Why investing for retirement is different

When you're still employed and earning a salary, there's money coming in that you can rely on. In retirement, and the absence of a regular salary you'll need to find a new way to secure enough income to cover your living costs.

Investing your money is one way to make the most of your savings and provide an income in retirement. But if you're expecting savings and investment earnings to help cover your expenses, it's important to get your strategy right.

Why timing matters

When accumulating super for retirement, you can afford to be patient. With years ahead to top up your super, you can stay invested during falls in the share market and wait for markets – and your assets – to bounce back. For the few years just before and after retirement, it's a different story. This period, known as the 'retirement risk zone', is the time when you have most to lose from a fall in the value of investments. Your super has likely reached its peak in value and you want to make the most of these savings for your future retirement income.

In order to protect your savings and provide you with income throughout your retirement, it's important to be aware of three key risks:

1. Living longer

Australians are living longer than ever before. Life expectancy has grown by more than 30 years in the last century. Living off retirement savings for 20-30 years or more introduces the very real risk of running out of money. So it's no wonder more than half of Australians aged 50+ are worried about outliving their savings according to a 2019 National Seniors Australia survey. We're lucky that we live in a country that if your retirement savings run out; the Age Pension is there as a safety net. But these regular payments may not be enough to maintain the lifestyle you've been enjoying in retirement. You could also be left with limited funds and options for aged care, if you should need it. That's why it's so important to make a financial plan early in your retirement so that you can help to protect your income now and in the future.

2. Inflation

Inflation measures the change in the cost of living over time and represents an important and often underestimated risk to your financial security in retirement. Given your retirement could last 20+ years, there's a good chance your savings and income will be affected by inflation. At an average annual inflation rate of 2.5%, a dollar today is worth roughly half what it was 25 years ago. Even this modest year-on-year rise in the price of goods and services can put you at risk of having an income that no longer covers your living expenses from year to year.

3. Market volatility

Market volatility is a risk for investors with exposure to investments such as shares, bonds and commodities. Falls in the value of investments are impossible to predict and can make a big difference to income and financial security throughout your retirement. When investments earn negative returns, your retirement savings are falling in value. Crucially, if you also need to make regular withdrawals to pay for living expenses, it's a twofold blow for your overall financial position in retirement. Less savings now means more potential for outliving those savings later in life.

Protecting your income and future in retirement

Diversifying your investments – balancing growth and defensive assets for example – can limit the impact of market risks and inflation on your retirement savings. However, even with a well-diversified portfolio, your super and Age Pension may not provide you enough income for your entire retirement. ***Source: Challenger***

Are you an investor or a speculator?

Many investors use a consistent, long-term strategy to build a more secure financial future through steady purchases of well-diversified investments.

Speculators and market timers are usually less concerned about consistency. They may switch investment philosophies on an emotional whim, sometimes treating their investments more like play money than the serious money needed for their financial future.

Most people would probably say they are investors, but the question is not so easily answered. During a bull market, it can be relatively easy to be a long-term investor. However, when the share market starts gyrating, investors' mettle can be tested—revealing many closet speculators.

The risks of market timing

Market timers follow a fairly predictable cycle. When prices seem low relative to historical norms, they buy. When an investment's value seems to peak, they sell. This cycle is repeated with the next "hot tip." In theory, market timing seems fairly rational, but in practice it rarely works. Even the most sophisticated investors, with years of experience and the best analytical tools, cannot predict the whims of the financial markets. What's more, market timers are often misled by emotional factors such as greed or fear. Many end up buying at the tail end of a market rally or selling in a panic at a loss. The difficulty of timing the markets is complicated by the fact that most market rallies occur in brief spurts. Market timers waiting for the right opportunity to buy or sell risk being out of the market during these sudden market changes. To benefit from market timing, you must accurately predict the future, not once, but twice. First you must correctly determine when to sell. Second, you must accurately determine when to get back in. Because falling markets can rise steeply within days, your timing must be nearly perfect.

Making decisions like an investor

To avoid falling into the speculator's trap, focus on the term "individual" before making any investment decision. Your individual long-term goals and your individual financial circumstances — not the daily gyrations of the stock market— should govern your decision.

