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planning/investing for retirement

Planning/Investing for Retirement

When you're young, or new to a job, retirement is typically far from your thoughts—but it really should be a priority. Waiting to plan for this important stage of life means you could come up short when the day arrives—and may need to keep on working. Fortunately, there are simple ways to accumulate a healthy stash of money for that day—*if* you start planning and investing for it now.

1. How much will you need?

People often underestimate how much money is needed to retire. Many financial experts say you'll need *about the same annual income as you did before retirement* to maintain the same standard of living. *Inflation*—even a low 2% or so per year—will make items you pay for in the future cost more than they do today. It's impossible to predict the economic environment you'll encounter at retirement; it could easily be a time of high interest rates and inflation.

The Wall Street Journal suggests that people save *more* than previously thought–15% of salary, *before* taxes. That assumes you start saving for retirement in your 20s. If you start later, you'll need to save more than 15% per year to live in retirement as you do today.

2. What about social security?

Under today's rules, you become eligible to collect Social Security beginning at age 62, but the monthly amount you receive increases each year you wait to collect, up to age 70. Few people, however, can live on that monthly government check alone. Be sure you receive credit for what you pay into Social Security; check the yearly statement against your pay stubs, because that amount determines what you will receive in the future. However, it is important to understand that no one should count on Social Security as her retirement mainstay.

compounding brings benefits:

If you invest $100 per month for 30 years, earn an 8% annual return, have a 28% capital-gains tax rate and a conservative-to-moderate risk profile, you will earn approximately 50% more in a pre-tax retirement account than a taxable account.

3. Save smart.

Typical savings accounts are not the place to save for retirement. The federal government created plans to help taxpayers make more of the money saved for our later years. These plans are called 401(k)s or 403(b)s— their tax-code numbers—and Individual Retirement Accounts (IRAs). All three offer *tax-deferred* savings; depositors pay no taxes now, only when making withdrawals in retirement. The funds invested offer the advantage of *compound growth*—you will not pay taxes on those earnings until retirement. When you do withdraw funds, your tax rate will likely be lower than it is now. (You are required to begin withdrawals by age 70 ½ on most retirement plans, when you may no longer make contributions. If you withdraw these tax-deferred funds before it's permitted at age 59 ½, you risk paying substantial *penalties*.)

If you work for a for-profit corporation, your employer may offer a **401(k)** plan that allows you to invest income for retirement. Non-profits and schools may offer employees a **403(b)** retirement plan to invest a portion of pre-tax wages. Many employers offer *matching funds* for 401(k)s. If your employer matches your retirement contributions, be sure to take advantage of this benefit! This is free money that will also grow tax-deferred in your account until you retire.

If your employer doesn't offer a 401(k) or 403(b) plan, you can open your own IRA to invest tax-deferred or tax-free income for retirement. A **traditional IRA** allows individuals up to age 50 to save up to $5,000 of earned income (2009 regulations); a "catch-up" provision lets you contribute $6,000 if you are 50 or older. The **Roth IRA** is only for post-tax retirement contributions, but funds invested grow *tax-free* and withdrawals after age 59 ½ are not taxed. (For specifics on which IRA to open, call the IRS toll-free for expert guidance: 1-800-829-1040.)

If you're self-employed with an unincorporated business, **Keogh plans** are one way to invest for retirement, tax-deferred; qualified individuals may contribute up to 25% of earned income. Some independent workers prefer the **SEP-IRA**, a

leaving a job?

When you leave an employer and are required to move your 401(k) or 403(b) account, you must transfer funds to a rollover IRA. This assures that your money will keep its tax-deferred status, as long as you roll the entire amount into another retirement plan *within 90 days.* If not, you risk *severe penalties* and *tax consequences.* You should set up your rollover IRA with a reputable discount brokerage or investment company; popular choices include Fidelity Investments, Charles Schwab & Co. and Vanguard.

simpler retirement plan than the Keogh. Compare benefits and drawbacks with your accountant or the IRS.

Fill it to the max. Whatever your tax-advantaged retirement plan, try to *contribute the maximum amount permitted each year*, or the largest sum you possibly can. In 2009, if you are under the age of 50, you may contribute up to $16,500.

Invest with care. The 401(k), 403(b) or any type of IRA is *not* the retirement investment itself—it is simply the plan. It's up to you to *choose actual investment vehicles* for your contributions. *Mutual funds* are usually the best choice. They buy a variety of stocks and/or bonds, following a particular investment focus. When you buy shares of a mutual fund, you're buying a small portion of every stock and/or bond the fund owns. Unless you're extremely knowledgeable about them, individual stocks or bonds aren't a good place for your retirement funds—this includes your own employer's stock.

