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5 Steps For Making Equities Your Best Friend in Retirement

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If you're like many investors, at the beginning of every year, you review your retirement accounts, weighing and measuring the different options before coming up with an asset allocation that feels more like a stab in the dark than an informed decision. Even in a small company 401(k) plan, there are more variables than anyone can track and unpredictability in every choice you make. Yikes!

Yet you must determine the correct investment mix to fulfill your hopefully well-laid out retirement plans. So how do you make an asset allocation decision today with imperfect information about what tomorrow holds? By making friends with equities.

I know what you're thinking. "I'm 55 years old and only have ten years until retirement. Shouldn't I be worried about risk in my portfolio?" Absolutely! But the key to retirement income planning is to understand and balance not just one risk, but two competing risks: loss of principal versus loss of buying power.

When most folks talk about investment risk, they're talking about loss of principle, which is a definite possibility when you put your money where the market is. So if you're someone who's especially afraid of losing money, you may be inclined to shun equity investments, because they are volatile, and favor fixed-income investments, because you view them as steady.

But these days, when you need to plan for a retirement bordering on 30 years, you face an even greater risk: loss of purchasing power, i.e., inflation. Although inflation may be imperceptible from year to year, loss of buying power can be devastating over a 30-year retirement. That's why I'm a proponent of building a retirement portfolio that includes the asset class that has historically done a better job of overcoming the risk of inflation: equities!

We have been trained to love fixed-income investments for their steadiness, despite the fact that they do not provide as much long-term protection against inflation as equities. I get the longing for security, but a 'fixed'-income investment focus in a rising cost world makes little sense.

On the other hand, while stocks can do a much better job of protecting against the real risk of rising costs, putting all of your investment eggs into the equity basket can create a huge emotional liability that may be harmful to the health of your retirement account. We humans are inclined to get overly excited as our investments increase in value, when we should be adopting a cautious approach. Or we become depressed if they fall in value, when we should be excited the market is on sale.

Such tendencies lead us to make errors in judgment around our buy and sell decisions. The harsh reality is that your own behavior can cause much more damage to your retirement accounts than inflation or volatility combined. That's why you need to be mindful of the impact panic and irrational exuberance can have on your portfolio before you increase the equity exposure in your portfolio.

Ready to take the plunge? Here are five easy steps that can help you and your stocks have a lasting friendship:

1. Make peace with your fear or anxiety about the unknown. Emotional intelligence in equity investing requires accepting that the markets happen to everyone equally. Some of us are less affected by them than others. Make a conscious choice to be less affected.

2. Invest enough of your portfolio in equities to get you to your goals, but not so much that you can't sleep at night.

3. Dollar Cost Average into your retirement portfolio every single paycheck, every month of every year you work, in order to take advantage of wild swings in markets. Buying fewer shares at high prices and more shares at low prices is one of the best ways to build the asset bases you'll need for a successful retirement.

4. Rebalance the equity and fixed-income allocations in your retirement account on an annual basis. Choose a specific month/day of the year to rebalance and stick to it, rather that tinkering with your portfolio whenever you feel scared or excited about near-term events that won't mean anything 20 years from now. This annual discipline removes human foibles from the equation.

5. Equities may be your new best friend, but keep 1-2 years worth of expenses sitting in cash on the sidelines. That way when the market has another extreme meltdown, like 2001 or 2008, you won't have to sell low when you should be buying low.

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