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Living With Market Volatility

How to protect your investments

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Market volatility is up: The Chicago Board Options Exchange's Volatility Index, which measures swings in the market, has more than doubled since the beginning of 2007.¹ Such volatility can be unsettling for retired investors who have to draw on their portfolio for living expenses. It's painful to watch your nest egg shrink -- a process that speeds up drastically when you are forced to sell principal to meet living expenses.

Some retirees might be tempted to shift assets into cash. But selling into a weak market can lock in losses. Here's what you may want to consider doing instead:

Remember that markets recover

Most retirees can expect to live at least a decade or two after they leave the work force, making them long-term investors. There is a 50% chance that at least one member of a healthy 65-year old couple will live to age 92². And as long-term investors, they can afford to ride out market declines. Large-company stocks have posted positive returns during 88% of five-year periods -- and 97% of 10-year periods -- since 1926, according to Morningstar.³

"The major risk for retirees is not the day-to-day volatility in the market -- it's the chance that their savings won't keep pace with inflation over several decades," says Jeff Bernier, managing director of Tandem Growth Financial Advisors in Roswell, Ga.

Assess your withdrawal strategy

Fidelity research has found that prudent withdrawal rates can extend the life of your portfolio.⁴ Consider a hypothetical 65-year-old couple that retired in 1972 -- not long before a major bear market -- with investments of \$500,000. They hold a balanced portfolio of 50% stocks, 40% bonds, and 10% short-term investments (30-day T-bills). If they had adopted a 10% annual withdrawal rate, they would have exhausted their savings in just eight years. If they had instead adopted a 5% withdrawal rate,

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their portfolio would have lasted 23 years. And at a 4% withdrawal rate their savings would have lasted more than 30 years.

It's worth noting that this example was constructed using historical data, meaning it included not only the bull market of the late 20th century but also two of the worst bear markets in Wall Street history, five recessions, and the high inflation of the late 1970s.

"It's simple," says Jane Marchand, president of Marchand Faries Financial Management, Inc., a fee-only financial planning firm in Jacksonville, Fla. "The less you take out now, the more you'll have later."

Examine your asset allocation

Your withdrawal rate alone won't determine how long your funds will last. Asset allocation plays a significant role in maintaining the value of your portfolio in retirement. Specifically, Fidelity research⁴ has found that portfolios with stock allocations of less than 50% have historically led to lower success.

For example, assuming a 5% withdrawal rate, a portfolio consisting of 20% stocks, 50% bonds, and 30% short-term investments has a 40% chance of lasting 25 years and just a 10% chance of lasting 30 years. Increase the allocation to stocks, however, and the scenario improves dramatically (assuming the same 5% withdrawal rate). A portfolio consisting of 50% stocks, 40% bonds, and 10% short-term investments has an 85% chance of lasting 25 years and a better than 60% chance of lasting 30 years.

"The best defense against the rising costs you're likely to face in retirement is a rising income stream," says Bernier of TandemGrowth Financial Advisors. "And to achieve that you've got to have exposure to equity-based investments with part of your portfolio."

Given that, you might be tempted to move to an all-stock portfolio, seeking even more certainty that your savings will last through retirement. However, doing so puts you at risk if the market drops sharply early in your retirement. An all-stock portfolio also exposes you to a significant amount of volatility -- so much so that you might find it difficult to

maintain your long-term investing strategy.

Older retirees can take a much more conservative approach than newly retired investors. Fidelity research has found that an all-short-term portfolio has never lasted less than 15 years at a 5% withdrawal rate. That said, a lower withdrawal rate during late retirement greatly increases the chance that you'll leave a significant estate to your heirs.

Look into alternative investments

Another way to reduce volatility is to increase your portfolio's exposure to a wide array of asset classes. Craig Israelsen, an associate professor at Brigham Young University, recently studied the effects of diversifying a portfolio that is in withdrawal mode.⁵ Israelsen found that a portfolio containing seven asset classes has a higher return than a portfolio containing just domestic equities. What's more, the highly diversified portfolio has about half as much risk as the domestic equity portfolio.

In particular, Israelsen found that real estate investment trusts (REITs) and commodities do more to reduce volatility than any other asset class, since they have a low correlation with the rest of the market. Keep in the mind that changes in real estate values or economic conditions can have a positive or negative effect on issuers in the real estate industry.

Another alternative: Consider investing in an a new type of mutual fund that offers investors regular monthly withdrawals from portfolios that are overseen by professional fund managers. For example, Fidelity offers income replacement funds with target dates every two years from 2016 to 2036. The funds invest in diversified portfolios tailored to the needs of investors with specific time horizons, with the aim of producing monthly payments that seek to keep pace with inflation.

Each of the funds is a fund-of-funds that will invest in a combination of underlying Fidelity mutual funds, as well as in funds that were designed especially for Fidelity fund-of-funds products, such as the Fidelity Freedom Funds® . Like the Freedom Funds, the foundation of the income replacement funds is a dynamic, asset-allocation approach, and proprietary rolldown -- or a strategy that begins with a

more aggressive asset allocation for longer-dated funds and gradually shifts to a more conservative asset allocation over each fund's time horizon.

Spend less -- or earn a little bit more

You might be able to extend the life of your savings significantly by temporarily trimming your withdrawal rate by a percentage point. You can do that if you're willing to cut your spending for a time, or if you find a part-time job that makes up for decline in your withdrawal rate. Either way, you'll be able to reinvest more in your portfolio. That can make a surprising difference in your long-term financial outlook.

How Fidelity can help

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1. As of March 17, 2008
2. Annuity 2000 Mortality Table; Society of Actuaries. Figure assumes a person is in good health.
3. Morningstar large-company returns as of December 31, 2007.
4. Retirement Income Planning: America's Lifetime Income Challenge, February 2008.
5. Craig Israelsen: " The Benefits of Low Correlation," published in The Journal of Indexes, November/December 2007

Performance of the Fidelity Income Replacement Funds depends on that of their underlying Fidelity funds. These funds are subject to the volatility of the financial markets in the U.S. and abroad and may be subject to the additional risks associated with investing in high yield, small cap and foreign securities.

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