from the October 01, 2007 edition - http://www.csmonitor.com/2007/1001/p13s01-wmgn.html

Time to reassess investment risk

Market volatility this summer has led investors to seek safer ground. Here's where to go.

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For investors, this summer put risk back on the radar screen. Stock markets witnessed some of the biggest one-day swings of the decade, and the Dow Jones Industrial Average was hit with a roughly 10 percent downward correction.

For all the bumps, the Dow today isn't far from the record high it reached back in July, but uncertainty lingers.

The concerns: Tighter credit conditions and a housing slump appear to be slowing the economy, and that could potentially spell trouble for corporate earnings.

At the very least, this isn't a quiet bull market anymore and some investors are wondering whether they should apply any new strategies to manage risk. "I've been fielding more calls" on the subject, says Jason Mirsky, director of wealth management at RiskMetrics Group, a New York firm that specializes in analyzing financial threats.

Some of the best steps people can take will resonate with anyone who has read the handouts from their 401(k) plan or brokerage firm: Spread your risk by diversifying, and rebalance your portfolio if it gets out of line with your desired mix of stocks, bonds, and other holdings.

But financial experts also point to other, less familiar moves. They include investing in yourself, buying insurance products, and taking advantage of opportunities overseas.

The issue of risk came to the forefront this summer as banks and other institutions grappled with a plunge in the value of investments tied to subprime mortgage loans. The collapse of a few mortgage lenders rippled outward. Financial pros began repricing investments with a more sober assessment of the potential for trouble as well as for gains. "You've seen what happens when you look for too much return" and forget about risk, even in supposedly safer fixed-income investments like mortgage-backed securities, Mr. Mirsky says.

The answer isn't necessarily to sell all your stocks – which often offer the greatest potential for large investment gains over the long-term.

But the subject of risk is relevant now for reasons that are more far-reaching than the gyrations on Wall Street.

With the aging of the baby boom generation, more Americans are nearing the end of their careers. This comes as longer life spans are increasing the length of retirement. This "longevity risk" means people may need more money than ever for retirement living and the possibility of long-term nursing care.

"If you were going to prefund all your healthcare costs ... a single individual at 65 would need about a quarter of a million dollars," says Olivia Mitchell, an expert on retirement finances at the University of Pennsylvania's Wharton School in Philadelphia.

Invest in yourself

To meet those and other costs in retirement, the best investment workers can make probably isn't in stocks, bonds, or their home – it's in themselves. To increase financial security, Ms. Mitchell says, "work until you're 70.... The longer you can continue working, even on a part-time job, the later you can defer having to draw down your assets."

Moves to maximize salary and employability can pay big dividends. Mitchell recommends that people learn new computer skills and about the latest trends in their industries. "All those things make you much more viable as an employee in your 60s," she says.

In addition, boomers can participate in social networks like your own neighborhood. The connections you make, and the help you give to others, could bounce back to assist you if you face a job loss or other need.

Consider annuities

Another option that experts say can reduce risk is annuities. The decline of the employer-sponsored pension with a guaranteed payout for life has added a new measure of retirement insecurity for millions of Americans. To address that, insurance companies are offering a variety of annuity products that promise a fixed lifetime payout.

One relatively new program from MetLife approximates the virtues of a traditional defined-benefit plan. Called Personal Pension Builder, it's offered as an option in some 401(k) plans from Merrill Lynch.

"It's a complete change in the way people think about their 401(k)," says Jody Strakosch, a MetLife executive for the product. "We've thought about 'accumulate, accumulate, accumulate,'" she says. This option represents a growing focus on income reliability.

Ms. Strakosch says it's not an either-or choice. By putting some money into a relatively risk-free annuity, investors might feel freer to dabble in stocks.

If a worker plows $100 a month into MetLife's "pension builder" starting at age 35, she'll receive monthly checks of $708 during the distribution phase starting at age 65. The return on investment may not beat the stock market, but it's assured (subject to the financial health of the insurance company).

While annuity payments are often fixed, inflation isn't. To counteract that, you might seek a product that comes with built-in adjustments tied to changes in the consumer price index. Also, keep in mind that unless you opt to pay extra, an annuity leaves nothing to the heirs of your estate.

Outside of 401(k) plans, MetLife also offers a retail variant of its pension builder, called Personal Income Builder. The growing range of annuity products comes as recent academic research has affirmed the usefulness of guaranteed-income annuities.

Globalize your portfolio

Finally, overseas stocks may be a better risk-reducer than you think. It's true that foreign and domestic stocks generally move in the same direction. And US stocks have traditionally performed about as well as foreign ones when measured over long periods. That may continue, but it's also clear that globalization is rapidly changing the world economy. Other nations are growing fast.

In addition, some experts worry that the value of the US dollar could continue to decline. Recently, an index of the dollar relative to a basket of other currencies hit a four-decade low.

Overseas investments, notably mutual funds that don't hedge their currency exposure, are one way to minimize the risk of a falling dollar. "You don't want to ignore international," says Mirsky of RiskMetrics.

That doesn't mean now is the time for a headlong rush overseas. The dollar could as easily go up next as down. Ultimately, the best strategy is to stay diversified and match your investments to your own risk tolerance.

"If someone is not comfortable, they can reduce exposure," says Peng Chen, president of Ibbotson, a division of Morningstar that specializes in asset allocation.

Know your risk profile

The Internet is filled with tools to help you get a better handle on the realities of risk. Not only do they help you understand your risk tolerance, they can recommend asset-allocation models based on tolerance levels and even show how potential adjustments would alter the risk level of your portfolio.

One site, www.riskgrades.com, created by the RiskMetrics Group, contains a written guide titled "Return is only half the equation." Among its lessons: that stocks are not always the best investment over the long term. For example, a stock investment made at the start of 1929 would have taken 25 years to get back to its original value. For an investment made at the market peak in 1973, it would have taken 10 years. (This summer, by the way, the Standard & Poor's 500 finally made it back to its 2000 high – and it still isn't there on an inflation-adjusted basis. The Nasdaq index, laden with high-tech firms, stands at about half its peak value reached in 2000.)

At RiskGrades, you can enter real or hypothetical portfolios and analyze their risk. The site makes the risk assessment process understandable, displaying the risk of potential losses in percentage and dollar terms.

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