Retirement

“I Love Not Having to Work Anymore”

Life Smarts:

– Compute a retirement portfolio given a specific scenario.

Retirement statistics

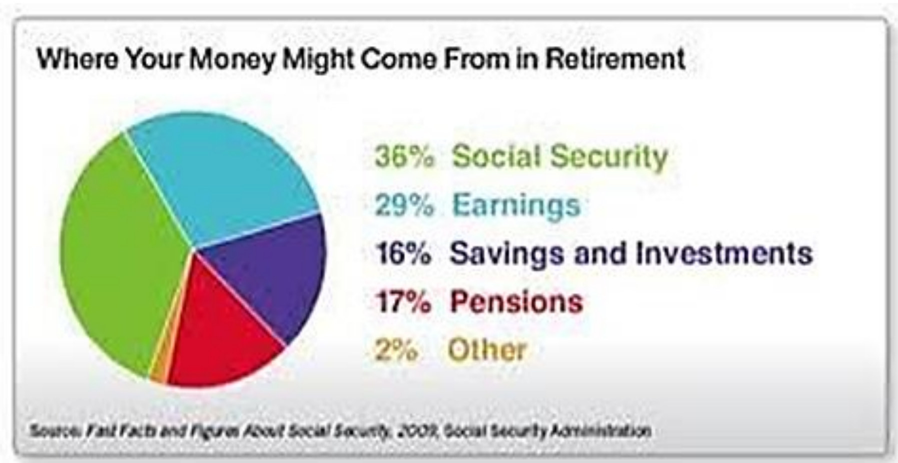
Retirement is the voluntary removal from the workforce due to age or years of service. Next to the purchase of a home, investing for **retirement** is one of the best investments possible. As we age, most of us will become restricted in what we can do, which may limit us to certain types of work. If you start planning now for retirement, you might be able to live comfortably and maintain a decent standard of living without having to work well into old age.

Many books and articles have been written on retirement. There are calculators that will tell you how much you need to invest for your individual retirement needs. However, every person and situation is unique, and there is no magic formula or calculation that will answer all of the questions concerning retirement.

Here are some quick facts regarding retirement. According to the Employee Benefit Research Institute, **only 14% of American workers are confident that they will have enough money in retirement to live comfortably**. They also reported in a survey conducted in 2012 that 30% of workers had less than $1,000 in savings and investments. Sixty percent of workers had savings and investments of less than $25,000 (excluding home values and defined benefit pensions). **Indications are that only 58% of Americans are even saving for retirement**.

Fidelity Investments indicates that a retired couple of age 65 that retires now will need about $240,000 to cover just their medical expenses throughout their retirement years.

The Center for Retirement Research indicates that only 42% of private sector workers aged 25 to 64 have pension coverage in their current jobs. They also indicate that about one-third of households end up entirely dependent on Social Security.



In addition, 21% of workers offered a 401(k) plan do not participate. They also indicated that one-third of households end up with no employee-sponsored retirement plan at all.

According to the federal government several years ago, the typical household had 401(k)/IRA balances of about $120,000 as they approached retirement. This number is far short of what many will need for their retirement.

Consider all the above and realize that studies indicate that **individuals who retire will need about 80% of their pre-retirement income for retirement**.

Now, let's discuss sources for that income.

1. If you were earning $75,000 per year before you retired, how much would you need in retirement income to live comfortably?

   Answer: $60,000 (75,000 x .80)

Saving and retirement

Let's review some of the information from the Investing and Savings topic earlier, because it is a component of retirement.

Savings

Throughout your working life, you should set a goal for saving part of your earnings, not only for retirement but for that "Rainy Day" that will occur. Basic Savings Accounts, money market accounts, and certificates of deposits are usually insured by the **Federal Deposit Insurance Corporation (FDIC)** for banks and by the **National Credit Union Administration (NCUA)** for credit unions.

Basic Savings Account – Low or no minimum balance. Very low interest return on investment.

Money Market Account – Requires an individual to have more money in the account than a basic savings account and returns a slightly higher rate of interest.

Certificate of Deposit (CD) – A certificate of deposit is a timed deposit of one month to five years in duration. A CD can have a **fixed** (stays the same) or **variable** (changes based on market conditions) interest rate.

Investing and retirement

Investing can be an important ingredient in saving for retirement. An investor wants to reduce risk and strive for the highest rate of return. Diversifying one's investing strategy helps with risk and return. Review the following investments that were discussed in the Investing and Savings topic:

Stocks – Purchasing a stock gives you partial ownership in the company that you invest in. Dividends that are declared and paid by certain companies can be a good source of income and provide a good rate of return on your investment.

Bonds – Offer investors a specific interest rate of return; a maturity date with return of the investor's principal; and act as a loan so a company can use capital for specific projects.

Mutual Funds – A pool of money from investors to be invested in stocks, bonds, treasury bills, real estate, etc.

Real Estate – From 1945 until 2007, real estate investing was a means for appreciation and significant return on one's investment with little risk for a long-term investor. However, since 2007, real estate investments have shown the capacity to depreciate and lose value or stay stagnant.

Defined-benefit plan

Defined-benefit plans – About 20% of Americans today participate in traditional pension plans. This percentage is half of what it was in the mid-1970s. Pensions are calculated from workers' salaries and the number of years they work for a particular employer. They guarantee a **set monthly payment for former employees during their retirement**. Investment risk and portfolio management are entirely under the control of the company.

Many employers offer retirement savings plans. The most common of these plans is a **401(k) plan**. This type of investment is offered by private employers to their employees; a certain percentage of before-tax earnings are deducted from their paychecks for saving purposes. Most 401(k) plans are professionally managed and offer choices from a variety of investments.

