Retirement

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10 rules for the retirement road

Many investment professionals recommend that investors follow these 10 strategies as they plot their way toward retirement. If you're worried that your retirement investment plan is adrift, these rules can help you steer in the right direction.

By the numbers[1]

- **3.4** is the number of workers for each Social Security beneficiary today. By 2030, there will be 2.1 workers for each beneficiary.
- **38%** of retirees' annual income is received from Social Security.
- **82.5** years is the life expectancy of a 65-year-old. In 1940, the life expectancy of a 65-year-old was 77.5 years.

[1] Social Security Administration, 2003

Rule 1: Pay yourself first.

Many investment professionals start their preretirement pep talk with the same three words: "Pay yourself first." This includes contributing the maximum amount possible to your 401(k) plans and investing additional amounts in IRAs and mutual funds through automatic payroll deductions. Automatic investment plans are an easy way to stick with a retirement investing program because the money is invested before it can get spent on anything else. While automatic investing does not guarantee a profit or protect against a loss in declining markets, it does make retirement investing a priority. With any automatic investing program, you should, of course, consider your financial ability to continue to invest through periods of low prices.

Rule 2: Don't let today's bills sink tomorrow's needs.

Supporting yourself and your family is not easy. Chances are, especially if you have children, your household expenses will grow over time. That's why it's important, especially through times of difficulty and new expenses, to keep contributing toward your retirement.

When you are thinking of reducing or ceasing investing for your future to cover current expenses, stop, think, and try to find another way to cover your current expenses.

Rule 3: Put time on your side.

It's simple. When you give your money more time to accumulate, the earnings on your investments — and the annual compounding of those earnings — can make a big difference in your final return.

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Key points

Today is the best time to start planning for retirement. Why?

- Time is an investor's greatest asset.
- Investing is a habit that is best started as soon as possible.
- Once you have a plan in place, it's easy to modify.
- Your retirement is ultimately your responsibility.

Consider a hypothetical investor who saved $2,000 per year for 10 years then didn't add to her nest egg for the next 10 years. She has $48,341 after 20 years, assuming she earned 6% annually in a tax-deferred account. Another hypothetical investor waited 10 years, then tried to make up for lost time by investing $3,000 annually for the next 10 years. Even though he invests more — $30,000 versus the early bird's $20,000 — he still ends up with a smaller nest egg. Assuming he also earns 6% per year, his final account value is only $45,313. Most of the procrastinator's nest egg — 66% — is the principal he invested. The majority of the early bird's account — 59% — is earnings.

Rule 4: Don't count on Social Security.

While politicians consistently tell us that Social Security isn't going anywhere, it's still very likely, especially if you are under age 50, that the program will be very different from its current form when you retire.

According to the Social Security Administration, Social Security benefits represent 38% of income for Americans over age 65.[2] The remaining income comes predominantly from pensions and investments. They also state that by 2030, there will be twice as many elderly Americans as today, growing to 35 million from 70 million. While the dollars and cents result of this growth is hard to determine, it is clear that investing for retirement is a prudent course of action.

[2] Social Security Administration, 2003

Rule 5: Resist borrowing from your 401(k).

Loans are a popular feature of 401(k) plans. People like being able to get access to their money. But many investment professionals recommend clients consider borrowing from other sources, such as the equity in one's home, before taking a 401(k) loan.

Here are some reasons why.

Fixed return. When you pay yourself interest when you pay back a 401(k) loan, your interest rate is the amount you earn on that money. This may be a modest return compared to what your money could earn if you left it invested in the financial markets.

Payback challenge. Repaying a 401(k) loan when trying to maintain contributions may be difficult. There is a real chance that your retirement plans may suffer when you try to repay and continue to invest simultaneously.

Tax penalties. Switching jobs before a 401(k) loan is repaid can bring unwanted tax consequences. You may be able to pay off or transfer your loan to your new employer's plan, but if neither option is available to you, your loan balance will be considered a distribution from your plan. As a result, you may owe ordinary income taxes and a premature distribution penalty tax of 10% unless you meet one of the age or systematic payout method exemptions provided in the Internal Revenue Code.

