reinventing retirement

Your Retirement Planning Newsletter

Third Quarter 2014

It's a Big, Open Road in Your 20s: Find the On-Ramp to Financial Independence

In your 20s, the horizon seems limitless. You're in your first grown-up job, making a regular paycheck. You may be tempted to spend it on fun stuff. But here are four areas that should take priority.

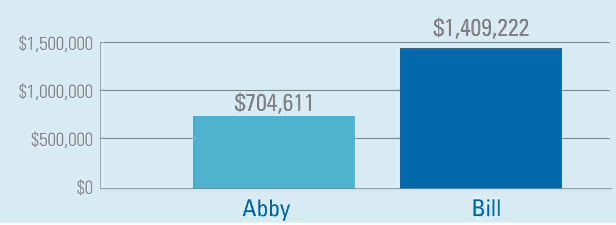
1. **Pay off credit card debt.** If you carry a hefty monthly balance, or are just paying the minimum interest, stop. Credit card interest can be 18% or more, which will derail your savings plan if left unchecked. Paying off your balance each month to dodge interest charges is a no-brainer.
2. **Build an emergency fund.** Maybe it's a brake job for your car. Or it could be more serious, such as an underinsured illness. Experts recommend squirreling away six to eight months of cash to cover essentials, such as rent, food, transportation, taxes and utilities.
3. **Contribute to a Roth IRA.** Open a Roth IRA while you're young. That's because when you're in a lower tax bracket you pay less tax on your up-front contributions. You also may be able to tolerate more risk when you're young for greater potential long-term gain. If you set up a Roth when you're 20, invest the maximum of $458.33 per month, and earn a hypothetical average annual return of 8%, you'll have $2,216,799 saved tax-free when you retire at 65.[1]
4. **Sock more away in your 401(k).** Contribute up to your employer's maximum matching contribution (if one is offered in your plan). Any money you save above that amount should go toward maxing out the Roth IRA or adding to your emergency fund.

Hypothetical example

Abby and Bill, both age 25, participate in a 401(k). The plan offers a 50% matching contribution up to 10% of employee pre-tax contributions. Both employees make $35,000 a year. If Abby contributes 5% of her pre-tax income to the plan

each year and earns a hypothetical 8% annual average return in addition to the employer's match, she will have saved $704,611 by retirement at 65. But Bill, who contributes 10% to his account and earns the same rate of return as Abby, takes full advantage of the maximum employer match and will in theory boost his savings to $1,409,222 when he retires—nearly double the amount ($704,611) of Abby's savings.

It Pays to Contribute More to Your 401(k)



As always, the real key to retirement success is saving more and spending less. By managing debt and saving regularly while you're in your 20s, you can leverage the positive power that time and compound interest can have on your investments.

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[1] This hypothetical example is intended to illustrate the concept of after-tax investing through a Roth IRA, not the performance of any investment. All investing involves risk, including loss of principal. No investment or administrative fees were deducted from the hypothetical investment; had they been deducted, returns would have been lower.

Sitting Out the Market? Wading in May Be Better Than Diving In

Jim, 57, sold his stock funds in March 2009, after the S&P 500 Index lost more than a third of its value.[2] Since then, a four-year bull market has roared back, with U.S. stocks tripling in value. Sidelined in a money market account, Jim's savings have stagnated. With fewer than 10 years to go until retirement, he's itching to get back into stocks.

Tiptoeing back into the markets may be a more sensible approach for Jim than letting his emotions guide his impulse to dive back in. He needs to create a plan that matches his objectives and time horizon, taking into account that there always will be periods of market volatility and recognizing that his investment strategy likely will need to change over time. Strategies for Jim to consider might include:

- Dollar-cost average.[3] Rather than getting back into stocks all at once, Jim could set aside a fixed amount each month and invest over a 12- to 18-month period.
- Invest in a set-it-and-forget-it fund. Jim could pick a single target date fund[4] that most closely matches the date when he expects to retire. The fund is designed to become more conservative as Jim approaches retirement.
- Dial back risk. Five years before his expected retirement date, Jim might consider reducing his total stock exposure to perhaps not more than 30% or 40% of his portfolio, depending on his expected retirement time horizon and risk tolerance.

You should be aware that a financial advisor charges a fee or commission for his or her services, and that target date funds and managed accounts also have fees and charges associated with them. If you prefer to manage your account yourself, there are a host of online calculators and worksheets from your plan provider, AARP.com and many other sources. Check out AARP's blog at http://tinyurl.com/AARPBlogs for practical ideas for managing your finances.

[2] The S&P 500 is an unmanaged index and, therefore, has no expenses. Investors cannot invest directly in an index.

[3] Dollar-cost averaging does not protect against loss or guarantee a profit. Investors should carefully consider their ability to maintain a dollar-cost averaging program in a declining market.

[4] The principal value of a target date fund is not guaranteed at any time, including at the target date.

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One Route That May Simplify Your Investing

Some investors who lack the time or interest to invest on their own may benefit from a "do it for me" approach. Some plans offer the option to invest through an advised separately managed account (SMA), a custom portfolio that reflects your specific circumstances and goals. With more flexibility and investment choices, an SMA allows you to work closely with a financial advisor to create a portfolio that's matched more directly to your needs.

Lassoing the Retirement Moon: Setting Realistic Expectations

George and Mary Bailey, both 55 and active, want to retire early, in 2019. They need to be realistic about what lifestyle they can afford after they stop working.

George and Mary live frugally. Late last year, they paid off the mortgage on their home, which is now worth $200,000, and have no credit card debt. Their two kids have graduated from college and have launched their careers. Freedom beckons.

