Can You Afford to Take Investment Risks?

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Summary

There are several important reasons why you should take significantly less investment risk during retirement than before retirement.

People who need to stretch their retirement dollars as far as possible ó that is, most people ó should invest most if not all of their funds conservatively. Investing more aggressively would offer them the likelihood of financial relief down the road or perhaps even prosperity, but it also offers a significant possibility of inferior results or outright losses. This is generally not a good trade-off for retirees on tight budgets.

People who have more resources than they need for what they consider to be their essential comforts are free to make riskier investments. They are encouraged to do so if they want better investment performance and are comfortable with the market fluctuations and occasional losses that will occur.

When You Can Afford to Take Investment Risks

Traditionally, retired people tended to invest their money conservatively ó this suited the generation that grew up during the Great Depression. Then in the 1990s, the idea went out that since people are retiring earlier and living longer, they have both the need and the opportunity to invest more aggressively. Advisors began recommending, typically, 40-60% of assets invested in stock market mutual funds. Two rules of thumb are at play here:

- If you take more risk, you are likely to get more reward for it (which is true, generally).
- Riskier investments are more dangerous in the short run because their values are more changeable. But if you have time on your side, these fluctuations are OK, because the higher growth rate of riskier investment will more than compensate.

There is fallacy here, though. Riskier investments are described as õriskierö not just because their values float around a lot (õvolatility riskö), but also because sometimes they go down and never recover at all (õdefault riskö). Many retirees discovered this, to their regret, when the market boom of the 1990s turned into a crash, and again in 2009.

There are some ways, which we will discuss later, to reduce risk even while investing more aggressively. But as a retired person, you should be taking very little unnecessary investment risk unless one of the following is true:

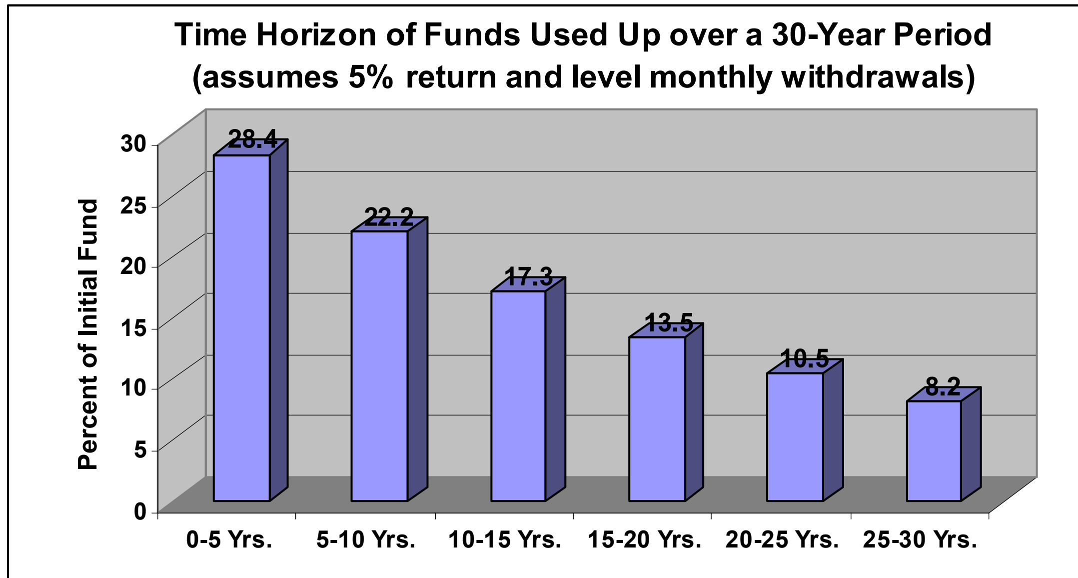
- You have enough assets so that you can afford to take some losses and still get by. Perhaps, for example, a financial analysis shows that you could probably live to a ripe old age *without* having to use the equity in your home ó so that your house becomes your ace-in-the-hole. Or maybe you just have a bigger nest-egg than you really need to get by on, so if you happen to lose some of it, your standard of living will not suffer.

- You receive Social Security, a pension, and/or other guaranteed income, and you are comfortable that you could live on those sources alone if you had to, or at least that you could cut back enough on other expenses so that reduced investment income would be acceptable.
- You have close family or friends who would support you financially, if need be, and both you and they are OK with that.
- It would be tolerable, as a last resort, for you to live on governmental, church, or other private programs for the elderly poor.

