RETIREMENT PLANNING: THE BASICS

Don't leave retirement planning to the government! While most Americans are eligible for Social Security retirement benefits, they are only meant to supplement what you have saved. Very few people can live comfortably on Social Security income alone. You can ensure that your lifestyle doesn't suffer when you stop working by taking an active role in retirement planning.

Challenges to Retirement Planning

When planning for retirement, it is a good idea to consider the various challenges that can affect the amount you need to save to live comfortably, such as:

- **More years spent not working:** Over time, the average lifespan has increased more than the average retirement age, meaning retirement savings need to cover expenses for a longer period of time. Someone who retires at age 65 and lives until age 85 will be drawing on retirement income for 20 years. Because women, on average, live longer than men, they especially need to be concerned with the possibility of running out of retirement savings.
- **Increasing medical costs:** Healthcare expenses are rising rapidly, and since our bodies tend to need more care and treatment as we age, chances are at least some of what you have saved will go toward keeping yourself healthy. Keep in mind that Medicare does not cover everything – many seniors pay several hundred dollars out of their own pocket for prescriptions and co-payments on a monthly basis.
- **Rising inflation:** One of the most significant threats to retirement savings is inflation. Over time, the value of most goods and services increases, meaning your dollars will not go as far as the used to. For example, assuming an inflation rate of 3%, goods and services costing $10,000 today will cost about $18,000 in 20 years.

How Much Will You Need?

It would be nice if there was a simple formula to determine how much you need to save for retirement, but getting a realistic figure requires some legwork. Luckily, there are many retirement calculators available online that can help you figure it out. You can also consult with a financial advisor. (You may be able to speak to one for free through your workplace or financial institution.) Factors that you need to consider include:

Your costs: A general rule of thumb is that retirees' expenses are 70-80% of what they were before retirement. However, it will vary from person to person – your expenses may be more or less. Think about how you expect your expenses to change when you retire.

Costs that may decrease: Once you stop working, employment-related expenses, such as commuting costs, business attire, and lunches out, will be reduced or eliminated. Many homeowners have paid off their mortgage by the time they retire, so their housing expenses will be considerably less than what they once were. If retiring from work will put you in a lower tax bracket, your tax liability will also decrease.

Costs that may increase: If your vision of an ideal retirement includes cruise ships and European vacations, you'll need to plan for increased travel expenses. Healthcare and insurance expenses are likely to go up too. If you are a tenant, your rent costs may rise with the housing market in your area.

Length of retirement: The length of your retirement is your age at death minus your age at retirement. Think about what your ideal retirement age is. Do you want to start sailing around the world at age 60? Or do you want to wait until you are a bit older? Obviously, your age of death is unknown ahead of time, but you can use a life expectancy calculator to estimate it.

Social Security retirement benefits: While you don't want to rely on Social Security benefits completely to fund your retirement, if you are eligible to receive them, you can factor them in as a source of income during your golden years. A benefits estimator is available at www.ssa.gov/planners/benefitcalculators.htm. (If you are several years from retirement, keep in mind that adjustments may be made to Social Security before you retire.)

Inflation: In retirement, because of inflation, it will cost you more each year to buy the same things. Comprehensive retirement calculators automatically consider inflation.

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Rate of return on investments: Your retirement savings will consist of your contributions and the return you earn on your investments. Some investments have a fixed rate of return that is known ahead of time. Other investments have a return that varies based on market conditions or other factors. Although it is hard to know exactly how variable investments will perform in the future, one way to estimate the return is to look at how they have performed in the past.

Creating a Budget

Successful retirement planning requires setting aside money on a regular basis. Realistically, to be able to save, your expenses need to be less than your income. If you are spending more than you are earning, you will likely be worried about how you will pay your bills now, not how you will pay them 30 years from now.

To figure out your current cash flow, fill out the Budget Worksheet. Don't forget to list savings for retirement and other goals. To determine a monthly amount for periodic income or expenses, calculate the per year amount and divide by 12. If you are not sure what some of your expenses are, just use your best guess for now. By tracking your expenses for a few months (you can use the Tracking Worksheet on page 4 or create a spreadsheet on your computer) you can create a more accurate budget in the future.