By focusing on your individual needs and sticking to your investment plan, you could actually benefit from the share market's gyrations. For example, a good long-term investment strategy generally includes investing a set amount at regular intervals. If you maintain this schedule during a market dip, you may end up purchasing some strong buys at discount prices.

Of course, changing your investments during a gyrating market is not always speculating. It can be an astute, tactical decision if the reasons for your changes are consistent with your individual long-term goals.

Examining your goals

Instead of market timing, try lifestyle timing. Look at your own investment portfolio and compare it to your long and short-term goals. Do you need to withdraw money within the next year or so to begin financing your retirement or to make some other lifestyle change? If so, you might want to re-balance your portfolio to a more conservative mix of assets. What about your long-term goals? Short-term market gyrations will probably not significantly affect your long-term plans, and it may be wise to stick with your current strategy.

Source: Russell Investments

Your biggest investing problem may be you, yourself!

Every day we make numerous judgements and decisions. As the human brain has evolved it's developed little shortcuts, or 'heuristics'. These mental pathways circumvent multi-stage decisions and allow us to make judgements quickly and efficiently. While heuristics are helpful and allow us to function without stopping to think about our next action, they can – and do – lead to cognitive biases. These biases sometimes trip us up leading to bad judgements and poor decisions. Unfortunately – and consequentially - such biases exist in the full spectrum of our decision-making, including those in the realm of investing. A vital ingredient to successful investing over the longer term is knowing yourself – and specifically knowing the mental traps you may fall into when making investment decisions. Here are a few of the more typical behavioural biases of investment decision-makers.

Anchoring bias

Anchoring bias is the tendency to rely on a particular event or piece of information. Many people base their investment decisions on the current price of an asset relative to its history. Another anchor is the purchase price of an asset. While a gain or loss represents the difference between the current price and the purchase price, is this actually helpful when deciding to buy, hold or sell?

People also anchor to events, with a good example being the Global Financial Crisis. Many investors, scarred by their loss of capital through the GFC, now anchor to the event (and the associated financial loss or psychological pain) when making investment decisions.

Investors should attempt to determine an asset's current and potential future worth in isolation from other values (or events).

Herd mentality

Humans are hard-wired to herd. So it's not surprising that this is common in investment circles. With this bias there's an element of FOMO (fear of missing out) when there's a bull-rush to a type of investment (think tech stocks in 1999); there's the psychological pain of going against the crowd; and then there's the fear of humiliation or embarrassment (aside from the financial consideration) of just being proven wrong. Recognising the lure of running with the pack requires an ability to think independently. Be self-aware about the social and emotional pull of the herd.

Confirmation bias

Confirmation bias is the tendency of people to pay close attention to information that confirms their belief and ignore information that contradicts it. This can lead to overconfidence and the risk of being blindsided.

It feels good to hear our opinions reflected back to us. There's nothing particularly wrong with this, but such bias can validate and reinforce a view which may be flawed. Instead, we should be looking for disconfirming information to test against an initial view. A discipline of stress-testing and deconstructing ideas runs consistent in many of the world's most successful investors.

Overconfidence bias

People tend to overestimate their skills, abilities, and predictions for success. Careful risk management is critical to successful investing and overconfidence tends to make us less cautious in our investment decisions. Many of these mistakes stem from an illusion of knowledge and/or an illusion of control. Overconfident investors often put down their wins to talent and losses to plain bad luck. Guarding against overconfidence involves acute self-awareness and the ability to isolate the role of skill versus timing, or luck.

Loss aversion

Loss aversion is a tendency to dislike losing money a lot more than enjoying making money. The GFC is a period in many investors' lives which created an enduring fear of substantial loss. Scarred by losses from such periods, investors can be at risk of creating portfolios too conservatively invested with a primary goal of fortifying against loss, rather than looking at their time horizon and structuring a portfolio to suit. Investors need to remember that to generate a certain level of returns they need to take a certain level of risk, and periods of negative returns are to be expected when taking on risk. The idea is to not take excessive risks in seeking to achieve a return goal.

What are your biases?

What biases might you be most prone to? Can you ascribe one or more biases to an investment mistake? Common to overcoming a lot of these biases is the ability to think independently. And if you can't do this, or don't have the time and energy, then consider employing a professional investment manager to do it for you. The best money managers are acutely aware of their biases and actively guard against them by slowing down and testing decision drivers before transacting.

Source: Pendal