Why You Can't Afford Much Risk

Your ability to accept risk goes down significantly the day you retire, and it continues to go down from there. There are several reasons for this:

- If things go badly, you have few options for recovery. After being out of the workforce for a year or two, your credentials are stale, and if you need to go back you are unlikely to earn the kind of pay you once did. If you have been out for more than a few years, you might not even be physically able to work, or you might be able to get only minimum-wage employment. So you canøt risk having your savings disappear prematurely.
- Withdrawing money, rather than putting it in, changes everything. When you are still working, you hate to see the market plummet, but this is actually a good thing if you are putting money *in*. If the market drops 50%, you can buy twice as many shares for your dollar, and then when the market rebounds, you are that much better off. But when you are retired and taking money out, it works just the other way around. If the market drops 50%, you have to *liquidate* twice as many shares to cover your living expenses. Then when the market recovers, your funds never do recover completely, because more of them are gone. So you may not be able to risk a large dip, even a temporary one, in the value of your funds (especially if it should happen relatively early in your retirement).
- You are getting older, and your time horizon for investments is shrinking. It is indeed true that when most people retire, their life expectancy at that point is another 20-25 years. Thatøs a long time. But itøs not as long as it seems, because only a small portion of your money will be around that long. Why? Because you need to be withdrawing most of it in the meantime. If you had a pile of money earning 5% and you were withdrawing it at a steady rate every month so that it would all be gone in 30 years, over half of your starting amount would go toward covering the first 10 years, while only 8% of your initial amount would go toward covering the last five years. (The last five years are cheaper to start with, because that pot of money has a lot of time to grow by then.) So that means that half your money has a 0-10 year period of investment, and only a tiny portion has the full 30 years.



- You already are taking a huge risk, far greater than you probably should, but you canøt do anything about it. What risk are we referring to? The risk of living longer than you expect. Chances are, you will not live to be 100 years old, or even 90 years old, if you are retiring today. But you might: a lot of people do. Some people even live well beyond age 100. If you are like most people you cannot afford to make your money stretch that far, so if you are õunluckyö enough to live that long, you could face real financial hardship. There are conservative investment strategies that can make this risk go away, but with more aggressive investments, it is a risk that does not go away. On the contrary, the risk of õliving too longö multiplies the risk that is part of the investment itself. Like the other items in this list, this is not an issue before retirement, but it is certainly a problem once you do retire.

- When you retire, and as you get older, your psychological ability to accept risk is likely to decline noticeably. Even for people who havenøt thought about all the details listed above, as we get older and as we see our savings gradually decline, we naturally become more conservative about our finances. Having money invested in higher-risk financial instruments does not fit well with this pattern. Such investments, even when they make sense financially, are likely to cause stress and, when markets decline, unhappiness or even depression. Stress, in turn, can injure oneøs health and sour oneøs relationships with others. For most people, this is too high a price to pay for the possibility of a better long-term return on investment.

Another Hidden Financial Risk: Inflation

People who say you should take more investment risks in retirement usually point to inflation as the reason. You may be getting by all right for now, but if your income remains flat for ten, twenty, thirty years or more while prices keep rising, you will end up in trouble.

This is true, but it is a reason why you need to be *more* careful with your money now, not less. When you plan how much money you can afford to be taking from your nest-egg every year, you need to be taking inflation into account. If you are counting on high returns from higher-risk investments to cover the difference, you are simply rolling the dice. As we said before, this can be perfectly acceptable for some people. But if you really want to be self-sufficient for the rest of your life and you need to rely on your nest-egg to make that happen, then you need to be protective of those funds.

Also keep in mind that most peopleøs expenses stop inflating once they get into their eighties. Among major expense categories, only medical costs and real estate taxes tend to continue going up for the truly elderly. Most other expenses go down, because most people in their upper eighties and nineties (or older) no longer travel, seldom go out for entertainment, and rarely buy new cars, furniture, clothes or other durable consumer goods. So on balance, inflation nearly stops for most people after twenty years or so of retirement.

Higher Risks Do Not Guarantee Higher Returns

It is generally true that higher risks will produce higher returns, but in some cases they do not, and in some cases they produce lower returns, even catastrophically lower returns.

Interestingly, many analyses have been done on the amount of money retired people can withdraw õsafelyö from relatively aggressive investment portfolios. In general, the answer is that only about 4% can be taken, and some studies indicate less than that. The 4% amount has a significant failure rate: that is, you have at least a modest chance of running out of savings entirely before you die. The truly õsafeö rate is more like 2% or 3% a year. Only if you are extremely unlucky with your investments or if you live to be very, very old would this not be adequate.

This result is interesting. You can almost always earn *more* than 4% from a mix of relatively *conservative* investments. That means you could live off the interest alone, never spend any of your original balance, and the money would *never* run out, no matter how long you live. Furthermore, to the extent that you can earn greater than 4% without taking significant risk, you can plow the extra earnings back into your savings fund and help keep up with inflation that way.

