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Chapter 7
Retirement Planning: Realities and Resources

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Get an Early Start

A lot of thinking and planning is necessary for funding your retirement years. The best retirement planning is done very early in your working life. Always, when you're dealing with financial matters, your options are much better if you have time on your side. Setting aside enough for financial security is more important than ever because today's retirees are living longer than ever.

Retirement Income Sources: The Big Three

Historically, there are three basic sources of retirement income. You may have all three or a combination, depending on the nature and duration of your employment.

Social Security

The first and most common income source, Social Security, is designed to replace around 30 percent of your preretirement income for those with low to moderate earnings. Although in the past, households often looked to Social Security as their primary source of income for retirement, Social Security was never designed to completely fund retirement.

Employee-sponsored Retirement Plan

If either you or your spouse is not self-employed, the second source of income is generally funded jointly by you and your employer. It may include pension funds or monthly annuity payments from one or more employer retirement plans. As an employee in your own farm or nonfarm business, you also have options for funding your retirement including Simplified Employee Pension (SEP) or Savings Incentive Match Plan for Employees (SIMPLE) plans.

Personal Assets

Your third source is the personal assets you've accumulated throughout your working years. These could include savings and investments as well as personal and real property (land, timber, buildings, equipment, vehicles, etc.). Personal and real property will have to be liquidated to serve as a source of income, so once that has happened, the assets will not be available to pass on to your heirs. (See notes in Farm or Business Transfer Box, below.)

Farm or Business Transfer: An Important Decision. Make It Early!

If you own a farm or business, you'll have two options, and each of these has very different implications for your retirement planning. If you want to pass your farm down intact to your heirs, it will be very important to protect your farm assets by setting aside enough personal (nonfarm) assets to see you through your retirement years and by making sure that you have enough long-term care insurance to finance end-of-life care. If you do not plan to pass your farm or business intact to your heirs, you'll be able to liquidate your farm or business assets to fund your retirement needs. Regardless of the option you choose, the earlier you make that decision and begin retirement planning, the better!

Retirement Planning

While planning for retirement may seem overwhelming, don't let that be an excuse for delaying those important decisions. The longer you delay, the fewer options you'll have. This section contains very basic information and resources for planning to help you get started. If your finances are complex — and particularly if you own a successful business — you'll need to also talk with a qualified financial advisor. Discussing with a qualified financial advisor can be a great starting place.

Basic Questions to Guide You

Your goal for successful retirement planning is not to have to drastically lower your level of living after retirement. Some key questions you'll need to ask are:

At what age do I plan to retire?

Retirement before age 65 has been an increasing trend in recent years, but the downside is that early retirees have fewer years to save, fewer years for their savings to grow and a longer time period to sustain themselves on invested assets.

How many years will I spend in retirement?

In the last century (1900 to 2000), average life expectancy increased by about 30 years. Many people are living into their 80s and 90s. The average worker now spends more than 20 years in retirement — double the amount of time spent by the previous generation of retirees. Longer life expectancies combined with more years in retirement have major implications for how you finance your life after work.

What income will I have from a retirement plan or Social Security?

If you or your spouse has worked outside your own farm or business, if you have paid enough Self Employment Tax or if you have made contributions on your own behalf to a SEP or SIMPLE Retirement Plan, you should have a regular income stream from one or more of these sources. Those funds can serve as a basis for your retirement needs.

How much will I have in personal assets?

You can draw on these funds or assets for special needs or even for day-to-day expenses if your necessities exceed your combined income from Social Security and your retirement plans.

Estimating Retirement Needs

Retirement worksheets and calculators can help you plan more accurately for retirement. Using an estimate calculator is an easy way to get a general idea of the amount you need to save. You can access a variety of calculators at choosetosave.org.

To complete a realistic retirement savings analysis, you need to know how much you'll receive from Social Security and/or an employer pension plan. To obtain a personalized Social Security estimate based on your real earnings, you should create a Social Security account. An account can be created by visiting ssa.gov/myaccount.

When preparing your retirement projections, be sure to include pensions from all jobs in which you have vested benefits, even if you no longer work there.

Saving Versus Investing

We often talk about saving and investing as if they are interchangeable. However, there are two important distinctions. Savings accounts generally have a lower interest rate, but your money is safe from market and/or interest fluctuations. Investments usually have a higher rate of return over time, but rates often fluctuate in the short term and your investment could even lose money.

Investment Options

You do not need a sophisticated knowledge of investing to plan for your retirement. However, at minimum, you will need to know enough about basic investing to make intelligent decisions about the mutual fund options offered in 401(k)s or other retirement accounts. Ask your fund representative to fully explain the options available to you and the advantages and disadvantages of each.

When thinking about investment options, it's helpful to categorize them according to whether they are offered through the workplace or obtained on your own. The chart below lists common investment options in each category.

