Growing Your Nest Egg: Risk and Return

Growing your nest egg requires a commitment to set money aside for future use. Your retirement nest egg can consist of many different income-generating sources. Social Security or an employer provided pension often would form the basis. Employment also may give you access to 401(k), 403(b), profit sharing, stock options, and other employer sponsored retirement accounts. Individuals may add certificates of deposit, savings bonds, a private IRA, or Roth IRA to supplement retirement income. Business ownership, rental properties, homeownership, and collectibles are examples of “eggs” that may eventually create an income flow during retirement. How these various parts increase in value will depend on the annual amount you contribute during your working years, your investment choices, management decisions you and others make during your accumulation lifetime, and changes in economic conditions (also see PM 1818A, Retirement Income: How Much Do You Need?—store.extension.iastate.edu/Product/PM1818A).

All sources of retirement income are important to your overall retirement security. When you invest, you are putting your dollars at risk or taking a chance. The outcome can be a loss or gain. Potential return on an investment can be current income (such as interest, dividends, or rent) and/or capital gains (in which an investment has increased or appreciated in value). The combination of income and capital gains is the total return from an investment.

Not all your investment choices have the same potential for return. Savings accounts involving almost no risk, typically earn less money than all other investment or saving choices. More risk is involved when you invest in stocks or bonds. This is known as the risk-return relationship. In general, if you want higher returns and potential for growth, you must accept greater risk.
Management of Risk and Return

Your investment and savings choices should be based on your comfort level with risk and knowledge of the potential return.

- **Low risk investments** offer the comfort of knowing your contributions will not be lost. The risk associated with these choices is inflation. As the price of goods and services increases, the return on the investments may be too low. To grow the account you may have to make higher deposits over time. During retirement you will need to use both earnings and principle to cover living expenses. The assets in this investment choice may be depleted more rapidly.

- **Stocks, bonds, and other investments** on the Risk and Return chart have the potential for greater gain resulting in the potential for sufficient income to pay retirement expenses. These investments also have market and financial risks. Market risk includes economic, social, and political events. Financial risk is related to the financial health of the companies offering the investments. The impact of the associated risks can be loss of income flow and loss of principle.

- At the high risk end of investment and savings options are choices that can have financial risk, market risk, and marketability risk. Marketability risk results in greater swings in value over time and the investment can sometimes be difficult to convert into cash because of rapid changes in market demand. The attractiveness of these investments may not be returns they offer, but the possibility of risk reduction as they tend to increase in value when inflation is high.

Strategies for Managing Risk

**Asset Allocation** and **Diversification** are the division of your money among different risk levels or within a specific risk level. In simple terms, it means not putting all your retirement eggs in one basket.

The following examples show different approaches to asset allocation or diversification:

- Divide your conservative investment eggs into small time frames. Certificates of Deposit can be laddered (purchased over time with maturity dates occurring monthly resulting in less risk for interest rate changes).

- Retirement accounts can have funds allocated to a variety of investments including large company stocks, bonds, money market funds, and/or real estate funds (REITS).

- Stock or bond investments can be diversified by sectors. Sectors are specific industries such as utilities, energy, manufacturing, and health care.

- Stock holdings can be diversified by including companies defined by their assets or performance. Companies are grouped in categories such as large (large-cap), medium (mid-cap), small (small-cap); companies that have low prices compared to financial assets (value funds); companies that are getting bigger (growth); and international companies.

Diversification will result in more stability for your retirement accounts. When market risk results in a loss of value for one class, another class may have an opposite reaction and increase in value.

### Risk/Return Trade-Off

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<th>High Return</th>
<th>Collectibles</th>
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<td>Real Estate</td>
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An individual’s total investment in different categories (stocks, bonds, cash) is called an investment portfolio. **Asset Allocation** is the dollar portion of your total value placed in each of these categories. Investors are often defined as conservative, moderate, or aggressive in their allocation of funds.

- **Conservative investors** protect their dollar contributions with low risk choices and accept lower returns: 30 percent in stocks, 40 percent in bonds, 30 percent in cash.
- **Moderate investors** risk a greater amount of funds to increase their return: 60 percent in stocks, 30 percent in bonds, 10 percent in cash.
- **Aggressive investors** seek the highest return on their investments and take higher risks: 70 percent in stocks, 30 percent in bonds. Their choices also may include collectibles and other speculative investments.

**Give Your Allocations an Annual Tune-up**

Investment portfolios are not static—they change over time. When you are young, you can have a greater allocation in high risk choices that might give you a higher return allowing your balance to grow more quickly. A typical allocation for young investors can be 80 percent in stocks and other high risk/return investments, 20 percent in bonds. An older investor who has fewer years remaining in the workforce and less time before distributions will occur could have 50 percent in stocks and other high risk/return investments, 20 percent in bonds, and 30 percent in cash accounts. Financial firms have attempted to make this reallocation of assets simple by introducing **target date funds**. Investors indicate the year they are most likely to retire when they open the account and adjustments are automatically made as the target date nears.

The pie charts illustrate possible mixes for different stages of life. However, they do not take into account an individual investor’s risk tolerance level.

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**The Accumulation Years**
- Goal is to accumulate funds for retirement. Growth of investments is important.
- Because the time horizon is long, the investor may take on more risk by investing in stocks with potential for higher returns.

**The Transition Years**
- Nearing retirement, the prudent investor moves some retirement dollars from stocks.

**The Early Retirement Years**
- Retiree begins to spend some of the capital for living expenses. The assets must last for 20 to 30 years.
- Not all retirement funds are needed at once. Part of retirement investments should be allowed to continue to grow.

**The Late Retirement Years**
- Greater need for income as health expenses increase.
- Inflation is still a factor to consider; some investments should show growth.
- Individuals with a larger portfolio may have estate settlement objectives.

Source: Investing in Mutual Funds, Denise Matejic, Rutgers
Funds with Limited Management Options

Social Security and employer provided pensions are managed by others. Your Social Security contributions, the financial management, and withdrawal options will be established by Federal legislation. Pensions are dependent upon the financial health of the business or government organization that sponsors the plan, the skills of the management team, and the general economy. You will be able to check the annual statements to confirm contribution records are accurate, determine when to begin withdrawal of benefits, and in some cases decide if there is a remainder interest for survivors. For Social Security and pension plans, your main responsibility is to clearly understand the formula for calculating benefits, the impact of early or late retirement, cost of living adjustments that may be built into the plan, and adequacy of the fund to meet commitments.

Pensions may or may not be insured through the Pension Benefit Guaranty Corporation. Changes in participation in a pension should include meeting with the appropriate pension fund managers to determine your options for fund transfers or withdrawals. To understand your options for Social Security, refer to PM 1825B, Social Security—store.extension.iastate.edu/Product/PM1825B.

An investment portfolio needs to change as your goals, time horizon, and return needs change. An annual review of your income, cash reserve, tax situation, and asset allocation can direct your investment strategies. Keep up to date on changes in financial products to ensure you are taking advantage of new innovations that can help with diversification and return. Tax laws and changes in social programs and Social Security should be factored into evaluation of your nest egg to determine if you are making progress and to identify fine-tuning measures if you are off track. You may want to visit with a financial planner, your employer’s retirement fund manager, or other trusted financial professionals to take advantage of their expert advice.

FOR MORE INFORMATION

- Investing for Your Future: A National Extension Home Study Course—www.extension.org/pages/10984