

Part VIII Investing for Retirement

Because personal savings and investments represent a significant source of retirement income for most people, few people can afford not to save for retirement. A general rule of thumb is that individuals need 60% to 80% of their pre retirement annual income to maintain their lifestyle in retirement. The combination of pension and Social Security income typically falls short of this goal.

Younger investors may be even more reliant on personal savings. As the population ages, the ratio of workers to retirees is expected to plunge, and some predict that Social Security payments may decrease. In addition, the average life expectancy continues to increase, adding to the number of years spent in retirement.

Because one's investment earnings will compound over time, the earlier he begins saving for retirement, the faster his money will grow. Starting early makes a difference. Many retirement plans let one invest pretax dollars. These plans not only help his money grow faster by sheltering investment earnings from taxes until he withdraws assets during retirement, but they also lower his current tax bills.

Whether investing for retirement through a company retirement plan such as a 401(k), through an IRA, or through a taxable account, the question remains:

- In what should one invest?

Once one understands what he needs from his retirement investments, most investment options easily can be eliminated as inappropriate.

Basics of Investing

The two most fundamental elements that one will need to consider about any possible investment are its potential for risk and its probable long-term return. There are ultra-low-risk investment options available, and on the surface, these can have some appeal. Such investments might offer a near-ironclad guarantee that one will not lose money. Some even offer virtually guaranteed returns each year. There are a great many investments that come with no guarantees. Generally, low-risk investments also are low-return investments. If one wants his investments to earn significantly more than the rate of inflation, then he essentially is required to put his money in investments that have the potential to lose money.

How one invests his retirement savings can be just as important as how much one saves. There are literally tens of thousands of investment options vying for one's retirement savings dollars. Many of these can be easily dismissed as totally inappropriate for one's retirement savings.

Many investors do not fully understand the fundamentals of investing and therefore may have unrealistic expectations about an investment's future performance. For example, money market mutual funds represent a low-risk haven for emergency reserves and should not be expected to match the performance of more volatile bonds.

Bonds or bond funds may not generate the growth one needs if he is retiring in 20 years or less. While the steady decline in interest rates that began in the mid-1980s has resulted in substantial capital returns for bonds funds, inexperienced investors may view these yield-driven price gains as a sustainable component of the investment returns on bond funds. When interest rates reverse their protracted decline, these investors may be severely disappointed. When one understands how to analyze an investment's past performance records and its expected role in one's retirement plan, he must learn about investment strategies and how they apply to those investments that he has selected.

Ratio analysis is used in making credit judgments utilizing the relationship of figures to determine values and evaluate risks. In other words, converting figures into ratios makes it possible to compare the value of two different sized companies. Instead of getting hung up on the price of a stock or another investment, one can look at the financial ratios that tell one the company's earnings per share or the value of assets per share.

Basics of Risk and Return

Risk is generally equated with a price fluctuation or, more accurately, the volatility of total return. Slight changes in return up or down each year denote lower risk, while wider swings constitute higher risk. **Return** is the gain one makes on an investment and his earnings; it is how much one is ahead. With a bank savings account, one's return is the amount of interest one collects. **Market risk** is the danger that financial markets can rise or fall in value. As they do, these markets affect the value of a particular investment in the market even though the other risk factors for that investment may remain unchanged.

Risk

When people refer to investment risk, they are referring to the odds that the value of an investment will decline. For example, if one takes his retirement savings and opens a restaurant, there is significant risk that the business will fail, and that he will lose his entire investment. To a certain extent, the stock market is like this as well. If one invests in a stock, not only is there no guarantee that it will provide any preordained level of returns; there is also a possibility that one could lose some or all the money that he invests.

The odds that he will lose all of his money investing in stocks are very slim, particularly if he sticks to shares of large, established firms. For example, if one invests in General Motors or General Electric, he can be reasonably confident that he will not lose all his money, since these firms have been around for a long time and the odds of their going totally out of business are remote—still, there is the possibility that one could lose some of his investment, particularly in the short term. All stocks eventually go through periods where their values decline to some degree.

