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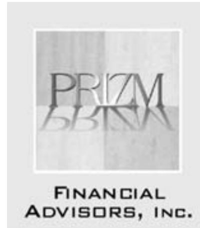

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Financial Concepts

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Is 10% Enough?

A common rule of thumb when planning for retirement is to save 10% of your gross income during your working years. Since this rule of thumb has been around for a long time, it's logical to question whether it's still an appropriate guideline. Several trends suggest that it is probably on the low side:

- **Fewer individuals are covered by defined-benefit plans.** The 10% guideline anticipated that a retiree would receive a defined-benefit pension as well as Social Security benefits. But a substantial portion of the work force is no longer covered by a defined-benefit pension.
- **The Social Security system will face increasing pressure in the future.** Due to the unprecedented number of baby boomers who will be retiring in the near future, there will be fewer workers to pay the benefits for each retiree. By 2037, unless changes are made to the system, benefits will need to be reduced by approximately 25% to equal revenues collected (Source: Social Security Administration, 2009).
- **Life expectancies are continuing to increase.** Average retirement ages have been decreasing, while life expectancies have been increasing. Currently, at age 65, the average life expectancy is 82 years for a man and 85 years for a woman, compared to 78 years for a man and 81 years for a woman in 1950 (Source: *Journal of Financial Planning*, August 2008).
- **Plans for retirement have changed.** Another common retirement planning rule of thumb is that you'll need 70% of preretirement income during retirement. However, that guideline assumed a relatively inactive retirement lifestyle. Increasingly, retirees view retirement as a time to travel extensively or engage in expensive new hobbies. Thus, more and more retirees are finding little change in their income needs after retirement.

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Finding Money to Save

Everyone knows that they should be saving at least 10% of their gross income for retirement, but that can seem like an impossible goal after paying all your bills. However, don't just figure that goal is unachievable without first looking at the after-tax cost.

For instance, assume you earn $50,000 annually and your employer matches 50 cents for every dollar you contribute to your 401(k) plan, up to 6% of your pay. If you put 6% of your pay, or $3,000, in the plan, your employer will match 3%, or $1,500. Your contribution really costs less than 6%, because the money is taken out before income taxes. If you are in the 25% tax bracket, your $3,000 contribution will save $750 in taxes, or 1.5% of your pay. So, between your contributions and your employer's match, you will contribute 9% of your pay toward retirement, but it will only cost you 4.5% of your pay.

Made over long periods of time, those levels of contributions can help significantly in funding your retirement. If you contribute $4,500 annually starting at age 30, you could potentially accumulate $837,460 by age 65 with an investment return of 8% annually. *(This example is provided for illustrative purposes only and is not indicative of the return of a specific investment.)* If possible, you should strive to contribute even larger sums of money. In 2010, the maximum 401(k) contribution is $16,500, plus individuals over age 50 can make an additional $5,500 catch-up contribution.

What if you don't have a 401(k) plan at work? Take a look at individual retirement accounts (IRAs). ❍❍❍

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Is 10% Enough?

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All these trends point to the fact that future retirees will be responsible for providing more of their income for a longer period of time. Thus, you should consider higher, not lower, savings rates. While 10% of income may sound like a lot of money, consider how many years you expect to work compared to how many years will be spent in retirement. Assume you start working at age 22, work until age 62, and then die at age 82. Thus, you work 40 years and are retired for 20 years — for every two years you work, you need to support yourself for one year in retirement. If your retirement expenses don't go down and you don't have a defined-benefit pension, you'll need to save significant sums to support yourself for that length of time.

Contrast the current situation with a typical scenario in 1950. At that time, the average retiree worked 47 years before retiring for nine years. Thus, that person worked over five years to support one year of retirement.

For many people, then, the answer may be to extend their working years. In the above example, if you wait until age 70 instead of age 62 to retire, you will work for 48 years and be retired for 12 years. Thus, you will work four years for every year of retirement. While preretirees may not have the mathematics down, many realize that working longer, rather than retiring earlier, may be the only way to ensure that they don't run out of retirement funds. Almost all recent surveys of baby boomers indicate that the majority expect to work at least part-time during retirement.

