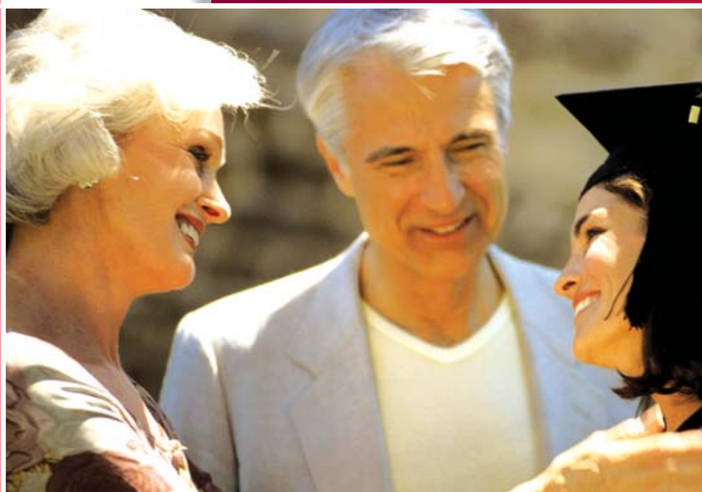
Fundamentals of PERSONAL FINANCE



Making informed financial choices

# Your Retirement Guidelines & Goals

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# Your Retirement Guidelines & Goals


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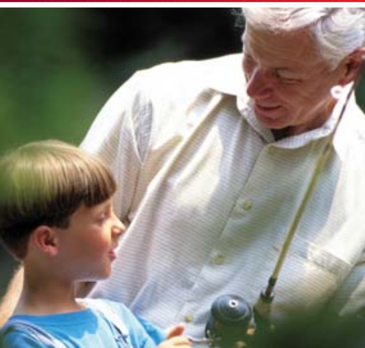
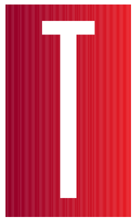


# Your Retirement Plan Is Crucial

**The journey of a thousand miles begins with the first step.** *–Lao Tzu*




his booklet is a primer. It will acquaint you with the things you need to consider as you plan for retirement. These include setting goals, understanding your investment and savings options, and finding people and resources that can help you.

If you are like almost half of all adult Americans, you haven't yet made any real retirement plans or put aside savings for it. We list steps that will show you how to begin catching up, and ways you can secure post-retirement income. If you are young and retirement seems impossibly far away, read the section "Starting Young: The Amazing Power of Compounding" (p. 25). It will show you how just a little effort now in your youth will pay off wonderfully when you retire.

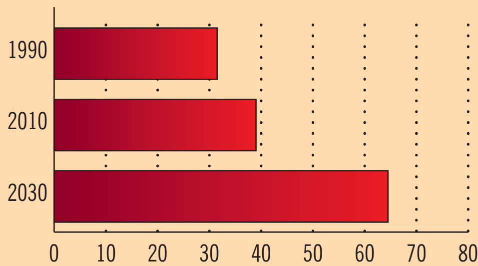
Why is planning for your retirement so crucial? There are three reasons.

- First, planning has become mostly a do-it-yourself thing. That's because traditional sources of retirement income are either taking less responsibility for your retirement or are becoming less important. Many employers are abandoning traditional "defined-benefit" retirement plans where they assume the investment risk. Instead, they're turning to "defined-contribution" plans where you, the employee, must bear the investment risks. Social Security is less and less able to serve as an adequate source of primary retirement income. That makes personal savings and investments a crucial component of retirement income, and growing them is now your responsibility.

> Just a little effort now will pay off when you retire.

- Second, longer life spans complicate your plans for retirement. If you turned 65 today, you reasonably could expect to live into your

early 80s. Many people will live into their 90s. And, current estimates suggest that a million or more people now in their 40s can expect to live to be 100 or older, according to Standard & Poor's "Guide to Saving for Retirement." That means you must plan for 20 to 25 years of life after retirement. You have to build a portfolio that can resist inflation and market fluctuations, and sustain you comfortably over a long time.



*Source: U.S. House of Representatives' Select Committee on Aging*

- Third, retirement is no longer a one-size-fits-all scenario where you leave a job at 65 and live for a short span afterward on a pension and Social Security. Today's "new retirement" includes options that range from retiring early (55 and even younger) or working part time at your old job, to starting a new business, or "dipping" in and out of the job market at will in your later years. How many of these things you can do will depend on the money you've set aside in previous years to grow into a retirement portfolio.

The bad news is that the financial markets today are not performing as well as they were in the go-go period of the late '90s. But the good news is that recessions and bear markets rarely last long in the modern U.S. economy. With a little patience—and guidance, such as what we offer here—you can take control of your life after retirement.

Finally, we can't stress enough the importance of seeking professional help in your planning. Your credit union can be of great assistance.

