Planning for the Stages of Retirement

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Retirement planning is critical

Most of us know that retirement is something we must actively plan and save toward. Social Security alone isn't enough, and traditional pension plans that pay lifetime defined benefits are becoming increasingly scarce. Yet the majority of Americans typically don't know how much to save and don't save enough, according to numerous polls and experts.

Moreover, retirement today is more than just a matter of accumulating enough money. Increasing life expectancy has made retirement an extended stage of life. People can expect to spend 15 to 35 years or more in retirement. That's a long time. What kind of retirement do you want to have? How should you spend money during retirement? How can you prepare for it and when should you start?

This brochure, prepared by the Financial Planning Association (FPA), addresses various stages of retirement planning, from starting out in the work world to retirement, in order to help you achieve your dream of a comfortable, fulfilling, financially secure retirement.

A CFP professional can also help you design a realistic, effective retirement plan.

Getting started...

Your 20s and early 30s

Early in your career is the perfect time to start a habit of saving for retirement because you have one huge advantage you'll never get again…TIME.

A dollar invested early in life can grow, through the power of compounding, far larger than the same dollar invested later in life.

Say you open a tax-deductible Individual Retirement Account (IRA) at age 25 and invest $100 a month until age 65. If the account earns eight percent a year, you could amass $349,100 by age 65. If you wait until age 35 to start saving the same $100 a month, you could end up with $149,035 when you are 65. Waiting 10 years to start saving and investing could cost you over $200,000!

You may shake your head at the recommendation of setting aside money for something you won't need for 30 or 40 years, especially if you're still paying off college loans, trying to save money for a home or just enjoying spending your first real paychecks. Remember that every little bit helps.

Even lower-income taxpayers have an incentive to contribute to an IRA. For each dollar put in, up to $2,000, lower-income taxpayers receive up to a 50-cent tax credit on each tax dollar they owe, up to a maximum tax credit of $1,000 (you must have a tax liability in order to receive the credit).

Look at it this way: Time will either work for you or against you when saving for retirement, and it's a lot easier when time is on your side.

Investing opportunities

So where can you start investing for retirement? Most likely, it will be through an employer-sponsored defined contribution retirement plan, such as a 401(k) or 403(b), that works by you electing to have money automatically deducted from your paycheck on a pre-tax basis.

Try to save at least 10 percent pre-tax income in your plan, up to the limit the plan allows. Saving 10 percent isn't as difficult as it may seem, because it won't cost you 10 percent to save 10 percent. Depending on your tax bracket, it may only cost you six to seven percent or less (with state taxes factored in) on an after-tax basis.

Still, if 10 percent is too much on a tight budget, a smaller percentage can still make a dramatic difference. The important thing is to start now—no matter how small the amount. Saving $10 a week can put $520 into your plan this year. Another tip: Take half of your next raise and have it deducted automatically right into your retirement plan.

If the employer matches your contributions (say 50 cents or $1 for every dollar you put in), try to contribute at least enough to maximize the match —typically up to six percent of your salary. Saving six percent with six percent matching means you immediately double your savings. It's like "free money"—and where else can you get this kind of return on your investment?

Note: If your employer offers a Roth 401(k), be aware that the employer's matches will be made with pre-tax dollars, but your contributions will be made with after-tax dollars.

What if your employer offers no plan? Your options are more limited. A tax-deductible option is a traditional IRA. Through 2007, you can put up to $4,000 annually into one (up to $8,000 as a couple), with additional increases after that. Or, you currently can contribute up to $4,000 annually in *after-tax* dollars to a Roth IRA, with the advantage that earnings generally avoid taxation. In addition, you can put unlimited amounts into taxable investment accounts and start building your portfolio of stocks, mutual funds, annuities and other investments.

If you're self-employed, you have more tax-deferred choices. You can open a solo 401(k) plan, simplified employee pension (SEP), savings incentive match plan for employees (SIMPLE) or Keogh plan. You can find more information about these types of retirement plans at the IRS Web site (www.irs.gov). Choose the plan that best fits your particular needs and circumstances.

What types of investments should you use for your retirement plan? That depends on several factors, including your tolerance for risk, your overall financial situation, job stability and so on. In general, however, most experts say that at a younger age, you can probably afford to invest as aggressively as your comfort level allows. You have the time to ride out the inevitable market downturns and replace any losses with more savings. Dollar-cost averaging—investing the same dollar amount each month—is another way to build wealth over the long term.

CAUTION: Don't cash out your 401(k) or other employer-sponsored plan when you change jobs. Younger workers often are tempted to do this because the amounts are small and they want the money to buy a new car or make other purchases. You'll pay income taxes and a penalty tax on the withdrawal. In addition, you'll lose the ability for the money to grow tax deferred. So, roll it over into a self-directed retirement plan, such as an IRA, or transfer it to your new employer's retirement plan. Remember, you will *need* this money when you retire.

