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RETIREMENT PLANNING BASICS

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The Retirement Marathon

Investing for retirement is a long-term pursuit of financial security.

A successful plan for reaching your goal of long-term financial security includes earning income that you invest over time. That's true in part because earned income is essential for taking advantage of most tax-deferred opportunities for building retirement savings.

Tax-deferral allows assets in qualifying accounts to compound untaxed until they're withdrawn. Postponing taxes means the account value can grow much more quickly than it could in a taxable account where money was taken out each year to pay the taxes that would be due.



READY, SET, GO

You can start investing for retirement when you earn income for the first time. That's when you can begin contributing to an individual retirement account (IRA). You can participate in retirement plans that your employers offer. If you work for yourself or own a small business, you can establish your own retirement plan. In fact, ideally, you'll take advantage of several of these ways to accumulate retirement savings during your working life. These dedicated assets, in combination with your taxable investment accounts, Social Security, and an employer pension if you have one, are the foundation of a financially secure future.

STARTING OUT

In the first few years you're working, there are lots of demands on your income, from living expenses and commuting costs to income taxes and required payments on a student loan.

Putting money away for retirement is probably the last thing on your mind. But it's actually the best time to get in the habit of contributing regularly to an employer plan, IRA, or taxable account. The sooner you begin investing, the stronger the potential for building the financial resources you'll need when that time eventually comes.

Many employers make the decision easy by enrolling all new hires automatically in their plans and matching a portion of each participant's contribution.

HITTING YOUR STRIDE

One thing that's likely to remain constant as you pursue your goal of building your long-term investments is the need to juggle your income to pay for things that might seem more pressing, like buying a home, starting a business, or anticipating your children's college expenses.

One technique is to split the amount you invest between long- and short-term goals. Even if you put less into long-term plans than you'd like, these tax-deferred investments have the potential to grow, especially if you're building on a portfolio you started earlier. Generally speaking, investments for longer-term goals should focus on stocks, stock mutual funds, or stock ETFs. But investments for nearer-term goals should probably be more liquid.

Keep in mind that investing for the long term is often good for your current financial situation too:

- You may save on taxes by participating in a tax-deferred retirement savings plan
- You may qualify for a mortgage loan more easily or be offered a lower rate if you have investment assets
- You be able to borrow from some retirement plans without incurring taxes and penalties though interest will be due

WHAT THE FUTURE HOLDS

When people retire is relative, not fixed. Some wait until they qualify for full Social Security benefits, once 65, but now 67 for anyone born in 1960 or later. Many retire the first day they're eligible. Others work productively through their 80s or 90s, dismissing

retirement as something other people do. Still others leave work unwillingly, with an early retirement package if they're lucky.

But whether retirement is a long way off, or sneaking up on you faster than you care to imagine, planning for this part of your life has two, or perhaps three, main targets:

- Enough income to live comfortably
- Access to affordable good healthcare
- Benefits for your heirs

CHECK IT OUT

Recognizing that the burden of repaying student loans keeps some employees from investing for retirement, employers are authorized but not required under the CARES Act of 2020 to make tax-free loan repayments up to \$5,250 directly to an employee or loan servicer annually through 2025.

THE FAR TURN

As time goes by, you may be earning more than before, but you may be spending more too. College expenses can wreak havoc on a family budget, cutting into what you can contribute to retirement savings. So can buying a vacation home or expanding your business.

On the other hand, if you've established good investing habits—like participating in a retirement savings plan and putting money into stocks, ETFs, and stock mutual funds—your long-term goals should be on track. You may also find that the demands on your current income eventually begin to decrease: The mortgage gets paid off, the children grow up, or you inherit assets from your parents.

That means you can begin to invest more money in your long-term portfolio—through your employer's retirement plan, IRAs, taxable mutual funds or brokerage accounts, and perhaps income-producing investments such as REITs or bonds.

THE HOME STRETCH

When you start thinking seriously about retirement, you'll want to be sure you have enough income to live comfortably. If you have money coming in from both tax-deferred and taxable investments, you'll have more flexibility to retire when you want.

Because many people can expect to live 20 or 30 years after they retire, you'll want to continue to invest even as you begin collecting on Social Security and your retirement plans. One approach is to deposit earnings on certain investments into an account earmarked for new investments. Another is to time the maturity dates of bonds or other fixed income assets, like CDs, so that you have capital to reinvest if a good opportunity comes along.

Some of the financial decisions you'll be facing may be dictated by government rules about when and how much you must withdraw from your tax-deferred accounts. Others may be driven by your concerns about healthcare or your desire to leave money to your heirs. At the least, you'll have to consider:

- Shifting investments to produce more income with fewer risks, in case of a sudden downturn in the financial markets
- Rolling over eligible retirement payouts to preserve their tax-deferred status
- Finding ways to reduce taxes and pay for those that are unavoidable

The Last Paycheck

Retiring means stitching together different sources of income.

When you retire, you'll share a common experience with everyone who has already made the change: You won't get a paycheck anymore.

Without this steady stream of revenue, you'll have to arrange for the income you'll need. Specifically, you'll want to answer the following questions:

- What sources of income are you confident you can count on?
- How much income will they provide each year?
- How and when will the income be paid?
- How will you coordinate payments from different sources to create a steady stream of income, so that there's money in the bank when you need it?

WHAT THE SOURCES ARE

You'll probably count on income from a number of different sources.

Social Security income is paid to people who contribute to the system, and to their surviving spouses.

Defined benefit pensions are designed to provide lifetime income from a plan your employer creates and funds.

Defined contribution plans, such as 401(k) plans, are designed to provide income from contributions and earnings on those contributions, which may be made by you, your employer, or both.

IRAs are individual retirement accounts. You contribute income you've earned to produce tax-deferred investment

earnings that you can withdraw after 59½ as retirement income.

Annuities are fixed or variable insurance company products that allow you to convert your premiums and any tax-deferred earnings to lifetime income.

Personal investments in taxable accounts can provide interest, dividends, and capital gains to use as retirement income or reinvest.

Jobs can provide income if you want to work and work is available.

WHEN THE MONEY ARRIVES

Unlike a paycheck, which arrives regularly, retirement income arrives on different schedules. Social Security, annuity, and pension payments usually come monthly. Others, like stock dividends, arrive quarterly. Interest on bonds is paid semi-annually. Few, if any payments, are weekly or biweekly. That means you have to think about balancing the amount coming in to meet your expenses.

PUTTING IT TOGETHER

Managing your finances during retirement involves juggling your sources of income to make sure you have enough money to live on. It's a lot like making a quilt: No piece by itself is big enough to keep you warm at night. But properly stitched together, the pieces can provide a lot of comfort.

THE BIGGER PICTURE

The regular income you can expect from Social Security and a defined benefit pension depends on your work history. In general, the longer you work and the higher your salary, the more income you can anticipate, up to the annual ceilings.