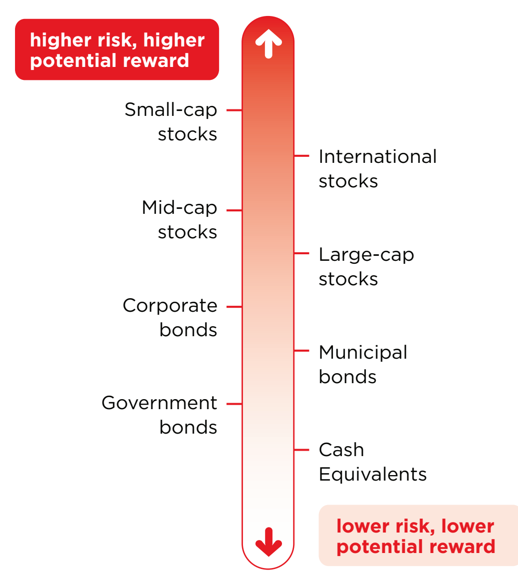
4. How do I invest my retirement funds?

Whether you have an IRA or an employer-sponsored retirement plan, you will need to make choices about how to invest your retirement money. Most employer plans offer several mutual funds. An IRA with an investment firm may offer you a wider range of choices. In either case, there is no guarantee of how mutual fund investments will perform. Most mutual funds show positive returns when left to grow for a number of years; however, since losing money is always possible, you must make well-informed choices.

Diversification is key. Smart investors spread their investments over a number of stock and bond funds to reduce their financial risk. Be sure to choose several mutual funds, but not more than *7 to 10 different funds*. That will give you adequate diversification, and you'll be able to keep better track of each fund's progress. The volatile markets of 2007-2009 illustrate why it's important to diversify among different investments.

Know your risk-tolerance level. Knowing how much risk you're comfortable with is a major factor in planning for retirement. The more risk you're willing to take, the higher your potential return—but there are real tradeoffs. Consider the "sleep factor" to determine where you fall on the risk scale. Are you stressed out when the stock market index drops 200 points? Or do you take a longer-term view, knowing that stocks have a greater potential for long-term growth than other types of investments? Informed caution is good, but emotional reactions to short-term market movements are not. Overcautiousness can be equally detrimental. Balance what you could lose (your entire principal) against what you could gain (a great return on your money), then select investments based on your level of risk—aggressive, moderate or conservative.

Consider how these investments correlate with your risk comfort level:



Your **time horizon**—how many years before you'll withdraw money for retirement—is another important factor. Consider your current age, target retirement date, and your timeline for all your financial goals. As you get closer to retirement, your investment style should become more conservative.

5. Sizing up mutual funds.

Consider these common types of mutual funds in light of your risk-tolerance level (a mutual fund may span more than one category):

- **Equities, or stocks:** partial ownership in publicly traded companies
- **Fixed-income, or bonds:** partial ownership of a company's debt, for which you get a share of interest payments
- **Income:** a fund whose primary purpose is generating income instead of reinvesting for growth of principal; useful when you are closer to retirement
- **Stability of principal:** funds with a low risk of losing principal, but no potential for high returns; useful when closer to retirement
- **Balanced:** moderate risk; contains a mix of stocks and bonds
- **Index funds:** tied to performance of a market measure, such as the S&P 500 Index (the 500 largest U.S. companies)
- **Target retirement funds:** periodically, these funds automatically rebalance your portfolio for a certain risk level, according to your target retirement year
- **Domestic:** invest only in U.S. vehicles
- **Global:** invest in stocks and/or bonds anywhere in the world
- **Growth:** invest in higher-risk companies
- **Small-cap:** buy riskier companies that are small in overall market value, with greater potential for volatility and higher returns
- **Large-cap:** buy the largest U.S. companies in market value, such as AT&T, General Electric and Johnson & Johnson, which are typically less risky

Mutual fund families offer a variety of funds under the same company umbrella, and come with several advantages. If you stick with one family, all your retirement investments will be listed on the same statement and Web site, and it's easier to move money among different funds (which you can usually do with no charge). As your investments grow, you may gain a higher level of customer service. Some well-regarded families include Fidelity, Franklin Templeton, ING and Schwab. Vanguard in particular is known for charging lower fees than its competitors.

Fees: In mutual fund investing, you should seek to *minimize the fees* you pay. If your fund has "back-end" fees, you will owe a percentage of your investment when you withdraw; "load" funds charge a percentage of each investment when you make it. *"No-load," no-transaction-fee funds can be your best bet*, since high fees will have a negative impact on your fund's performance over time. All mutual funds have a service charge; look for those that charge less than 1%.

Performance and size count: Size up how a fund has performed over time by examining its 3-year, 5-year and 10-year returns. Choose funds with the most *consistent* positive returns compared to others with similar risk profiles. A very small fund (with $100 million invested) is much riskier than a larger one; a $10 billion fund is considered medium to large, and suggests more stability.

Allocate your assets: Unless you've chosen a target-date retirement fund, you need to determine, based on your risk level, what percentage you will keep in stock funds, bond funds or cash equivalents. Review your quarterly performance statements and rebalance your allocations once or twice a year if they have moved significantly away from your original percentage goals. If a fund performs quite poorly for more than a few quarters, consider selling it and buying another fund. As retirement grows closer, you should increase your allocations in more conservative funds.

Do it now. Don't procrastinate on planning for retirement because you are intimidated about mutual fund choices. Just get started contributing to your tax-deferred retirement plan. When your account is established, you can always make changes to your mix of funds.

No matter how remote retirement seems, start planning for it today!

This material is adapted from Bottomless Closet's Financial Management Series, created and led by board member and financial professional Tami Peter.
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