Balancing Risk and Reward within Your Retirement Strategy

By Scott Ho on May 31, 2015

Even the best laid retirement plans are at risk for monetary losses or unexpected complications. As we saw back in 2008, a major stock market crash could bankrupt your pension plan, high inflation rates could eat away at your savings faster than you'd planned for and a rising life expectancy could mean you outlive your assets.

When it comes to investing, risk — the possibility that an investment will decline in value — is virtually unavoidable. Rather than quake or freeze in the face of risk, take some time to understand the various kinds of risk you face. From there you can begin to make educated investment choices which mitigate risk in manner which brings you rewards.

The goal, of course, is to set the right balance of solutions given all the risks you might face. For some retirees that could mean higher risk/reward stocks and fewer guaranteed products. Others will need more low-risk or guaranteed products and fewer stocks. And many will need to change their savings strategy completely.

If you are retired or planning for retirement, you must understand the risks ahead and how they could impact your financial safety net. Here are *seven* types of risk you may encounter as you set and review your retirement plans.

7 Types of Risk Prevalent in Retirement Planning

Market or Currency Devaluation

Most of us are familiar with the idea of risk involved when purchasing stocks or bonds on the open market. You risk losing money when the price of an investment declines, whether that is your from your personal stock portfolio or company managed mutual fund. Even the market value of a currency can affect the price of investments held by American businesses and thus their stock value.

It is possible to manage market risk by diversifying widely among investment classes (owning a mixture of stocks, bonds, indexed funds, etc.), owning individual securities, and being prepared to absorb possible losses. Speak with your broker about asset allocation and diversification strategies.

For those needing to build their retirement savings in a short amount of time, the market can offer a high return although for a high amount of risk. Older employees and retirees may want to limit their exposure to market risk since recovery from losses can take time they may not have to waste.

Risk of Inflation

A period of high inflation can devastate the budget of those living on a fixed income. Hopefully, most retirement planners are aware of the possibility that the growth of an investment may not keep pace with the average rate of inflation — a sustained increase in the price of goods or services.

As a result you and your financial advisors should be on the lookout for investments which earn an average return above the average rate. For example, if your investments are earning 2.5% each year, but inflation is averaging 3.22% (CPI inflation from 2004-2014), then it’s fair to expect your investments are losing money. The amount of things you could buy with your investments tomorrow (or the day you cash out years into the future) will be less than what you could buy with the money today.

To keep ahead of inflation many financial advisors will want you to consider: common stocks, inflation-indexed Treasury bonds, inflation-indexed annuities, commodities and natural resources. In the short-run these investments may not bring huge returns, but in the long-run they tend to outperform inflation.

Fluctuating Interest Rates

There is a real risk of stocks losing value or a high cost of borrowing when interest rates are on the rise. Conversely, low interest rates could mean small investment returns, meaning retirees or employees will need more time or money to reach their financial goals.

Higher interest rates tend to reduce stock prices since they increase the cost of borrowing for companies. And those looking to finance a new home or car after retirement could be paying more.

With low interest rates investors aren't likely to see large dividend checks; instead they will be reinvesting their money for a longer period.

Outliving Your Retirement Savings

There is a real risk that you will outlive your retirement income. We know that life expectancy in the U.S. is on the rise, and while we can estimate that the average retiree will live to age 78.8 (81 for women), we cannot precisely predict our own life expectancy. What will you do if your nest-egg runs out at age 80 and you live to 99?

Social Security benefits, traditional pensions and annuities may be able to guarantee a specified amount of income for life, but it's rarely enough. Then, in an attempt to avoid the dangers of running out of money, many will be overly cautious and needlessly restrict their lifestyle.

Thankfully, there are new products or additional annuities you can attain which do not start paying benefits until later in life, or involve a *managed payout* plan. Some retirees choose to phase into retirement or go back to work.

Unexpected Health Care and/or Nursing Home Expenses

It's fairly impossible to predict and budget for unexpected medical expenses, but there is a real risk that you will need more money than your current retirement plan can afford. Seniors historically have greater health care needs and one emergency could require professional caregivers or a change in living arrangement (i.e. nursing home or moving in with a family member).

Either way, it's going to cost you, so why not make a plan for saving, investing and covering yourself with more insurance. Owning Medigap insurance or working for an employer that provides health insurance can reduce the risk of having unexpected health-care needs. Long Term Care Insurance, cash value life insurance, annuities and other investments may be able to give you the financial support you need in a medical emergency or when you can no longer live independently.

Personal and Family Challenges

Changes in your life or the life of a loved one could impact your retirement income stream. A change in marital status can affect benefit entitlements and disposable income. The death of a spouse is a financial burden in and of itself, however, it may also lead to a reduction in pension benefits. Then there are the times we choose to help other family members when they have financial or medical emergencies, perhaps we become a caregiver to an aging sibling.

Unfortunately, because this risk comes in so many shapes and sizes, it will be hard to predict how it will affect you. To provide for your surviving family, set some estate plans to protect your assets and income. You will need to speak with your trusted financial advisors to assist you with big financial decisions (such as lending money to a family member or getting divorced) and conduct regular reviews to make adjustments as your lifestyle evolves.

Public Policy Changes Affecting Retirees

Everyone’s financial plan is subject to public policy, whereby government decisions will affect your tax burden, entitlement benefits (such as Medicare or Social Security) and even the price of your stocks or bonds. It is important to know your rights and to be aware of your entitlements to state and local authority benefits so you can mitigate financial losses.

Managing Risk

Generally, the more risk you take, the higher the potential rewards; and avoiding risk altogether can be a risk itself. The most successful retirement plans require you to consider various kinds of risk and to continually find a balance among a range of investments to manage that risk well into your golden years.

Although some risks can be minimized through careful planning, many potential risks are completely out of our control. You and your trusted retirement planner, tax professional or legal counsel will want to review the post-retirement risks which are most relevant to you to ensure they are mitigated and properly managed. If you are already retired you may need to review your plan, as life changes and policy changes may require adjustments.