WEALTH CARE KIT℠

Retirement Planning

SmartAboutMoney.org

A website built by the National Endowment for Financial Education dedicated to your financial well-being.

The headlines paint a grim picture—

"Most Americans Ill-Prepared for Retirement." "Retirees Face Cloudy Sunset." "Social Security May Go Broke by 2041."

While elements of the truth may lie behind these headlines, don't be discouraged. Chances are good that you'll have a financially comfortable retirement if you start planning adequately today.

First, let's look at some of the facts behind the headlines:

• According to a recent national survey, more than half of American workers report that they are saving for retirement, yet of those, the majority has saved less than $50,000, and almost one-half of all workers have saved less than $25,000 toward retirement.

• About 40 percent of those surveyed report that they have calculated how much money they will need to save by the time they retire, but their calculations often do not include a realistic estimate of how long they will live in retirement or how much they can count on Social Security.

• Social Security makes up less than half of the retirement needs for the majority of Americans. For example, assuming you maintain the same lifestyle expenses, Social Security would provide roughly 40 percent of your retirement income.

• The average Social Security benefit was $950 per month in 2005. Many workers are not confident that Social Security and Medicare will continue to provide benefits equivalent to those received today.

> "MANY FACTORS ACCOUNT FOR CHANGES IN RETIREMENT PLANNING, BUT TWO STAND OUT: INCREASED LIFE EXPECTANCY AND INFLATION."

• Americans say they are counting on money from savings and investments as retirement income, yet the personal saving rate in the U.S. was less than 2 percent in 2004, a very low rate.

• Fewer and fewer companies are providing traditional pension plans (guaranteed monthly payments, usually based on pay), but many of these businesses are providing alternatives, such as 401(k) plans. Such plans depend on annual employer and employee contributions and the performance of the invested assets.

CHANGING DEMOGRAPHICS AND LIFE EXPECTANCY

Many factors account for these and other wrenching changes in retirement planning, but two stand out: increased life expectancy and inflation.

As little as a generation ago, people didn't expect to live much beyond the normal retirement age of 65. Today, a person living to age 65 can expect to live another 20 years, if not longer. For some, retirement can last almost as long as their working years, particularly if they retire early or joined the workforce late in life. Assuming good health, their retirement years are likely to be more active than those of previous generations, often requiring still more money.

The impact of this increase in retirement years wouldn't be nearly so powerful if it wasn't for these significant factors: the diminishing number of pensions available today, the steady increase in health-care costs, and inflation. While inflation —commonly referred to as the rise in the cost of living—has been low in recent years, it has the potential to increase in the future, perhaps just as you are about to enter retirement.

What do these factors mean for your efforts to have your Golden Years be truly golden? More than ever before, you must take charge of your retirement future. Especially important is to strengthen your personal savings, and investments.

GETTING STARTED

So where do you start? Retirement planning is a complex and critical aspect of financial planning. While you can and should take charge of your own retirement destiny, you may need professional assistance along the way for such things as investment advice. As you near retirement, advice on the timing of retirement distributions to avoid penalties and minimize taxes can be crucial. A financial planner can help you assess where you are, where you want to go, and how you can get there. But first, familiarize yourself with the following five steps—the same steps the planner will take in greater detail—and fill out the simplified chart at the end of this section.

1. Set your retirement goals. This may not be easy if you are many years from retiring, but give it a try anyway. What kind of retirement do you envision? Exotic travel? Puttering in the garden? Starting your own business? Part-time work? Early retirement? Selling the house and moving to a warmer climate? Spending time with your grandchildren? Volunteering?

2. Estimate annual retirement expenses. While it is best to seek a financial professional's help with calculations, a very rough rule of thumb for maintaining your current lifestyle in retirement is that you will need 80 to 100 percent of your present income, adjusted upward for inflation each year during retirement. While some costs, such as income taxes and housing (if your house is paid off), may decline, others, such as health care and travel, are likely to rise. The lifestyle goals you listed in Step 1 and the costs associated with them will have a lot to do with estimating your future expenses more precisely. When looking at your own finances, consider a broad spectrum of retirement issues.

Be sure to plan well beyond age 65. As mentioned on page 1, if your lifestyle costs $45,000 at age 45, you'll need over $98,000 at age 65 to stay even with four percent inflation. By age 75, you'll need almost $117,000 a year, assuming only 80 percent of your pre-retirement income level and 4 percent inflation!

3. Determine potential resources. Calculate the amount of income that Social Security and your pension plan (if any) will provide in today's dollars. But, while Social Security adjusts annually for inflation, most pension plans do not. Over time, your pension benefits will make up a declining portion of your retirement income, forcing your investments and personal savings to make up the difference.

> "MORE THAN EVER BEFORE, YOU MUST TAKE CHARGE OF YOUR RETIREMENT FUTURE."