Table 1. Common Investment Options

Workplace-sponsored	Personal
401(k) Retirement Plan	Individual Retirement Account (IRA)
401(k) Roth Retirement Plan	Roth IRA
403(b) Retirement Plan	529 Education Savings Plan
459 Retirement Plan	Coverdell Educational Savings Plan
SEP Retirement Plan	U.S. Treasuries
SIMPLE Retirement Plan	Mutual Funds
Keogh Retirement Plan	Brokerage Accounts (for stocks, bonds or other securities)
	Whole Life Insurance
	Annuities

Tax Considerations

Because the U.S. government wants to encourage its citizens to save for retirement, you can realize certain tax advantages on the money you put into retirement accounts that are not available in other accounts. For example, you can set some of your income aside in an Individual Retirement Account (IRA) or a 401(k) and defer paying taxes on that income until it is withdrawn at an eligible age. You may also put some of the money you've already paid taxes on in a Roth IRA or a Roth 401(k) and pay no taxes on the money it earns in the future. In the case of a Roth, both your contribution as well as all of the interest or return on your investment can be withdrawn tax-free after retirement.

Tax-Deferred Versus Tax-Sheltered

In a tax-deferred account, you contribute money that has not yet been taxed. In reality, you are putting off (deferring) paying the tax on that money until after it is withdrawn from the account. Upon withdrawal, you'll pay taxes on both the amount you've contributed and what has been earned in interest or return. The assumption is that upon retirement you will be in a lower tax bracket and the money withdrawn will be taxed at a lower rate. In a tax-sheltered account, you contribute money on which you've already paid taxes. Your investment then grows tax-free, and when you withdraw funds at an eligible age or for an eligible reason, you pay no taxes on either your contributions or your earnings.

Education savings plans, both 529 and Coverdell accounts, work in a similar way. They are financed with after-tax income, but earnings grow tax free. In the case of the college savings plans, it is enrollment of the beneficiary in a qualified educational institution that triggers penalty-free withdrawal.

In all tax-deferred or sheltered accounts, whether they are retirement accounts or educational savings accounts, you will incur a heavy penalty for early withdrawal. If you take money out of a tax-sheltered or tax-deferred fund before you reach retirement, you'll pay a 10 percent penalty in addition to any taxes owed on the amount you withdraw. It's important to plan carefully before you commit funds to a retirement account, because that money won't be available for meeting the financial goals you have before you retire.

Risk Versus Return

In general, investments that yield a higher rate of return are the most risky, and investments with lower rates of return are usually less risky. You'll want your initial investments — those you depend on for meeting essential needs — in relatively safe investments. As you accumulate more and more money to invest, you can afford to invest in more aggressive — and risky — funds that provide you the opportunity to realize higher returns.

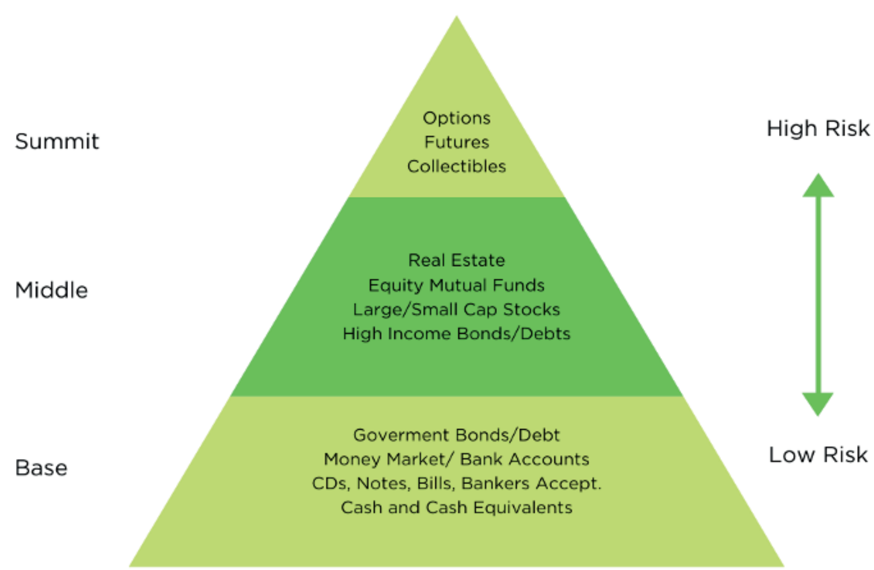

Figure 1. Examples of Risks By Investments.

Most of us never reach the summit of financial security where we can afford to take the risks associated with individual speculative stocks, options, futures contracts and collectibles, but if your middle-level investments turn out to be very successful, there's always that possibility!

How much risk should you take with your investments? Financial experts will say that the answer depends on two factors. The first is your capacity for risk. Your capacity for risk depends on the amount of your total assets. If you have more money than you need to be financially secure, you can certainly afford to take more risk than the person who has just enough. Your capacity also depends on your financial responsibilities. If you have most of your money tied up in a business on which your income, and that of others, depends, you wouldn't have many funds available for speculative investments. Finally, your capacity for risk depends on your stage in life. If you are 25, you have many years to recover from investment losses before you are dependent on your investment income for day-to-day living. If you're 65, you don't have much time to recover from losses.