Realistically, though, neither of these sources is likely to be as important a provider of retirement income in the future as it has been in the past. Social Security faces the imbalance of more beneficiaries and fewer workers. And fewer employers are offering defined benefit plans.

The retirement income you can expect from investments you've made depends on three things: how much is invested, where it's invested, and the long-term return those investments provide. You have much greater control over these choices, so much greater responsibility for the outcome than you may realize.

That's why it's critical to put basic investment principles to work, including asset allocation and diversification, across your tax-deferred, Roth, and taxable portfolios. It's also why you want to start thinking seriously about retirement income before you start thinking seriously about retiring.

TURNING INVESTMENTS INTO INCOME

One of the challenges you face in planning retirement income is that net worth doesn't translate directly into income that you can use to pay your bills or make new investments. Stocks may pay dividends, but much of their value is the price per share you could realize only if you sold—and that value could drop in a weak market. You can spend bond interest, but if you liquidate the bond when it matures rather than reinvesting the principal, you won't earn interest in the future.

On the other hand, you must take required regular cash distributions from your tax-deferred retirement accounts once you reach 72. To meet that requirement—and create a cash flow—you might establish a systematic withdrawal schedule, or, in the case of an annuity contract, choose annuitization. That means converting your account value to a lifetime income stream.

One approach is to spread your retirement savings around among a number of products and accounts, each designed to fill a different role. That might mean putting some money in stocks, some in bonds, some in mutual funds, some in real estate, and some in fixed or variable annuities or both.

Realistic Expectations

The smartest approach to planning a satisfying retirement is having realistic expectations.

The first step in making sure your expectations for retirement are realistic is having a clear sense of what you'll be spending, both on the everyday costs of living and on the special activities you're planning.

You'll need 70% to 90% of your preretirement income to live comfortably during retirement

WAYS AND MEANS

The widely accepted, and often repeated, retirement rule of thumb is that you need between 70% and 90% of your preretirement income to maintain your standard of living after you stop working. That formula may be too simplistic, though, to figure what you'll actually be spending.

One place to start is to calculate what the essentials are costing you right now: food and clothing, heat and home maintenance, utilities, insurance, and property taxes. You can be fairly confident you'll go on paying these bills and that inflation will push their cost up.

Next, think about the things you're likely to spend less on. Your mortgage may be paid off, you won't be commuting, and maybe your financial responsibilities for children and parents will come to an end.

You may be paying less in income tax, and after you retire you're no longer paying into Social Security.

But also consider the additional expenses you may encounter, such as medical and dental care and the cost of your plans for winter in a warm place and summer in a cool one, or perhaps long-postponed trips or classes and equipment to master new skills.

COSTS THAT COULD GO DOWN:

- Home mortgage
- Commuting
- Financial responsibility for children or parents
- Work-related clothing

EXPECTING THE UNEXPECTED

Ideally, what you would like to know ahead of time are the things that may go wrong, putting a financial strain on your retirement income. Although you can't predict what might happen, you can prepare by creating an investment account equal to up to two years of living expenses to be ready for market drops or emergencies.

It's generally smart to keep your reserve money **liquid**, which means you can turn it into cash easily if you need it. For example, you might put some of these assets in money market accounts for immediate access, and some in US Treasury bills or certificates of deposit with six-month to one-year terms.

The danger of investing your emergency fund in stocks or other equities is that you risk having to sell during a period when prices are down if you need cash immediately. This is one case where—on a limited portion of your portfolio—stability is more important than growth.

The value of a reserve fund that you draw on only in a real financial emergency is that you'll have quick access to money when you need it most—whenever that is.

COSTS THAT COULD GO UP:

- Healthcare
- Travel
- Second home
- Further education
- Hobbies

MAINTAINING YOUR SAVINGS RATE

If you've been saving and investing for much of your adult life, now isn't the time to stop. In fact, if anything, it's the time to jump up the rate at which you're putting money away, to perhaps closer to 15% of gross income rather than 10%. That will help boost your chances of having the future income you need.

DOING THE MATH

The tried and true way of figuring out the cost of living in retirement is to list all your current expenses and then estimate what they'll be when you plan to retire and on into your retirement years.

You can do this using a mathematical formula that accounts for:

- The number of years until you plan to retire
- The amount you have already saved
- The anticipated inflation rate
- The estimated real rate of return, or what you earn on your investments after adjusting for inflation

You can find work charts like the one illustrated here to help guide you through the calculation. Check the websites of your bank, brokerage firm, or mutual fund company or ask your investment professional to refer you to a source.

FACTORS TO CONSIDER

As you prepare a retirement budget, you'll want to take these factors into account:

People who retire in their 60s can expect to live into their 80s.

To estimate a retirement income of 80% of your final salary, you have to account for inflation. The number will be higher than 80% of your current income.

You have to anticipate changes in Social Security in the future, which means you may get less income from that source.

You can't predict the cost of healthcare insurance or out-of-pocket costs after you retire.

There's a direct relationship between age and health costs: About 7% of Americans between ages 65 and 74 need help in handling the tasks of everyday living. But by age 85 almost 30% do.

That may mean you'll face nursing home or home care costs.

Source: Urban Institute

The Practical Retirement Worksheet

| | |
|--------------------------------|-------------|
| Current age | 57 |
| Retirement age | 67 |
| Current annual income | \$250,000 |
| Annual inflation rate | 3% |
| Income needed year 1 | \$200,000 |
| Current retirement assets | \$850,000 |
| Additional annual contribution | \$37,500 |
| Annual rate of return | 7% |
| Value at retirement | \$2,011,865 |
| Annual income at retirement | \$200,000 |
| Annual income-Social Security | \$45,000 |
| Annual income-pensions | \$0 |
| Total annual retirement income | \$245,000 |

Source: Lightbulb Press and Bankrate.com. This hypothetical example is for illustration only and is not intended to represent or imply the actual performance of any specific investment.