The major advantage of such “low-risk” investments as an FDIC-insured bank savings account is that the risk of losing one’s money in this way is virtually nil. But while potential volatility is minimal with savings accounts and the like, there is another very significant form of risk that many investors overlook: the risk that one’s savings will be eroded by inflation and will not provide the money that one needs for retirement.

Return

Different asset classes have provided substantially different levels of returns throughout the years. Even a small increase in the annual return earned by one’s retirement investment each year can make a huge difference in his ability to finance his retirement. For example:

- \$1,000 invested between 1926 and now would have given the following returns:
 - invested in small-cap stocks – returned \$5.48 million
 - invested in large-cap stocks – returned \$1.83 million
 - long-term government bonds – returned \$38,500

The investment in small-cap stocks was worth more than 142 times as much as the investment in long-term government bonds. Over shorter time periods, the difference is less dramatic, but still very substantial.

The type of investments that one should make for retirement depend largely on three factors:

- One's retirement time horizon. Volatile investments such as stocks are not as risky if they are invested over a long period of time.
- One's retirement savings targets. This determines how aggressive one needs to be in their retirement investments.
- One's investment personality. Some investors are steel-nerved types who could watch their retirement savings decline in value by 30 or 40 percent and not panic. Others would not be able to sleep because of the potential volatility of their portfolio. Each investor needs to invest in a way that gives him peace of mind.

Diversification

Diversification is one dependable way to decrease one's investments' risk without necessarily reducing their potential for some long-term returns. **Diversification** means spreading one's investment dollars among a variety of different investments and different types of investments. Since different investments often react in differing ways to the same market condition, this can reduce the chances that one's entire investment portfolio will take a nosedive at any given moment. There are times when nearly every stock will go up or every stock will go down—although to different degrees. There are even times when both stocks and bonds head in the same direction. It is not always obvious how a stock will react to a given market condition, or possible to predict what conditions might prevail in the future.

The amount of diversification necessary depends largely on the type of investments one is talking about. With especially risky investments, such as the stocks of young technology or biotech companies, for example, the risk might be so great that most investors should have no more than a small percentage of their retirement savings in any one of these stocks. A risk-tolerant investor might be willing to hold a more significant portion of his portfolio in a single investment, if the investment is a proven stock with a track record of dependable performance.

Mechanics of a Retirement Portfolio

As noted above, the investor's retirement target, personality, and age are the three important factors in establishing the right balance of stock market returns and bond- and money-market security. The most significant factor is age. The further one is from the time he needs this money—the less stock market volatility should be a concern for him. The closer he gets to retirement it makes sense to become increasingly cautious.

One's retirement portfolio should be divided among a variety of investments. The growth portion of his portfolio should include both growth stocks and grow-oriented mutual funds. Selecting growth in both individual stocks and in mutual funds means seeking companies that will generate above-average increases in earnings, and will outperform the market in the long run.

Stocks

Usually when one buys a stock, he is buying common stock. Common stock may or may not pay dividends. The amount of dividends that each share of stock pays is known as the yield. If some shares of stock pay relatively small dividends, a higher yield might be obtained by simply investing those funds in Treasury bills. If the choice has to be made between the stock of two companies within the same industry, both with comparable qualities, the amount of the dividend may be an important deciding factor.

Stock usually refers to common stock, which represents an ownership share in the company that issued it. **Dividends** are profits that the company distributes to its owners and shareholders. **Yield** is determined by dividing the current annual dividend of any stock by the share price.

Many companies also issue a special class of shares called preferred stock. These shares generally pay a higher dividend than common stock but don't have the same price-appreciation potential of common stock.

Categories of Stocks

There are five basic, often overlapping, stock categories that one should consider for his own retirement portfolio:

- **Growth Stocks.** These stocks have good prospects for growing faster than the economy or the stock market in general. They show consistent earnings growth.
- **Blue Chip Stocks.** This is a loosely defined group. Many large growth stocks are often also considered blue chip. Blue chip stocks are generally shares of stock in industry-leading companies with highly rated financial credentials. They pay decent, steadily rising dividends, generate some growth, and offer safety and reliability.
- **Income Stocks.** These securities pay a much larger portion of their profits, often as much as 50 to 80 percent, to investors in the form of quarterly dividends than do other stocks. They tend to be more mature, slower-growth companies and the dividends paid to investors make these shares generally less risky to own than shares of growth or small company stocks.

