Retirement: It Is a Scary New World Out There

BY ZAIM HAJDARI

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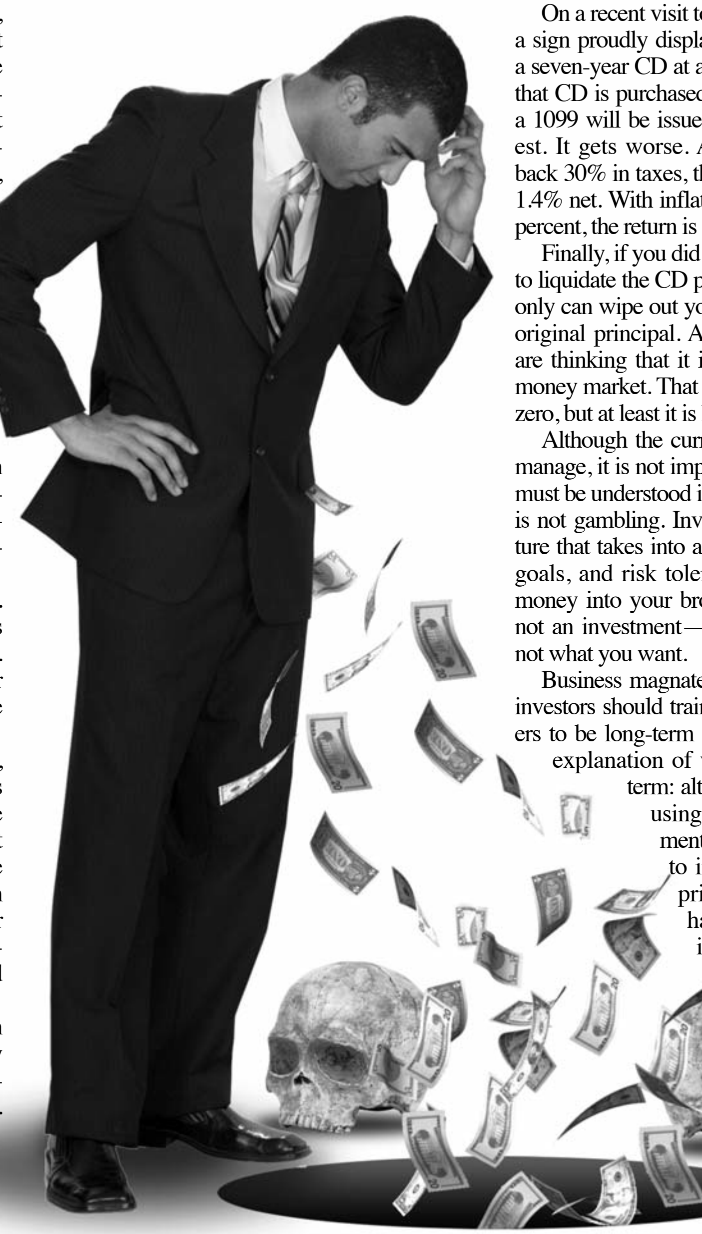

IN THE IMMEDIATE postwar years, funding the American Dream seemed a lot simpler. More citizens could rely on the traditional pension plan from their employers—as well as on Social Security—without having to listen to dire predictions of its bankruptcy. People went to work, bought a house, and put their children through school. After the kids moved out, parents finished paying off their mortgages and eventually became grandparents. Then they retired, collected their guaranteed income, and enjoyed their golden years.

This was the American Dream my own parents pursued when immigrating to the states. Their understanding was that, through hard work, disciplined saving, modest investing, and living within your own means, you can live a good life, raise and provide for your family, and retire comfortably—regardless of whether you were an entrepreneur, corporate executive, or union worker.

Today, the financial world is more complex. People are feeling panicked and, with worries about their financial future, they are pulling back. That, however, is not what the market needs—or what each individual investor should do. A more measured response is called for.

Fewer companies are offering pension plans, and many that do have them are in the process of dissolving them. Even if you believe in the long-term sustainability of Social Security, that is missing the point. The main issue is that the move to a 401(k)-based retirement system means that the future of retirement is in your hands—not your employer's and not the government's. You have to educate yourself, and take responsibility for getting the help you need.