LOOKING AT THE FUTURE

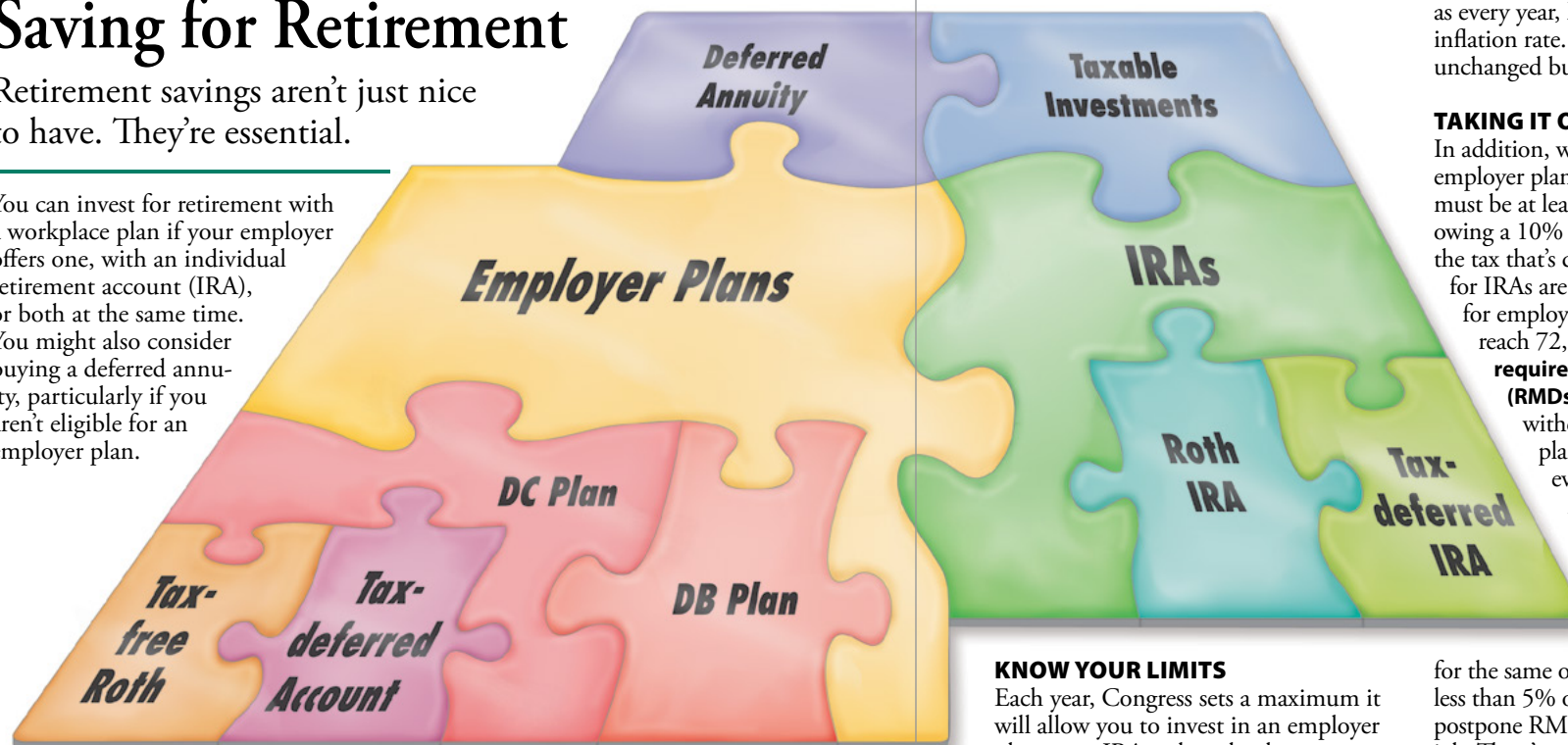
The most revealing thing that projecting your future needs will tell you is how much you will have to add to your retirement accounts each year to produce the income you need to maintain a comfortable life. In the example above, the assumption is that you're able to add about 14% of your income each year.

But projecting future needs emphasizes how important the rate of return is to your retirement assets. In some periods, when investment markets are depressed, you may not achieve adequate growth, especially if markets are down at the time you begin taking income. That's why, to ensure you'll have money as long as you need it, the most you should plan to withdraw each year is 3% to 4% of your assets.

Saving for Retirement

Retirement savings aren't just nice to have. They're essential.

You can invest for retirement with a workplace plan if your employer offers one, with an individual retirement account (IRA), or both at the same time. You might also consider buying a deferred annuity, particularly if you aren't eligible for an employer plan.



All these retirement-specific accounts are similar in one way: Earnings you accumulate are tax deferred and automatically reinvested, so your account can compound more quickly than if you were withdrawing to pay annual income taxes or other expenses. Contributions may also be tax deferred.

DEFINING THE PLAN

When you invest for retirement by deferring income to a plan your employer offers, you're participating in a **defined contribution (DC) plan**. The earnings you accumulate and the value of your account when you're ready to begin taking money out are determined by how much you—and your employer if your contributions are matched—contribute, the return on your investments, and the number of years you participate. There are no guarantees about how much it will be.

Participation in the plan may be voluntary, so you must enroll. But employers are increasingly enrolling everyone who is eligible automatically, with the condition that you can drop out if you wish.

In contrast, a **defined benefit (DB) plan** is funded entirely by your employer with money that's separate from your salary. A DB plan pays a benefit, determined by the plan's formula, when you

retire. That income, called a pension, generally depends on how old you are when you begin to collect, the number of years you worked, and what you were earning. All employees are enrolled, and it's the employer's responsibility to meet its obligation to pay. However, these plans are increasingly rare.

PUTTING IT OFF

If you contribute pretax income to a tax-deferred employer plan, you reduce your salary and what you owe in income tax for the year. The tradeoff is that when you begin taking money out, you'll owe tax on what you withdraw at the same rate you're paying on your ordinary income.

Employers who offer a tax-deferred plan may have the option of also offering a Roth version of the plan. If you choose this alternative, you contribute after-tax income but are eligible to take tax-free withdrawals, provided your account has been open at least five years when you retire and you're 59½ or older. Some employers allow you to split your contribution between a traditional account and a Roth account.

IRAs also have a tax-free version, called a Roth IRA. The big difference is that there are income caps that may limit your eligibility to contribute to a Roth IRA. There are no such limits with the Roth alternative in an employer's plan.

as every year, linked to increases in the inflation rate. In some years they are unchanged but have never been reduced.

TAKING IT OUT

In addition, when you invest in either an employer plan or an IRA, you usually must be at least 59½ to withdraw without owing a 10% tax penalty in addition to the tax that's due—though the rules for IRAs are a little more flexible than for employer plans. And once you reach 72, you must begin taking **required minimum distributions (RMDs)**—the official name for withdrawals—from all employer plans and tax-deferred IRAs, even if you don't need the income. The withdrawal rate is fixed, based on your age.

There is an RMD exception with employer plans. If you're still working for the same organization and you own less than 5% of the company, you can postpone RMDs until after you leave the job. There's nothing comparable for IRAs.

GETTING BACK TO BASICS

In addition, you can invest for retirement in a taxable investment portfolio that gives you more flexibility than retirement plans, plus some tax benefits. Rules that apply to qualified plans and IRAs—like contribution limits and required withdrawals—don't apply to taxable accounts. This means you have more control over how much you invest and what you do with your account assets.

KNOW YOUR LIMITS

Each year, Congress sets a maximum it will allow you to invest in an employer plan or an IRA—though what you put in one doesn't affect what you can put in the other. If you split your contribution among IRAs or between traditional and Roth employer accounts, the total you can contribute is the same as if you were using one IRA or employer account.

