Protecting Your Nest Egg in Volatile Times

Today's Retirees Must Control Risk Even as Longer Lifespans Mean They Need More Income

By ELEANOR LAISE
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As the first baby boomers hit retirement age, volatile financial markets are increasing the risk this new wave of retirees could outlive their nest eggs.

Sharp market swings can be devastating to retirees who are regularly withdrawing money from their portfolios, by forcing them to sell holdings whose value has just plummeted. What's more, retirees' portfolios can have a tough time recovering from such a hit, because regular withdrawals reduce assets available to achieve future growth.

Complicating matters, retirees are being told they need to hold a larger share of stocks in their retirement portfolios. Over time, stocks return more than the traditional retiree choice of bonds, and today's retirees are expected to need more money because they are living longer and facing higher health-care costs. But stocks can add more volatility to a portfolio.

Although investors can't do anything about market swings, retirement advisers are recommending a number of strategies that can minimize volatility and help a nest egg last longer. Holding a well-diversified portfolio will help to reduce sharp swings overall. And having a large cash reserve can shield you if you happen to retire on the eve of a particularly turbulent market period.

Financial firms have also launched a number of new products that they say can reduce volatility while providing a steady stream of income. Among these are so-called covered-call-writing funds, which sell call options on stocks they hold.

Volatility is on the rise. The Chicago Board Options Exchange's Volatility Index, a key measure of market jitters, has roughly doubled since the start of 2007. For younger investors, volatile markets can be good news by offering attractive buying opportunities when prices are low. But it can be worrisome for the oldest baby boomers, who this month turn 62 and become eligible for...
Social Security retirement benefits. Yesterday, the Dow Jones Industrial Average dropped 277.04 points, or 2.2% to 12501.11.

"If you're withdrawing money at the same time as your portfolio is going down, you just exacerbated a bad situation," says Christine Fahlund, senior financial planner at T. Rowe Price Group Inc.

Financial advisers have all but abandoned recommending the traditional strategy of loading up on bonds in retirement. "They'll run out of money very quickly doing that," says Bill Bengen, a financial adviser in El Cajon, Calif. T. Rowe Price advises people early in retirement to keep 40% to 60% of their portfolio in stocks.

Holding a mix of stocks and bonds can mean lower average annual returns than a portfolio consisting only of stocks. But the diversification may more than compensate for this by reducing volatility, thereby helping your nest egg last longer.

Consider an individual who retired in 1973 with a $500,000 portfolio, withdrew 5% of that nest egg in the first year of retirement and increased the withdrawals annually to keep pace with inflation. If that investor put all his money in the S&P 500-stock index, the average annual return through 1990 would be 11.3%, but he would run out of money in that year, according to Franklin Templeton Investments. If the same investor put half his money in stocks and half in bonds, he would still have nearly $100,000 left in 1992, though he received a lower 10.5% average annual return. The stock-and-bond portfolio has only about half the volatility of the all-stock portfolio, "and that's why it's more successful," says Gail Buckner, retirement specialist at Franklin Templeton.

Alternative Investments

Other recent research suggests retirees need more than just stocks, bonds and cash, and should venture into alternative investments that behave differently from traditional asset classes. Craig Israelsen, an associate professor at Brigham Young University, recently studied the effects of diversifying a portfolio that is in withdrawal mode, tracking the investments over a 37-year period ending in 2006. He added foreign stocks, bonds, cash, real-estate investment trusts and commodities to a basic portfolio of large and small U.S. stocks, measuring returns and volatility as each asset class was added. The portfolio holding all seven asset classes had the lowest volatility and the highest returns. In its worst year, it lost just 10.2%, including the annual withdrawal, far better than any of the other portfolios.

When shopping for stocks, some advisers suggest retirees focus on high-quality, dividend-paying shares, which tend to be less volatile. "Very often the company is going to continue to pay the dividend even though the value of the shares is going down, so there can be some buffer there," says T. Rowe's Ms. Fahlund. Scott Thoma, market strategist at Edward Jones, suggests retirees look at sectors like health care and consumer staples, where many companies have a long history of paying -- and increasing -- dividends.

Another key defense against volatility is a sizable cash reserve, because it can keep you from having to sell stocks if the market is down. Diane Pearson, an adviser at Legend Financial Advisors Inc., suggests soon-to-be retirees put their first year's worth of living expenses in a high-yielding money-market account and the second, third and fourth years' worth of expenses in one-, two- and three-year certificates of deposit.
Fund companies are also launching new offerings that they say can help reduce volatility. So-called covered-call writing funds sell call options on stocks they hold or on stock indexes. Recent offerings include Eaton Vance Tax-Managed Global Diversified Equity Income closed-end fund and PowerShares S&P 500 BuyWrite Portfolio exchange-traded fund.

In covered-call writing funds, premiums from the sale of options provides a steady stream of income and a buffer against stock slides. Typically, the greater the market volatility, the greater the premiums. But these funds may underperform in strong bull markets as some of their best-performing holdings are called away by the owners of the options.

The Horizon Date

Another recent offering is from Fidelity Investments, which launched 11 Income Replacement funds. These offer investors regular monthly withdrawals, gradually liquidating the investments in the funds as they approach their so-called horizon dates. The funds also gradually shift to a more conservative mix of stocks and bonds as they get closer to the horizon date.

Another tactic for retirees to make their nest eggs last is simply to spend less. Many advisers say that a 4% initial withdrawal rate, increased annually to keep pace with inflation, is safe for most retirees. But "as the market takes a tumble, you want to be extra cautious about how much you take out of your portfolio," T. Rowe's Ms. Fahlund says. Even trimming expenses by 5% "can make a big difference in getting through retirement successfully," says Mr. Bengen, the financial adviser.

Write to Eleanor Laise at eleanor.laise@wsj.com

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