Monthly Income (Net)	
Job	
Spouse's job	
Part-time job	
Commissions/bonuses	
Rental and investment income	
Government benefits	
Child support/alimony	
Retirement income	
Other	
Total	

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Monthly Expenses					
Expense	Current	Proposed	Expense	Current	Proposed
Rent/mortgage			Storage fees		
Second mortgage			Beauty or barber		
HOA dues			Movies or videos		
Property taxes			Internet access		
Homeowner's insurance			Cable or satellite		
Renter's insurance			Dining out or snacks		
Gas/electric (house)			Sports or hobbies		
Water/sewer/garbage			Gym membership		
Telephone			Vacation or travel		
Groceries			Books or music		
Household items			Clothing purchases		
Health insurance			Laundry or dry cleaning		
Co-pays (medical)			Pool/hot tub service		
Car payment #1			Gardening		
Car payment #2			Alarm system		
Gasoline			Gifts or cards		
Repairs (house)			Pet care		
Repairs (cars)			Cell phone or pager		
Auto insurance			Banking fees		
Auto registration			Postage		
Tolls or parking			Cigarettes or alcohol		
Public transportation			Savings		
Daycare or babysitting			IRA contributions		
Alimony or child support			Debt payment		
Tuition or lessons			Debt payment		
Student loan payment			Debt payment		
Taxes (payment plan)			Other		
Life insurance			Other		
Donations			Total		

Bottom Line		
Total Monthly Income	- Total Monthly Expenses	= Monthly Surplus or Deficit

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Employer-Sponsored Plan Contributions	
401(k)/403(b) contributions	
401(k)/403(b) contributions (spouse)	

**List for reference only – do not add contributions to your expenses since they are deducted from your paycheck pre-tax.*

Value of Retirement Accounts	
401(k)/403(b)	
401(k)/403(b) (spouse)	
IRA	
IRA (spouse)	
Other	
Total	

Weekly Tracking Chart

Item	Daily Expenses							Total Weekly Expenses
	Mon	Tue	Wed	Thu	Fri	Sat	Sun	
Groceries								
Restaurants/ take-out								
Laundry/dry cleaning								
Medical/dental								
Auto/gas/parking								
Other transportation								
Babysitting								
Personal care								
Clothing								
Bank fees/postage								
Entertainment								
Books/music/video								
Cigarettes/alcohol								
Gifts/cards								
Home/garden								
Contributions								
Other								
Other								

Once you have completed your budget, total up your expenses and subtract them from your net income. If your expenses are less than your income, great! If not, look over the worksheet and think about what changes you can make to improve your cash flow. Can you bring your lunch to work instead of buy it? Nix the land-line and just use your cell-phone? Give up your tap dancing lessons? Be honest about what is truly a necessity and what can be reduced, postponed, or cut out completely. Put any adjustments you plan to make in the Proposed column of the budget.

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Types of Retirement Accounts

When saving for retirement, it is a good idea to take advantage of accounts that give you a break on your taxes. Paying less in taxes means more money in your pocket.

Employer-Sponsored Plans

There are two basic types of employer-sponsored retirement plans: the defined-benefit plan, in which a certain level of benefits is promised and it is the employer's responsibility to fund it, and the defined-contribution plan, in which the employee makes defined contributions and there is no guaranteed payout. The value of a defined-contribution plan is dependent on how much is put in it and how well the investments perform. Employers generally let employees determine how much they want to contribute per paycheck, and some even match all or part of their employees' contributions. Today, defined-contribution plans are much more common than defined-benefit plans. An example of a defined-contribution plan is the 401(k). (The 403(b) is the equivalent for employees of non-profits.) The money that you contribute to a 401(k) or 403(b) is deducted from your paycheck pre-tax, meaning you don't have to pay state or federal income taxes on it. While your money is invested in the plan, you don't pay taxes on the earnings either. You only pay taxes on the withdrawals you make.

Individual Retirement Accounts (IRAs)

IRAs are retirement accounts that are not tied to your employer – you can open one at a variety of financial institutions, such as credit unions, banks, and mutual fund companies. In order to contribute to an IRA, you or your spouse must have earned income.

The two most common types of IRAs are the Traditional IRA and Roth IRA. Like with 401(k)s and 403(b)s, you do not have to pay income taxes on the contributions made to or in-plan earnings of a Traditional IRA, only the withdrawals. (The contributions are made with post-tax income, but you can deduct them on your tax return.)