- **Small Company Stocks.** Shares in these companies are riskier than blue chip or income stocks. As a group, their long-term average returns are also higher. These are typically newer, fast-growing companies.
- **Foreign Stocks.** These investments also play a role in most retirement nest eggs. They are available through an array of foreign stock mutual funds. The two key benefits of adding an international flavor to one's portfolio are diversification and performance. While most investors think only in terms of owning U.S. shares, the American market represents less than half of all stock market opportunities worldwide. Foreign shares help diversify one's investment because international markets usually perform differently than the U.S. market does.

Mutual Funds

A mutual fund is a professionally managed investment company comprised of a pool of investors' money used to purchase a diversified portfolio of stocks, bonds, money market instruments, or other securities. Each share in a mutual fund represents a small slice of the mutual fund's total portfolio.

Mutual Funds Categories

Like stocks, mutual funds also fall into a number of very broad categories.

- A stock or equity mutual fund invests its money in stocks of individual companies, large and small, new and old, here and abroad.
- A bond mutual fund invests its money in bonds of companies or governments that are as varied as those that stock funds invest in.
- A money market fund invests its money in short-term financial instruments, such as Treasury bills and CDs.

Mutual funds types are often described as:

- **Open-End Mutual Fund.** These sell an unlimited number of new shares and constantly repurchase or redeem outstanding one's. The amount of money in the fund is always changing.
- **Closed-End Mutual Funds.** These have a relatively fixed amount of assets under management. Closed-end funds raise money as ordinary companies do—with an initial offering on a recognized stock exchange. After they are issued, the shares of closed-end mutual funds are traded just like any other stock: on the major stock exchanges and over the counter.

Mutual funds are popular because:

- It is easy to invest in them.
- They have excellent performance.
- They are a low-cost way to diversify one's retirement
- Funds are managed by experienced professionals.
- Many of them automatically reinvest dividends and capital gains.
- Planned investment programs are offered which makes it easy to keep informed on their performance

Disadvantages of a mutual fund are:

- Their asset value will fluctuate with changing market conditions.
- Commission and fee structures of mutual funds can be confusing.

Effects of Tax Changes

The following tax changes effective in 1997 or later have a definite on impact on one's retirement portfolio:

- *Spousal IRA* - Increase the maximum IRA deduction from \$2,250 to \$4,000 for a family with one non-working spouse.
- *Spouses working in same company get a break.* The family aggregation rule will be eliminated that prevented a husband & wife working in the same company from receiving their maximum retirement benefits if they jointly earned more than \$150,000 (i.e. \$75,000 each).
- *IRAs* - Penalty free early withdrawal for medical. The 10% federal early withdrawal penalty is waived for IRA distributions for medical expenses exceeding 7.5% of AGI and the purchase of health insurance if receiving unemployment benefits for more than 12 weeks. This was part of the new Health Insurance Act
- *\$5,000 Death Benefit Exclusion* - One will no longer be able to receive \$5,000 tax free if he inherits a 401(k) or profit sharing plan from decedents dying after date of enactment (8/20/96). This was only available from business retirement plans & never applied to IRAs or SEPs.
- *5 Year Income Averaging for Lump Sum Distributions* - The 5 year income averaging method will no longer be available after 1999 for lump sum distributions from

- 401(k), profit sharing etc. This was a special tax rate that lowered the income taxes on the lump sum distribution. It also did not apply to IRAs & SEPs. The 10 year averaging method is still available to people born before Jan 1, 1936.
- *15% Excise Tax on Excess Distributions* - This tax was waived beginning in 1997 for only 3 years. The government is hoping to generate significant revenues from people who want to reduce their sizable retirement balances. Currently there is a 15% excise tax on annual withdrawals greater than \$155,000 per year or if one has too much at death from retirement accounts. This presents some interesting income & estate tax planning questions. Is it better to pay a 40+ % margin tax rate on the higher distributions now in order to avoid the 15% excise tax on tax deferred growth in the future?