These stark realities don't mean that you can't retire, just that you need to plan carefully. Thus, you should start saving as much as possible as soon as possible for your retirement. Waiting even a few years to start saving can substantially increase the annual amount you need to save.

Trying to gauge whether your retirement savings are on track? While there's nothing like going through a thorough analysis, you can take a quick look by adding up all your retirement assets and multiplying that balance by 3% or 4%. These withdrawal percentages should ensure that your retirement assets last for several decades. If you'd like to discuss your retirement plans and how much you should be saving for retirement, please call. ❍❍❍

Why Use Asset Allocation?

Your asset allocation strategy represents your personal decisions about how much of your portfolio to allocate to various investment categories, such as stocks, bonds, cash, and other alternatives. When stock market returns were above average for an extended period, investors did not have much interest in asset allocation. Then, the best strategy seemed to be to only own stocks. But with the stock market volatility of the past several years, investors are again focusing on asset allocation. Some of the advantages of an asset allocation strategy include:

- **Providing a disciplined approach to diversification.** An asset allocation strategy is another name for diversification, an important strategy for reducing portfolio risk. Since different investments are affected differently by economic events and market factors, owning different types of investments helps reduce the chance that your portfolio will be adversely affected by a particular risk type.
- **Encouraging long-term investing.** An asset allocation strategy is designed to control your portfolio's long-term makeup. It should not change based on economic conditions or market fluctuations.
- **Eliminating the need to time investment decisions.** Market timing is a difficult concept to implement. Not only do investment professionals have a difficult time accurately predicting the market's movements, but waiting for the perfect time to invest keeps many investors on the sidelines. With an asset allocation strategy, you don't have to worry about timing the market, you just have to ensure your investments stay within the proper percentages.
- **Reducing the risk in your portfolio.** Investments with higher returns typically have higher risk and more volatility in year-to-year returns. Asset allocation combines more aggressive investments with less aggressive ones. This combination can help reduce your portfolio's overall risk.
- **Adjusting your portfolio's risk over time.** Your portfolio's risk can be adjusted by changing allocations for the different investments you hold. By anticipating changes in your personal situation, you can make those changes gradually.
- **Focusing on the big picture.** Staying focused on your asset allocation strategy will help prevent you from investing in assets that won't help accomplish your goals. Rather than investing in a haphazard manner, it gives you a framework for making investment decisions.

Your asset allocation strategy will depend on a variety of factors unique to your situation. Please call if you'd like to discuss asset allocation in more detail. ❍❍❍

How Much Life Insurance Do You Need?

While life insurance can serve a variety of purposes, one of the most common is to maintain your family's standard of living in case you die. Thus, you need to purchase an appropriate amount of insurance to ensure your family is adequately protected. Many rules of thumb exist, such as five to seven times your annual income, but don't rely on rules of thumb to determine your coverage. These rules don't take into account your individual circumstances, so they could leave you with an inadequate amount of insurance. To determine how much insurance you need, consider these questions:

What lifestyle do you want to provide for your spouse and dependents after your death? Review your needs in detail, taking a look at things like:

- ❍ Do you want to provide the same standard of living? Will your spouse and children live in the same house?
- ❍ Will the family have to make different child care arrangements?
- ❍ Do you want to provide for college educations for your children?
- ❍ If your spouse doesn't work, do you want that to continue, or do you expect him/her to work after your death?
- ❍ Do you need to consider the support of elderly parents or other relatives?
- ❍ How long must your family live off the insurance proceeds?
- ❍ Do you want to pay off a mortgage or other debt?
- ❍ Do you have estate tax considerations you want to address?

How much will that lifestyle cost? Come up with an estimate of how much this lifestyle will cost. Include all of your current expenses that would remain the same as well as any new expenses you have identified, such as for child care. Remember to factor in hidden costs, such as providing for health insurance that was paid for by your employer. For large debts, such as a mortgage, determine whether it makes sense to pay the loan off in full or to continue making monthly payments.

How much life insurance do you need? First, consider what other income sources your spouse and/or dependents will have. This could include your spouse's earnings, retirement plans, Social Security benefits, savings, and investments. Life insurance proceeds will be needed to provide the difference.