Combined, the couple earns $51,000 a year, the median household income in the United States for 2013, of which they spend about half on fixed expenses. They set aside 5% of their income each year in their company retirement plans.

Their dream is to take an extended trip to Hawaii around their 60th birthdays, and then eventually buy a small bungalow in a retirement community somewhere in the Southwest.

Crunching the numbers

To determine whether these are realistic goals, let's look at the couple's overall financial situation in more detail. The Baileys have saved diligently and managed their money well, and have set aside $500,000 in their Roth retirement accounts.

If they sell their home in five years for $250,000 and their retirement savings earn, on average, 8% a year and grow to $750,000 in that time period, they will have a total of $1,000,000 to spend on their retirement. (Assume, for the time being, that they won't take Social Security until 67.)

At this rate, George and Mary easily will retire at 60 as millionaires. Sound like a perfect plan? Unfortunately, the numbers tell a different story. If they use a conservative rule of thumb to withdraw no more than 4% of their savings in their first year of retirement, the newly retired couple will have $40,000 to spend that first year. Assuming the two-week Hawaiian junket will cost them $10,000 and that their fixed monthly expenses are $2,000, their projected first-year income will just barely cover living costs and the dream trip.

Remember that the Baileys are active and healthy, so they likely will need their million-dollar nest egg to last well into their 80s and 90s. In addition, the Baileys will need to live somewhere. Even if they are able to buy a modest retirement home for $200,000, that will reduce their total available retirement funds to $800,000 in year two of their retirement. Even if they keep to their withdrawal rate of 4% in year two, and assuming a 5% growth in their retirement accounts in the same year, George and Mary will have $33,600 to spend—less than they had to spend in year one. Meanwhile, fixed expenses—housing costs, taxes, food, utilities, health insurance—will chip away at their nest egg.

The Baileys clearly need to reframe their expectations about their retirement. Here are a couple of possibilities that could help them find that "wonderful life":

- They can increase their current savings rate to 25% of their pre-tax income. Assuming the same average rate of return, this will boost their savings to $812,168 at age 60 and their first-year retirement income to $42,487.
- They can delay their retirement date and house sale to age 65—giving them five additional years of contributions. If their contributions earn 8% annually, their nest egg will grow to $1,520,845 by the time they reach 65, and a first-year withdrawal of 4% will net them $60,834 in income—more than enough to cover their fixed expenses and trip to the islands (and maybe an even nicer home).

George and Mary have another option, of course: They can set their sights lower. But what's the fun in that?

retirement in motion Tips and resources that everyone can use

Boomers on the Brink: Issues Affecting Participants as They Approach Retirement

Leaving your home to heirs

Probate, the process of dividing your estate after death, is generally something you want to spare those who will inherit your home. One relatively simple tool for doing that is a "life estate," a deed that allows you to remain in your home for the remainder of your life and permits your heirs to inherit it without the delay of probate. A life estate only covers real estate, not any other assets. The life estate has advantages but also certain limitations. Before you make any decisions, consult an attorney who focuses on estate planning.

Quarterly Reminder

Did you receive a tax refund? Consider funding an IRA

Your refund can give your finances a boost, but only if you don't spend it. If you're already contributing the maximum allowed to a 401(k) or 403(b), an IRA funded with extra refund money can be put straight to work. By setting up an IRA now, you can indicate on your 2014 Form 1040 that all or part of next year's refund (up to $5,500/$6,500 if over 50) be sent to that IRA via direct deposit. Download instructions at www.irs.gov.

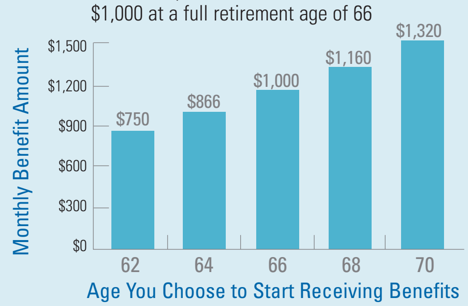
Q&A: Common Questions Plan Participants Ask

When is the best time to begin taking Social Security benefits?

It depends. Do you need the money now? If you need immediate income, delaying benefits is probably not an option. If you don't need the money, though, waiting may be better, especially if you're still working or under the age of 66. Secondly, if you like guaranteed payouts, delaying Social Security benefits may make sense, because payments are higher the longer you delay taking them. Finally, life expectancy is a factor. Taking payments at 62 may boost your income now, but what if you live until 100? Consult a financial advisor so that you fully understand the options that are available, and you make the best choice.

Monthly Benefit Amounts Differ Based on the Age You Decide to Start Receiving Benefits

This example assumes a benefit of $1,000 at a full retirement age of 66



Source: Social Security Administration

Tools and Techniques: Resources to Help Guide Your Retirement Plan

Which is better, a Roth IRA or Traditional IRA?

Both types of IRAs can add significantly to your savings. With a Roth IRA, you make after-tax contributions, withdrawals are tax-free, and you won't be required to take minimum distributions in the year you reach age 70½. With a Traditional IRA, your contributions may be tax-deductible (depending on whether you or your spouse is already covered by a plan at work), you'll pay taxes when you make withdrawals in retirement, and there are required minimum distributions (RMDs) starting the year you reach age 70½.

Corner on the Market: Basic Financial Terms to Know

Asset Allocation Fund

A mutual fund that includes a ready-made portfolio of stocks, bonds and cash equivalents is known as an asset allocation fund. Some funds maintain a specific proportion of asset classes over time (such as a 60/40 stock/bond fund), while others manage risk by altering that ratio in response to economic and market changes.

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