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Surprise: Yes you can prepare for volatility

If you don't know where you're going then any path will take you there. And during periods of high volatility, you're likely to wander aimlessly making bad decisions along the way. We like financial calculators because they provide a path to your retirement goal.

Recently we've been in a period of high volatility, both positive and negative. Market volatility is the variation of market prices.

What about "fat tail" or "Black Swan" events, made famous by Nassim Nicholas Taleb, professor of finance and former Wall Street trader, that move more and have only about a 0.3% chance of occurring? Three standard deviations include 99.7% of all outcomes. The event may be so good that suddenly holdings double or so bad that market prices drop in half. Although rare, these events happen and can devastate a portfolio when mishandled by the investor.

Positive fat tail events include the implementation of the mass assembly line and the creation of the public internet. Negative fat tail event examples include the terrorist attack of 9/11/01, Hurricane Katrina in 2005 and WWI that started in 1914.

Black swan events are distinctive because they are not usually a result of irresponsible market behavior, but usually an event that has so much impact, either positive or negative, that markets react and the world as we know it changes.

Housing prices started their decline in 2006 and the stock market crashed in 2008, but these are not considered black swan events because they were reactions to poor valuations and credit. Bad market behavior produced bad market outcomes.

Whether expensive hedges should be placed on portfolios to counter these unlikely events is the million dollar question. Hedging (using options, derivatives, futures, etc.) is a bit like buying insurance. If you buy it and don't need it, you're out the money you paid.

Diversification is a commonly used investment strategy. A diversified portfolio is likely to have winners and losers providing an opportunity to buy more of a beaten down position while selling some of the winner when it is high. This process is called rebalancing.

Asset categories often react differently to the same event, so holding a variety of assets (i.e. real estate, stocks, bonds, commodities, precious metals, cash, etc.) can reduce risk. Sometimes asset categories react in opposite directions.

Financial Calculators should stress-test portfolios against potential black swan events and bad timing. Although it's tempting to apply a fixed rate of return to see how long a nest egg will last, market returns aren't linear. In a volatile environment, the worst scenario for a retirement portfolio has the worst two years of investment performance occurring at the beginning of retirement.

Adding Monte Carlo simulation to the financial calculator produces a percentage of possible outcomes of not running out of money using at least a thousand different market return scenarios in random order of returns.

When riskier assets are held in long-term portfolios and safer assets are held for short term purposes, black swan events and bad market years can be managed by avoiding selling assets with negative returns. Instead, withdraw from the short-term, safer investments. This is known as the bucket strategy. After all, the key is to not run out of money while you're still breathing.

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