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Make some New Year's adjustments to your 401(k) fund

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2017 was a great year for risk takers. A typical balanced portfolio ended the year with a return in the midteens, while many U.S. stock funds returned over 20%.

If you were invested in more adventurous areas such as foreign developed or foreign emerging market stock funds, it's likely you enjoyed returns north of 25% for the year.

Returns like these can generate strong emotions. Unfortunately, two of the most common are envy and regret. Envy comes from listening to friends discuss how well they're doing and fearing you're being left behind. Regret is that nagging feeling you get wondering where you'd be today if you only bought a bunch of bitcoin at $200 a couple of years ago.

Both emotions are dangerous for investors because they motivate you to act contrary to your best interests. They tempt you to chase investments that are doing well to lessen your feelings of envy and regret, yet investing 101 teaches us to be wary of such investments because they are likely overpriced.

In the spirit of helping you combat your emotions, here's a review of the top risks in the common 401(k) menu looking ahead to 2018.

Target date funds

If you're like many 401(k) participants, you rely on your plan's target date funds to make investment decisions for you. If so, be advised most of these products take risks assuming you plan on leaving your money invested in them long after you retire.

According to the S&P Target Date Fund Index, the average target date fund for someone planning on retiring in two years, 2020, has 51% invested in stocks. During the last bear market, the average portfolio with this exposure to stocks declined 29%. If you're younger, the average 2040 target date fund has 85% invested in stocks. During that same bear market, such a portfolio declined 47%.

It's important to understand these are risks portfolio managers must take to generate the kind of satisfying return you enjoyed in 2017. If you're nearing retirement, and have all or most of your money invested in a target date fund, ask yourself if you're OK with this kind of short-term risk. If not, take back the reins and begin migrating some of your savings to safer options in your plan's menu.

U.S. Stock Valuations

It's been quite a four-year run for the U.S. stock market. Not since the late 1990s have U.S. stocks so dominated all other asset classes in terms of total return. For this reason, by almost any measure, U.S. stocks look expensive today, making them more prone to a big selloff. Funds that are heavy in FANG stocks (Facebook, Amazon, Netflix, Google) look particularly vulnerable to correction.

So while the economy remains strong, and these stocks are likely to continue to do well, be careful your portfolio has not become too overweighted in them. My suggestion, take your profits out of growth and U.S. index funds and reallocate toward value funds that have much less exposure to these overpriced sectors of the market.

Rising Interest Rates

Since 2008, central banks around the world have flooded the world's capital markets with cash to first stabilize then stimulate economic activity. The good news, this unprecedented monetary stimulus has accomplished what policy-makers set out to do — helping the economy recover from its deepest recession since the 1930s. The bad news, with the global economic expansion underway, you can expect interest rates to rise in 2018.

Rising interest rates are the enemy of longer-term bonds, because an investment with a fixed rate of return becomes less valuable as instruments with higher yields become available. My suggestion is to lessen your interest rate risk, not by selling bond funds, but by shortening your duration. That's Wall Street lingo for lessening your exposure to longer-term bonds and increasing your holdings in short-term bond, money market and stable value funds.

Let's be clear, this is not a recommendation to get out of bonds. They remain your portfolio's best protection in the event of an economic downturn or any kind of market disrupting geopolitical event. Bonds protect your accumulated wealth when you don't have a lot of time to recoup losses.

Now that we've gone over the warnings, it's my duty to point out just because we are more than eight years into a bull market doesn't mean a bear market (defined as a 20% decline from its peak) is imminent.

Bull markets don't die of old age, they get run over by unforeseeable economic, geopolitical or emotional phenomena. The new year arrives with the stimulus of new tax policies in the U.S. and a global economy that has seldom looked stronger. Most 401(k) investors should think long term when it comes to their investment decisions. The odds are high that more good times for investors lie ahead.

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