Part I
Introduction to Retirement Planning

Many Americans are not planning adequately for their retirement. Over one-third of all Americans age 25 and over have not yet begun saving for retirement at all. About 28% of workers age 55 or older have not yet begun to save for their retirement. Nearly three-quarters of all employees have no idea how much they will need to save for retirement. Surveys show the following as the main reasons that people don't save for retirement:

- **Tight budgets** – Employees not in the habit of saving feel that it is not possible for people in their pay range to set money aside for retirement.
- **Youth** – young people feel that retirement is too distant a prospect to worry about.
- **Daunting size of task** – the fact that retirement requires significant savings leads many to despair and inaction.
- **Impulsive spending** – non-savers seem to always find somewhere else to spend the money that had been earmarked for savings.

Starting Early

It is easy to find excuses not to start saving for retirement. Workers in their 20s are a long way from retirement, and their income at that stage in life is relatively low. Generally, it is later in our working lives that most of us reach our peak earnings potential. By the time an employee reaches their 30s and 40s, he or she finds themselves faced with a family and a large number of conflicting financial goals. Growing families incur growing bills, including higher mortgage payments, college funding, and simple day-to-day expenses. All of these can conspire to push retirement savings to the bottom of the priority list. But those who manage to overcome these impediments and start saving for retirement as soon as possible will be glad that they did. It is vitally important to start early, even if one can afford to save only small amounts in the early in their career.

Funding a comfortable retirement is expensive. If one retires at 65 and lives to 87, he or she must in effect fund one year of retirement for every two years worked. While retirement planning is a sizable task with sometimes-complex rules, the most important advice is quite straightforward: **<u>start saving now.</u>**

Compound Interest

The most important reason for starting early to save for retirement is the power of compound interest. Even small investments made early in life can be worth a considerable amount by the time one is ready to retire.

- Invest $500 a year –or less than $10 a week – from age 20 to age 30 in a stock mutual fund that earns an annual return of 10 percent.
- Even if one stops investing at age 30 and simply leaves the investment in the stock fund, he or she will have nearly $250,000 by age 65 – with an investment of only $5000.
- Increase the $10 per week investment to $20 per week, and the $250,000 becomes more than $500,000!

Compound interest is increasingly less potent the shorter time it is given to work. If one puts aside the same $500 a year from age 40 to 50, rather than age 20 to 30, in the same stock mutual fund earning 10 percent per year, the investment will grow to less than $37,000 by the time the employee reaches age 65.

To make up for not investing the $500 per year in his or her 20s, the worker would have to invest $6,000 per year in their 40s, or more than $115 per week, to come up with an amount equivalent to that $250,000.

The mechanics of compound interest enables one to project the impact of time on money, such as the money one expects to save and spend in the years ahead. By using the mathematics of compound interest to estimate living costs over the period of retirement years, the employee can calculate the amount needed each year in order to accumulate a nest egg by retirement, plus estimate how many years that the nest egg will last.

Start Saving Early

A wide range of options is available specifically for retirement savers, from company-sponsored 401(k) plans to Individual Retirement Accounts (IRAs), all of which can help the employee get more in accumulated retirement savings. Once the worker selects the proper savings vehicle or vehicles, he or she will need to decide what specific investment, such as stocks, bonds, or mutual funds, to place within the plans.

Many employers that have a 401(k) plan available to their employees will contribute a certain amount (perhaps 25 cents or 50 cents to the dollar) to the employee's savings for every dollar that the worker contributes, up to a certain point. This is one of the best retirement savings deals one will find. It is similar to receiving an automatic raise, or to earning an automatic profit of 25 percent or 50 percent on one's investment. If the employee fails to take advantage of this plan, he or she won't be able to make up for the delay by putting twice as much in the plan at some future time. Contribution matching offers inevitably are limited to a relatively small amount each year – either a certain dollar figure or a certain percentage of one's salary. The only way to take full advantage of the offer is to make maximum contributions each and every year that the matching offer is available.

Similar rules apply to all of the best tax-advantaged retirement plans. Even without employer matching, retirement savings vehicles such as 401(k) plans and Individual Retirement Accounts offer unique advantages to many savers. The ability to defer taxes on the money saved until it is withdrawn is the most attractive feature of these plans, however, the amount that can be contributed on a tax-deferred basis each year is inevitably capped by either one's employer, the government, or both.