The second factor determining how much risk you should take is your personal risk tolerance. Some people are comfortable taking risks, while others prefer a more conservative approach to investing across the life cycle.

Regardless of your risk tolerance, you should diversify your investments to maximize return and minimize risk. By diversification, we mean that you should invest in a variety of types of funds so that if some lose value, others might hold or gain value.

Asset Allocation

The way you choose to divide your investments among different funds to manage your risks and reach your financial goals is called "asset allocation." Your asset allocation will need to change with your life changes and changes in the larger economy.

Financial Goals

Over your life, your asset allocation will change as you save for and achieve your financial goals. For example, if you are planning to use a portion of your investment for down payment on a house, you might want that money in a very safe fund. If you don't plan an immediate withdrawal of funds to meet a financial goal, you can afford more risk.

Personal Circumstances

Your asset allocation will change with your personal circumstances, as well. If your life is affected by illness, job loss, divorce or a natural disaster, you would likely need to move nonliquid assets to cash and, at least for a time, hold those assets in very safe investments. As you accumulate assets beyond those you'll need to fund your basic immediate and future needs, you can afford to allocate those assets to riskier investments with the prospects of higher yields.

Larger Economy

You'll certainly need to consider what the economy as a whole is doing, reallocating your investment assets to safer investments during turbulent economic times and to investments with more earning potential when the overall economy is booming.

Age

One of the most important factors in your asset allocation may be your age or the number of years you plan to work before you retire. This is because time is on your side as a young investor. Since the larger economy and financial markets, in general, fluctuate and cycle, there are usually times when just about everyone makes money through investments and other times when just about everyone loses money. If you happen to lose money because of an economic downturn — which more severely affects riskier investments — when you are near retirement, you may not be able to leave your investments intact until the markets go back up. You may need to withdraw funds to supplement your retirement. If more of your funds are in safer investments — those not as vulnerable to economic fluctuations — as you near retirement, you don't face this risk.

Investment Costs

Costs associated with investing vary according to the type of investment and how they are purchased. You should try to minimize the costs as much as possible while still choosing your best options.

Cost Associated with Stocks

If you purchase stocks, you will pay fees to the broker who handles that transaction. Of course, you want to find the broker who charges the lowest fees. But often, brokers who discount their fees aren't available for us to ask questions and rely on them for support. If you are new to stocks and want the ability to pick up the phone and talk to your broker, you may want to pay more in fees for that support. If you are more comfortable investing, you may choose a discount broker.

Costs Associated with Mutual Funds

A percentage of a mutual fund investment that is deducted to cover the cost of managing the fund is called a load. Funds with a front-end load deduct the cost when shares of the fund are purchased. Funds with a back-end load make the deduction when the shares are sold. In a 401(k), the cost may be called a "fee" and will be listed in the fund report.

In Closing

When you are investing, you should decide how active you want to be in making decisions about your accounts. If you choose to be active, you will need to watch your accounts carefully and move money between accounts and investment options to maximize your returns. If you remain passive, you will need to invest your money for the long term, essentially letting it ride the economic roller coaster over time.

Remember to fully investigate all your options before you invest. Consider whether your money is more appropriately invested in retirement or preretirement funds; what tax advantages you might realize from your choices; how safe your money is; whether it's in the best fund for your life circumstances and economic environment; the costs involved; and how actively your investment must be monitored and managed.

What Do the Letters Mean?

Though credentialing for financial planners is not required by federal or state law, you should expect that persons calling themselves professionals to have the appropriate educational background, have significant professional experience, be licensed by the appropriate government regulatory agency, and have a commitment to helping others. A number of certifications and designations exist:

Certified Financial Planner (CFP) is probably the best-known certification in the field of financial planning. CFP licensees have to complete, study and pass examinations in risk management, investments, tax planning, retirement planning and estate planning. They must also have a minimum level of three years work experience, continue to update their knowledge in the field, and adhere to a prescribed code of ethics. CFP licensees are certified by the Certified Financial Planner Board of Standards, Inc.

Chartered Financial Analyst (CFA) designations are awarded by the Association for Investment Management and Research (AIMR). Three levels of examinations can be taken. For example, the first level includes understanding investment analysis and management, financial markets, portfolio management and securities law.

Chartered Financial Consultants (ChFC) complete courses in economics, investments, insurance, taxation and related areas from the American College in Bryn Mawr, Pennsylvania.

Personal Financial Specialist (PFS) designations are obtained by some certified public accountants (CPAs). Additional specialized education is needed and other requirements established by the American Institute of CPAs must be met. CPAs with the PFS designation provide a broad range of personal financial services, which may include investment advice.

Accredited Financial Counselors (AFC) must pass two examinations, one in personal finance and one in financial counseling, and subscribe to the AFC code of ethics.

You can find out more about investment professionals and their qualifications by visiting the following website:
https://www.finra.org/investors/professional-designations

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