APOGEE WEALTH ACADEMY

Top Investment Risks to Portfolio Performance (And How Tactical Asset Allocation Can Save the Day)

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When you're nearing or already in retirement, your investment portfolio becomes your lifeline—one you'll rely on for decades. But just as you settle in for a life of leisure, along come a host of risks threatening your nest egg. From market volatility to inflation to interest rate fluctuations and behavioral mistakes, there's a lot that can go wrong if you're not prepared.

But don't worry! We're not here to stress you out—quite the opposite. This post will break down the top risks to investment portfolio performance, with a heavy focus on how **tactical asset allocation (TAA)** can complement your **strategic asset allocation (SAA)** to shield your investments. And we won't bog you down with financial terminology to keep things interesting.

Risk #1: Market Volatility – The Rollercoaster No One Enjoys

Market volatility feels like that wild amusement park ride you didn't sign up for. It's thrilling when you're young and still working, but when you're in retirement, those market dips and surges can leave you clutching your seatbelt.

In the accumulation phase of life (when you're working and saving), market downturns are just opportunities to buy stocks at a discount. It doesn't carry the same psychological impact either because your paycheck is providing financial stability in this phase of life. But market drops become more dangerous when you're in retirement—drawing on your portfolio. This is because of **sequence-of-returns risk**, where bad returns in the early years of retirement can permanently damage your portfolio.

Solution: Enter Tactical Asset Allocation (TAA)

Tactical asset allocation is like the "seatbelt" for your portfolio, allowing you to adjust your investments based on current market conditions. For example, if you sense a downturn looming, TAA gives you the flexibility to shift more of your investments into safer assets like bonds or cash.

On the other hand, **strategic asset allocation (SAA)** keeps you diversified for the long term. You might have a 60/40 portfolio (60% stocks, 40% bonds) as your SAA, but with TAA, you could tactically reduce your equity exposure to 50%, or lower if you think a bear market is on the horizon. It's the equivalent of adjusting the allocation of your resources based on what's happening in the environment rather than blindly ignoring what's going on in the world.

In short, **TAA helps you weather the storm**, while SAA ensures you're diversified enough to ride out long-term market cycles

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Risk #2: Inflation – The Silent Portfolio Killer

Ah, inflation—the sneaky villain that silently erodes your purchasing power. Imagine having a retirement portfolio that's growing at a modest 3% per year, but inflation is chugging along at 4%. You're actually losing money in real terms. Not great, right?

For retirees, inflation is particularly damaging because you're often living on fixed income sources like Social Security or bonds. As inflation eats away at the value of your dollars, the cost of living keeps rising, making it harder to stretch your savings over the years.

Solution: TAA to the Rescue (Again)

Tactical asset allocation can help you combat inflation by shifting your portfolio due to deteriorating economic and market conditions. Nothing will kill your portfolio's ability to keep up with inflation in retirement like significant declines in the market. The dramatic decline, however long that may be, can dramatically limit your opportunity to recover. Losing 20% or more of your assets due to market conditions while still seeing increases in your spending requirements due to inflation is financially and psychologically burdensome.