Every year, you should receive an estimate of your Social Security benefits from the Social Security Administration. (If you don't, call 1-800-772-1213.) The Personal Earnings and Benefit Estimate Statement will show your earnings records, your work credit, and an estimate of benefits. You also can request this information by visiting www.ssa.gov. For information on your pension plan, talk to your company's benefits specialist/personnel representative.

What is the current total value of your taxable and nontaxable savings and investments that you can devote to retirement, including employer-sponsored retirement plans? If you have a defined contribution plan, project the average return of investments in your account to determine how much personal savings you will have accumulated by retirement age. Then project how much income you can realistically expect from your plan. Are there other potential resources, such as an inheritance, a business you will have an interest in or sell, or rental property? Discussing these matters and making rough calculations with a financial planner can help you reach safe retirement ground.

4. Estimate how much you'll need to save to fund your retirement. Subtract your annual Social Security estimate and any other inflation adjusted retirement income sources from your annual retirement income needs. The difference is what you must fund out of your investments and any employer-sponsored savings plans. After considering the amount you'll get from other investments and pension benefits (which you can estimate based on information from your current company's employee benefits/personnel officer and/or from past employee records), compare your financial resources to your retirement income needs (see the chart at the end of this section).

5. Make adjustments. If current and projected resources won't provide the necessary income, you'll need to make adjustments. Options include saving more by increasing current income or reducing expenses, increasing the return on your investments, selling your home when you retire, working part time during retirement, retiring later, or lowering your projected standard of living during retirement.

OTHER RETIREMENT CONSIDERATIONS

The high cost of health care is a concern for many people facing retirement. Medical expenses can destroy the best of retirement plans. Medicare, which covers hospitalization and doctor's fees, generally provides slightly over half of the health-related costs of people age 65 and over. Private Medigap insurance can help supplement the government program.

Medical care is of special concern if you retire early, since you won't have access to Medicare until age 65. Many companies are reducing or dropping medical benefits offered to

their early retirees. You may have to extend coverage through your ex-employer's plan via COBRA rules, buy private insurance, or consider going back to work to get into a health plan.
Expensive long-term nursing home care can devastate a retirement plan. Depending on the size of the estate and other factors, financial planners advise many people to buy a long-term-care insurance policy to cover some of this risk. Working after retirement is becoming increasingly common as traditional sources of support, such as Social Security, become less viable.

ESTATE PLANNING TOOLS

A variety of estate planning tools can be invaluable in protecting your retirement nest egg from unnecessary medical, legal, or financial expenses.
A durable power of attorney is a legal document which ensures that if you can no longer manage your financial and personal affairs, a designated representative, i.e., agent, can act on your behalf.

A living will is a statement of your personal wishes as to what life-sustaining medical treatment you want or don't want should you become terminally ill and comatose. Without it, you could end up incurring medical expenses and medical treatment you may not want.

A medical durable power of attorney (sometimes called a healthcare proxy) combines the above documents. In it, you designate a representative to make medical decisions on your behalf in accordance with your wishes stated in this power of attorney.

Depending on the size and complexity of your estate, revocable trusts can be a useful alternative to a durable power of attorney to assist in property management and will reduce probate costs, but will not save estate taxes.

As you can see, retirement planning requires consideration of many components. Pulling them together mandates careful planning.

KEYS TO A COMFORTABLE RETIREMENT

With these steps in mind, here are a few strategies for making your retirement years more financially sound.

PAY YOURSELF FIRST

Even if you're trying to save money for your children's college education, a home, or other financial goals, regularly set aside money for retirement. It is best to determine a fixed amount to save regularly. Financial planners recommend saving about 10 percent per year, depending on your age, other resources, and lifestyle goals.

START SAVING IMMEDIATELY

Start saving immediately! If you invest $10,000 in a tax-deferred account at 8 percent at age 35, it will grow through the power of compounding to $100,627 by the time you retire at age 65. If you wait until age 50, you'll need to invest $31,722 at 8 percent to see it grow to the same amount by age 65.

MAXIMIZE CONTRIBUTIONS

Maximize contributions to tax-deferred retirement plans available to many working people through their employer. It's the best tax shelter around. Employee contribution plans, such as 401(k)s and tax-sheltered annuities/403(b)s (for employees of schools and nonprofits), can build significant retirement funds, especially if you contribute as much as possible to them. In many cases, the employer will match your contributions. Even with this attractive benefit, almost a fourth of eligible employees don't participate.

If you're self-employed, set up your own tax-deferred retirement account, such as a Keogh plan, simplified employee pension plan (SEP), savings incentive match plan for employees (SIMPLE), or IRA, and contribute the maximum amount possible.

Take advantage of nondeductible education IRAs, nondeductible Roth IRAs, and the liberalized rules for establishing IRAs. See your tax advisor for more details.

