

A Risk Drill for Your Retirement Portfolio

By [Christine Benz](#) | 05-20-16 | 06:00 AM | [Email Article](#)

This article is part of our [Risk Management Boot Camp](#) special report.

For many accumulators, the concept of risk falls into the realm of comfort level. In a market shock they might avoid looking at their statements or pour a stiff drink at the end of a particularly bad day for stocks. But unless they need their money imminently or have a habit of shifting to a more conservative stance after their holdings have fallen a lot, market volatility probably won't have too much of an effect on their plans.

Volatility--and indeed real risk--has much more tangible ramifications in retirement. A retiree who takes too little risk in her portfolio--or simply takes too much out in withdrawals--heightens the odds of running out of money if she lives a very long time. Meanwhile, the retiree with a portfolio that's too aggressively positioned could run headlong into a big equity sell-off too close to retirement, permanently impairing the portfolio he was ready to draw down.

In short, proper risk management--not too much, not too little--is of utmost importance in retirement. If you're nearing or in retirement, answering these seven questions can help you assess whether your portfolio strikes the appropriate balance.

Question 1: Does the portfolio have enough liquidity?

Liquidity--ready cash you can draw upon to meet in-retirement living expenses--is the lynchpin of [the bucket approach to retirement portfolio planning](#). The idea is that even though your long-term holdings (stocks and bonds) may slump at various points in time, having enough cash set aside can tide you through those weak market environments without having to sell anything when it's depressed.

To arrive at a baseline target for liquid reserves, I recommend that investors determine their annual in-retirement income needs, then subtract from that amount any certain sources of income, such as Social Security or pension income. The amount that's left over is the amount that the portfolio will need to replace per year; multiply that amount by 1 or 2 to help right-size your cash reserves. Retirees will also want to have emergency funds set aside to cover unanticipated expenses. [This article](#) takes a closer look at liquidity during retirement.

Question 2: Does the portfolio have enough growth potential?

Look at it this way: Cash yields next to nothing. Current bond yields, meanwhile, are a good predictor of what you can expect from the fixed income asset class; high-quality bonds are currently paying about 1% to 3%, depending on maturity. Given those numbers, it's easy to see how a portfolio composed of fixed-rate investments is apt to be decimated by inflation over time. To earn a positive real return over their 15- to 30-year in-retirement time horizons, investors have must venture into assets with a higher potential payoffs, especially stocks. That explains why [Morningstar's Lifetime Allocation Indexes](#)--as well as [my model "bucket" portfolios](#)--feature

significant equity weightings, even for investors who are near or in retirement. Retirees for whom Social Security and/or a pension are supplying a big share of their living expenses may be able to run with even higher stock weightings than what is featured in the aggressive versions of my model portfolios.

Question 3: Is the portfolio courting too much risk?

At the opposite extreme, retirement portfolios that are too heavy on stocks court sequence of return risk, which I discussed in [this article](#). That means that if a stock-heavy retirement portfolio runs into a lousy equity market early on, and the retiree spends from that portfolio rather than leaving the depressed equities in place to recover, the portfolio's sustainability over a long time horizon is imperiled. Not only that, but retirees with too-risky portfolios court more behavioral risks--that is, if their portfolios are too stock-heavy, they might be inclined to switch to a more conservative mix after their portfolios swoon. [This article](#) delves into the importance of periodically trimming appreciated securities (especially equities) in the years leading up to and during retirement.

Question 4: Does the portfolio have a well-thought-out drawdown strategy?

Withdrawals can make or break a retirement plan. Take too much and you risk running out of money prematurely; take too little and you risk not enjoying your retirement fully because you've underspent. The specific strategy you use to extract money from your portfolio--harvesting income, selling appreciated securities, or a combination of the two--can also influence your long-term return. Because drawdown/withdrawal strategies are so central to the success or failure of a retirement plan, paying an advisor for a second set of eyes on your approach can be money well spent. [This article](#) takes a closer look at the key considerations when setting your drawdown strategy; [this one](#) features a template for documenting your withdrawal plan.

Question 5: Is there adequate inflation protection?

Young accumulators don't need to worry too much about inflation-protecting their portfolios for a few key reasons. First, they're drawing from their salaries, rather than their portfolios, for income; workers generally receive salary adjustments to compensate for cost-of-living increases. Moreover, young accumulators usually have heavy stock weightings (or they should, at least); over long periods of time, stocks will usually deliver returns in excess of inflation.

Inflation is far less benign in retirement. While retirees may receive an inflation of adjustment in some of their income sources, such as Social Security, the real income they draw from their portfolios is diminished as inflation rises. To help combat that problem, retirees need to add inflation protection to their portfolios. Treasury Inflation-Protected securities and I-Bonds provide the most direct hedge against inflation; categories like commodities, real estate, and bank loans have also tended to generate positive returns in inflationary environments. [This article](#) takes a closer look at how much of a portfolio to devote to inflation-fighting investments, while [this one](#) highlights some of Morningstar analysts' top inflation-hedging picks.

Question 6: Is the portfolio insulated from spending shocks?

Even retiree portfolios that are sensibly allocated and employ reasonable drawdown strategies can run into problems if spending exceeds expectations. Healthcare

expenses in retirement can surprise on the downside; [Fidelity estimated last year that a retired 65-year-old couple would spend more than \\$245,000 in retirement on various healthcare outlays](#). Even more sobering, the Fidelity estimate doesn't encompass long-term care costs. [This article](#) takes a closer look at the expenses that Morningstar readers say surprised them in retirement. [This one](#) delves into the basics of long-term care, and [this article](#) discusses some thoughts to bear in mind if you've decided to forego long-term care insurance.

Question 7: Is there a backup plan?

Last but not least, every portfolio needs a succession plan--a basic outline of what should happen if you're no longer able to manage your assets on your own. Enumerating all of your financial assets in a spreadsheet or other document is a good first step; [this article](#) provides a template for doing so. [This piece](#) outlines other steps in the succession-planning process, including drafting a brief explanation of your portfolio strategy and identifying someone who could manage your portfolio if you were unable to do so. Another aspect of succession planning is streamlining your investment mix and automating as much as you can: Not only will those steps simplify life for your successors, but they can also provide at least some safeguards against cognitive decline.

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No strategy assures success or protects against loss. Stock investing involves risk including loss of principal.

Bonds are subject to market and interest rate risk if sold prior to maturity. Bond values will decline as interest rates rise and bonds are subject to availability and change in price.

Treasury Inflation-Protected Securities, or TIPS, are subject to market risk and significant interest rate risk as their longer durations makes them more sensitive to price declines associated with higher interest rates.