December 13, 2019

Assessing the Risks in Various Asset Classes for Retirement

David Kudla *Forbes* Contributor
Retirement
I write about investing, retirement, & workplace savings plans.

As people look ahead to their retirement years, a primary objective is to identify areas of risk, with the goal of eliminating each and every risk that they believe could cause them harm. Experienced planners are trained to listen to these concerns, and their recommendations are typically well-intentioned efforts to meet this goal of risk reduction. A common "tried-and-true" approach is to systematically change a client's asset allocation, by reducing or even eliminating any investments in stocks. These assets are then shifted to investment vehicles deemed "safe", such as cash, bonds, real estate, precious metals, or even fixed annuities.

Unfortunately, none of these asset classes are completely safe from risk. Holding most or all of one's assets in cash remains a tempting approach, and not just when the market is jumping around wildly. In the environment of 2019, where the market has been relatively steady and has grown to its all-time high, many folks shift to cash under the premise that "things are too good" and that something bad will inevitably happen. Of course, assets held in cash steadily loses purchasing power as long as the inflation rate remains higher than the interest rate earned on cash balances. Even with relatively low inflation over the last 20 years, a 2019 dollar is only worth about 65 cents in 1999 dollars. It's why economists refer to inflation as the "silent thief". Meanwhile, a majority of those who retire in their 50s and 60s expect to live much longer than 20 years, and thus, most consider inflation risks as much of a threat as stock market risk.

Bonds are certainly a respected and popular asset class, with the appeal of a guaranteed principal amount for U.S. Treasuries, and a higher income yield compared to cash, that historically has been much more successful at keeping up with inflation. Of course, in a low interest rate environment, this yield has been declining to the point where it does not always keep up with the annual CPI (Consumer Price Index), meaning that a portfolio excessively weighted toward bonds will not totally eliminate purchasing power risk. Moreover, bond prices are inversely related to the direction of interest rates, meaning that a change in Federal Reserve policy to increase interest rates, or even the perception that the Fed might tighten at some point in the near future, will send bond prices lower. Although the principal on individual Treasuries is guaranteed, most investors do not buy a bond at par and hold it for the full duration. Investors usually buy bonds as an asset class, packaged through a mutual fund or ETF, and thus feel the full effect of declining bond prices. In short, bonds can carry a measure of market risk, inflation risk, and interest rate risk. Plus, corporate bonds particularly in the "junk" category may potentially lose principal.

Investors can also mitigate some of these risks by allocating some of their investments to real assets. Real estate returns are historically not highly correlated to stock market returns, meaning that there will be years when a stock market decline will be partly offset by a steady or even increasing value of one's

real estate. On the other hand, real estate values have a demonstrated history of “bubbles”, where the actual value of a property becomes inflated, only to crash and decline well below the original cost. Gold and other precious metals have their proponents, in many cases for reasons similar to that of real estate (their statistical correlation properties), as well as a reputation for acting as a hedge against inflation. Precious metals do have many months, quarters, and even years of out-performance versus stock market averages. However, they can also underperform for lengthy periods, and at the end of the day, are vulnerable to the same sort of market risks and declines facing stock market participants, albeit in a different category.

Fixed annuities hold particular appeal to those in their retirement years, given the prospect of a guarantee of lifetime income. These products are slickly marketed by insurance companies, yet oftentimes make difficult to understand terms of their payoff and exact returns. That said, one of their biggest risks can be their liquidity risk, and their lack of flexibility. Should one’s circumstances require some or all of the net worth of an annuity contract, the penalties can be severe, and these losses incurred are unlikely to be made up.

Given the variety of risk factors to which most retirees are subjected, it can be understandably intimidating and confusing to know what exactly to do with one’s retirement nest egg. The most sensible approach to asset allocation is to enlist the help of a credentialed financial professional with sufficient knowledge of the characteristics of all of the basic investment categories, and the experience to understand statistical correlation and its role in diversification and risk reduction. Since markets change and situations in retirement change, there’s tremendous merit to retaining flexibility in one’s retirement accounts which will allow a retiree to shift one’s asset allocation tactically.