

What to do if the Declining Market is Impacting Your Retirement Goals – October 2002

If your retirement portfolio has NOT suffered a decline over the past 2½ years then you may have a retirement problem, and you should discuss your situation with a CFP® practitioner as soon as possible. Does this seem counter intuitive to you? Actually, it's not. Here's why: While there are exceptions, most people need to invest a significant portion of their retirement portfolio in the stock market in order to reduce inflation risk and meet their long-term goals. OK, so your retirement portfolio *has* been invested in the stock market and you have suffered a significant decline – what now?

Can't sleep? September closed out the worst quarter since the market crash of 1987, and the damage was widespread across all equity asset classes (growth, value, large cap, small cap and international). However, the ten-year Treasury bonds returned over 11% on the quarter. Remember that your overall return primarily depends on your allocation between stocks and bonds. Consider: Since January 2000, the Vanguard Total Stock Market Index fund has lost 49%, but the Vanguard Total Bond Market Index fund has gained 26%. The Vanguard Balanced Index fund, which invests 60% in stocks and 40% in bonds, only lost 26%. The lesson: A well-diversified portfolio will reduce your losses, and make it easier for you to sleep at night. If you can't sleep with your current asset allocation, you may want to reevaluate it relative to your retirement needs and your risk tolerance.

Ready to jump ship? Let's assume that you have a good asset allocation, but the market has hit your overall portfolio pretty hard and it is pushing the limits of your risk tolerance. If possible, consider hanging on to your stocks and stock mutual funds for now, especially those in tax-deferred and tax-free accounts. The market as a whole—though not necessarily specific individual stocks or mutual funds—almost certainly will recover. The question is, how quickly? According to many experts, the stock market appears to be significantly undervalued—as much as 30% to 50% below a fair value. If you reduce your stock holdings now, it is likely that you will lose out on a rebound, and will probably end up selling low now and buying high later.

Since 1949, the median bear market, from peak to valley, has lasted around 12 months, with a median decline of 23 percent. The longest decline during this period was 22.8 months, from 1973–74, with a 45 percent decline in value. The shortest was less than three months. The current bear market has run over 30 months, but there are some positive signs; for example, there is a massive wave of mortgage refinancing in progress and that may improve consumer spending. If you do reduce your stock holdings, you should realize that bond prices are at record highs and interest rates are at record lows. If you sell stocks and put the proceeds into bonds, it is likely that you will suffer losses when interest rates return to normal levels. In fact, this may be a good time to sell bonds and put the proceeds into stocks.

Any bright spots? If you have losses in taxable investments, this may be a good time to harvest those losses. This process involves selling securities that have a capital loss, and buying a similar investment to participate in future market gains. However, this can be complicated due to IRS wash rules, and you should consult a professional before proceeding down that path.

How bad is it? This is a good time to reevaluate your retirement plan relative to your current financial situation. A substantial decline in your portfolio value may, unfortunately, require you to scale back your retirement goals or increase retirement savings. Those close to retirement may have to work longer than intended. Current retirees may have to return to work, at least part time, or reduce spending.

Alternatively, you may find that you really don't have a problem when you look at the big picture. If you have a good retirement plan, market corrections like we are experiencing today will not have a significant impact on your retirement goals.