

## **Planning for the Stages of Retirement**

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Retirement is being reinvented. It's no longer our parent's retirement. Social Security alone won't see us through retirement, especially for higher income earners. And traditional pension plans that pay generous lifetime defined benefits are becoming less common. Instead, we must be more personally responsible for funding our retirement.

Moreover, retirement today is more than just a matter of accumulating a sufficient nest egg. Increasing life expectancy and the trend toward early retirement has made retirement an extended stage of life. People can expect to spend 15 to 35 years or more in retirement, which begs many questions. What retirement lifestyle do you envision? Do you want to work part-time...travel...start a small business...golf? How should you save for retirement? What's the best asset allocation and distribution strategies to make your money last during that long retirement?

Following these "stages of retirement" can help you answer these many questions and achieve your dream of a comfortable, fulfilling, financially secure retirement.

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## **Getting started... Your 20s and early 30s**

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You may shake your head at the idea of setting aside money for a retirement you won't reach for another 30 to 40 years, particularly if you're still paying off college loans, trying to save money for a home or just enjoying spending your first real paychecks. And your vision for

retirement is probably hazy at this stage—but the advantages of saving for retirement are not. This is the perfect time to start a habit of saving for retirement because you have one huge advantage you'll never get again...TIME.

The dollars invested early in your career will be worth far more when you retire, through the power of compounding, than the dollars invested closer to retirement. Say you begin investing in a 401(k) or similar tax-deductible employer-sponsored retirement plan at age 25 and invest \$300 a month until age 65. If the account earns eight percent a year, you'll earn \$600,194 more by age 65 than if you wait until age 35 to start saving the same \$300 a month.

### *Investing opportunities*

So where can you start investing for retirement? Most likely, it will be through an employer-sponsored retirement plan, such as a 401(k), that depends mainly on you having money automatically deducted from your paycheck on a pre-tax basis.

Try to put at least ten percent of your paycheck into the plan, up to the limit the plan allows. If ten percent is too much on a tight budget, a smaller percentage can still make a dramatic difference over time.

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 employer's match—typically up to six percent of your salary. Saving six percent with a six percent matching means you immediately earn 100 percent return on your money!

What if your employer offers no plan? Your options are more limited. The only tax-deductible option is through an individual

retirement account, and you can only put up to \$3,000 annually into one through 2004 (up to \$6,000 as a couple), with additional increases after that. But you can put unlimited amounts into after-tax choices including variable annuities (whose earnings grow tax deferred), stocks, mutual funds and other investments.

If you're self-employed, you have more tax-deferred choices, such as a simplified employee pension (SEP), Keogh plan, and for higher earners, a solo 401(k).

What types of investments should you choose? That depends on several factors, including your tolerance for risk, your overall financial situation, job stability and so on. In general, however, at a younger age you can probably afford to invest more aggressively than you would later in life, say most investment experts. You have the time to ride out the inevitable market downturns.

But as recent market downturns illustrate, diversification remains key regardless of your age and tolerance for investment risk, particularly when it comes to company stock. Many financial planners recommend keeping company stock to no more than 10 to 20 percent of your overall portfolio.

**CAUTION:** Young workers tend to cash out their 401(k) or other employer-sponsored plan account when they change jobs because the amounts are usually small and they want the money to buy a new car or other purchases. But 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 qualified retirement plan.

## **Working on it... Your 30s through your 40s**

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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 such as a mortgage, raising children or perhaps financing a business.

A classic conflict involves saving for retirement versus saving for your children's college education. Most CERTIFIED FINANCIAL PLANNER™ professionals will tell you that retirement should be your top priority. Your child can usually find financial aid and help fund their own 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 (for your spouse's retirement), disability insurance to replace lost income and adequate health insurance. A cash emergency fund also can help avoid selling retirement investments should you 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.

## **The home stretch... Your 50s and 60s**

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Now is the last opportunity to really sock away retirement dollars. Try to boost your retirement savings 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. Perhaps you've inherited money from your parents. (On the other hand, you might have parents who need your financial help.)

Take advantage of the catch-up provisions Congress passed in 2001. Workers age 50 or over can invest extra dollars into their employer's retirement plan (if the plan allows it) once they've maxed out their regular contributions. The extra amount ranges from \$2,000 in 2003 to \$5,000 in 2006 and beyond (adjusted for inflation).

You also can put a \$500 catch-up amount annually into your IRA through 2005, at which point it doubles to \$1,000.

Once you maximize contributions to your employer's plan, and IRAs if you qualify, invest additional money into annuities or investments that don't create much taxable income.

Investing at this stage typically needs to be more cautious. Planners recommend shifting a portion of your higher-risk investments into less volatile (and usually lower returning) assets. But planners also recommend maintaining a significant 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 stay ahead of inflation.

### *What kind of retirement?*

It's time to start focusing more closely on what kind of retirement you want and what financial resources you have to pay for it. The choices are many and so are the costs associated with them. Planners often advise people to "practice" at 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 if you haven't already—but avoid 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.

Calculate what *realistic* financial resources you'll have to pay for your retirement. Also, talk to a financial adviser 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, though not recklessly
- Postpone retirement or retire part-time
- Make smart withdrawals from retirement accounts once you retire

## *Retiring early?*

Want to retire before “normal” retirement age? For that, you’ll need a larger nest egg than if you retired later because you’ll have more retirement years to pay for—yet you’ll have fewer years to build that nest egg. You’ll also have to calculate whether to take Social Security and pension plan benefits early, which would mean smaller payments.

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. Retiring before age 59 1/2 also can present tax problems. And you may 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 implications before taking the plunge.

**CAUTION:** Failing health requiring long-term care is often the biggest single threat to a retirement nest egg, so consider buying long-term care insurance while you’re in your 50s or early 60s. It’s more affordable the earlier you buy it.

## **Retired at Last...**

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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 what accounts to withdraw from.

Much research in recent years has concluded that withdrawals should be more conservative than once thought. Many experts recommend withdrawal rates no higher than four or five percent, adjusted for inflation, in order to ensure that you don't run out of money due to periodic market declines.

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.

### *From which accounts?*

The general advice is to first withdraw from taxable investments in order to allow tax-deferred retirement assets to continue to grow. But this approach isn't always appropriate. For example, if your taxable investments are mostly bonds and your tax-deferred accounts mostly stock, withdrawing only the bonds first would make your overall portfolio riskier by becoming stock heavy.

Once you reach 70 1/2, your choices are further limited because you're required to start minimum distributions from your IRAs and retirement plans (except for a plan run by an employer you still work for).

### *Investment decisions*

What should you be invested in? You'll probably want to be more conservative than before retirement. Yet that doesn't necessarily mean abandoning stocks. With potentially 20 or more years in retirement, inflation can eat away at lower-returning assets.

Planners often recommend that the portfolio hold at least two to three years of living expenses in cash and bonds that can see you through a stock market decline. Beyond that, there is no magic allocation of stocks/bonds/cash or other assets. Much depends on your other sources of income, risk tolerance, age, living expenses and financial goals such as leaving money to children.

### *Non-financial 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" for retirement pay off?

As noted earlier, it's common today for retirees to return to work—not always out of financial necessity but 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 enjoying this stage of retirement, say experts.