If you're 50 or older, you're also entitled to make an annual **catch up contribution** to either type of plan even if you've always contributed the maximum amount.

Basic and catch-up contributions, which are higher for employer plans than for IRAs, may be adjusted as frequently

CHANGING JOBS

If you're part of a DC plan and you change jobs, the contributions you've made to the plan plus the earnings they've generated belong to you. So do any employer contributions and their earnings if you've been on the job long enough to be entitled to them, or **vested**. That's a major attraction of these plans.

It's your responsibility to decide what to do with these portable assets:

- You always have the option to roll the balance over into an IRA.
- You may be able to leave your account with your former employer.



- You may be able to roll the account value into your new employer's plan if the plan accepts rollovers.

It's smart to discuss the alternatives with your financial adviser, as there are pros and cons with each approach. Among the things to consider are the fees you'll pay and the flexibility you'll have in making contributions and taking withdrawals.

Even if you're short of cash, the biggest mistake you can make is taking a cash distribution and spending the money. You'll pay taxes and a 10% penalty, plus miss out on potential future earnings.

Personal Investing Goals

Chances are, living the life you want after you retire will depend on your investment income.

When you invest, you use your **principal**, or money you already have, to produce additional income that will help you achieve a variety of financial goals that are important to you.

When one of your goals is providing for a secure long-term retirement, there's no fixed point when you need the money, as there is when you buy a house or pay college tuition. Rather, you need to plan for a continuous process that evolves through three distinct phases:

- **Building the value of your portfolio**
- **Producing income**
- **Preserving your principal**

A THREE-STAGE PLAN

The challenge is that each phase of meeting your goals requires a different mindset. Accumulating assets that will increase in value requires some risk-taking, including being prepared to ride out market downturns. Converting from growth to income production requires evaluating which investments to sell off and where to put the money for the most reliable return. Preserving principal for 20 or 30 years while it produces the income you need to live on may be the most difficult of all. It requires regularly adjusting what you spend as your investment return varies.

SETTING A GOAL

One of the challenges of investing for retirement is trying to anticipate how much you need to accumulate. That's the case in part because you can't predict investment returns or future tax and inflation rates—which affect everyone—or more personal things like how long you'll live.

If you'd like more direction than "save as much as you can," you might use the rule of thumb that says you'll ideally have savings equal to 25 times the amount you'll need to withdraw from your accounts the first year you're retired to supplement the Social Security and pension income you expect to receive.



SEEKING GROWTH

Growth is the first order of business, and investments may grow in many ways.

- You can **add to your principal** on a regular basis by contributing a percentage of your income to your investment account or contributing the maximum to an IRA.
- You can **reinvest** your investment earnings rather than spend them, either by using an official plan offered by a mutual fund or stock reinvestment program, or by putting all your interest and dividend payments into a special investment account.
- You can invest in **equity** products like stocks, ETFs, and stock funds, though growth isn't guaranteed, and they could also lose value in a weak or falling market.
- You can **allocate your assets** across asset classes to help reduce your exposure to recurring market and interest-rate risk.
- You can **diversify** your portfolio within asset classes to help reduce the risk of being too narrowly focused, though diversification doesn't guarantee a return or protect you against losses in a falling market.

A WINNING STRATEGY

Random buying—a few stocks here, a bond there—rarely produces a strong enough return to provide the extra income you need in retirement. Jumping into what's hot works the same way, since usually by the time an investment is hyped, it has started to cool off. And you don't want to have paid a high price for an investment that ends up trading for less.

It's not that there's a single right way to make money with your investments. There are several approaches that you can adapt to suit your needs, your resources, and the risks you're willing to take.

The key is that to be a successful investor, you need a sense of what you want to accomplish, and a **strategy**, or plan, for getting there.

A PLAN, NOT A STRAITJACKET

As an investor, you need to be flexible. The economy moves through different periods, affecting investment markets in various ways. In some periods, strong corporate profits mean that stocks tend to gain value, while in other periods they're likely to provide disappointing returns. Similar ups and downs affect bonds, mutual funds, real estate, and other investment categories. That means you may have to modify your portfolio from time to time to meet your goals.

You're likely to come up short, for example, if you keep lots of retirement money

in **certificates of deposit (CDs)** and the interest they're paying is less than the rate of inflation. Just because CDs provide a handy place to keep your emergency funds and the money you're allocating to short-term goals like buying a new car, that doesn't mean they're necessarily a wise choice for the long term.

When you're investing for retirement, it may also make sense to shift your strategy as you get closer to actually leaving the workforce, moving from concentrating primarily on growth to a greater focus on producing income. You can take some risks in your 30s and 40s since you'll still have time to recover from market downturns. But a big loss in your 60s can be harder to overcome.

DRAWING ON PRINCIPAL

While preserving principal and accumulating earnings are critical while you're investing for retirement, you can expect to use some of your principal as a source of income after you retire. Here, too, you need a plan for tapping your resources and a sense of which investments to liquidate and when to sell.

A maturing bond, for example, can become a source of current income. When it comes due, you can deposit the principal in a money market or savings account to draw on over the year, as you need cash. That might be smarter than selling off an investment that's generating growth and income, like a stock fund, or liquidating an asset when it has dropped in value if you expect it to rebound.

Remember, too, that once you reach 72 you'll have to withdraw at least the required minimum each year from your tax-deferred employer plans and your traditional **individual retirement accounts (IRAs)**.

PLANNING INCOME

Income-producing investments are especially important after you retire. For example, the interest on a bond or the dividends from a stock may help cover day-to-day expenses or pay for the extras you enjoy. Since those payments are usually made quarterly or semi-annually,

you can plan on them. You can also ladder some investments, like certificates of deposit (CDs) or



intermediate-term bonds, to mature on a specific schedule, and replenish your cash reserve if you need the money.

There's risk, though. Interest rates may drop, dividends may be cut, and some expenses may rise. So you could end up with less income than you expect or need.

PRESERVING PRINCIPAL

If you're planning to live on the income your investments provide, you have a vested interest in making sure it doesn't shrink in value or, worse yet, disappear. Curiously, the best preservation technique is often to continue to seek growth—slower, safer growth than you were looking for when you first began to build your portfolio, but growth nonetheless. Money earning minimal interest in a savings account doesn't keep its value. In fact, because of inflation, it shrinks. So keeping too much in cash is one of the biggest threats to your long-term financial security.



Making Critical Choices

You'll have the answers you need down the road if you ask the right questions now.

The idea of retiring isn't new. People who grew too old or too ill stopped working and stayed home long before pensions

Q: What financial decisions must I make?

A: Set your retirement timeline

- You may be eligible for full pension benefits from some employer plans if you have enough years of service.