It does remain true, of course, that a successful riskier investment strategy will make your assets grow faster than a successful conservative strategy will. *Before* retirement this can make sense: it increases your chances of retiring rich. But *after* retirement, it mainly increases your chances of dying rich, while also increasing your chances of dying broke. For most people, this is an inappropriate trade-off, because dying rich usually isnøt very important, but going broke can turn oneøs final years into misery.

How Conservative Should You Be?

This is partly a matter of personal taste, but here is a good general scheme to follow:

- ***Have at least 6-to-18 months' income in a safe, liquid form.*** õLiquid,ö in this context, means that you can turn it into cash at a momentøs notice, without paying any penalties or taking any market risks (savings accounts, checking accounts,

and money market funds provide this benefit). The reason you need such liquidity is that even some õconservativeö investments have values that can float according to the economic conditions. These may still be perfectly suitable, but always make sure you have substantial funds on hand that are not subject to such conditions, and that donøt have early withdrawal penalties. That way you are not forced to liquidate funds at an economically inopportune time or in an emergency. Liquid savings vehicles pay lower interest, however, so donøt overdo it.

- ***Put most of your funds into safe higher-yielding investments.*** Such relatively safe investments include long-term certificates of deposit, some kinds of bonds, and some stocks. Your options are itemized and described in a different paper in this series (see: õConservative Investment Strategies and Financial Instrumentsö).
- ***Inflation-adjusted savings may be right for you.*** The U.S. Government offers bonds that start out paying a lower amount, but that increase their payments in line with the Consumer Price Index. Some amount of these might be suitable for you (see: õConservative Investment Strategies and Financial Instrumentsö).
- ***Annuities can boost your income significantly.*** You can trade some of your nest-egg for an õannuity.ö This kind of product, offered by insurance companies, has two great advantages: it will pay you back at a significantly higher rate than other conservative investments, and it is guaranteed to pay you for as long as you live, even if you set the world record! The main drawback is that you lose control of those assets (either totally, or in part). Annuities are described in more detail in a different paper (see: õAnnuities: Basics You Need to Knowö).
- ***Diversify.*** Just because your investments are conservative doesnøt mean itøs all right to put all of your eggs in one basket. Different kinds of investments are susceptible to different kinds of economic influences, so that even though your underlying investment is safe, the rate of return can vary. So get different kinds of investments, and get ones that mature at different times. Furthermore, the more you diversify, the more you can accept small amounts of investment risk, and maybe stretch your income a little more.
- ***Use higher-risk investments when it makes sense.*** If you are in the lucky minority that really owns more assets than it needs for a reasonably comfortable retirement, you can afford more risk. It might make sense to think of your nest-egg as divided into two main parts: the part you need to keep safe to assure yourself of that basic level of retirement comfort, and the extra part that is over and above that. Invest the first part conservatively, and the second part more aggressively, if you are game for it. After all, dying rich is not a bad thing: you probably have children or other relatives, or perhaps a church or school or other charity you would feel good about leaving something behind for. Or perhaps, if your investments do well, you will find ways to spend the extra amount on yourself.

As was suggested in the beginning, the amount you need to keep safe depends on what other resources ó financial, family, societal ó you have, and your willingness to accept the possibility of having to rely on them. If you have such resources, or if you are simply the sort of person who is willing to take a chance, then you may

prefer to take some modest risks in order to improve your odds of getting a higher investment return.

If you do take on some riskier investments, keep the following in mind:

- The range of risk available extends from the non-existent to the extreme. Unless you enjoy the sporting nature of taking investment risks and can afford to lose some money, keep your risk-taking in the moderate range.
- Diversify. If anything, diversification is more important when taking risks than when investing conservatively. Diversification reduces risk.
- Maintain an even larger õsafeö fund, because you might have to ride out deeper market troughs. You should still have 6-to-18 months held in very liquid form, and another 2-to-3 yearsø worth in other conservative investments.
- Get advice from a professional advisor. Again, unless this is your hobby and you can afford to take losses, let someone with experience help you. At the very least, such a person can help educate you about the risks that different investments carry, even though the final choice is yours.

For More Information

- ***Papers available from this same source:***
  - õConservative Investment Strategies and Financial Instrumentsö
  - õAnnuities: Basics You Need to Knowö
- ***Gauging your risk tolerance:***
  - You canøt trust measures of risk tolerance. Our tolerance for losses changes as our life changes, and as the investment markets fluctuate. But if you are curious about how you compare to other people, try this quiz on the Rutgers University site:
    http://njaes.rutgers.edu/money/riskquiz/