Saving and investing have become an even greater challenge because of the extraordinary time that we are in and the unconventional market environment. Saving alone is not enough. We now face a bigger question: where do we put our money so it can grow and keep pace with inflation? If you answered "under the mattress," you are not alone.

On a recent visit to the bank, I nearly ran into a sign proudly displaying an advertisement for a seven-year CD at a mere two percent—and if that CD is purchased outside a retirement plan, a 1099 will be issued taxing you on that interest. It gets worse. Assuming you are giving back 30% in taxes, that only is approximately a 1.4% net. With inflation at approximately three percent, the return is a negative 1.6%.

Finally, if you did not plan properly and need to liquidate the CD prematurely, the penalty not only can wipe out your interest but invade your original principal. At this point, you probably are thinking that it is best just to leave it in a money market. That has an interest rate close to zero, but at least it is liquid—some choice.

Although the current situation is difficult to manage, it is not impossible. The first thing that must be understood is what it means to invest. It is not gambling. Investing is a plan for the future that takes into account your current assets, goals, and risk tolerance. Putting all of your money into your brother-in-law's restaurant is not an investment—it is a gamble, and that is not what you want.

Business magnate Warren Buffett once said investors should train themselves as shareholders to be long-term investors. Here is a useful explanation of what it means to be long term: although I am not suggesting using your home as an investment, it is a profitable exercise to imagine your house being priced on a daily basis and having the price published in the *Wall Street Journal*. I guarantee you there would be days when there was no market for it. Does that mean that it is not worth anything? Of course not. It only means that you should not let your long-term visions become blurred by daily volatility.

Indeed, the biggest mistake the average investor can make is monitoring the value of his or her portfolio on a daily or weekly basis—monthly is the most you should do. If you have a sound plan, assembled with the aid of a professional financial planner, there is no good reason to be monitoring your investments on a daily basis and tuning into financial news. That kind of checking encourages emotional and irrational decisions.

A Harvard University study of investment habits found that those who consumed no financial news earned better returns than others who were fed a constant stream of it, and the results were even more dramatic with regard to volatile stocks: in those cases, investors who learned nothing about their stock earned more than twice as much money as those whose trades were influenced by the media. The bottom line is that you should not be investing in stocks unless you can commit to at least a five-year time horizon. (Only half-kidding, Nobel Prize-winning psychologist Daniel Kahneman once said investors should only be allowed to check their retirement accounts once every five years.)

Of course, the devil is in the details. A sound plan with a long-term investment strategy is needed; picking whatever stocks look good at the moment is not a plan, although many individuals seem to think it is. You should rest easy under the assumption that nothing fundamentally has changed with an investment as it goes through normal cycles. It will fluctuate; that is normal. You should not be making decisions to buy or sell simply because the market is gyrating. When the market is down, you need to understand your own investment objectives, and how these relate to your risk tolerance and time horizon. When the market is up, you need to ask yourself the same questions. Recognize what you can and cannot control. You cannot control the markets, but you can control your personal finances.

It is common not to have a plan, so you are in good company, but Americans are facing yet another problem—too much information, and it can be paralyzing. The sheer choice of underlying investments can create as much confusion as it does opportunity.

How much do individuals need to be saving today and, going forward, in order to live the life they choose? How do they manage those investments, including 401(k) plans, IRAs, or other accounts? Ask yourself: what should I be investing in during different stages? That is, what is the investor life cycle? How much do you need today or every week or month or year to achieve that goal? Are you acting your age when it comes to investing, whether it means being more or less aggressive? Ultimately, time is what will smooth out the ride—just be aware of how much time you have. You never want a permanent solution to a temporary problem and you probably cannot afford to lose the opportunity cost.

Finally, whom are you taking advice from? Is that person really more qualified than you are? When you do choose a financial advisor, use the same methodology as you would going to a health professional—be up front as you can—and be prepared with a solid idea of your financial stomach. Make sure your advisor shows an interest in your goals and dreams, and does not just want to sell you products. It is about you, not the mutual funds, stocks, bonds, or annuities you are purchasing.