PAYING FOR HEALTHCARE

Anticipating the cost of healthcare after you retire is much more difficult than estimating your living expenses. And you have less flexibility in managing medical bills if you become seriously ill or disabled than you do in managing many of your variable costs.

As you begin retirement planning, you'll want to pay particular attention to the health coverage available through your employer, if that's how you're insured. You need to know what will happen to the coverage if you retire before you're eligible for Medicare at 65, whether your employer pays the cost of supplemental, or Medigap, coverage, and what arrangements you could make to continue health insurance if your spouse has been covered under your plan and you're eligible for Medicare before he or she is.

You may want to investigate long-term care insurance, especially if there's a group plan for which you're eligible. As an alternative, you may want to investigate buying a life insurance policy with a long-term care rider.

and Social Security. But as people live longer, the retirement experience takes on a different meaning. Not only can you expect more years of retirement than of adolescence, but they can be a lot more satisfying and rewarding.

The complication is that you're faced with a number of decisions, some of them irrevocable. So rather than waiting to evaluate your alternatives until it's time to choose, it's smart to start thinking about them now.

Q: How do I make my healthcare wishes known?

A: A living will and proxy

A **living will** is a document that describes the kind of medical treatment you want—and don't want—if you are terminally ill or in a permanent vegetative state (which means you're unconscious, not able to communicate, and unlikely to get better). In writing your living will, you should be as specific as possible about the kinds of drugs and medical procedures you have in mind and the situations under which they should—or should not be—used.

Though almost all states accept living wills, the laws of each state are a little different, so you want to be sure that the living will you sign meets local requirements.

Q: Should I enroll in Medicare at 65?

A: It depends

If you're paying for individual coverage, the answer is almost certainly yes. If you're still eligible for your employer's plan, you can wait. The key is that you must have what the government considers comparable

coverage. If you do, you can enroll without penalty in Medicare within eight months after that coverage ends.

If you don't have comparable coverage and delay enrolling after you turn 65, you face a permanent surcharge on your

Parts B and D premiums for each year you were eligible and didn't enroll.

If you work for a small company, you may be required to enroll in Medicare Part A—the hospitalization portion—at 65 but be able to keep your employer-plan coverage for doctor visits and prescription drugs. You should be sure to confirm that your insurer will continue to pay claims.

| 55 | 59½ | 62 | 65 | 67 | 70 | 72 |
|---|---|---|--|---|---|---|
| <ul style="list-style-type: none">You can usually begin withdrawing from 401(k)s, 403(b)s, and certain other plans without a 10% penalty if you retire, quit, or are fired. | <ul style="list-style-type: none">You can withdraw money from tax-deferred savings plans (IRAs, deferred annuities) without paying a 10% penalty. | <ul style="list-style-type: none">You may be eligible for full pension benefits from your employer.You can receive reduced Social Security benefits. | <ul style="list-style-type: none">You are eligible for full pension benefits from most employers.You qualify for Medicare benefits. | <ul style="list-style-type: none">You're eligible for full Social Security benefits if you were born in 1960 or later | <ul style="list-style-type: none">You should begin to collect your Social Security benefits if you haven't already because your base benefit has reached its maximum. | <ul style="list-style-type: none">You must begin withdrawals from your 401(k) and traditional IRAs, but not from Roth IRAs or from employer sponsored retirement plans if you're still working. |

GRADUAL RETIREMENT

An alternative to moving abruptly from working one day to retirement the next may be working gradually less over a period of time.

Gradual, or phased, retirement can take different forms. You might reduce the number of days you work each week—from five to four to three—or the number of hours a day. Or you might find a new job with a flexible schedule.

There may be some roadblocks to staying where you are. Qualified employer plans have strict rules limiting your ability to collect retirement income while you're still employed at the same company. Your reduced schedule would have to provide enough income for you to maintain your standard of living if you didn't want to begin tapping your retirement savings.

If retiring slowly sounds appealing, it's probably smart to start investigating your alternatives sooner rather than later. If your employer values your work, he or she may consider rehiring you as an independent contractor or consultant or find some other way to keep you on board. But you'll probably have to take the initiative.

Meet Your 401(k)

If you're lucky enough to be introduced to a 401(k), you'll make a friend for life.



Even if you're just starting your first real job—actually, *especially* if you're just starting your first real job—it's time to start thinking about retiring. That's not a comment on how motivated—or unmotivated—you are, or a suggestion that you should wish your life away. It's just reality.

That's because you, like many people, will be responsible for supporting yourself during the 30 or more years you

can expect to live after you retire. To do that, you need a source of income that will stretch further than the safety net of Social Security and be more reliable than winning the lottery.

Some—but increasingly few—employers offer traditional pensions, which pay you retirement income based on your final salary and time on the job. Others contribute to a cash balance, profit sharing, or other plan on your

behalf. But most employers offer you, instead, the opportunity to participate in a **tax-advantaged defined contribution plan**, such as a **401(k)**.

GETTING STARTED

If your employer offers a tax-advantaged plan, it's usually the most painless way to set aside money for the future. All you have to do is agree to have a percentage of your gross income withheld each pay period and added to the money already invested in your plan account.

When your account is opened, you may have a choice between traditional tax-deferred 401(k) and a Roth 401(k). Your choice of investments is the same in either, but the tax treatment differs.

With the traditional account, your contribution is tax-deferred, which reduces your current taxable income. Eventually you'll be required to take withdrawals, which will be taxed at the same rate as your other income.

With a Roth account, your contributions aren't tax-deferred, but your eventual withdrawals are exempt from tax if you're at least 59½ and the account has been open at least five years.

Any earnings in either a traditional account or a Roth account accumulate tax deferred. That means the earnings are reinvested to increase the base on which additional earnings can accumulate, a process called **compounding**.

WHY NOW?