Double taxation. The money you use to pay interest on your loan will be taxed twice. It will be taxed first when you are repaying the loan because, even though you can contribute to a 401(k) with "pretax" dollars, you can't do the same with loan payments. It will be taxed a second time, as other 401(k) earnings are, when you make withdrawals from your account in retirement.

Rule 6: Don't "cash out" retirement plans when switching jobs.

When you leave a job, the vested benefits in your retirement plans are an enticing source of money. It may be difficult to resist the urge to take that money as cash, particularly if retirement is many years away. But generally you will have to pay federal income taxes, state income taxes, and a 10% penalty if you're under age 55. This can cut into your investments significantly. In Maryland, for example, with its 7.5% state income tax, someone in the 25% federal tax bracket would lose 42.5% of the amount they took.

  25% (federal tax)
+ 7.5% (state tax)
+ 10% (penalty)

= 42.5%

When changing jobs, generally you have three options for leaving your retirement money invested. You can keep the money in your old employer's plan, roll it over into an IRA, or transfer the money to your new employer's plan if that plan accepts rollovers. Learn more about these three options before deciding which will work best for you.

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Rule 7: Take advantage of your IRA options.

The Roth IRA has become a popular way to expand retirement investing for many investors. But with many IRA options available today, it's important to know why you are investing before you decide where to start. And, once you decide on a direction, it's important to make your annual contribution. Annual contribution limits recently have increased making IRAs a more valuable way to invest for retirement. Your investment professional can help you determine which IRA will work best for your situation.

Rule 8: Compare the merits of the Roth IRA and a 401(k) plan.

The variety of retirement savings options available today is a boon for investors. But the range of choices can also be confusing. Many investors now are trying to compare the potential advantages of the Roth IRA with their 401(k) or other type of defined contribution plan at work. The choice is especially difficult for those with limited budgets who can afford to invest in only one of the options. Work with your investment professional to determine whether the Roth IRA or your 401(k) offers more advantages for you. The answer will depend on many factors, including how many years you have left until retirement, your tax bracket, and whether your employer matches contributions to your 401(k).

Rule 9: Don't try to time the stock market.

Some investors, even those for whom retirement is still many years away, frequently shift their money in and out of the stock market. They'll get out when they fear a crash and get back in when they expect a boom. The problem with trying to time the market is that no one can consistently predict the short-term events that push the market up or down. It's better to have an investing plan adjusted for your goals, time frame, and risk tolerance that diversifies your investments, allocates them among different asset classes, and rebalances your portfolio.

Rule 10: Allocate, diversify, and rebalance

You have certain long-term financial goals in mind. You also have a certain tolerance for risk when it comes to investing your money. Asset allocation can help you find and maintain your balancing point. So you can pursue your goals at a risk level you find comfortable.

As part of a disciplined diversification investment strategy, asset allocation enables you to seamlessly follow this proven three-step process.

Allocate your assets across the major asset classes — stocks, bonds, and cash — to help you pursue the optimal returns for the risk level you're willing to undertake.

Diversify within each class to take advantage of different investment styles — such as growth and value stocks — and various market sectors — such as government and corporate bonds.

Rebalance regularly. Market activity can shift the percentages of your portfolio that you have dedicated to each asset class. Rebalancing will help you maintain your desired allocation.

Resources

Hinden, Stan, *How to Retire Happy: Everything You Need to Know about the 12 Most Important Decisions You Must Make before You Retire.* McGraw-Hill Trade, 2000, 224 p., $14.95.

Morris, Kenneth M., *The Wall Street Journal Guide to Planning Your Financial Future, 3rd Edition: The Easy-to-Read Guide to Planning for Retirement.* Fireside; 2002, 187 p., $15.95.

Morris, Virginia B., *Creating Retirement Income.* McGraw-Hill Trade, 1999, 153 p., $14.95.

Contact your investment professional for more information.

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