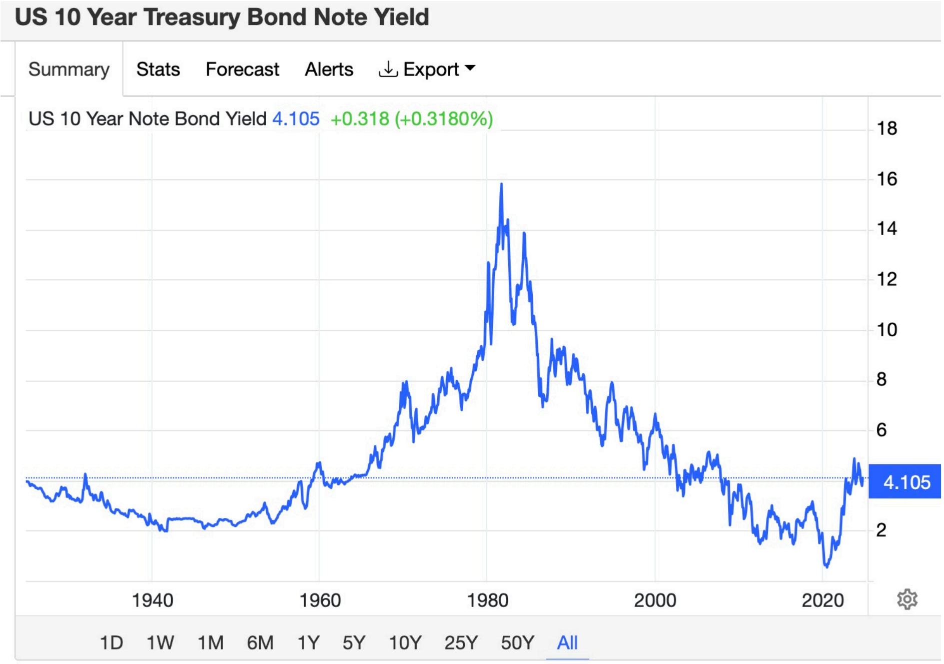
By shifting the focus of your portfolio to capital preservation in bad times, you can temporarily preserve your assets and your purchasing power. Avoiding those big declines will also provide peace of mind, which is invaluable in retirement.

Risk #3: Interest Rate Risk – Bonds Aren't Always Safe

For retirees, bonds are often seen as a "safe haven"—providing steady income without the wild swings of the stock market. But there's a catch: interest rates. When interest rates rise, bond prices fall, meaning your seemingly safe bond investments can suddenly lose value.

This is especially problematic for retirees relying on bonds for income. If you're heavily invested in long-term bonds and interest rates rise, you could be left holding bonds that are worth significantly less than when you bought them.

In August 2020, we saw interest rates bottom and the end of the declining interest rate cycle that began in 1981. We saw increases and decreases in the Federal Funds Rate in that period. However, the gradual trend was lower; therefore, bond prices steadily increased. Likewise, many experts see August of 2020 as the end of that cycle and the beginning of a rising cycle. Historically, like in a declining interest rate cycle, bond prices go up and down in a rising cycle. So don't be surprised if rates don't gradually rise, no matter what the Fed does in the near term. By the way, the last rising interest rate cycle we had lasted 40 years from 1941-1981.



Source: https://tradingeconomics.com/united-states/government-bond-yield

Solution: TAA Saves the Day (Yet Again)

Tactical asset allocation allows you to adjust your bond holdings in response to interest rate changes. If you think rates are going to rise, you can tactically shift into **short-duration bonds** or **floating-rate bonds**, which are less sensitive to rate hikes.

Meanwhile, you could also pursue bond alternatives that provide stability without the interest rate sensitivity of traditional bonds. Fixed-indexed annuities, real assets, secured lending portfolios, and so on are all potential vehicles that can be used as a surrogate for traditional bonds in a portfolio. You should work with a fiduciary to identify what is in your best interest when evaluating these options as there are always pros and cons with any investment strategy.

Meanwhile, your **strategic allocation** ensures that you're not putting all your eggs in one basket. A diversified bond portfolio—combined with equities, real assets, and other alternatives—helps cushion your portfolio from interest rate swings.

Risk #4: Sequence of Returns Risk – Timing is Everything

This risk is the most devious of the bunch. You could have the exact same average returns as someone else, but if you experience a market downturn early in your retirement, your portfolio could run out of steam faster. This is **sequence-of-returns risk**, and it's one of the biggest threats to a retiree's portfolio.

The basic idea is that withdrawing money during a market downturn locks in losses, which reduces the amount of capital left to grow when the market recovers. Over time, this can dramatically reduce your portfolio's lifespan.

What is Sequence of Returns Risk?

Sequence of returns risk is simply the idea that if you average a particular rate of return, let's say 8% over time, you won't actually get 8% every year. It will be some sequence of returns that generates your average return. Some particular statistical factors that come into play are your **standard deviation** and the **Sharpe ratio** of your portfolio.