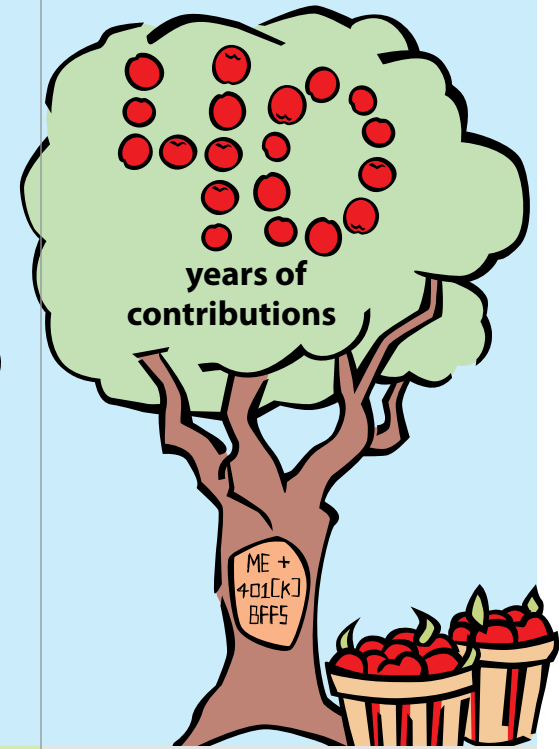
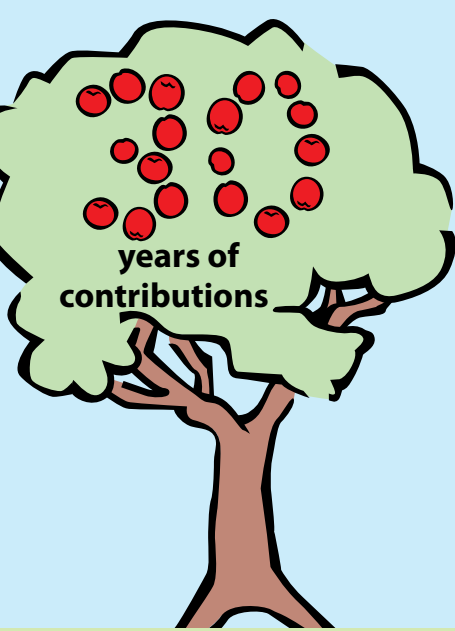
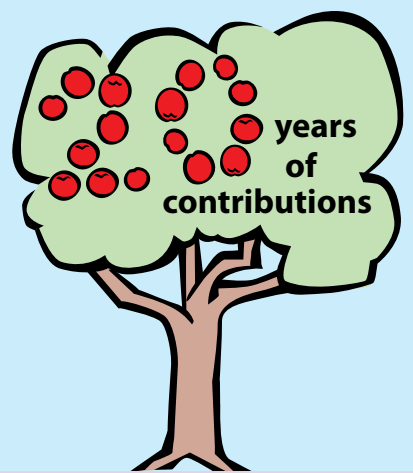
When **compounding** is involved, time is money. The more years that you add contributions to your plan, and the more years that any earnings increase your principal, the larger your account balance has the potential to grow.

Of course, there are no guarantees about either the rate or the regularity of the earnings. They may be outstanding one year and dismal the next, or they may go through longer, but still alternating, periods of growth and decline. That's the reality of investing. Having time on your side means that bumps in the road, like a period when investment prices go down and your account value shrinks, may be setbacks. But they don't have to be fatal.

BRIGHT AND EARLY

To show the impact of starting to invest as early as you can in a 401(k) or other retirement savings plan, compare the potential results if you began investing at different points in your working life. To keep matters simple, assume your employer doesn't match your contributions and you put in the same amount each year you participate.

Remember that returns are not guaranteed. Your return could be low, and you could lose as well as make money.



| | |
|-----------------|--------------|
| My contribution | \$100,000 |
| Annual return | 8% |
| Account value | \$247,114.61 |

You decide to enjoy the money you have while you're young, and you don't start contributing to your 401(k) until you're 45. If you contribute \$5,000 a year and average an 8% annual return, you'll have about \$247,000 in your account if you stop contributing at 65, based on a total contribution of \$100,000.

| | |
|-----------------|--------------|
| My contribution | \$150,000 |
| Annual return | 8% |
| Account value | \$611,729.34 |

When you reach 35, you realize it's time to get serious about the future, so you start contributing \$5,000 a year to your 401(k). Your investment return averages 8% a year. When you retire at 65, your account value will be about \$611,000, based on a total contribution of \$150,000.

| | |
|-----------------|----------------|
| My contribution | \$200,000 |
| Annual return | 8% |
| Account value | \$1,398,905.20 |

You start contributing to a 401(k) at 25, or as soon as you're eligible for a plan. You contribute \$5,000 a year for 40 years until you retire at 65. Your return averages 8%, so your account value is almost \$1.4 million, based on a total contribution of \$200,000.

A 401(k) BY ANY OTHER NAME...

401(k) plans are the most common, and best known, employer sponsored tax-advantaged plans. But they're not the only ones. If you work for a not-for-profit organization such as a school or college, a hospital, a cultural institution, or a charitable organization, your employer may offer a **403(b) plan**, sometimes known as a **tax-deferred annuity (TDA)**.

Similarly, the plan a state or municipal government offers may be a **457 plan**, while federal government departments and agencies provide a **thrift savings plan**. And if you work for a small company—one with fewer than 100 employees—you may be part of a **SIMPLE plan**, an acronym for **Savings Incentive Match Plan for Employees**.

Making 401(k) Decisions

Your 401(k) plan offers a wide menu of choices. But you've got to serve yourself.

The point of investing in a 401(k) now, when you know that you won't realize the benefits for 30 or 40 years, is that you have the opportunity to amass a tidy sum.

In the 60 plus years that 401(k) plans have been in existence, many people have been able to accumulate accounts of substantial value despite sometimes dramatic drops in the overall investment market. The key is to maintain a long-term perspective. Realizing an average annual return of 6% to 7% a year for 30 years can produce significant gains.

Of course, that doesn't happen automatically, and the return is never guaranteed. You've got to decide how your contribution is invested by selecting from among the investments your 401(k) plan offers.

WHAT THE CHOICES ARE

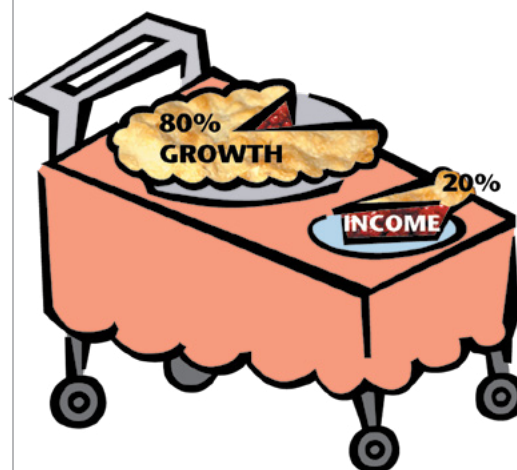
Mutual funds are the most common entrées on 401(k) menus. Most plans offer a range of funds, including **stock funds**, **bond funds**, and **money market funds**, as well as **balanced funds** that invest in both stocks and bonds. **Index**

funds, which invest to reproduce the performance of a particular market index, are also typical. You might also find a few more specialized funds, such as one that invests in international stocks, or one that focuses on up-and-coming small companies.

Many plans offer **target date funds** as a one-stop alternative. Each of these funds owns a number of other funds and has a actual date in its name, like 2050 or 2070. When its date is far in the future, a fund concentrates on growth and then switches gradually to more emphasis on providing income as its date approaches. But it's an investment, so there's no guarantee it will meet its goal when it reaches its date.