Create a Plan

The single biggest mistake retirement savers make is procrastination. Even those who dive into retirement planning with the best of intentions sometimes don't accomplish everything right away. The following suggestions will help anyone to create a plan and get started:

- Make retirement savings a part of the budget. It must be a regular part of one's budget – even if it is just a small amount per paycheck.
- Take full advantage of any employer matching in a 401(k) or similar retirement plan.
- Invest aggressively, especially if one is still young. It is important that one's investments earn a healthy annual return. That usually means investing in the stock market. Over extended periods of time the stock market has historically headed consistently upward. If the employee still has 20 years or more until retirement, short-term stock market volatility is not a major factor

Assessing Resources

One of the first steps in retirement planning is to prepare a personal financial summary. This will help one to know where he or she stands financially. This summary should have two parts: (1) a balance sheet and (2) a cash flow statement. The **balance sheet** is a

snapshot of financial condition as of a single date, such as the last day of the year. It lists what one has and what he or she owes. It will list the following:

- The value of all assets, such as investments, home, car, etc.
- The amount of all liabilities, such as mortgage loans and credit card balances
- Net worth, which is simply the difference between assets and liabilities

A **cash flow statement** measures a person's cash income and cash expenses over a period of time, usually a year. The difference between income and expenses represents the amount available for investment and savings.

Asset Evaluation

Home Equity - The equity in one's home is not usually considered "available" until one reaches the age of 55. That is the earliest that one can take up to $125,000 of profit tax-free upon sale. A person may sell their home at any time and use the equity for his early retirement; however, doing so before age 55 usually results in a capital gains tax and a loss of funds to their retirement nest egg.

One may want to exploit the financial value of the equity in their home by investing it to speed retirement funds accumulation. Because of the one-time, $125,000 capital gains tax exclusion available to those 55 or older, the owner may be able to **trade down** to a smaller home and free up a substantial amount of money from the proceeds of the sale to add to his or her retirement investment portfolio. To be eligible, neither the owner or spouse may have used the exclusion previously, plus the home must have been the principal residence for at least three of the last five years before the sale date.

Reverse mortgage loans are a new form of mortgage that allows one to convert their home equity into installment payments that could provide a monthly income for life. One often has the option of receiving the proceeds from a reverse mortgage either in the form of regular payments for a predetermined period of time or in the form of a credit line against which he or she can withdraw money when wanted or needed. When one dies or moves from the house, the reverse equity loan becomes due immediately. Since there are no monthly payments due for a reverse mortgage, one does not need a salary or other earnings to qualify. The amount of monthly income that may be obtained through a reverse mortgage depends on several factors, including age, prevailing interest rates, and the value of the property. Reverse mortgages are only available for borrowers age 62 or older. The older one is when applying for a reverse mortgage, the higher the monthly payments received.

Asset Allocation

How one apportions his or her money among cash, bonds, stocks, and hard assets will determine investment return. Focusing on asset allocation can help one reach their retirement goal. Stock and bonds prices will usually fluctuate over time. Instead of focusing on the ups and downs, one should concentrate on maintaining the proper mix among the asset categories in their retirement nest egg.

Savings versus Investing

Saving money means not spending it; investing money means taking money one has saved and earning a return on it. When one waits to save and invest for retirement, they may find themselves pressed to seek higher returns from their investments in order to attain desired retirement goals. This usually means increased risk – the possibility of losing money.

Bank accounts up to the $100,000 FDIC insurance limit are free of the risk of loss of principal and interest. However, those insured savings are vulnerable to purchasing power risk, which is the chance that money invested in those accounts will have less purchasing power in the future than today.

Treasury bills and federally insured bank accounts are good examples of hidden risks one may not be aware of. The principal and interest are both guaranteed by the government up to insurance limits, but one's return may not keep pace with inflation.

Estimating Retirement Expenses

One reason that retirement planning can seem so challenging is that it is very difficult to gauge just how much will be needed at retirement. Actually this estimate is three inter-related questions:

- How much it will cost to live for one year in retirement?
- How long will the retirement be?
- What affect will inflation have?

Annual Retirement Expenses

For most people, expenses fall once they retire. A general rule of thumb is that typical individuals can maintain their pre-retirement standard of living on approximately 60 to 80 percent of their pre-retirement gross income – and sometimes even less. Most retirees find that their budget for clothing, transportation, and dining declines once they no longer head

to the office every day. Insurance bills might decline as well, since life and disability coverage often can be cut way back or skipped entirely in retirement. One should also save on taxes, since Social Security taxes are removed only from earned income, not from investment profits or pension plan income. The Social Security payments one receives should be at least partially tax free. Also, saving for retirement won't be a major part of one's budget once retired.