Working on it...

Your 30s through your 40s

At this stage, you're likely full stride into your career and your income probably reflects that. The challenge to saving for retirement at this stage comes from large competing expenses: a mortgage, raising children and saving for their college, or perhaps financing your business.

As when you were younger, it's critical to find a way to squeeze out dollars for retirement. Time is still on your side, though you've begun to lose some of your compounding power. Try to invest a minimum of 10 percent of your salary towards retirement.

One of the classic conflicts is saving for retirement versus saving for college. Most financial planners will tell you that retirement should be your top priority. Your child can usually find financial aid to help fund their education. You'll be on your own for retirement.

Some expenses shouldn't be avoided, however. Financial catastrophes could seriously derail your retirement plans, so be sure to have adequate life insurance to protect the continuity of your financial plan should you die, disability insurance to replace lost income if you can't work, and adequate health insurance to protect you when you get sick. A 3-6 month cash emergency fund, set aside in a savings account to pay for fixed and essential living costs, also can prevent you having to sell tax-deferred investments should you suddenly need the dollars.

Your investment portfolio probably shouldn't change much from when you were in the *Getting Started* stage. You still have considerable time before retirement, even if you plan to retire early.

CAUTION: Avoid tapping into your retirement accounts for such things as a home down payment or college. You can end up paying income taxes and penalties, and you'll suffer the loss of further tax deferral.

The home stretch...

Your 50s and 60s

Now is the last opportunity to really sock away retirement funds. Try to boost your retirement savings goal up to 20 percent or more of your income. Ideally, you're at your peak earning years and some of the major household expenses, such as a mortgage or child-rearing, are behind you, or soon will be.

Workers age 50 or over can invest extra dollars into their employer's retirement plan once they've maxed out their regular contributions. The catch-up amount is $5,000 for 2006 through 2008 and will be adjusted for inflation in the future.

You also can put extra dollars into your IRA if you are over age 50. The catch-up amount is $1,000 for 2006 through 2008.

Once you maximize contributions to your retirement plans, save additional money in investments that don't create much taxable income.

Investing at this stage typically needs to be a little more cautious. Time is starting to work against you, since you have fewer years of earning power to make up any losses. Planners recommend shifting a portion of your higher-risk investments into less volatile (and usually lower returning) assets such as bonds, although bonds have different sorts of risk, mainly based on what happens to interest rates in the future.

In addition, most planners recommend maintaining a substantial exposure to stocks. You still have a lot of years ahead of you, both to reach retirement and during retirement itself. You'll need some assets that can help you stay ahead of inflation and preserve purchasing power of your income.

What kind of retirement?

It's also time to start focusing on what kind of retirement you want and what financial resources you have to pay for it. Do you plan to stay home and garden, or travel the world? Work part-time? Go back to school? Start a new hobby? Move to a vacation spot? This is the time to start dreaming of what your new life will look like and to start putting "price tags" on those dreams.

The choices are many and so are the costs associated with them. Planners often advise people to "practice" their retirement. Want to move? Vacation there several times—in all seasons. Try out that hobby you've always thought about.

Share your dreams with your spouse. It's important that both of you explore and work out differences. What if one wants to travel and the other wants to stay home?

Calculate what your dream retirement will cost— but watch out for rules of thumb. Arbitrarily figuring you'll need only 70 or 80 percent of your pre-retirement income may prove too low, or too high. Expenses also can vary during phases of retirement: typically high at first (all that travel and fun), lower in the middle, then higher later if health declines.

Calculate what realistic financial resources you'll have to pay for your retirement. Also, begin thinking about how you'll roll over your retirement assets in ways that either preserve their tax deferral or reduce potential taxes.

Little time to save?

What if you have saved little toward retirement yet you want to retire soon? Your options are more limited at this stage.

- Reduce expenses and invest the savings
- Increase income through a second or better-paying job
- Maximize retirement plan contributions
- Invest more aggressively, but not recklessly
- Postpone retirement or retire part time
- Make smart withdrawals from retirement accounts once you retire

Retiring early?

Want to retire early—that is, before "normal" retirement age? The big challenge—a problem most of us are glad to have—is that we're living longer. Retire in your mid-fifties and you could live 40 years or more in retirement.

For a longer retirement period, you'll need a larger nest egg than if you retired later, yet you'll have fewer years to build that nest egg. Early retirement means smaller monthly Social Security benefits. The same applies to traditional pension plan benefit amounts.

