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Your Money: Keeping it safe

Licking your wounds after yesterday's massive selloff? Here's how to make sure your nest egg doesn't break.

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Last Updated: September 30, 2008: 4:18 PM ET

NEW YORK (Money Magazine) -- Scared yet? The U.S. stock market suffered a massive selloff on Monday and though it regained some ground on Tuesday, prospects of a bear market and a recession loom large.

The selloff erased more than a trillion dollars in stock-market value and brought 401(k)s and other retirement accounts down with it.

Whether you were for or against the \$700 billion bailout package that was defeated in Congress this week, you're probably more concerned about your own savings plan.

It's okay to feel the fear. But it's not okay to react to it. Panicking and making big changes in your accounts is likely to do a heck of a lot more damage than a recession ever could.

Sticking to some tried-and-true principles can help you get through the bad times with your sanity and your savings intact.

"Don't panic, stay the course," said Allan Roth, a financial planner in Colorado Springs. "If you can't be right at least be consistent. We're allowed to feel the emotions, but how we react to them is going to be far more important than any short-term swings."

An early start

If you're just starting to think about saving for retirement, don't delay. Despite the upheaval of the past few months - and the past week in particular - it would be a mistake for someone in their 20s or 30s to hold off on investing now.

The key here is the long-term prospects for stocks. Ultimately, stock values hinge on the productivity of U.S. workers and the earnings power of American companies. And it's not as if those engines of long-term growth are about to disappear.

The country may need some time to work through the detritus of the housing bubble and lending excesses. And stock returns could very well be anemic as that happens. But history shows that some of the best long-term gains go to investors willing to buy stocks when they're reviled, as in the years following major setbacks like the 1929 crash and the 1973-1974 bear market.

Of course, the long view may not seem particularly relevant to you at the moment. But remember: the money that you contribute to accounts such as a 401(k) is going to be invested for many years.

The real question isn't whether you should be contributing to a 401(k). It's how you should be investing the money you contribute, as well as the money that's already there.

If you're in your 20's or 30s, you still want most of your 401(k) money in stocks, say between 80% and 90%. That may be a tough sell emotionally in these uncertain times. But the important thing isn't what your 401(k) is worth over the next few years - it's what its value will be in 2040 and beyond.

Mid-career

Even if you're older, you should still think of the money you're contributing now as a long-term investment. But you also need to give some consideration to preserving the assets you've already accumulated.

That means dialing back your stock exposure somewhat, although you don't want to hunker down completely in bonds and cash. Lightening up on stocks will give you more short-term stability. But if you get too conservative, you run the risk of stunting the eventual size of your nest egg - and your lifestyle in retirement.

But before you go tinkering around with your portfolio, keep in mind that while bear markets can hurt a portfolio, how you react to downturns can make matters worse, said Roth. He points out that investing in stocks when they're hot and then running to bonds when they're not has a name: performance chasing.

"When you move in and out, you're actually increasing risk while decreasing your returns," Roth said. Over time, market timing can cost investors around 1.5% a year in returns, according to Roth.

'The danger years'

The decade before you quit the work force, along with the five years immediately after, is the most sensitive period in an entire lifetime of retirement planning. The saving, investment and career decisions you make during this time will dictate in a major way whether you'll spend the next 30 to 40 years enjoying the life you've always looked forward to or eating the early-bird special at Denny's.

"It's natural to have a queasy feeling at this time in your life, wondering if your retirement will happen as planned," says Joseph Chadwick of the Longevity Alliance, a financial services firm that specializes in retirement products. "But there's no need to panic."

Stocks held for the long term can be counted on to bounce back eventually. But if you need to sell shares just as they're dropping in value - exactly the scenario many newly minted retirees have faced recently - you run a sharply higher risk that your money will someday run out. That's because when the market does recover, you'll have less money invested to benefit from renewed growth.

Fortunately, there's a minor tweak that can dramatically cut your risk.

Typically, to ensure your nest egg lasts as long as you do, you should withdraw no more than 4% of your savings for living expenses in your first year of retirement. In year two, you might take a little more to account for inflation.

The bear-market adjustment? Give up on the inflation increase until stocks recover.

A study by T. Rowe Price concludes that this simple step cuts the odds of running out of money over a 30-year period in half, from 22% to 11%, on a sample portfolio invested 55% in stocks and 45% in bonds.

Worried that forgoing your inflation raise will bust your budget? Pull a Brett Favre and go back to work part time to make up the "lost" income. You probably won't need to put in more than a few hours a week - a 3% increase on a \$75,000 annual withdrawal equals only \$200 a month. ■

First Published: September 30, 2008: 12:48 PM ET

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