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THE EXPERTS

The Investment Risk Retirees Should Pay Attention To

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ISTOCK

JONATHAN GUYTON: Stock-market corrections can cause more turmoil in your emotions than in your investment portfolio–especially if you rely on these assets for a regular monthly income.

When these times come, it is wise to focus on the horizontal risk of your retirement assets and not their vertical risk. The latter emphasizes questions like how far the stock market has fallen–the vertical–and how low it could go. While such volatility obviously affects things day-to-day, what matters more is your horizontal risk–how long your portfolio can provide the regular income you rely on before you're forced to sell stocks or equity funds at depressed prices. Remember, you don't actually have a loss until you sell.

For starters, a decline in your retirement-asset total need not mean that every holding has lost value. Such an occurrence is rare in a well-diversified portfolio–particularly one designed with an understanding of horizontal risk. Though a market correction will undoubtedly cause price drops in some assets, others will be unaffected. Still others may even rise in value.

The key to how big a portion remains unaffected is the makeup of your bond or fixed-income holdings. What matters more than their yield or the interest they pay is whether or not their value remains steady while the stock market declines. In such an environment, even precious metals' prices can fall significantly.

Most often, it is "plain vanilla" U.S. government securities that fare best exactly when it matters most. Intermediate and longer-term U.S. government bonds do better when interest rates are falling (e.g., when the fear is a recession) and the shorter-term variety, like Treasury bills or money-market funds, are preferable when rates are rising (e.g., when the fear is an overheating economy). This is exactly what happened in the 2008-2009 market meltdown and again this past summer.

Short-term, investment-grade bonds and funds can also work well, but holdings like high-yield bonds, floating-rate notes and emerging-market bonds can cause real heartburn at such times.

A hypothetical example may help: Jill has a $1 million diversified portfolio, with $600,000 allocated to stocks and $400,000 to bonds. She withdraws $50,000 yearly, of which $15,000 is dividends and interest. The other $35,000 comes from periodic rebalancing and taking gains on various equity holdings as they rise. Then, almost overnight, her asset value drops to $900,000. Is everything down the same 10%? No. On closer inspection, the stocks have fallen to $500,000 while the bonds are unaffected. The $15,000 investment income is still paid, and the other $35,000 now comes from selling bondholdings while Jill waits for equities to recover. Even if the stock market falls further (vertical risk), Jill could whether this storm for 10-11 years as long as her $400,000 bond value remains unaffected. Her horizontal risk doesn't start for over a decade.

Like Jill, Jack also has a $1 million portfolio allocated 60% to stocks and 40% to bonds. However, $200,000 of Jack's bonds are from lower-rated corporate and emerging markets, increasing his interest and dividend total to $21,000. When the market drops, Jack's asset total falls to $880,000 because these high-yield bonds have declined 10%. Assuming no bond defaults, this $21,000 is still paid; however, Jack must now hope that his $200,000 in unaffected bonds can fund the other $29,000 until the market recovers. They can, but only for six to seven years. Jack certainly hasn't (yet) lost his crown in this fall, but his horizontal risk kicks in four years before Jill's.

The key takeaway: Let the prognosticators and market timers try to predict the next market low. Spare your emotional health and avoid costly mistakes by focusing on your portfolio's horizontal risk–the length of a market storm it can help you weather.

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