The Big Four Retirement Planning (Investment) Risk Factors

Description

When doing retirement and financial planning there four investment risk factors one must be aware of and prepare for. Understanding what these are and how to mitigate them will greatly increase oneâ??s financial certainty and avoid the greatest risk in financial planning: running out of money.

Risk of Loss

Risk of loss is the risk of investing in something that isnâ??t profitable. If you invest in your friendâ??s inflatable dartboard business and then it doesnâ??t turn a profit, this would be an example of a loss. Or if your entire portfolio was in Nortel, Enron, Bre-X, Lehman Brothers, General Motors, or you had all your money tied up in real estate when the housing bubble burst.

One should note that in addition to losing on individual companies, one may lose money by investing heavily in the â??wrongâ?• sector, asset class, or geography.

It is also important to note that the failure of companies is far more common than we realize. Since 1980 40% of the companies in the Russell 3000 stock companies lost 70% of their value. What that translates to is that roughly 2 in 5 listed companies in the United States lost at least 70% of their value in the past 40 years.

How do we mitigate the risk of loss? Diversification. Diversification. Diversification. **The key to mitigating risk is diversification.** This lets you take advantage of tail events (which we will discuss in another post) and limit your loss on any one bet.

Market, Systemic or Volatility Risk

Market or volatility risk is the risk of value fluctuations, or the ups and downs of the value of a stock or investment. Examples of this risk are stock price fluctuations, interest rate changes, and the prices of commodities changing. While we expect a properly diversified portfolio to increase in value over the long run this isnâ??t consistent. This risk of swings in value is something that we expect to increase in the future, in both frequency and magnitude. And the risk to an investor is that if they need money quickly, either for life or to cover leverage, this could cost them significantly.

To mitigate the risk of being forced to sell at an inopportune time, we utilize asset, risk, and need allocation to have cash available for predictable and semi-predictable needs as well as smaller cash flow issues in the near to medium term. We use insurance and risk transfer to have cash available for needs we canâ??t foresee or time accurately or those with the potential for the largest negative impact on our wealth.

Interest Rate & Inflation Risk

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These are separate but connected things which pose a huge problem to those nearing retirement today. Inflation risk occurs when interest rates are high or increasing and depletes the spending power of your dollars. Remember when gas was 50 cents a litre?

In 1935 a dozen eggs cost 31 cents.

In 1960 a dozen eggs cost 55 cents.

In 1985 a dozen eggs cost $1.37.

In 2008 it was $2.57.

In 2020 a dozen eggs would cost you $3.59.

Education, medical, and other costs rise far faster than this. Inflation risk is the risk that between now, retirement, and your ultimate death, the money you plan on using will buy less and less until it is effectively useless.

Interest rate risk is similar and far more deadly. When you purchase GICâ??s or bonds or other fixed income assets, their value is tied to the prevailing interest rates. When interest rates go down their value increases. When interest rates rise their value falls.

For decades we have been telling people nearing retirement to invest in bonds and GICâ??s. With interest rates today around 0% the fear is that when interest rates rise people will experience inflation (a loss of purchasing power) and at the same time the actual dollars they will get for their fixed income investments will decrease. This will wipe out the lifestyles of millions of retirees in the future.

The best ways to protect against inflation are investing in equities and capital property (ie. own your own home).

Sequence of returns risk

You can read about what sequence of return risk here.

The way to mitigate sequence of return risk is the same as mitigating volatility risk â?? utilize asset, risk, and need allocation to have cash available for predictable and semi-predictable needs as well as smaller cash flow issues in the near to medium term. We use insurance and risk transfer to have cash available for needs we canâ??t foresee or time accurately or those with the potential for the largest negative impact on our wealth.

CATEGORY

1. Financial Planning

POST TAG

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