Don't Let Late-in-the-Game Losses Destroy Years of Smart Saving

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Financial professionals spend a lot of time talking about volatility, and with good reason. It's every investor's worst enemy. Over time, it can harm your returns.

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Mark Twain once wrote: "There are two times in a man's life when he should not speculate: When he can't afford it, and when he can."

I would add a third and fourth time: When he's approaching retirement, and when he's actually retired.

Why stock losses are so hard to recover from

That's a hard lesson for many investors to absorb after years of striving for growth. But a major market loss can be devastating for those who are in or near retirement. And just getting back to even after a pullback or correction requires recovering much more than what you lost, because the gain is on a reduced amount.

The more you lose, the more difficult it gets. A 10% loss requires an 11.1% gain. A 30% loss requires a 42.9% gain. And a 50% loss requires a 100% gain.

So, let's say you have a balance of $100,000 in your investment account, and the markets drop about 20%. Your loss is $20,000, and your new balance is $80,000. You're a little freaked out, but you wait. And sure enough, the markets go back up by 20%.

Unfortunately, that isn't enough to get you back to your original $100,000 balance. Your gain on $80,000 was $16,000, so you're still down. You would need a gain of 25% to get back to even.

Every investor should understand that losses overshadow gains. But when you have less time to make up those losses, preserving your savings is especially important.

This principle is known as "sequence of returns risk," and it means that individuals who experience significant losses at the beginning of retirement will have vastly different results than those who experience losses many years before or after retirement.

What to do if you're at risk

Of course, no one knows what the markets will do next week or next year, so you can't time your retirement date to avoid misfortune. Instead, you have to plan around it.

One key strategy is to de-risk your portfolio by reducing the percentage of your holdings tied to the markets--at least during those 10 years or so surrounding your retirement date.

Remember, during the distribution phase, the focus is no longer on what you can earn. It's about how much you can keep. Talk to your adviser about moving some of your money to financial vehicles that have no market exposure, such as specially constructed life insurance policies with tax-exempt income, fixed and fixed index annuities with optional lifetime income riders and long-term-care riders and, in some states, life settlements. A life settlement is an investment in the secondary life insurance market, considered to be an alternative investment.

You also may wish to discuss how you might adjust your withdrawal strategy if your portfolio took a hit. The order in which you plan to tap into your retirement accounts could be key as well.

Americans are living longer--and often they're retiring without the guaranteed pensions their parents and grandparents could depend upon. Protecting your savings from the destructive effects of large losses is becoming increasingly crucial.

Market losses that occur right before or as you begin retirement not only diminish years of smart saving, they can increase the chances that you'll run out of the money you'll need either for retirement income or to leave behind as a legacy for your loved ones.

Make sure your asset allocation is appropriate for your age, risk tolerance and how much you truly can afford to lose.

Freelance writer Kim Franke-Folstad contributed to this article.