to increase. That could lead producers to overreact to news tidbits or sensationalize minor events. One small incident usually doesn't portend a complete economic collapse, so take reports of impending doom with a grain of salt. It isn't likely that the sky is falling!

4. Market timing is difficult, if not impossible.

To be successful at market timing, you have to be extremely skilled or lucky, or both. Over the long term, buying or selling based on what you hear or read almost never beats a consistent, methodical long-term approach. It's better to make investment decisions based on financial particulars rather than on instincts and hunches.

Building a diversified portfolio combining stocks, bonds, and other investments can help you progress toward your financial goals—and it can help you stop worrying about what you hear on the news. ●

Roll Over And Play Dead To The IRS

Suppose you're getting ready to retire at your current job. At long last, you'll be entitled to the funds you have been scrimping to save in your 401(k) or other employer plan all these years. But the big payoff on retirement day can come with a punch: A hefty income tax bill at rates now reaching as high as 39.6% on the federal level plus any state and local income taxes you may owe. A distribution also might trigger the new 3.8% Medicare surtax that applies to some high-income investors.

What's a soon-to-be retiree to do? If you require all of the cash right away, you'll have to take your lumps. However, if you don't need the money, or at least you can do without much of it, the tax-smart approach is to roll over the funds into an IRA.

A "rollover" is pretty much what it sounds like. You simply take as much cash as you like from the 401(k) and deposit it in an IRA in your name. As long as the rollover is completed within 60 days of your retirement, the amount transferred is completely tax-free. Then you can withdraw the money as desired—it's taxable at ordinary income rates in each year that you take a distribution—although you must begin minimum distributions no later than the year after the year in which you turn age 70½. In the meantime, the funds in the IRA have the opportunity to continue to grow and compound on a tax-deferred basis.

You can use the funds however you like during the 60-day window. That might be useful, for example, if you're downsizing to a smaller retirement home and you need cash for a down payment before the sale on your old place closes. Just be sure to deposit the amount of your withdrawal in the IRA before the deadline. But any distribution that actually makes it into your hands is subject to automatic 20% income tax withholding, money you likely can

Five Ways To Plan For The Long Haul

Maybe you're in the homestretch before retirement or perhaps you've already stopped working. If you've been diligent in setting aside funds to sustain you through your golden years, congratulations are in order, but you can't rest on your laurels. As life expectancies continue to increase, it's more important than ever to address concerns that you might outlast your money. As the rebound in the economy and stocks has demonstrated, you need to take steps to plan for the long haul and stick with that plan through downturns. Although there are no guarantees when it comes to investing, consider these five suggestions for planning for the long term:

1. Be able to ride out stock market downturns. Even if investing in equities helped get you where you are today, you may decide that the inherent volatility of the stock market means you should get out of it altogether during retirement. That might not be the best approach.

Instead, try to stay on a path for sustained growth that factors in your personal tolerance for risk. For instance, a conservative investor embarking on retirement might allocate 30% of a portfolio to equities and 70% to fixed-income investments. A more aggressive investor likely would choose a higher percentage—perhaps 40% or 50%—to keep in stocks. But the important thing is to find a balance between risk and reward that helps you meet your goals and that won't send you fleeing from stocks when they decline sharply.

2. Try to live off the income your investments generate. The longer you can go without tapping the principal of your savings, the better. But that doesn't mean that interest and dividends alone always can carry the day. Assume you have a $1 million portfolio that produces 3% in annual income ($30,000), plus you and your spouse receive Social Security benefits of $2,000 a month each. That gives the two of you a total of $78,000 annually before taxes, and that may not be enough to support the lifestyle you have in mind.

Depending on your situation, you could arrange to do some consulting work in retirement, wait until age 70 to begin drawing Social Security—a delay that will earn you a higher monthly benefit—or seek higher investment returns. In any event, look for ways to avoid drawing down your savings too quickly.

3. Weigh the 4% solution. That's a rule of thumb for the percentage of a nest egg you might withdraw annually to take income to fund a 30-year retirement. The idea is to take 4% of your total portfolio during the first year of your retirement and then to adjust that amount in subsequent years to account for inflation.

But like any rule of thumb, this doesn't factor in unusual circumstances, like the economic conditions you may face. You might decide a lower or higher percentage would be appropriate depending on your situation.

4. Let the IRS determine your income. Once you reach age 70½, you'll have to begin taking "required minimum distributions" from 401(k)s and other employer-sponsored plans (if you're no longer working) and IRAs. The size of each year's RMD depends on your account balances and your life expectancy. Another way to determine how much income to draw from your portfolio during retirement is to use the IRS calculation for your RMDs.

Suppose that you are age 70½ and have $500,000 in an IRA. The IRS says your first distribution would be about $18,800. Will that be sufficient to supplement your other sources of income? In some cases, such an approach might work well, but it doesn't take all of your personal circumstances into account.

