Volatility — One of The Biggest Threats to Your Retirement

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Imagine that you are 65 and just finished your last day at work. The big sendoff party was better than expected, and you've got a nice shiny gold watch on your wrist to prove it. You get on your Harley and ride off into the sunset with your significant other to enjoy the rest of your life the way you always imagined.

Fast forward 20 years and you've slowed down a bit — traded in the 2-wheeled hog for a 3-wheeled version that's battery powered and joystick operated — but life is still good. You ride down to the mailbox one afternoon and pull your account statement out of the mailbox, open it, and realize your investment account is all zeros!

At that age, what are your alternatives? Going back to work would be a monumental task, even if you are lucky enough to maintain your health and vigor. Social Security or other sources of retirement income may help, but your lifestyle certainly would suffer without your retirement portfolio as a source of income.

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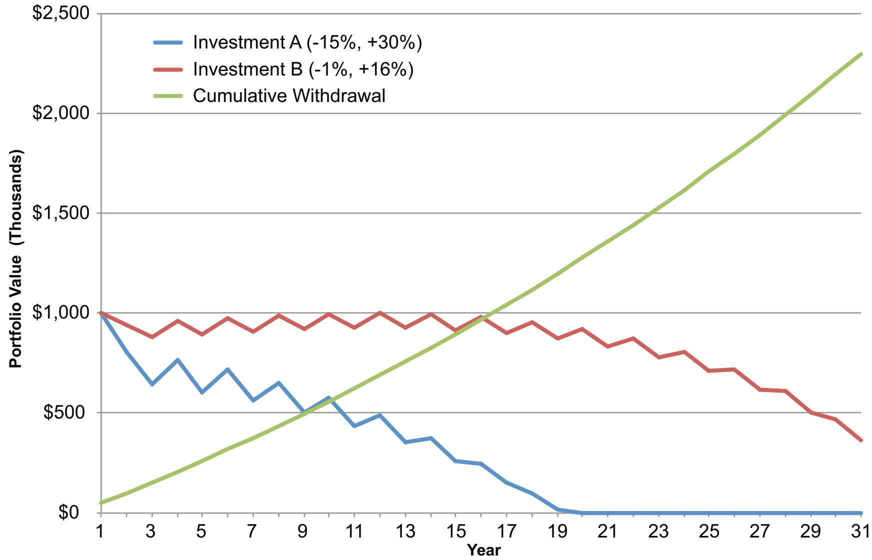
This is a nightmare scenario many retirees face and one that takes a good financial advisor, sound planning and prudent investment choices to avoid. If I lost you at investment choices, let me use the following illustration to explain what I mean.

Imagine you have two investment options when entering retirement. They both will earn an average return of 7.5% over the next 30 years. Investment A will lose 15% the first year then gain 30% the second and will repeat this sequence for the next 30 years. Investment B also will lose 1 percent in year one and gain 16% in year two, repeated for the next 30 years.

Though they both have a 7.5% average return, Investment A's returns fluctuate more from year to year than Investment B's returns. In other words, Investment A has higher volatility. What does this have to do with your retirement? Let's look.

Portfolio Perspectives



Assume you have one million dollars to invest at the start of your retirement and will withdraw $50,000 each year, growing the withdrawal by 2.5% to keep up with inflation and maintain your standard of living ($50,000 at the start of year one, $51,250 at the start of year two… all the way to $104,878 at the start of year 30).

Investment A, the investment with the higher volatility, runs out of money in year 19. Investment B, the lower volatility option, not only lasts through year 30, but still has $364,644 left in the account…and that's on top of the two million dollars you've withdrawn from the account over 30 years. If both investment options experienced the same average return, what was the difference? Volatility, that's what!

Volatility is one of the biggest threats to your retirement, yet most people are unaware of its impact. The greater volatility of investment A reduces its compound growth rate. It also increases the effect those annual withdrawals have on the portfolio value. Since the annual withdrawal is increasing each year, its proportion in relation to the total portfolio value becomes greater, especially when the big down years hit.

To better understand what is happening here, let's look at another example using historical index data. Imagine investing $1,000,000 in U.S. Large Cap stocks at the start of 2008. If you remember, this was a particularly bad year, with the U.S. Large Cap market losing 37% (as measured by the S&P 500 index). Your $1,000,000 investment would have been worth only $630,000 at the end of 2008. Now if you withdraw $50,000 at the start of 2009 you would be withdrawing almost 8% of your investment value. At that rate, it wouldn't take long to deplete your portfolio.

If you haven't gotten my point yet, let me say it again: Volatility is one of the biggest threats to your retirement.

Extreme portfolio fluctuations can cause your periodic withdrawals to become an excessive drag on your portfolio's growth. Growth is what you need to stay abreast of inflation so that you can maintain your desired standard of living.

So how can you control volatility within your portfolio? Diversification doesn't guarantee gains or protect from losses but it is a great way to manage portfolio volatility.

Strategies that invest in one segment of the market, like U.S. Large companies, don't provide the breadth of diversification needed for a successful retirement, in my opinion. Diversification is more than just investing in several hundred U.S. companies. It starts with the correct mix of bonds for volatility reduction and stocks for growth. Once you and your advisor have determined that mix, then begins the process of buying and owning several thousand great companies across the globe. Diversification needs to be expansive to be effective.

Diversification neither assures a profit nor guarantees against loss in a declining market.

Past performance does not guarantee future.

Indexes are unmanaged baskets of securities in which investors cannot directly invest; they do not reflect the payment of advisory fees or other expenses associated with specific investments or the management of an actual portfolio.

International markets involve additional risks, including, but not limited to, currency fluctuation, political instability, foreign taxes, and different methods of accounting and financial reporting. As a result, they may not be suitable investment options for everyone.

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