SLICING THE PIE

Since you've got the time to weather the ups and downs of the stock market, you may want to consider putting up to 80% of your contributions in different types of stock funds, including stock index funds, that have the potential to increase in value over the long term. These funds may lose value more



quickly than a **balanced fund** that buys a mix of stocks and bonds, which tend to react differently to changes in the economy or the investment markets. But remember that stock funds may increase in value more dramatically as well. That's why variety is so important.

You may want to split the rest of your 401(k) money between **income** investments and those designed to provide **stability**, sometimes described as preservation of principal. For example, you might choose a bond fund to provide a stream of interest that can be reinvested to buy additional shares of the fund. And since different investment classes perform well at different times, those bond funds may provide a better return when stocks are doing badly.

Stable value funds usually invest in conservative investments, which generally don't have a lot of potential for growth. It may be a good idea to put a little money into stability funds. But remember that you should be doing it for the sake of some level of security, not for any large gain.

GO YOUR OWN WAY

While most young people select a 401(k) portfolio concentrated in stock funds—fairly aggressive is one way to describe it—that's not the only way to structure your investments. If you're just not comfortable taking that kind of risk, think about putting a little more of your contribution into equity income or growth and income funds.

Or if you've got a trust or a taxable investment portfolio that will provide you with money for retirement, it's perfectly reasonable to rethink how you want to split up, or **allocate**, your 401(k).

401(k) TO GO

If you change jobs, your 401(k) is **portable**. That means your contributions and whatever they've earned are yours to keep. And if you've been at your job long enough, your employer's matching contributions are yours too.

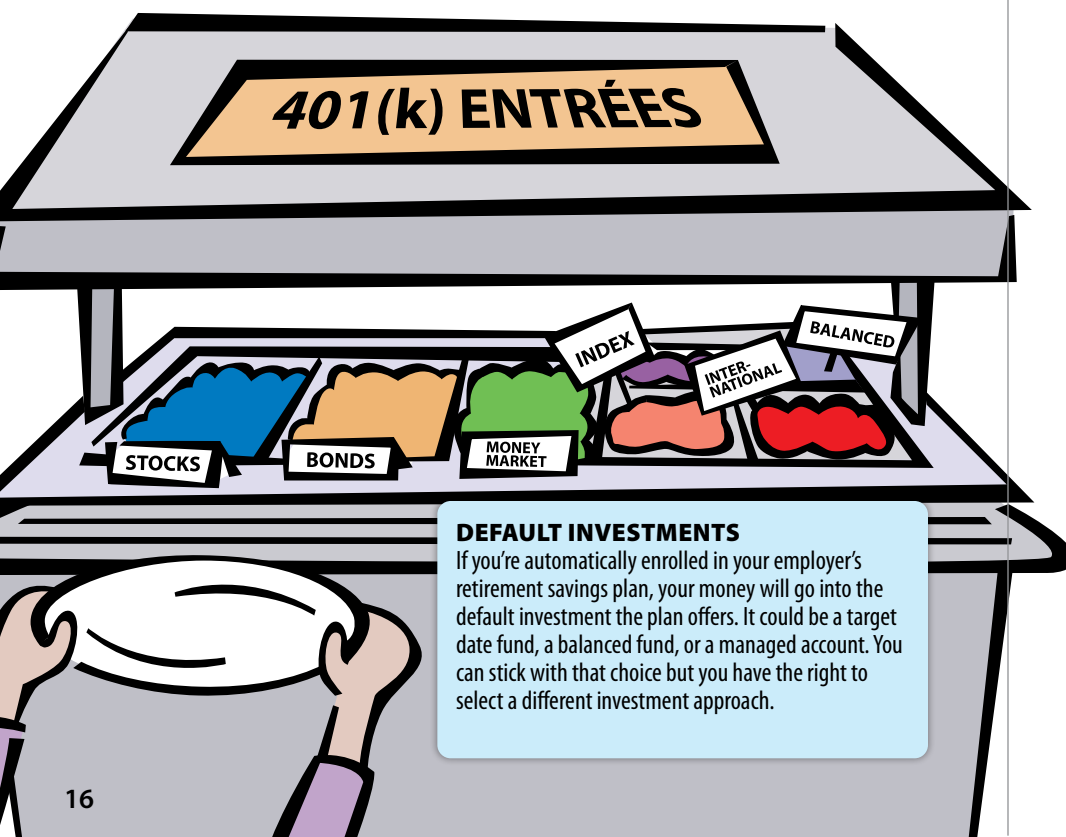
You may be able to transfer what you've got to a new employer's plan, and you can always put it in an IRA if your new employer doesn't have a plan or doesn't allow you to transfer money from your old one.

What you don't want to do when you change jobs is take the money out of your retirement savings plan and spend it. First of all, you'll owe income tax on the lump sum—which you might have to pay at a higher rate if the amount propels you into a new tax bracket. You'll also owe a 10% penalty on the entire amount of the withdrawal. And perhaps worst of all, you'll have to start all over again to build a retirement account.

If your account balance is between \$1,000 and \$5,000 when you leave your job, your employer may roll the money into an IRA unless you provide other instructions. You'll be notified where it is, and you have the right to move it. If the balance is less than \$1,000, your employer has the right to cash you out, or send you a check for the balance minus 20% that must be withheld for income tax.

Even if that happens, you can put the money (plus the withheld 20% from some other source if you've got it) into a rollover IRA within 60 days and hold onto its tax-deferred status. If you don't qualify to join your new employer's plan until you've been on the job for a year, money you've moved to an IRA can continue to accumulate tax-deferred earnings. And you may make your annual IRA contribution to that account.

No matter which investment route you take, the most important thing to do is to get started. Don't tell yourself you'll start investing, contributing, or allocating your contributions more aggressively, sometime in the future. Even if you do eventually follow through on it, you'll be missing out on growth potential now.



DEFAULT INVESTMENTS

If you're automatically enrolled in your employer's retirement savings plan, your money will go into the default investment the plan offers. It could be a target date fund, a balanced fund, or a managed account. You can stick with that choice but you have the right to select a different investment approach.

Target Date Funds

If you've got your eye on a retirement date, a target fund may fit the bill.

When you invest for retirement, you can select a portfolio of individual securities, mutual funds, and ETFs or choose a **target date fund**. Its objective is to build and then preserve assets, so that investors in the fund can look forward to a more financially secure retirement.

To meet its goal, a target date fund assembles and regularly realigns a portfolio of individual mutual funds to:

- Help manage investment risk without significantly reducing return during the fund's growth phase
- Try to provide continued, if sometimes modest, growth during the fund's income-producing or asset-preservation phase

FINDING A FUND

While target date funds are a relatively new way to invest in mutual funds, they're increasingly available in 401(k) and similar retirement plans, as an investment choice in individual retirement accounts (IRAs), and as an investment alternative in regular taxable accounts.

