CH. 14 PLANNING FOR RETIREMENT

1

RETIREMENT PLANNING PITFALLS

- Starting too late: Many wait until they are in their 30's or later.
- Putting away too little: Tendency to spend now
- Investing too conservatively: Earlier you start, more risk you can take; low-yielding investments will build small nest eggs.

2

RETIREMENT PLANNING

- Start now! Compounding rewards the investor who starts early.
  - ✓ Set retirement goals.
    - Standard of living when retired
    - What income level you will need to fund that standard
    - Relocation costs
  - ✓ Determine the amount you need to accumulate for retirement.
  - ✓ Design an investment program to build you "nest egg".

3

RETIREMENT PLANNING

- Power of Compounding

	Contribution of $2,000/Year at These Average Rates of Return				Contribution of $5,000/Year at These Average Rates of Return			
Accumulation Period*	4%	6%	8%	10%	4%	6%	8%	10%
10 yrs. (55 yrs. old)	$ 24,010	$ 26,360	$ 28,970	$ 31,870	$ 60,030	$ 65,900	$ 72,440	$ 79,690
20 yrs. (45 yrs. old)	59,560	73,570	91,520	114,550	148,890	183,930	228,810	286,370
25 yrs. (40 yrs. old)	83,290	109,720	146,210	196,690	208,230	274,300	365,530	491,730
30 yrs. (35 yrs. old)	112,170	158,110	226,560	328,980	280,420	395,290	566,410	822,460
35 yrs. (30 yrs. old)	147,300	222,860	344,630	542,040	368,260	557,160	861,570	1,355,090
40 yrs. (25 yrs. old)	190,050	309,520	518,100	885,160	475,120	773,790	1,295,260	2,212,900

4

RETIREMENT PLANNING

- Determine the total need investments for retirement
  - ✓ Start with current living expenses
  - ✓ Estimate future as a percent of current; rule of thumb 80%
  - ✓ Estimate Retirement Income
  - ✓ Social Security benefits
  - ✓ Company retirement benefits/pension plan
  - ✓ Investments
- To determine systematic saving amount needed = Future retirement fund amount ÷ annuity factor

5

SOURCES OF RETIREMENT INCOME

- Social Security
  - ✓ Almost all Americans will receive monthly payments from the Social Security Administration (SSA) in retirement, which are guaranteed to keep up with inflation. According to the SSA, more than 85% of people 65 and older receive Social Security benefits. Of that, 38% depend on Social Security for the majority of their retirement income.

	Single	Married
2020 average monthly income from Social Security	$1,503	Depends on retirement age and lifetime earnings of both spouses. If both spouses collect the average monthly income, $3,006
2020 average annual income from Social Security	$18,036	If both spouses collect the average monthly income, $36,072
50% or more of income comes from Social Security	71%	50%

6

SOURCES OF RETIREMENT INCOME

- Social Security
  - ✓ Qualifications: Must worked 40 quarters or 10 years of full-time work
  - ✓ For Full benefits, must meet qualifying age requirement:
  - ✓ If born in 1960 or later, full retirement age is 67
  - ✓ Benefits are increased by 8% per year if defer taking benefits after age 67 until you reach age 70. No addition increase after age 70.
  - ✓ FICA (Federal Insurance Contributions Act) taxes: FICA taxes fund the Social Security and Medicare programs and add up to 7.65% of your pay (in 2021). 6.2% for Social Security (on wages up to $142,800) and 1.45% for Medicare (plus an additional 0.90% for wages in excess of $200,000). FICA taxes are automatically deducted from your paycheck. Your company sends the money, along with its match (an additional 7.65% of your pay), to the government.

7

SOURCES OF RETIREMENT INCOME

- Social Security
  - ✓ You can take reduced benefits at 62, wait until you're eligible to receive your full benefits, or postpone your first payment to qualify for a larger amount. Many financial professionals suggest waiting at least until you are eligible for full benefits, or even longer, if you are able to do so.
  - ✓ If you and your spouse earned approximately equal amounts over your working lives, drawing on your individual accounts will provide the greatest benefits. But if one of you earned substantially more than the other, compare your alternatives.
  - ✓ If you are eligible for both your own retirement benefit and for benefits as a spouse, SSA will always pay you benefits based on your record first. If your benefit as a spouse is higher than your retirement benefit, you will receive a combination of benefits equaling the higher spouse's benefits.