## Some Retirement Statistics

- Less than half of Americans have planned for retirement.
- Americans reaching age 65 can expect to live into their early 80s, if not longer.
- After you retire, experts say you will need at least 80% to 90% of your pre-retirement income each year to sustain your current lifestyle. (Other experts say it will take even more, because retirees' longer life spans will give inflation more time to gnaw at their nest eggs.)
- Eighty percent of baby boomers (those born from 1946 to 1964) say they intend to work after retirement.
- In the late 1990s, the federal government reported that 80% of elderly Americans relied on Social Security as their main source of retirement income. In the 21st century, no reasonable retirement plan can depend on Social Security payments as a primary income source.

# How Much Will You Need?

The old rule of thumb says you'll need at least 70% of your preretirement income to maintain your current standard of living. This assumes you'll be paying fewer taxes because you're no longer receiving earned income and that you have completed your major material acquisitions—house, furniture, car—expenditures that require a higher level of income and outgo. You've also paid off credit card debt.

We say "old rule of thumb" because increased life spans are making that 70% figure suspect. When pension plans and Social Security were introduced, the retirement age of 65 was considered old. Most people who reached it and retired didn't live too long afterward. Today, people who turn 65 have a reasonable chance of living at least into their early 80s, which means they must plan for at least 15 years of retirement. That means you have to take long-term inflation and the consequences of aging into account. Inflation, even if low, compounds over the years, slowly eroding the buying power of your dollars. You'll also face higher medical bills as you age.

One other factor is making the 70% benchmark obsolete. Because people are retiring in good health, they're more inclined to be active—to travel, entertain, and want to continue at their accustomed level of consumption.

## Life Expectancy

| Demographic characteristics | Your life expectancy if you are 65 now | Your life expectancy if you are 75 now |
|---|---|---|
| Average: all whites | 17.9 more years | 11.3 more years |
| Average: males, white | 16.3 | 10.1 |
| Average: females, white | 19.2 | 12.1 |
| Average: all blacks | 16.2 | 10.5 |
| Average: males, black | 14.5 | 9.4 |
| Average: females, black | 17.4 | 11.2 |

*Source: National Center for Health Statistics*

## Figure for inflation

Your calculation will go like this (we've factored in a Consumer Price Index inflation rate of 3.04% per year, which has been the average rate of inflation in the 20 years from 1987 to 2006). Assume that:

**1 (your estimated annual income at the time you retire) × 1.0304 (inflation factor) = what you'll need to maintain your current lifestyle.**

This shows how much you'll need as you enter your first year of retirement. Multiply that result by the same formula to see how much you'll need in your second year. Repeat this 15 or 20 times to see what inflation will do to your dollars over the years. The total of all those calculations—year one + year two + year three, and so on—is how much money you'll need.

For example, if your income at retirement is $50,000 per year, you'll need $51,520 to produce the same buying power in your first year of retirement. In year five, you'll need $58,076; in year 10, you'll need $64,457; in year 15, you'll need $78,353; and in year 20 you'll need $91,010. Over a 15-year retirement, you'll need $961,000 in income. Over a 20-year retirement, you'll need $1.4 million.

If you plan to live at a more modest level after retirement, multiply the inflation factor by 0.9, or 0.8, or 0.7 of your current income.

To determine how much you must save, your calculation must take the following into account:

1. How much money can you expect from Social Security? (To find out, visit Social Security online at *ssa.gov/planners/calculators.htm*. Three calculators will appear with different options.)

## When Are You Ready to Retire?

Objectively, you're ready to retire when you have enough set aside to allow you to receive at least 80% of your current income for 20 years without ever having to work again. You also should be debt-free, with your mortgage, car, and credit cards paid off. You should have enough potential income to handle rising medical, life, and long-term care insurance premiums as you age.

Subjectively, you're ready to retire when:

- Your current line of work no longer inspires you;
- You are physically less and less able to meet the demands of your job; or
- You find yourself wanting to take on a new vocation, step up your volunteer work, do long-term travel, or even start a new business.

Although the federal government has set ages at which you may draw full Social Security benefits (66 starting in 2004) and when you must begin withdrawing distributions from your IRAs (individual retirement accounts) and other tax-deferred savings plans, there are no rules that say you must retire at a certain age. (Do keep in mind that you *must* begin taking distributions from your IRAs and similar investment plans by age 70½.)

2. How much money can you expect from pensions or trust funds?

3. What's the difference between the total you'll need and the income you'll receive from Social Security, pensions, and trust funds? The answer to this question will be how much money you must save.

Your savings formula becomes:

**Amount annually saved × number of years × interest rate = the money you'll have to retire on.**

Use the compounding calculator listed in "Online Resources" (p. 32) in this booklet to get a quick estimate of what numbers you should put into the equation above. The same calculator shows, for example, that a couple jointly saving $5,000 per year for 20 years in an IRA at 6% interest will have $195,000. At 30 years, they'll have $419,000. At 8% annual growth, the 20- and 30-year sums would be $247,000 and $612,000, respectively. Again, you can see the advantage compounding bestows on people who start saving early.