Please call if you'd like help with your life insurance needs. ❍❍❍

Don't Forget about Inflation

Inflation has been tame for so long that it's easy to forget how much it can affect your purchasing power over a long retirement. Over the past 10 years, inflation, as measured by the consumer price index, has averaged 2.5% (Source: Bureau of Labor Statistics, 2009). At 2.5% inflation, $1 is worth 78¢ after 10 years, 61¢ after 20 years, and 48¢ after 30 years. Thus, you need to look for strategies to lessen inflation's impact during retirement:

- ❍ **Use a conservative inflation rate when planning for retirement.** You don't want to run out of money during retirement. So when calculating how much to accumulate by retirement age and how much to withdraw during retirement, use a conservative inflation rate. While inflation has averaged 2.5% over the past 10 years, it has averaged 3.9% over the past 30 years (Source: Bureau of Labor Statistics, 2009).
- ❍ **Determine how much of your retirement income is indexed for inflation.** Social Security benefits are currently indexed for inflation, but most defined-benefit pension plans do not make adjustments for inflation. Thus, other income sources will have to fill an increasing income gap over time.
- ❍ **Invest in tax-advantaged retirement vehicles.** Look into 401(k) plans, individual retirement accounts, and other retirement vehicles. While each has different rules for taxing contributions and earnings, all provide some tax-free or tax-deferred benefits. Since you aren't paying income taxes on earnings during the years, that typically means you'll have a larger balance at retirement.
- ❍ **Choose investments carefully.** To avoid losing purchasing power, your after-tax rate of return should be higher than the inflation rate. Review your investments annually to make sure you aren't losing purchasing power. ❍❍❍

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The Problem with Average Returns

When setting up an investment program, the assumed rate of return is typically an average return for some historical period. While that is generally viewed as a conservative approach, there are some problems with using an average return:

- Average returns are an average of past returns and do not indicate what will happen in the future. Economic and market events may or may not replicate past events.
- The average annual return can vary substantially, depending on the historical period used. For instance, from 1926 to 2008, the Standard & Poor's 500 (S&P 500) had an average annual return of 9.6%. From 1984 to 2008 (25 years), the average return was 9.2% and 6.4% from 1999 to 2008 (10 years).* Those differences in average return would project a substantially different portfolio value over an extended time.
- The average return does not reveal the pattern of returns over that period. Some years will experience higher returns, while other years will experience lower or even negative returns. Even if you select an average return that is exactly right, your portfolio's ultimate balance will depend on the pattern of returns over that period. For instance, if you experience high returns in the early years when your portfolio's balance is low and then lower returns in the later years when your portfolio's balance is higher, you will have a lower value than if the opposite occurred.

- Most people don't just allow a lump sum to grow, but make deposits and withdrawals over the years. Since your actual return fluctuates from year to year, your pattern of additions and withdrawals can also significantly impact your portfolio's ultimate value.

While it is instructive to consider average returns when developing an investment program, you can't simply project that return into the future and hope for the best. Instead, consider these steps when deciding on an estimated rate of return:

- **Evaluate your expectations for future returns against historical averages.** It may be prudent to assume lower returns in the future. It is easier to save less if you obtain higher returns than to try to save more over a short period of time if your actual return is lower.
- **Consider a range of possible returns for your portfolio.** What would happen to your portfolio's balance if you earned your expected return, 1% less, 2% less, etc.? This analysis can help you determine what adjustments would need to be made to compensate for lower returns.
- **Review your progress every year.** This will allow you to make adjustments along the way. If your return is lower than expected, you may need to increase savings or change investment allocations.

If you'd like help evaluating an appropriate expected rate of return for use in your investment program, please call. ❍❍❍

* Source: *Stocks, Bonds, Bills, and Inflation 2009 Yearbook*, Ibbotson Associates. The S&P 500 is an unmanaged index generally considered representative of the U.S. stock market. Investors cannot invest directly in an index. Past performance is not a guarantee of future results. Returns are presented for illustrative purposes only and are not intended to project the performance of a specific investment.

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