Retirement Budget

One should consider current annual expenditures, and then make a "best estimate" of how they will change when retired. One should carefully consider each of the following expenses:

- Housing - According to the U.S. Census Bureau, 55 percent of American homeowners have paid off their mortgage by the time they reach 65. If one is in this group, the budget will be reduced dramatically. If one plans to move to a smaller house or condo when retired, he or she might reap some savings benefit on housing costs through lower property taxes, maintenance, and heating bills, in addition to saving on the mortgage if it hasn't paid it off yet. But, as people get older, they are often less able to handle home maintenance chores themselves or they sometimes live in older homes that require substantial care.

- Insurance bills - Some retirees drop their life and disability insurance coverage, representing major savings. Other insurance premiums can be affected in the other direction. If one is currently covered by a group medical plan through an employer, they might find that medical insurance bills rise in retirement, since many retirees choose to supplement Medicare coverage, often with a Medigap policy. With or without supplemental medical insurance, one should be prepared to spend more on medical care as they gets older. The typical retiree spends 10 percent of his or her annual budget on medical coverage and care. Long term care insurance can also be a great expense.

- Taxes - One's tax bill will probably be lowered significantly by retirement. Unless one is working, they will probably not face any Social Security withholding, since these taxes apply only to earned income. Since gross income will be lower, he or she might fall into a lower tax bracket. At least a portion of Social Security benefits should be tax free.

- Clothing – It is common to reduce wardrobe expenses in retirement, since one does not need business clothes. Clothing costs should not be cut from one's retirement

- budget entirely. For most retiring professionals, they should decline by perhaps 25 percent.

- Travel, dining, and other entertainment costs – many retirees find that these expenses actually climb in the years immediately following their retirement, as they enjoy their new freedom. Travel costs may come back down as retirees get tired of traveling or as health considerations slow them down. Since one is not eating lunch out every weekday, the food budget might not rise, even though they are taking more vacations or going out more often in the evening.

- Automotive - Some retired couples decide that they no longer need two cars. Travel expenses usually drop because of not commuting to work each day.

- Savings – many savings goals such as retirement or college for children will be behind one when they retire. If a couple has been putting $10,000 aside each year for retirement, and also saving $10,000 a year for college education, they will have an automatic savings of $20,000 per year in retirement.

- Dependents – By the time one retires, their children are likely to be out of the house, which means no more expenses for them. If one is caring for their aging parents, it is possible that those expenses, too, will be nearing an end

Life Expectancy

According to a U.S. Census Bureau estimate, there are more than 100,000 Americans past the age of 100. This means that there are some people who will outlive their retirement savings, even if they have planned responsibly.

In general an American man now can expect to live to age 73.1; an American woman to 79.1. The man who has reached age 65 can expect to live an additional 15.7 years, to age 80.7; and the typical 65 year old woman an additional 18.9 years, to age 83.9. Mortality figures are just rough guides. Any number of outside factors can be added to the equation to make the estimate more accurate. Eating, drinking, smoking, and driving habits all play a role. Family health and longevity histories must also be included.

Even the best life expectancy estimates are just estimates. Unlike insurance companies that can spread the risk of a policyholder dying unusually early or unusually late over hundreds of thousands of policies, individual retirement planners must be financially prepared for the fact that they might live considerably longer than projected.

The Inflation Factor

In the vast majority of years, inflation rates in the United States remain in the low single digits. Since 1925, they have averaged roughly 3 percent per year. Inflation has been especially tame in recent years, running at a rate of only 2.5 percent per year or so over the course of the past decade. With inflation rates as low as 2.5 percent or 3 percent it's easy to consider this only a minor nuisance. In many states we pay twice that amount in sales tax.

But when it comes to inflation, the small numbers are deceiving. The cumulative affect of even low rates of inflation have a tremendous impact. Here is an example:

- A 35-year-old man determines that in order to maintain his current standard of living, he'll need $40,000 a year during retirement. He has constructed a savings plan that will deliver him exactly that amount each year. In 30 years when he reaches age 65, even a low 3 percent annual rate of inflation will have reduced the purchasing power of that $40,000 to the equivalent of approximately $16,000 in today's dollars; the man will effectively be living on 40 percent of his expected budget. By the time this man reaches age 85, that $40,000 annual income will be worth approximately $8,700 in today's dollars, 22 percent of the amount he expected.

This illustration is built on the assumption that inflation will remain low. It is risky to take for granted that inflation rates will remain low in the coming decades. It is probably a good idea to base retirement calculations on an assumption of 4 percent annual inflation. While that is higher than the average rate that has prevailed since 1925, it is lower than the roughly 4.5 percent annual rate that has existed over the past 40 years.