For example, you and your advisor have to discuss your tolerance for risk and volatility. Transparency, with open and honest communication, is the only route to having your personal and financial genetic makeup mapped out. Together, you will take a snapshot of your life right now and compare it with where you wish to be. Then discussions can take place on how to get there.

Once your plan is in place, do not make any major changes to it without some discussion. Would you amputate your hand for a paper cut on your finger without a second opinion? If you feel really passionate about something, speak to someone—then sleep on it. It may prevent you from making emotional decisions.

Every investor is unique. What is right for you is not necessarily right for your neighbor, but there are some general rules and concepts you can follow. Here are a few strategies to help you focus your financial plan:

Do not chase returns. Very few investments in life will be so dramatic that they cannot wait a day or two, or even a week. On the other hand, do not panic just because you have seen some short-term volatility. For instance, given the long-time horizon if you are 20 or more years away from retirement, one should have substantial exposure to developed and emerging international markets. Yes, there are plenty of ups and downs, but there is enormous growth potential there.

Some people go to the other extreme, however. They become so concerned with any and all changes to such a degree that they only are willing to make conservative investments—such as government bonds. Although these may have a place in your portfolio, they should not be the only thing, especially if retirement still is far away. These bonds may be backed by the full faith and credit of the government—but it is a double-edged sword, and you may not have enough for retirement.

Stop trying to keep up with the Joneses. Do not spend—think about saving. Take lessons from Uncle Sam, who always is first in line to be paid (assuming you are a W-2 employee and have taxes deducted from your paycheck automatically). Pay yourself first. Save—and nothing beats starting early—and commit to a regular plan, especially through a 401(k) if your company has one. Put yourself on a systematic plan where you invest a fixed dollar amount on the same day of each month. This is called dollar-cost averaging. You schedule automatic transfers of a predetermined amount from checking to an investment program.

Once you get on a plan, stick to it. Use the George Foreman adage: "Set it and forget it." Monitor it every month or quarter for continued progress and tweak it if your goals, time horizons, or tolerance for risk or volatility change. Tweaking should be rare, however. Again, it is not about chasing a hot stock. Many advisors suggest changing your plan no more than annually, and only in response to major changes in your life.

Just bear in mind while you are monitoring to ask yourself, based on your latest set of personal conditions, how much cash will you need (in today's dollars) to retire? In a balanced portfolio, I like to use a six percent return assumption for the next 10 years to fund future goals.

Be risk averse. Allocate your investments by hedging your bets in the market. For example, let us say your husband encourages you to buy 100 shares of Apple because expected earnings are being reported at the end of the week and he feels the price of shares will react favorably. In today's investing climate, try buying 25 shares. That way, if it does great you will feel good about it, and if it does not and the market reacts negatively overall and it drops, then you will feel good that you did not allocate the entire investment in one lump sum. Besides, in a week or two, or month, down the road, another opportunity will present itself. It is about averaging out your cost.

Stay diversified. Probably the most important step in building your investment portfolio is diversification through proper asset allocation. By following this strategy, you can avoid the pitfalls of chasing the latest investment trends. Explore a wide range of products that can give you the returns you want while limiting your risk. If you have a 401(k) plan, it almost certainly comes with a wide range of investment options and selections based on your age and risk profile.

If you are self-employed, you and your advisor will have to be a little more proactive. For instance, you might want to explore annuities, which can help create a long-term income stream that resembles a traditional pension. It can complement your stock and fixed income investments nicely and help provide for income certainty later in life. Always be sure to choose a highly rated annuity provider as guarantees are based upon the claims-paying ability of the insurer.

Retirement is not 'the end.' Rather, it is the beginning of a long—and well-funded—chapter in your life. The present economic environment may be tougher than the last generation's. However, today's investment scenario simply is about perseverance and tenacity. Manage the present to create your future. ★

Zaim Hajdari *is a branch manager of Raymond James Financial Services Private Client Group and founder and president of the Hajdari Group, New York.*