Roth IRAs operate a bit differently than most other retirement accounts in that you do have to pay taxes on the contributions you make. However, earnings grow tax-free in the account, and you do not have to pay taxes on qualified withdrawals. Many financial experts prefer Roth IRAs to Traditional IRAs, but which one is more beneficial is dependent on your tax bracket now versus your tax bracket in retirement.

One of the downsides of employer-sponsored plans is that the investment options are typically limited. In contrast, with an IRA, you can invest in what you want. You also do not have to worry about what to do with your IRA when you leave your job. On the other hand, you don't have the benefit of automatic payroll deduction (or matching funds if your employer provides that), and the contribution limits are higher for employer-sponsored plans than IRAs. You can contribute to both at the same time, but contributions to a Traditional IRA are not deductible if you are covered by a retirement plan at work and your income is above a certain amount. (See www.irs.gov for more information.)
Plans for the Self-Employed

If you are self-employed, you can still contribute to a Traditional or Roth IRA. There are also retirement plans specifically for the self-employed and small business owners and employees, such as the Keogh plan, simplified employee pension (SEP) plan, savings incentive match plan for employees (SIMPLE plan), and solo 401(k). All allow you to make pre-tax contributions, and the earnings grow tax-free. The SIMPLE plan generally has the lowest administrative costs and is the easier to set up, but, depending on your earnings and age, other plans may allow larger contributions.

Types of Investments

There are three basic types of investment classes where you can put your retirement savings:

- **Stocks:** A share of stock represents a percentage of ownership in a corporation. In other words, if a company is divided into a million shares and you buy one share, you would own one millionth of that company. You can make money from receiving dividend payments and selling the stock for more than you bought it for. Historically, stocks have provided the greatest return (earnings) long term. However, there are no guarantees – one day your stock may be worth more than what you paid for it, the next, less.
- **Bonds:** A bond is a loan to a company or government, with you, the bondholder, as the lender. Generally, you receive the principal, called the par value, at maturity of the bond and interest periodically while you are holding the bond. Depending on the market, you may purchase a bond below, at, or above its par value. In general, bonds are between stocks and cash equivalents in regard to risk and return.

- **Cash equivalents:** Cash equivalents are assets that can be readily converted into cash, such as savings and checking accounts, certificates of deposit, money market deposit accounts, and U.S. Treasury bills. They tend to be low-risk, so there is little or no danger that you will lose the money you deposit. As a result, cash equivalents provide a low return.

Instead of picking several investments individually, most people choose to invest their retirement savings in a mutual fund. In a mutual fund, money from several investors is pooled to buy different stocks, bonds, and/or cash equivalents. There are a wide variety of mutual funds available with different investment compositions and goals. Some are aggressively focused, with a high percentage of the portfolio invested in the stocks of companies expected to grow. (Long term, this type of stock often provides the highest return, but there is more of a risk of losing some or all of your investment.) Some are more conservative, with a high percentage of the portfolio invested in established companies and/or bonds and cash equivalents. Some invest primarily in a certain industry, such as technology or real estate. Some track a particular index, such as the S&P 500.

As mentioned previously, for IRAs, your investment choices are virtually limitless. With a 401(k) or 403(b), your options will be limited by your employer – typically, you will able to choose among several options offered by one investment company. As a general rule, you should invest more aggressively the further you are from retirement. This means focusing on investments that have the potential to provide a high return (typically stocks), even if they are riskier. If you are close to retirement, you want to be a little safer since you don't have much time to recover if your investments perform poorly. However, regardless of how far you are from retirement, it is important to have diversity in your portfolio and not put all of your eggs in one basket. If you are not sure where you should invest, remember, you may want to consult with a financial advisor.

Start Now!

If you are not currently saving for retirement or not saving as much as you need to, don't wait to start or increase your contributions. The earlier you start, the longer your savings have time to grow. If you started investing $200 per month now in a vehicle earning an average of 5% a year, in 30 years, you would have $159,453 ($72,000 in contributions and $87,453 in interest earned). If you waited five years to start, you would only have $114,545 ($60,000 in contributions and $54,545 in interest earned). You should save for retirement even if you have debt or more immediate goals. Prioritizing retirement now means you will not have to work until you are 80!

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