5. Make a "bucket list." Another possible way to hedge your bets against market downturns and make your savings last is to divide your money into various "buckets." One bucket might be earmarked to supplement Social Security and other reliable income in covering your basic expenses, with the funds kept in conservative, liquid accounts. You could have a second bucket of money for discretionary expenses, such as travel, that you put into short- and intermediate-term bonds. The remainder could go into a third bucket, invested in a mix of stock and bond funds. As you rebalance the portfolio for the third bucket, you could use proceeds from investment sales to replenish the first two buckets.

All of these ideas are for illustrative purposes only. What you do will depend on your personal situation and goals. The important thing is to consider all of your options and come up with a plan that is realistic and based on the long haul. ●

recoup from the IRS when you file your return for the year of the rollover.

To avoid those complications, you could opt for a trustee-to-trustee rollover. In such transactions, the money goes directly from the 401(k) provider to the IRA custodian. Because you never have the funds, a trustee-to-trustee rollover is exempt from income tax withholding, though you still have to report the transfer on your tax return.

Furthermore, once the funds are ensconced safely in an IRA, don't think that they're locked in there forever. Under a similar set of rules, you can arrange to transfer the funds tax-free to a different IRA if you like. The same 60-day deadline applies to an IRA-to-IRA rollover.

What about rolling over funds from a 401(k) to a Roth IRA? That will be treated as a taxable distribution. The future benefits available with a Roth—qualified distributions are 100% tax-free after five years—may be worth it, but you'll have to pay a current tax price. ●

5 Tasty Tips For A Spending Diet

Whether it's the holidays, vacation season, or any other time of the year when you take your spending up a notch, the aftermath can be sobering. Credit card bills and bank statements arrive. Suddenly, you feel bloated—and resolve to cut some of the fat from your budget. These five steps could help you go on a spending diet to improve your financial health:

1. Count the "calories." Where is the extra weight really coming from? Before you can trim expenses, you need to know what they are. But documenting every single item can be tedious and nerve-wracking. For many people, a better option is to make a list, based on your statements, that provides a ballpark estimate. Then you can determine what percentage of income goes toward necessities, such as housing and food costs, and what is discretionary. Aim to save at least 20% by cutting back on the luxuries.

2. Focus on the "meat and potatoes." Don't ignore those major monthly costs—your mortgage, car loans, and insurance premiums. Look for ways you can spend less on these "fixed" items. For instance, it might make sense to refinance the mortgage and shop for less expensive auto insurance. Similarly, you might be able to reduce commuting costs by carpooling or switching to mass transportation.

3. Stick to the daily regimen. Just like you can't lose weight by starving one day and splurging the next, a savings diet requires a regular routine. Consider the impact of cutting your daily spending by an average of $3 or $4. That could add up to more than $100 a month, and over $1,200 a year. Small changes can multiply into a much bigger impact.

4. Give yourself an occasional break. Even if you're watching your spending waistline, you don't have to be good all the time. If you enjoy some small luxuries—going to the movies, say, or getting a manicure—you're entitled to treat yourself. But watch out for wasteful spending on upgrades that are way beyond your pay grade. Figure out what's truly important to you to decide where you can cut costs.

5. Try an all-cash diet for a week. When you put away your credit and debit cards, you may find that you're less likely to spend frivolously. This also helps you to pay more attention to how and what you're spending, and to prioritize your preferences.

Finally, don't just sit on the savings. Take the money you've managed to set aside on your diet and invest it where it can provide benefits in the future. If you've been skimping on your 401(k) or IRAs, those are good places to stash the extra cash. This will allow you to indulge more during retirement years when you're no longer pulling down a paycheck. ●

Identifying Investment Risk

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inflation-protection bonds. History has shown, however, that holding even a modest equity stake may increase returns without undue risk when compared to a pure fixed-income portfolio.

2. Emotional risk. It's easy to let emotions rule decision-making. Almost everyone is subject to bouts of fear and greed, and investors have an innate tendency to be overconfident about their ability to choose winning positions. But simply doing what feels right—or avoiding what feels wrong—can lead to adverse results.

Consider an investor who sits on the sidelines during a bull market, nervous about following the crowd—a tendency that indeed can be counterproductive. But finally the investor gets tired of losing out and jumps in, buying at the top of the market and without carefully considering the fundamentals of particular investments. Others get into trouble when the market is falling and they sell solid holdings in a panic, losing out on the chance to benefit when they rebound.

The best protection against emotion is to have a carefully considered investment plan and to try to stick with it even when markets are highly volatile. Having a balance of bond funds for stability and income and stocks for growth can help smooth out inevitable market bumps.

How do you manage risk? Everybody has a different risk tolerance. A good approach for managing yours is to stick to investment fundamentals. That may be as simple as refocusing on the key principles of diversification and asset allocation.

Diversification spreads your investments over a broad mix of asset classes, an approach that has the potential to reduce risk. Asset allocation is the process of assigning percentages to those asset classes based on your particular needs and risk tolerance, and then rebalancing your holdings regularly to keep them close to their assigned allotments.

There's no way to avoid risk completely, but you still can generate earnings while staying within your comfort zone. We're here to provide guidance. ●

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