Some employers will match a portion of every dollar invested in your 401(k). For example, if you choose to deduct $200 from your paycheck for your 401(k) every pay period, and your employer matches 20%, they will add $40 ($200 x 20%) to your 401(k) account. Free money – what a great deal! Your employer would then add $40 every pay period to your retirement account. Good questions to ask when interviewing with a company are: **(1)** Does your company offer a retirement package such as a 401(k)? **(2)** If so, do you contribute to the plan, and by how much?

Four things to keep in mind regarding a 401(k) plan: **(1)** You cannot take money out of this account until you reach the age of 59½; otherwise, you pay a penalty. **(2)** If you change companies, you may roll the account over into another 401(k) offered by your new employer or into another retirement account within a specified time period. **(3)** When making changes to your 401(k), bear in mind that retirement accounts are governed by the IRS. Check at www.irs.gov to be sure you adhere to the most recent guidelines for 401(k) withdrawals and rollovers. If you don't, there may be serious penalties! You may borrow up to 50% of the balance that you contributed, but it must be paid back with interest within five years. **(4)** There are limits on the amount of money that you can contribute yearly.

Similar to a 401(k) is a **403(b)** retirement account. A 403(b) retirement account is usually an option if you work for a public school, hospital, or other non-profit organization. Similar to a 401(k), you have the choice to participate or not. Also, like a 401(k), if you withdraw the money before you are 59½, you will incur a penalty and pay additional taxes on the withdrawal.

Individual Retirement Accounts

Individual Retirement Accounts (IRAs) are another way to save for retirement. This type of account allows money to grow tax-deferred (pay taxes later) and are sometimes tax-free.

There are two different types of IRAs. One type is known as a **traditional IRA**, which allows you to contribute a certain amount each year to the account. For 2013, the maximum contribution to a traditional IRA was $5,500, or $11,000 if you are married and one spouse works outside the home. An advantage to this type of IRA is that you may deduct the amount from your tax return that you contributed, thus lowering your taxable income. In turn, you pay less tax. Like the previous retirement accounts, you may begin withdrawing your money at age 59½ without penalty. However, once you begin withdrawals, you must report it on your tax return and pay tax on the amount taken out.

There is also a **Roth IRA**. In a Roth IRA, you may contribute to the account but cannot take a tax deduction for the year of contribution (unlike a traditional IRA). The advantage, however, is that once you begin withdrawing money (at age 59½,) you don’t report it on your tax return and don’t pay taxes on any of the earnings.

Social Security

Social Security is a federal government program that provides payouts to people based on age, disability, and employment status. The Social Security Act established it in 1935. The program is based on contributions that employees make into the system. The **Federal Insurance Contributions Act (FICA)** requires taxes to be withheld from an employee’s paycheck and are matched by the employer. **Medicare** is also a federal insurance program that is administered by the United States government. It guarantees access to health insurance for Americans age 65 and older and Americans under age 65 with disabilities. It is associated with Social Security because it is also withheld from the employee’s paycheck and matched by the employer. Currently, an employee's share of the Social Security tax is 6.2% of gross compensation up to a limit of $113,700 of gross wages. This results in a maximum Social Security tax of $7,049.40 and is referred to as “the ceiling.” The employer and employee are both responsible for 6.2% of the Social Security tax and 1.45% of the Medicare tax. The employee and employer each pay 7.65% into these taxes each pay period.

Social Security benefits are typically computed using "average indexed monthly earnings." This average summarizes up to 35 years of a worker's indexed earnings. Social Security applies a formula to this average to compute the primary insurance amount (PIA). The PIA is the basis for the benefits that are paid to an individual.

"Old-age benefit" amounts are generally related to the amount of Social Security payroll taxes paid by workers over the course of their lifetimes. The Social Security Administration has an online calculator that provides an estimate of monthly benefits based upon earnings, birth date, and expected retirement age. The results can be delivered in either today's dollars or in future (inflated) dollars. **In order to receive full Social Security benefits, you must obtain 40 quarters throughout your work life.**

Go to the following website and answer the following questions:

http://www.socialsecurity.gov/OACT/COLA/QC.html

2. What does (QC) stand for?

   Answer: Quarter of Coverage

3. What is the maximum number of QCs you can accumulate in one year?

   Answer: 4

4. Can you accumulate more QCs in a year when your earnings increase?

   Answer: No

Although Social Security has been in existence for many decades, there is speculation that it might not be around by the time you are eligible to receive it. Thus, it is wise to invest in other types of retirement accounts as discussed in previous sections.

Why are retirement accounts important to you?

"Why should I think about retirement now when I haven't even started working full time?" The answer to this is quite simple. If you save and invest while you are young, it will help you solve many problems later in life. Investing in your future is the right thing to do. Social Security may not exist or may be reduced by the time you are eligible to begin receiving it. And don't forget about compound interest; saving early will pay off for you later. Educating yourself about retirement will also help you make smart employment decisions. Look for a company that matches or contributes a portion to your retirement account. Last, if you start investing in your retirement now, you will achieve tax benefits and at the same time provide security in your golden years.

Life Smarts: Compute the value of retirement portfolio given the following information.

Go to the following website and determine if you, in the following hypothetical situation, are saving enough for retirement: http://www.aarp.org/work/retirement-planning/retirement_calculator.html Write your answer in the space below. Answers will vary.

- You are 25 years old.
- You earn $40,000 per year.
- You save 10% of your salary.
- You have $10,000 in retirement savings, which consists of the following:
  $5,000 in a 401(k); $2,000 in a Roth IRA, $2,000 in stocks and bonds; and $1,000 in a CD.
- Estimate that you will begin receiving Social Security at age 62, and your monthly payments will be $1,600 per month.
- Your lifestyle will stay the same upon retiring.