If you retire early, you may need to replace corporate benefits you lose, such as life insurance and, if you work part time or on your own during retirement, disability insurance. You also may need to come up with health insurance to cover the gap until you qualify for Medicare at your normal retirement age. Retiring before age 59-1/2 also can present a tax problem, since taking money out of your retirement plans may trigger a 10 percent tax penalty. And you could still have major expenses to fund, such as a mortgage and college.

The challenges of early retirement are not just financial, however. What are you going to do all those years? Many CFP professionals find their retired clients returning to work, often part time, out of boredom.

So although early retirement may sound appealing, be sure you've thought through the financial and non-financial issues before taking the plunge.

CAUTION: While still in your 50s or early 60s, evaluate whether long-term care insurance is appropriate for you. Failing health requiring long-term care is often the biggest single drain on a retirement nest egg. Medicare does not pay for extended long-term care. Without insurance, you'll have to pay out of pocket until you've spent most of your assets and can qualify for Medicaid assistance.

Retired at last...

Retirement planning doesn't end once you retire. Like any financial plan, it requires periodic adjusting.

Two of the first and most important decisions are *how much* to withdraw annually from your nest egg, and from *what accounts*.

Considerable research in recent years has concluded that retirees should be more conservative than once thought in how much they withdraw.

Retirees used to routinely withdraw from their nest egg six to eight percent or more a year, adjusted for inflation. Now, say some experts, withdrawal rates should range from three to six percent in an effort to protect you, as much as possible, from running out of money. The withdrawal percentage depends on how much you've saved, the investments you are using, your age and other factors. Retirees who withdraw at higher rates should be prepared to immediately cut back should their accounts suffer from a significant market downturn, or should their personal circumstances change for the worse.

In addition, consider putting enough money into a liquid money market account to cover your withdrawal needs for at least a year (or maybe more) so you don't have to take money out of your investments when the market is adjusting downwards.

From which accounts?

The general advice is to first take money out of taxable accounts in order to keep assets in retirement accounts growing tax deferred. This may involve some reallocation of your investments. For example, consider putting equity investments into taxable accounts and utilize the lower capital gains rates for withdrawals. Put bonds that produce income into tax-deferred accounts because bond income is taxed as ordinary income.

Once you reach 70-1/2, your choices are further complicated because you're required to start minimum distributions from your IRAs and retirement plans (except for a plan run by a current employer where you own less than 5 percent).

Investment decisions

What should you be invested in? You'll probably want to be more conservative than before retirement. Yet that does not mean abandoning stocks. With potentially 20 or more years in retirement, inflation can eat away at lower returning assets. Even at a modest three percent annual rate, inflation could cut your standard of living in half in 24 years.

Planners may recommend that the portfolio hold at least two to three years of living expenses in cash, CDs and short-term bonds that can see you through a stock market decline. Beyond that, there is no special rule of thumb for allocation of stocks, bonds, cash and other assets. Much depends on your other sources of income, risk tolerance, age, financial goals, such as leaving money to children, living expenses and so on.

Nonfinancial concerns

Besides adjusting your investments during retirement, you may need or want to adjust your lifestyle. Is retirement turning out as you envisioned? Did that "practice" you did just before retirement work out? How do you feel about yourself and your life now?

As noted earlier, it's common today for retirees to return to work—perhaps out of financial necessity, but also for something stimulating to do. Playing golf every day or traveling all the time can get boring for some. Besides work, you may want to consider going back to school or doing volunteer work. Keeping mentally, physically and socially active is key to building an enjoyable retirement, say experts.

Retirement Checklist

Getting started… Your 20s and early 30s

- Start saving right away
- Try to save 10 percent of income
- Join employer's retirement plan
  - Use IRA and other vehicles if your employer has no plan
  - Use solo 401(k), SEP, SIMPLE, Keogh or similar plan if self-employed
- Invest as aggressively as you are comfortable with
- Don't cash out retirement account

Working on it… Your 30s through your 40s

- Continue saving despite other expenses
  - Save at least 10 percent
  - Save for retirement before college
- Have adequate insurance and emergency fund
- Don't invest too conservatively
- Avoid tapping into retirement accounts

The home stretch… Your 50s and 60s

- Boost savings to 20 percent or more
- Take advantage of catch-up provisions
- Maximize tax-deferred contributions
- Begin to shift into lower-risk investments
- Start focusing on retirement lifestyle
- "Practice" retirement
- Share dreams with spouse
- Calculate realistic retirement resources

Retired at last…

- Determine how much money to withdraw each year
- Determine which accounts to withdraw from
- Remember required minimum distributions
- Invest more conservatively
- Don't abandon stocks
- Hold two to three years' living expenses in cash equivalents
- Adjust lifestyle if needed
- Polish your estate plan

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