HAVE A CASH RESERVE

Remember, have a cash reserve set aside, preferably enough to cover three to six months of expenses, so that you don't need to dip into your retirement contributions for extra money and pay the penalty associated with it. While you should check with your employee benefits/personnel representative and your tax preparer to make sure of penalties that would apply, most workers who take plan distributions prior to retirement face a short-term problem: they must pay more taxes. The plan trustee may have to withhold 20 percent for the IRS from the distribution. Additionally, the 10 percent early withdrawal penalty may apply to those under age 59 1/2. This withholding problem and any 10 percent early withdrawal penalty can be avoided by making a direct rollover to an IRA or any other qualified retirement plan.

INVEST TO BEAT INFLATION & TAXES

Invest to beat inflation and taxes. This means investing a significant portion of your funds in growth assets, such as stocks, compared to low-yielding CDs. By diversifying and investing for the long term (five years or longer), you can minimize investment risk. When approaching retirement, many people move into "safer," lower-earning, fixed-income investments. However, because retirement may last 20 years or more, it's important that even retirees keep some money in stocks to stay even or ahead of inflation.

MAKE YOUR TAX-DEFERRED MONEY WORK HARD

If you have investment control, make the money in your tax-deferred plan work hard. The ultimate size of your retirement account depends on two factors: the amount of contributions and the earnings on those contributions. Many plans offer investment alternatives. Follow the same investment advice given earlier: diversify and put a significant portion of your money in other equities (not just in your company's stock). And if your plan allows employee contributions and company matching, be sure to take advantage of it. Often, if the company matches an employee's contribution, the worker makes a 50 percent gain on his or her contribution immediately with no risk!

> "WHICH OPTION YOU PURSUE DEPENDS ON YOUR NEEDS. SEEK PROFESSIONAL ADVICE ABOUT THESE ISSUES"

CHOSE YOUR BENEFIT CAREFULLY

If you belong to an employer-sponsored retirement plan, choose your benefit carefully when you retire. Typically you'll have to choose to (1) receive monthly payments and pay taxes based on a ratio, (2) withdraw the funds in a lump sum and pay taxes on them, or (3) have the plan trustee roll the funds over into an IRA to defer taxes, which you then control fully. The law imposes special restrictions on the amount of lump-sum distributions that may be made from a defined benefit plan. Therefore, annuity payments (assuming normal longevity) may be more valuable than a lump-sum distribution in some defined benefit plans. Which option you pursue depends on your needs. Seek professional advice about these issues.

DON'T STOP INVESTING AT AGE 65

Don't stop investing at age 65. Remember, you're likely to have a long retirement.

DON'T TOUCH

Don't touch your retirement funds except for retirement. Participants often tap their retirement accounts to buy a home or to fund their children's college education, even to buy a car. Of those who receive their pension money in a lump sum upon early retirement or when they change jobs, only about one-third roll it over into an IRA.

Realize the resulting figure is a rough estimate, which assumes expenses and income sources do not increase with inflation. You and your planner then can determine the amount you must save annually.

STARTING THE PROCESS

STEP 1

Begin retirement planning by getting yourself ready to talk with a financial professional. Use the simplified chart that follows.

- Set your retirement goals.
- What do you foresee for your retirement lifestyle? If married, discuss this with your spouse.
- How many years until I/we want to retire?
- Where will I/we live after retirement?
- How many years will I/we be retired?
- What kind of activities and lifestyle do I/we want after retirement?

STEP 2

Estimate annual retirement expenses and your pre- and post-retirement budgets in today's dollars. Your planner will adjust these amounts for inflation and help determine if your numbers are realistic.

Now	Type of Expense	During Retirement
$__________________	Housing utilities	$__________________
$__________________	Food	$__________________
$__________________	Clothing, personal	$__________________
$__________________	Entertainment, travel	$__________________
$__________________	Medical, dental	$__________________
$__________________	Car transportation	$__________________
$__________________	Insurances	$__________________
$__________________	Gifts, contributions	$__________________
$__________________	Taxes	$__________________
$__________________	Total (today's dollars)	$__________________

STEP 3

Determine potential resources. List your sources of retirement income in today's dollars. Your financial planner will adjust them and help you determine if your estimates are realistic.

	$/Year
Social Security retirement benefits	$__________________
Pension or profit sharing from employer(s)	$__________________
IRA, TSA, 401(k) plans we contribute to	$__________________
Income from investments shown in Step 4 (below)	$__________________
Part-time/Full-time work during retirement	$__________________
Other retirement income (list source):	
Total Annual Retirement Income (today's dollars)	$__________________

STARTING THE PROCESS cont.

STEP 4
Calculate how much you'll need to save to fund your retirement. List your regular savings and investments that are earmarked just for retirement. The time value of money comes into play here.

• Every month, I/we save $ in my/our 401(k)/mutual fund/etc., which totals per year.

• My/our retirement investments are worth $ at present.

STEP 5
Estimate annual retirement expenses and your pre- and post-retirement budgets in today's dollars. Your planner will adjust these amounts for inflation and help determine if your numbers are realistic.