You may end up with a big difference between what you want to live on at retirement and the amount you realistically can expect to have saved by then—even including your pension and/or Social Security benefits. If this is the case, look at the "Catching Up" (p. 24) sidebar in the "Getting Started" section.

Remember that each section of your portfolio at retirement will have a different withdrawal rate. You'll want to consult with a professional adviser about how to best arrange the cash flow you seek. Your credit union pros may be able to help.

## How Much to Take Inflation in to Account?

Economists expect inflation of around 2.5% over the next 10 years. Millions of baby boomers will retire over the next 15 years and there may not be a large enough number of younger people behind them to buy up their houses and properties. An oversupply could drive prices down, denying retiring boomers their hoped-for level of return.

On the other hand, boomers stand to receive $16 trillion in transferred wealth from their parents' generation by 2020, most of it as property. It might seem that this immense wealth would be inflationary, but boomers will still face the problem of small markets where they can cash in.

The chances of high inflation, even with government deficit spending or boomer inheritances flooding the economy, doesn't seem likely. That's why we think a 2.5% to 3% per year inflation factor should be sufficient for your calculations.

# Funding Your Retirement

Traditionally retirees have based their income on three legs: Social Security, pension plans, and their own savings. The combination was thought sufficient to provide an adequate retirement income.

But with increases in longevity, retirees are living long enough to see inflation and changing economic conditions gnaw at their funds. Even a low rate of inflation can erode buying power over a 10- or 20-year period. Periodic stock market declines, which can last for months on end, can diminish dividend streams and lower the amount you'll receive if you sell off stock.

So, the conventional wisdom that you'll need 70%+ of your preretirement income to maintain a lifestyle that's close to the one you led before retiring is taking quite a beating. That's why financial experts are adding a fourth leg to the retirement "stool"—income from jobs you'll hold after retirement.

Let's examine each leg:

LEG 1

## Leg 1: Social Security

Although confidence about Social Security has increased over the past 10 years, concern about the future of the program is high, according to the Employee Benefit Research Institute's 2006 Retirement Confidence Survey. Fewer than one of 10 workers (6%) say they are very confident that the Social Security system will continue to provide benefits of at least equal value to the benefits received by retirees today, and more than one-quarter (27%) are somewhat confident. At the same time, a combined two-thirds are not too (33%) or not at all (34%) confident that future benefits will match or exceed the value of today's benefits.

Social Security is a "pay-as-you-go" system. Benefits are funded by payroll taxes paid by the current work force. By 2017, though, there will not be enough people in the U.S. work force to pay all of the benefits promised. This has been a looming problem for years. When the government established the program in 1935, there were 40 workers for every Social Security recipient. Today

## Go Direct

A program offered by the Treasury and the Federal Reserve encourages seniors to Go Direct® and choose to have their Social Security checks directly deposited. Direct deposit is the best way to receive your Social Security and other federal benefit payments.

Direct deposit offers:

- One less thing to worry about because it is the safest way for you to receive your money
- An easier and more convenient way to access your money
- More control over your money and your time because it is predictable and dependable

Visit *GoDirect.org* or call 800-333-1795 for more information.

there are approximately three workers for every beneficiary, and by 2020 that ratio will be 2.4 to one.

Obviously, something will have to give. Either payroll taxes (currently 7.65% for employees and 15.3% for the self-employed) will have to increase, or benefits will have to be cut back. In the meantime, the age at which you may start receiving full benefits went up to 66 in 2004, and will go up to 67 in 2022.

Whatever adjustments the government makes to Social Security, it would be foolhardy to factor it in as anything more than a supplemental source of income when you plan your retirement. Social Security will replace, at best, only 24% of your previous income.

Astonishingly, 47% of all current retirees depend on Social Security for 90% or more of their retirement income. Sixty-four percent rely on it for half or more.

Obviously retirement's first leg is not its strongest. Still, you want to be sure you do everything you need to receive your benefit. Money from any source after retirement is welcome.

## Finding out your benefit

Social Security's benefits formula looks at the 35 years of highest earnings in your work life. If you have been working for fewer than 35 years, the formula projects what you're likely to earn in the future and applies it to your current statistics.

Workers and former workers age 25 and older receive automatic annual mailings, of your Social Security Statement. Besides helping you with retirement planning, this benefits estimate will help you see if previous employers correctly reported your income.

## When to apply

Three months before you plan to retire, contact your local Social Security office. You'll be asked to make an in-person visit to start the process.

"Full retirement age" is going up. People born before 1937 were fully entitled when they reached age 65. People born in the years from 1943 through 1954 will have to be 66 before Social Security considers them as having reached full retirement age. People born in 1960 or later will have to be 67.

## Receiving benefits before age 65

You can begin receiving Social Security benefits at age 62, but will