8

SOURCES OF RETIREMENT INCOME

- Defined Benefit Plans
  - ✓ If you have a defined benefit pension, you should know before you retire about how much pension income you'll receive. This income is typically based on how long you worked at your company, what you earned and your age when you stopped working.
  - ✓ Pensions can be a major attraction to people working in the public sector and armed services.
    - Government employees may be required to contribute a percentage of their after-tax earnings to their pensions.
    - Government employees and military service members may be able to receive their pensions after a set time—such as 20 or 30 years—no matter how old they are or how close they are to the more traditional retirement age of 65.
    - Government pensions and military retired pay tend to be adjusted automatically for inflation using a cost of living index adjustment, or COLA.

SOURCES OF RETIREMENT INCOME

- Defined Contribution Plans
  - ✓ Employer-sponsored retirement plans - such as 401(k)s, 403(b)s and 457s - allow you to defer part of your current income into a retirement plan. You also decide how your money is invested by choosing among options offered through the plan.
  - ✓ Defined contribution plans differ from defined benefit plans in several respects. For one thing, most defined contribution plans offer quicker, or even instant, vesting rights on any contributions your employer has made. And you are always automatically 100 percent vested in your own contributions and any earnings on those contributions.

SOURCES OF RETIREMENT INCOME

- Traditional IRA
  - ✓ Traditional IRA accounts are set up by individuals and only account owners can make contributions. Traditional IRAs can be used in combination with or to supplement an employer-sponsored 401(k). Traditional IRA contributions are $6,000 per year in 2020.
  - ✓ Traditional IRA contributions are tax-deductible on both state and federal tax returns for the year you make the contribution. As a result, withdrawals, which are officially known as distributions, are taxed at your income tax rate when you make them, presumably in retirement.
- Roth IRA
  - ✓ Contributions to Roth accounts are made with after-tax dollars, and withdrawals after age 59½, including the earnings, are tax-free.

11

IRA: PRE-RETIREMENT WITHDRAWALS

- If you withdraw money from a traditional IRA before age 59½, you'll pay taxes and a 10% early withdrawal penalty. You can avoid the penalty (but not the taxes) in some specialized circumstances: If you use the money to pay for qualified first-time home-buyer expenses (up to $10,000) or qualified higher education expenses. Permanent disabilities and certain levels of unreimbursed medical expenses, may also be exempt from the penalty, but you'll still pay taxes on the distribution.
- In contrast, you can withdraw sums equivalent to your Roth IRA contributions penalty- and tax-free at any time, for any reason, even before age 59½. Five years after your first contribution and age 59½, earnings withdrawals are tax-free, too.

12

RETIREMENT PLANNING: ANNUITIES

- An annuity is an insurance product designed to provide consumers with guaranteed income for life.
- An annuity contract is a legally binding, written agreement between you and the insurance company that issues the contract. This contract transfers your longevity risk - the risk of you outliving your savings - to the insurance company. In exchange, you pay premiums as outlined in the contract.

13

RETIREMENT PLANNING: ANNUITIES

- Fixed annuities pay out a guaranteed amount. This type of annuity comes in two different styles - fixed immediate annuities, which pay a fixed rate right now, and fixed deferred annuities, which pay you later.
- Variable annuities provide an opportunity for a potentially higher return, accompanied by greater risk. In this case, you pick from a menu of mutual funds that go into your personal "sub-account." Here, your payments in retirement are based on the performance of investments in your sub-account.

14

RETIREMENT PLANNING: ANNUITIES

- Indexed annuities: You receive a guaranteed minimum payout, although a portion of your return is tied to the performance of a market index, such as the S&P 500. Note that your money isn't actually invested in the index. Instead, the annuity company will attribute your account with the returns that the index produces.
- As a way to limit returns, annuity companies often use participation rates or rate caps with indexed contracts.
  - ✓ Participation rate example: if the S&P 500 grows by 10% in a year and your contract has a 60% participation rate. The annuity company will then take that 10% growth and give you 60% of it, which would equal 6%.
  - ✓ Rate cap example: If the S&P 500 grows by 8% over a year, and your contract has a 5% rate cap. The result would be that your contract receives a 5% return, since the rate cap limits how much your contract can earn.

15

DISADVANTAGE OF ANNUITIES

- FDIC insurance does not cover annuities and withdrawals prior to age 59 1/2 are generally subject to a 10% IRS penalty.
- Annuities are one of the highest-cost investment products in the financial industry. Average annuity annual expenses are up to three times higher than some mutual funds' expenses.
- If you cash in a variable annuity, the government taxes gains at your income tax rate, not the lower capital gains tax rate. Also, annuities don't guarantee gains.
- If inflation picks up, fixed annuity payments lose purchasing power.
- Annuity owners need to hold the annuity for many years to realize the principal guarantee.
- Additional fees – surrender penalties – are standard if the holder cashes the annuity in sooner for any reason.

16