BUILDING BLOCKS FOR RETIREMENT

Investment Strategy

How Exposed Are Your Retirement Savings to Market Risk?

It's a given that the stock market is volatile and investors are at risk of suffering losses to their capital. Investors confront several different types of risks, including market risk, inflation risk, and interest rate risk. Of these risks, market risk is one that all investors, but especially those who are investing for their retirement, should understand and prepare for. Essentially, market risk is the risk that the prices of securities may fall due to external factors like economic changes, world events, or investors' expectations and outlook. Generally, stocks are most likely to be impacted by market risk and are most susceptible to volatility.

As traditional pension plans become less common, households with investments in 401(k) and other defined contribution plans increasingly bear the full brunt of turmoil in the stock market and the attendant market risk. Retirement plan investors have learned that declines in the major stock market indexes, such as the S&P 500, the Dow Jones Industrial Average, and the NASDAQ, occur relatively frequently and have been occasionally severe over the last half century. One of the most severe downturns occurred during the February-March 2020 period in the early months of the COVID-19 pandemic, in which the value of equities in employer-sponsored retirement plans and household portfolios fell by $14.2 trillion.[1] While the stock market has since recovered, it remains volatile and retirement plan assets remain exposed to risk.

While all investors have to temper their hopes for gains with the realization that the market can also deliver losses, they should also consider measures and employ strategies that seek to minimize both the potential for and the impact of capital losses. While no strategy offers a guarantee against losses, some strategies can help with managing the risks associated with market losses.

Assessing Your Risk Tolerance

Start by determining your risk tolerance. Your tolerance for investment risk is your ability to accept the chance of losses from an investment in return for the possibility of higher returns. You can measure your tolerance for investment risk by answering several questions:

When Will I Need the Money?

If your retirement is a decade or more in the future, you may be willing to take on more risk with your investments. If your investments experience losses in one year, you should have time to recover from them. However, if retirement is close, you may wish to consider reducing the percentage of your portfolio that is allocated to stocks and increasing the percentage allocated to bonds and cash equivalent investments. Essentially, this is a move from a strategy that stresses growth to one that focuses on earning a more modest return and preserving any gains you have made.

Would a Big Loss Derail My Future Plans?

Ask yourself what would happen if your portfolio were to decline 15%, 20%, 30%, or even more, in value? Would a loss of that size mean that you would have to postpone buying that dream retirement home or delay your planned retirement date by a year or more?

How Large a Loss Can I Handle?

Like many others, you may overestimate your ability to handle a loss. If you put the loss in real dollar terms, you may have a better understanding of your tolerance for investment risk. How would you react if your $450,000 retirement plan portfolio fell by $45,000 or more in a severe market correction? What other assets, if any, do you or your spouse have for retirement?

Implementing Risk Management Strategies

Once you understand your time frame for investing and your tolerance for investment risk and determine what other assets you may have available for retirement, then you are in a better position to take measures to protect against market turmoil. One of the keys to success in investing is to balance risk and potential reward. You can accomplish this by having a well-diversified portfolio and an appropriate asset allocation strategy.*

Diversification helps you manage risk by spreading your plan assets among a broad mix of different types of investments. Doing so allows you to take advantage of the fact that securities usually do not move in the same direction at the same time. The idea behind diversification is that the strong performance of one investment can offset the weak performance of another.

Spreading your portfolio among different asset classes, an approach known as asset allocation, takes diversification a step further. Investors who have a higher risk tolerance may decide to allocate a relatively large portion of their portfolios to stocks because of their greater return potential, while investors with a lower risk tolerance may choose a more conservative asset allocation with less exposure to stocks.

As always, the input of a financial professional can be very helpful when you are assessing your risk tolerance and crafting a strategy to protect your retirement savings from market turmoil.

[1]Center for Retirement Research, Boston College, Issue Briefs, June 2020, *How Exposed are Retirement Savings to Market Risk?*

**Asset allocation and diversification do not ensure a profit or protect against losses in a declining market.*

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