Proper Diversification Can Ease Retirement Income Worries

During your retirement, you will likely need to withdraw from your investment portfolio to help pay for your living expenses. So, naturally, you'd rather not see the value of that portfolio decline. Yet, if you spend two or three decades in retirement, you might experience several steep market declines – in fact, drops of at least 20 percent have typically occurred about every four years. So when a decline occurs, how concerned should you be?

Actually, maybe not all that much – if you've prepared your portfolio for all circumstances.

Here's the key thing to remember: While the financial markets may drop sharply at any time, it doesn't mean your portfolio will fall as precipitously. For example, the S&P 500, an index that tracks the stocks of 500 large U.S. companies, might fall 20 percent, but does your own portfolio only consist of these stocks? Most likely, it doesn't. In fact, it's generally a good idea to maintain a portfolio balanced between stocks and bonds, with the percentages of each based on your goals, risk tolerance and time horizon. While diversification cannot guarantee a profit or protect against a drop, it certainly can reduce the impact of a decline.

In fact, during a significant market downturn, the difference in performance between an all-stock portfolio and one containing a mix of stocks, bonds and other investments can be dramatic. Consider this: From January 1 through March 31 of this year, the period covering the initial market decline caused by the coronavirus pandemic, the S&P 500 fell almost 20%, but a more balanced portfolio (containing 45% in U.S. stocks, 20% in international stocks, and 35% in investment-grade bonds) declined about 12% – a sizable drop, to be sure, but far smaller than the tumble of the S&P 500. *

Clearly, owning a mix of investments can help reduce the effects of market volatility on your portfolio. But it's also important to diversify with a purpose in mind. Your stocks and stock-based mutual funds are designed to provide long-term growth potential – which you'll still need during your retirement to help you stay ahead of inflation. But as a retiree, you should also be able to rely on your cash and short-term, fixed-income investments – such as bonds with short maturities, Treasury bills and certificates of deposit – for your income needs over the next three to five years. Also, it's a good idea to have about a year's worth of your living expenses in cash and cash equivalent vehicles.

Cash instruments and short-term, fixed-income investments offer you two key advantages. First, they're highly liquid, so you typically will have no trouble accessing them when you choose. Second, by having sufficient amounts in these cash and short-term instruments, you will have some protection against having to tap into your longer-term, variable investments when the financial markets are down.

With sufficient cash and the right short-term investments in place, you can reduce your worries about what's happening in the stock market during your retirement years. And the fewer concerns you have, the more you can enjoy this time in your life.

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*Morningstar. U.S. Stocks represented by S&P 500; International Stocks represented by MSCI EAFE; Investment grade bonds represented by Barclays Aggregate Bond Index.

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