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Understand Investment Risks

By Michael Knight, CFP

Some risks can certainly be avoided; others cannot. The only certainty in investing — and probably in life — is *uncertainty,* and if you find that to be a little scary, you're in good company. Investing features risk, which means that preparing for long-term goals like retirement can really be an adventure. It's like a Lewis and Clark expedition: You may not be able to anticipate every step of the way, but you'll reach your destination if you understand the risks and you prepare for this long and exciting adventure.

With investing, it's easy to think that the only risk involves watching your investments lose their value when the market goes down. However, other risks — emotion, inflation, outliving your assets, and holding investments that you don't understand — are lurking in the shadows. These risks become less scary if you understand them better and develop a plan to deal with them.

Emotional Risks

The biggest threat to your financial freedom may be *you.* When the market went through its painful three-year downturn beginning in 2000, many investors decided to run for the exits and then missed out on the solid returns of the next five years. Fear and greed tend to drive markets, and it's easy to succumb to either of these powerful emotions. The worst thing that you can do is react to what happened in the market today or yesterday. You need a big windshield and a small rearview mirror.

REMEMBER

Take a long-term, disciplined, and consistent approach to investing with an understanding that market volatility is to be expected.

If you know yourself and if you know how you've reacted in the past, you're in a better position to invest in a way that is right for you. Here's what to do:

- Understand your risk tolerance (see Strategy #38).
- The best plans are based on clear and specific goals, so use the help of a fee-only advisor to help develop an investment plan that fits your financial and emotional needs.

- During times of uncertainty, look at your monthly statements, but don't check your investments daily and don't panic. Stick to your plan.

Threats of Inflation

One reason you invest is to keep pace with inflation and shield you from lost purchasing power. When you invest for a long-term goal, such as retirement, you need to think about the impact inflation will have over 30 or 40 years.

The longer the time period, the more inflation will erode your buying power. With 4 percent inflation a year, $1.00 today will buy just 30 cents worth of goods or services in 30 years. In other words, at an annual 4 percent inflation rate, $100,000 set aside today for retirement will be worth just $30,800 30 years from now. If inflation jumps to 5 percent, your $100,000 will be worth $23,000 in 30 years. Now that's scary.

Another negative affect of inflation is that it reduces the value of long-term bonds as interest rates rise. This includes government bonds that may be backed by the federal government but are subject to a decrease in value when interest rates go up.

TIP

Here are some ways to protect yourself from inflation:

- The best strategy is to invest for long-term growth and inflation protection with a diversified mixture of stocks and high-quality short term bonds. For more information, check out Strategy #41.
- Invest in a diversified mix of investments that includes both U.S. and international stocks.
- When interest rates are rising, use high-quality short-term bond funds and high-quality money market accounts.
- To protect against unexpected inflation, invest a small portion of your investments in Treasury inflation-protected securities (TIPS). You can easily do this with a mutual fund that invests in TIPS.

Roller Coaster: Market Volatility

Volatility is a measure of how much a security rises or falls within a short period of time. Low volatility is best because the greater the volatility, the more difficult it is to achieve your goals.

Many investors felt the pain of extreme volatility when the technology bubble burst in 2000. For example, one technology mutual fund, the Janus Venture Fund, fell 60 percent between March 2000 and February 2001. This means that $10,000 invested on March 1, 2000, was worth just $4,000 a year later. Returning to the $10,000 original investment would require a 150-percent gain.

You can reduce the risk of big, volatile swings in the value of your investments through diversification. And because volatility seems to diminish over time, carefully consider how soon you'll need your money when making investment choices. Here are a couple of strategies:

- If you'll need a certain amount of cash within the next five years, don't invest it in stocks. Use money market funds, CDs, and high-quality short-term bond funds instead.
- Avoid concentrated investments in any one company or market sector. This includes your employer's stock, which should be limited to no more than 10 percent of your investments.

The Risk of Outliving Your Money

One of life's greatest uncertainties is how long you'll live. Retire at 65, and you could live 30 years or more without a paycheck, running the risk of depleting your nest egg. Consider a married couple, both age 59 and non-smokers: There's a 50 percent chance that one of them will live to age 92 and a 30 percent chance that one of them will live to age 95.

One of the best strategies is to prepare now for a long retirement by saving more and spending less. It also helps to plan ahead and think about ways to generate income during retirement. Understand your current and future cash flow needs.

If your cash flow plan includes a way to separate fixed and discretionary expenses, you'll be able to adapt to the unexpected. Here's how:

- Expense control is essential, so look for a system for tracking expenses. Personal finance software programs like Quicken or Microsoft Money are good options. You can also find free templates with a personal budget worksheet and a family monthly budget planner on the Microsoft Office Web site (`office.microsoft.com/en-us/templates`).
- Be careful about withdrawal rates. One rule of thumb is that you shouldn't be withdrawing more than 4 percent from your savings and investments during the initial years of your retirement.

- Consider a fixed annuity with a portion of your savings, say 25 percent, but wait until you're approaching age 70 to invest in it. (Read Strategy #19 to find out more about fixed annuities.)
- Delay collecting Social Security until at least your full retirement age and even as late as 70 if possible.
- Plan ahead so you can generate some income in retirement. A part-time job can be fun and take some pressure off your investments.

The Risk of Making Investments You Don't Understand

Investments are sometimes complicated because they're designed to be good for the company selling the product rather than for you. Make sure you do some research and know what you're buying. Find out what penalties you may face if you want to get your money back.

TIP

Understand the compensation policies for salespersons. If you're dealing with investment products sold by banks, brokerage firms, or insurance companies, watch out for a potential conflict of interest. The person representing the institution is receiving a salary and often commissions from guiding you to a short list of products that produce income for the institution. To avoid this risk, follow these tips:

- Don't invest in products you don't understand.
- Be sure you know how the salesperson or advisor across the table is being paid.
- Use a fee-only advisor willing to provide you with a written statement that says that loyalty to you is the top priority.