Investment Guide

Retirement Rescue

Janet Novack and Ashlea Ebeling 12.08.08, 12:00 AM ET

Stay on the job. Defer spending. Grit your teeth and take a hard look at your portfolio.

In 2006 Michael and Lynn Neff, now 60 and 61, thought they had retirement figured out. He quit his corporate marketing job, she shut down her Washington, D.C. educational testing business and they retreated to a $1 million, 4,335-square-foot waterfront home in Irvington, Va. (pop. 650), where he would pursue a photography career and she would do a little consulting. They sank $160,000 into renovations and bought a $57,000 fishing boat.

But they found they didn't enjoy small-town life as much as they expected and, after their portfolio tanked, didn't want to spend so much on housing. "We swung the pendulum a little too far," Michael Neff admits. Now they plan to move to Charlotte, N.C., where they hope to work more and buy a house for half the price--once they can sell their 1-acre property. They're asking $874,900 and are open to a rent-to-buy deal. "We're stuck," he says. "If we have to stay here another year, I won't be happy."

The Neffs aren't your usual hard-luck story--they have a low-six-figure income, thanks in part to her royalties from a test she created. But they're not unusual in deciding to work more, spend less and take a new look at the allocation of their investments. The Neffs had 80% of their portfolio in stocks; market losses have reduced that to 60%, where they're sticking for now.

Folks of all ages are hurting, of course. But in theory, the market downturn could work to the advantage of those 45 and younger, with decades to go before retirement--if they keep buying stocks now on the cheap. Kelly Blake, 30, a Fort Lauderdale, Fla. insurance company data analyst, has seen the value of his 401(k) fall 40% this year. He's sticking with 100% stock and is upping his contributions from 6% to 10% of his salary. "I still have a lot of time until I need the money," reasons Blake.

At the other end of the age spectrum, only 35% of households headed by someone age 75 or older own any stock at all, compared to 63% of households headed by people between 55 and 64.

So it's not surprising that those in their 50s and 60s are the most likely to be hastily rewriting their plans. They own more equities and may also have been counting on their now shrinking home equity as a backstop in retirement. "The recently retired are the most nervous group, but the preretirees are beginning to realize that in many cases their retirement plans need to change," says Timothy Wyman, a partner with the Center for Financial Planning in Southfield, Mich., who has been calming such investors daily. Here are some moves to consider.

Work longer

Even before the current mess, those in their 50s and early 60s planned (according to numerous surveys) to retire later and work more in retirement than the previous generation had. The top reason they gave was staying active. Working longer is now a matter of necessity, particularly for those who will be relying on investments, as opposed to a fat, fixed company or government pension, to supplement Social Security.

Alicia H. Munnell, an economist and director of the Center for Retirement Research at Boston College, says that workers, once they hit 62 and can claim reduced Social Security benefits, sometimes quit impulsively, even when they had planned to work longer. "There's a natural tendency, as we get older, to become intolerant of nonsense," says Munnell, 66. "It's important for people to recognize that in themselves and resist the temptation to say, 'I'm out of here.' If you get a young boss you hate, suck it up." For each month you delay claiming Social Security, up to age 70, you earn a bigger government check. That check is adjusted each year for inflation and is key to making sure you can maintain a decent (not fancy) standard of living, no matter how old you get and no matter what your investments do.

Moreover, retiring into a bear market has drastic effects on your prospects. T. Rowe Price calculates that if a 65-year-old retires and his portfolio loses 30% in the first year, he stands a 60% chance of running out of money over the following 29 years, unless he chops planned withdrawals. Yet if that 30% drop doesn't hit until 15 years into the same investor's retirement, there's less than a 5% chance that with the same assets and spending plan he'll come up short.

Spend less

It won't help the overall economy, but it's crucial to conserve your cash, particularly if you are fully or partly retired and can't ramp up earnings. "Pull in your belt. Let Nancy Pelosi and Harry Reid do the spending for you [through a federal stimulus bill]," jokes Munnell. Planner Wyman has one client putting off a $20,000 roof job and another postponing the purchase of a $35,000 Chrysler.

If you're 70 or older and haven't taken your 2008 required minimum distribution from your individual retirement accounts, delay a few weeks more. There's a chance Congress could suspend the requirement that you take a payout this year. There's also a chance Congress might provide a tax break for the 2008 distributions you do take, so stay tuned.

If, however, you're young or affluent enough that you can leave your IRA to your kids, this might be the time to take money out of your traditional IRA and roll it into a Roth.

Rent before you buy

Couples often buy a retirement home in some leisure spot, only to find it's not Shangri-la. That was no big deal when you could sell your mistake easily, maybe even at a profit. Now? Rent first in the new location, says James LaGrone, a cpa in Rockville, Md. That's what he's urging his clients the Neffs to do in Charlotte.

A couple can exclude from tax up to $500,000 in gains on the sale of a primary residence they've lived in for at least two years. Reinvesting in a new house within a certain time frame is no longer relevant to taxes. So you can take your time after selling your old house. Moody's

Economy.com doesn't expect prices to bottom out in key Florida retirement markets until 2010 or later.

