The Risks You Aren't Considering

By Claire E. Toth, JD, MLT, CFP™

The financial media bombard us with news of market volatility and risk—it's their bread and butter. Point View has long advocated mitigating this volatility and risk through a disciplined approach of asset allocation, sector diversification, and regular rebalancing.

Investment risk is hardly the only one that can derail a financial future. There are many others, each of which warrants consideration even if they aren't sexy enough to talk about on television. In most cases, managing these risks, similar to managing stock market risk, comes down to diversification and vigilance.

Longevity Risk and Interest Rate Risk. Investors spooked by the stock market often retreat to fixed income and cash. That puts them at risk for the twin specters of outliving their assets and falling behind inflation. We've been in a benign interest rate environment for long enough that it's easy to forget the days of stagflation, double digit mortgage rates, and camping out overnight at the gas station. Even at a three percent inflation rate, prices double in 24 years. History may not quite repeat itself, but it often rhymes. A portfolio tilted too heavily away from stocks will not carry you through retirement comfortably.

Retirement Plan Risk. Whether or not you'll receive Social Security benefits for the rest of your life is the least of your worries. The federal government is the only payor that can print money to meet its obligations, so Social Security always has a funding source. If you have a traditional pension from a private employer or a state or local government, your benefit is only as good as the health of the plan. States such as New Jersey and Illinois have massive unfunded pension obligations. Earlier this year, Detroit retirees had their pensions reduced as part of the bankruptcy settlement. Although traditional private pensions are exempt from the employer's creditors, they are still subject to underfunding and investment mismanagement; the plan participants end up shouldering that risk without seeing what's in the plan. The Pension Benefit Guaranty Corporation, which backstops private pensions much as the FDIC backstops banks, only guarantees benefits up to a certain monthly amount. That differs with a retiree's age and marital status. For a 70 year old couple taking a joint and 50% survivor benefit, the monthly guaranteed amount is $7,487. However generous that sounds, the PBGC is woefully underfunded; a rash of pension plan payouts could easily empty its coffers.

Deferred compensation plans, typically offered to higher paid employees, carry a different risk. Because these plans are outside the traditional retirement plan arena, retirees cannot roll them out to IRAs—the only realistic choice is to receive a stream of payments. That payment stream is at risk if the employer goes bankrupt. More recently some companies have chosen to terminate their plans and pay retirees a lump sum present value payment. This creates a massive immediate tax bill and a greatly reduced after-tax investment pool to support the same monthly cash flow the retiree had been enjoying. Holding assets outside employer retirement plans helps balance both of these risks.

Real Estate Risk. Most peoples' home is their largest single investment, its equity representing a far larger share of their total net worth than does any single security. Add a vacation home within a few hours' drive, and an investor likely has a far larger exposure to real estate and the local economy than he realizes. Real estate offers many intrinsic rewards but comes with high carrying costs. It's illiquid and difficult to tap for ready cash. The same economic conditions that depress real estate prices often depress the overall market—in other words, real estate tanks when the markets do—witness 2008. Investors who would excoriate an investment advisor for putting ten percent of their net worth in a single stock think nothing of doing the same for themselves with local real estate.

Under-insurance Risk. Two speedy ways to deplete your wealth are to develop a debilitating medical condition and to get sued. The latter is far easier to protect against: carry a healthy amount (at least $2 million and perhaps as much as $5 million) of catastrophic coverage, often referred to as the umbrella policy. This is cheap insurance that protects you from the most devastating of losses. Chances are you can fund it by raising deductibles on your homeowner's and auto policies. You aren't going to file a claim for a $500 matter, so don't pay for a low deductible.

A medical catastrophe is more difficult to insure against. Present estimates for even routine end-of-life care, encompassing some combination of assisted living and skilled nursing, run about $1 million. Currently available long term care insurance doesn't begin to offer that in lifetime benefits, and the premiums are a hefty percentage of total benefits. Those still working, particularly those not close to retirement, need a concrete plan for dealing with disability. Most employer-provided disability insurance covers 60 percent of base salary (no bonuses or commissions) and is 100 percent taxable. Determine what your exposure is and work with your advisor to determine if there is a funding gap and how to bridge it.

Concentrated Stock Risk. Many investors have an outsized slug of their net worth invested in a single stock, whether by employment, inheritance, or some other factor. Often, investors are reluctant to sell, citing tax reasons. This risk is exacerbated when an investor holds her employer's stock—then both her job and her nest egg are at risk if something untoward happens to the company.

Diversification is one of the few free lunches in investing. If that outsized position became worthless, how badly would it affect your financial health? If you can't accept the hit, create a timetable—perhaps straddling a couple of years—to dollar cost average your way down to a reasonably sized position. Sales in tax deferred accounts are easy, because there is no tax bill. Start there, and move to your taxable accounts next.

Oversaving Risk. This is a problem we'd all like to have—facing retirement with more assets than we need for the rest of our lives. Don't be afraid to enjoy your money and use it for things and (more often) experiences that bring you joy. Just do it responsibly. Having a concrete plan you revisit periodically can keep you both from overspending and from being afraid to spend.