Standard deviation is simply a measure of how wide the swings of variability will be in your performance. A higher standard deviation will have wider swings(+/-) from the average compared to a lower standard deviation. A lower standard deviation would represent a portfolio that has a more narrow spread(+/-) around the mean.

The Sharpe ratio is a calculation that measures the excess returns(above the returns you could expect when taking no risk) present in your portfolio compared to the standard deviation of a benchmark. Simply put, if a portfolio has a higher Sharpe ratio, it has a greater return versus other investments with the same standard deviation. Also, if compared to a portfolio with a higher standard deviation but the same return expectations, the Sharpe ratio could also be higher.

Solution: TAA to the Rescue (Yet Again)

Tactical asset allocation allows you to **adjust your risk exposure** during times of market turbulence. If you see a downturn coming, you can tactically reduce your equity exposure and hold more cash or bonds, protecting your portfolio from early losses. Once the market stabilizes, you can adjust back into growth assets like stocks. TAA can provide additional diversification to your portfolio at the strategy level and potentially reduce your standard deviation (volatility) without sacrificing the long-term average return you are shooting for.

Your **strategic allocation**, meanwhile, ensures that you're not too heavily exposed to risky assets in the first place, which reduces the overall impact of sequence-of-returns risk.

Risk #5: Behavioral Risk – The Human Element

Let's face it: we're our own worst enemies when it comes to investing. Market crashes can send us into a panic, leading to selling at the worst possible time. On the flip side, market rallies can tempt us to chase hot stocks or sectors, which usually ends in tears. This is **behavioral risk**, and it's responsible for more investment missteps than any market crash ever will be.

Solution: TAA's Role in Tempering Emotional Reactions

Tactical asset allocation isn't just about making smart adjustments—it's also a **built-in guardrail against emotional decision-making**. TAA follows a rules-based approach that focuses on data and market signals rather than fear or greed. By having a tactical plan in place, you can avoid making knee-jerk decisions that harm your portfolio over the long term.

Meanwhile, your **strategic allocation** helps you stay disciplined, ensuring that your portfolio remains diversified and aligned with your long-term goals, even during emotional market events.

Bringing it All Together: TAA + SAA = Portfolio Resilience

So, how do **strategic asset allocation** and **tactical asset allocation** work together to protect your portfolio?

- **Strategic Asset Allocation (SAA)** is your long-term roadmap. It's based on your financial goals, risk tolerance, and time horizon. SAA ensures you're diversified across asset classes like stocks, bonds, and real assets, helping you grow your wealth over the long term.
- **Tactical Asset Allocation (TAA)** is your short-term toolkit. It allows you to make temporary adjustments based on current market conditions, economic factors, or geopolitical risks. TAA gives you the flexibility to protect your portfolio from near-term risks without veering off your long-term path.

When you combine these two approaches, you get the best of both worlds: a portfolio that's built for long-term growth but can adapt to short-term challenges.

Conclusion: Portfolio Risks Are Inevitable But Manageable

Every portfolio faces risks, especially when you're retired and living off your investments. But by blending **tactical asset allocation** with **strategic asset allocation**, you can build a resilient and adaptable portfolio.

Whether it's market volatility, inflation, interest rates, sequence of returns, or behavioral pitfalls, TAA offers a dynamic way to adjust your portfolio based on real-world conditions, while SAA keeps you grounded in your long-term goals.

So go ahead—enjoy your retirement, sip that piña colada, and sleep a little easier knowing your portfolio has a plan for whatever the market throws your way.

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Ed Harris is the Founder and CEO of Apogee Wealth Management and the driving force behind Apogee Wealth Academy, a 501(c)(3) nonprofit dedicated to financial education. With over 20 years of experience, Ed helps clients navigate complex financial landscapes and achieve their goals through a holistic approach that considers financial, emotional, and psychological aspects of financial decision-making.

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