So one should factor inflation into his or her plans when saving for retirement. Using a 4 percent rate of inflation to calculate here is another example:

- A 35-year-old woman who expects to retire at age 65 and wants to be prepared to live to 89 with an annual income of $40,000 would need $960,000 over the course of her retirement if inflation were not a factor. But when 4 percent inflation is taken into account, in order to have $40,000 in today's dollars during her first year of retirement at age 65, this woman actually will need $130,000 for her first year of retirement alone. By age 89, she will need nearly $333,000 just to have the spending power of $40,000 today.

Inflation could be compared to a tax on savings and investments. The bite that inflation takes out of savings and the return from those savings must be considered in even short-term retirement planning. Rising prices, and hopefully, one's rising income will both impact future spending needs and future financial resources. Failing to consider inflation may leave the employee wide of the mark in reaching his financial goals.

Fortunately, a dollar received today is worth more than a dollar received in the future, because today's dollar can be invested and earn a return. The levels of real returns that are available from different types of investments vary over time depending on the relationship between inflation and nominal investment returns.

Stocks in recent years have usually generated substantial real returns – the rate of return minus the rate of inflation. Real returns for money market funds and bank certificates of deposit are generally lower.

Laying the Foundation

After one looks thoroughly at:

- Annual retirement expenses
- Life expectancy
- Inflation

Then he or she is ready to:

- List estimated annual retirement expense
- Factor in the projected length of retirement
- Consider the age at which he or she expects to retire
- Account for inflation during his or her working life
- Determine the total amount needed for retirement

Professional Advice

Finding a competent adviser is well worth the effort. Some types of investments, such as stocks and bonds, can only be purchased through licensed brokers. CDs and savings accounts require the services and advice of a banker. Insurance-related investments require insurance agents or brokers.

A **professional money manager** can custom-design an individual portfolio for one that reflects his or her specific investment goals and objectives. The services of professional money managers were once available only to very wealthy individual investors. Today, growing numbers of people can take advantage of these services. Money management services are available from independent managers, trust or private banking departments, financial planners, and stockbrokers. A professional money manager is paid an annual fee, which is typically a percentage of the assets under management.

A **financial planner** can be a valuable ally in reaching one's retirement goals. One can work with a planner on a continuing basis or pay for advice periodically as a kind of second opinion on one's program. A good financial planning professional can see to it that one's investments are diversified and consistent with stated retirement goals. A good planner can also help the consumer anticipate the tax consequences of any financial decision that might affect his or her retirement nest egg.

Many planners are registered with the Securities and Exchange Commission as investment advisers. This means that they can serve as money managers for their clients. They can create and manage investment portfolios, and charge a fee comparable to that charged by mutual funds.

Certified Public Accountants, or CPAs, practice in every town in the country. A CPA provides a variety of services, and most are well-qualified to advise one on tax matters and to prepare one's income taxes. Many CPAs have also become proficient and certified in personal financial planning.

Other professionals, such as **bankers, insurance agents, or brokers and stockbrokers**, who practice in specialty areas of retirement planning may also be able to assist one in attaining specific goals. An **attorney** is essential for preparing necessary estate planning documents such as one's power of attorney and will.

Sources of Retirement Income

The following are traditional sources of retirement income:

- Social Security
- Company retirement plans
- Company-sponsored savings plans, such as Simplified Employee Pension (SEP) plans and 401(k) plans
- Personal savings

- Individual Retirement Accounts (IRAs)
- Annuities
- Investments
- Part-time work during retirement
- Proceeds from the sale of a home
- Cash value life insurance

Putting It All Together

If it is too late to start early to plan for retirement one can:

- Postpone retirement – every extra year that one works is one more year of income, and one less year of retirement to finance.
- Work in retirement – many people choose to only partially retire. Even if one can't continue to save additional funds with a part-time career, they might be able to postpone withdrawing money from savings.
- Plan a less extravagant retirement – a smaller home and cost-sensitive travel might make retirement possible.
- Put themselves on a strict pre-retirement budget to increase savings potential.

What really matters is that one:

- Starts a consistent savings plan
- Achieves high long-term returns from their investments
- Takes advantage of tax-advantaged savings plans
- Estimates how much will needed well before retirement
- Factors in inflation and a longer-than-likely life span
- Does not outlive his or her money

Saving for retirement will remain a frightening prospect until one figures out how much savings will be needed. When long life expectancies, inflation, and taxes are taken into account, the price tag for one's retirement could well be over a million dollars, even for a relatively modest retirement. But with time on our side, such amounts are not out of reach.

The amount one will need for retirement is not written in stone. If he or she does not think they will be able to reach the mark, even with an aggressive savings plan, there are options, including living more frugally in retirement, retiring later, or perhaps working during retirement.