Examine your stock/bond mix

Say you started 2008 with $1 million in Vanguard's Total Stock Market Index and $1 million in its Total Bond Market Index. On Nov. 12 your bond fund was worth $1 million and your stock fund only $590,000--cutting your stock allocation from 50% to 37%. Traditional investing advice would be to "rebalance" by selling bond shares and buying stock shares to get back to 50-50. In theory, rebalancing forces you to sell high and buy low. "It's the Warren Buffett point--the best returns to stock market investing come when you invest at an attractive price," says Harvard economics professor John Y. Campbell.

But before you rebalance, ask yourself if your old allocation was well considered and, if so, whether you're still comfortable with it. According to data from Fidelity Investments, 401(k) participants aged 60 to 64 held a median of 66% of their portfolios in equities at the end of 2007, up from 60% at the end of 2002. Why more stock? "Inertia. People just weren't paying attention," answers Richard Thaler, the University of Chicago behavioral economics pioneer. As their stock funds grew faster, participants never rebalanced away from them.

Is 66% stock at 60 too high? The traditional, conservative rule of thumb is to own your age in bonds, meaning a 60-year-old should be 60% in bonds, 40% in stocks. But some advisers have been advocating a higher stock allocation, based on longer life spans and the impact of inflation. T. Rowe Price, after much research, suggests 63% in stocks five years before retirement.

Maybe T. Rowe is right. Maybe not. But this higher stock allocation is not something you should allow yourself to drift into, particularly not until you assess your tolerance for risk. Nancy Anderson, a planner with Financial Finesse, which runs help lines as an employee benefit for big companies, says a recurring theme among older callers is that they discovered only after the bear market that they aren't very risk tolerant.

So what are those worried callers doing now? Mostly nothing. "People want to panic, but they don't know how," says Thaler. "They have strong competing urges. One is to get the hell out of stocks. And then there are people telling them, 'No, you should be rebalancing [to buy more stocks].' Both of these arguments sound compelling, so they do nothing," he adds.

Ironically, doing nothing now might not be such a bad response, unless an investor is young. That saver should put more in stocks, Thaler says.

What if you decided on a high-equity allocation before stocks tanked but now are uncomfortable with it? That's not so crazy--the world looks riskier, even to the pros, and you're poorer now. Campbell's research shows richer individual investors take on more risk. "People have a notion of a minimum amount they want to invest safely in a lockbox, for minimum subsistence. It's the surplus over that amount that you should rebalance, and the surplus is smaller now."

Says Ian Weinberg, head of Family Wealth Advocates, a Woodbury, N.Y. planning firm: "You need to build an allocation you can ride with."

Buy TIPs (and fixed annuities)

Don't just obsess over stocks. Take a hard look at the safe portion of your portfolio. It may not be as sturdy as you thought. Investment-grade corporate bonds have sustained double-digit losses this year, with high-yield bonds doing far worse. The result is that investors seeking safety have pushed yields on Treasury bonds to absurdly low levels--particularly considering the vast sums the U.S. is borrowing and pumping into the economy.

An exception is Treasury Inflation-Protected Securities, which provide some inflation protection, as well as protection from default risk. With TIPS, your principal is adjusted each year for inflation, and you receive a coupon consisting of a fixed percentage of that varying principal. The coupon (stated as a yield to maturity, which reflects whether the bond is trading at a premium or discount) is now 3.1% on ten-year TIPS.

If inflation stays at 4.9%, you'll get an 8% nominal return. (You're taxed each year on the whole 8% as ordinary income, even though you don't receive any cash flow from the principal adjustment. So TIPS are best held in an IRA or other tax-deferred account.) Weinberg is pouring his high-tax-bracket clients into another relatively safe option paying handsome returns: municipal bonds. In early November AAA-rated 30-year municipals were paying 5.2% in federal-tax-free interest.

Mark J. Warshawsky, director of retirement research for Watson Wyatt Worldwide, suggests investors in their 70s looking for steadier cash flow also buy fixed immediate annuities. (Vanguard and other low-cost providers now sell them.) You're letting the insurance company take the market risk and hedging another risk--namely that you'll live so long you'll outlast your money. What about the risk the insurer itself will go bust? Make sure your annuity is covered by a state guaranty fund.

Consider hiring a pro

Tools to help you gauge your risk and allocate assets are available on the Web. Fidelity's tools, for example, not only help you reach a target but also show you how specific sales or purchases would affect your overall allocation. If you find this too daunting, consider getting professional help. (But first read the story about when to fire a financial adviser.)

Erwin Freed, 68, and his wife, Carolyn, 64, decided to hire a pro when their 90% stock portfolio started getting slammed in the tech bust of 2000. Christopher Parr, their fee-only planner at Financial Advantage in Columbia, Md., says: "I told Erwin this was a high-testosterone portfolio and not suitable for someone at his stage of life."

The Freeds now have 42% of their $1.3 million portfolio in stock funds. That includes inverse funds that go up when the market is down, reducing their true equity long exposure to 30%. In the 12 months ended Sept. 30, the Freeds were down 8.6%, while the S&P 500 declined almost three times as much. Over the last five years Parr has, net of his fees averaging 0.86% a year, produced average annual returns of 5.15% for the Freeds--about the same as the S&P 500's return with a lot less volatility.

Not fantastic, but enough with the Freeds' $45,000 a year in pension and Social Security income to support their active, unpretentious lifestyle. Carolyn, a retired aerobics instructor, has got them both into ballroom dancing. Erwin is a bicycling buff. They rent a house in Florida each winter. Erwin Freed has no complaints. "Now I open my statements and say, 'No dog food tonight.'"