The financial institutions that offer target date funds never sponsor just one, but offer several funds with different end points to meet the needs of people at different stages in their lives. These end points are usually spaced in five-year or ten-year intervals—2030, 2035, 2040 and so on, for example.

In selecting a target date fund, you typically choose a fund whose date is closest to the date you plan to retire. For most people, that's often at some point in their 60s, since 65 remains the traditional, though not necessarily the average, retirement age.

TAKING CAREFUL AIM

One approach to investing in a target date fund, whether it's offered through your employer's retirement plan or you purchase it independently, is to concentrate your retirement assets in that account rather than using it as one account among many. Because the fund is already diversified, and the manager adjusts the way it is allocated to suit the approximate number of years until you retire, you don't have to be responsible for diversifying and reallocating a portfolio on your own.

In another approach, you might use a target date fund for a portion of your retirement portfolio while putting the rest into other investments. If you're comfortable taking more risk than may be typical for someone your age—perhaps because your spouse has an employer pension or you have received an inheritance—you might invest a portion of your IRA in a target fund and the rest in more aggressive funds. Or, you may want to put a larger percentage into conservative investments from the start.

THE INNER WORKINGS

The **time horizon** of a target date fund largely determines the investments the fund owns. Over time, the balance between risk and return is adjusted, either as part of a gradual, planned reallocation or in response to a combination of changing market conditions and the passage of time, depending on the philosophy of the fund.

Reallocation generally decreases the fund's assets invested in equity funds, while over time increasing the assets invested in bond funds. The pace and style of these changes are known as the fund's

NEW TARGET DATE INVESTMENTS ARE HERE!

glide path and determine the allocation at the target date.

This approach is based upon the principle that a portfolio of equities, even if well diversified, tends to be more volatile than a portfolio of bond funds, thereby exposing you to greater risk. Of course, bond returns aren't guaranteed either, since bond funds are subject to credit and interest-rate risk.

Like other funds, most target date funds hold a percentage of fund assets in cash. While cash returns tend to be lower than those of equities or bonds, and may be a drag on fund results, having money on hand gives the fund managers the flexibility to make new investments without necessarily having to sell off other assets in the portfolio. The fund may also elect to keep cash on hand to buy back shares of the fund that investors wish to sell. That reserve prevents having to sell off assets to repurchase shares, potentially throwing off the current allocation.

LOOKING UNDER THE HOOD

When a target date fund is a **fund of funds (FOF)**, as most are, its underlying investments may be proprietary mutual funds offered by the investment

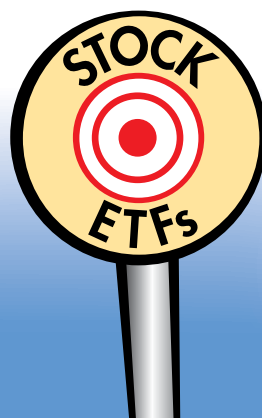
company sponsoring the FOF, funds offered by other investment companies, or a mix of affiliated and nonaffiliated funds. Some FOFs also invest in exchange traded funds (ETFs), which share similarities with both index funds and individual equities. And some FOFs use derivative products, such as equity or index options or certain futures contracts, to hedge against risk or to leverage the fund's assets.

The **prospectus** provides an overview of each fund and must be detailed enough to cover the information the Securities and Exchange Commission (SEC) requires. It's an essential read if you're considering a fund.

In addition, US Department of Labor rules require that employers who offer target date funds in a retirement savings plan provide a detailed explanation of each fund's risks and potential return. It must cover the fund's primary investment strategy, performance history, the risks it poses, and its fees and other expenses. In addition, you must be told

what allocation the fund plans for its target date, whether that allocation will continue to change, when it will reach its most conservative point, and when the fund expects investors to start withdrawing.

You'll want to consider these factors as you decide whether to invest in a FOF, and you'll want to continue to monitor the fund's progress in helping you reach your goals.



IRAs: What They Are

IRAs are easy to set up—but not always easy to understand.

IRAs, or individual retirement accounts, are tax-deferred, personal retirement plans. You can contribute every year you have earned income whether or not you participate in an employer's retirement plan. There are two types: the traditional IRAs, to which contributions may be deductible or nondeductible, and the Roth IRA.

- All **traditional IRAs** are **tax deferred**, which means you owe no tax on your earnings until you withdraw
- **Roth IRAs** are also tax deferred, so you owe no tax on your earnings as they accumulate. Withdrawals will be **tax free** if you follow the rules

WEIGHING THE CHOICE

If you have a choice of which IRA to open, you'll want to weigh the pros and cons:

| | ROTH | TRADITIONAL IRA | |
|------|---|--|---|
| | | Nondeductible | Deductible |
| PROS | <ul style="list-style-type: none">• Tax-free income at withdrawal• No required withdrawals | <ul style="list-style-type: none">• Tax-deferred earnings• No tax due on contributions at withdrawal | <ul style="list-style-type: none">• Immediate tax savings on tax-deductible contributions• Tax-deferred earnings |
| CONS | <ul style="list-style-type: none">• AGI limits• Not deductible• Requirements to qualify for tax-free withdrawal | <ul style="list-style-type: none">• Not deductible• Tax due at regular rates at withdrawal• Required withdrawals beginning at 72 | <ul style="list-style-type: none">• Tax due at regular rates at withdrawal• Required withdrawals beginning at 72 |

| DO YOU QUALIFY FOR A ROTH IRA? | | | |
|--------------------------------|-----------------------|------------------------|--------------|
| | | You qualify for a Roth | Partial Roth |
| SINGLE | Adjusted Gross Income | \$129,000 | |
| | | | \$144,000 |
| MARRIED | Adjusted Gross Income | \$204,000 | |
| | | | \$214,000 |

A SWEET DEAL
The only requirement for opening an IRA is having earned income—money you make for work you do. Your total annual contribution is limited to the annual cap. That's \$6,000 in 2022, whether you choose a traditional IRA or a Roth. If you're 50 or over, you can also make an additional annual catch-up contribution of \$1,000.

Any amount you earn qualifies, and you can contribute as much as you want, up to the cap. But you can't contribute more than you earn.

SPOUSAL ACCOUNTS
If your husband or wife doesn't work, but you do, you can put up to the annual limit into a separate spousal IRA in addition to your own contribution. The advantage for the nonworking spouse is being able to build an individual retirement fund.

WHICH IRA FOR YOU?
In addition to having earned income, you must qualify to deduct your contributions to a traditional IRA or contribute to a Roth IRA. The rules are different in each case.

If you're single, you qualify for a fully deductible IRA contribution when you file your federal income tax return if you were not covered by an employer sponsored retirement plan during that year. If you were covered by a plan, you may be able to deduct some or all of your contribution based on your modified adjusted gross income (MAGI).

If you're married and file jointly,

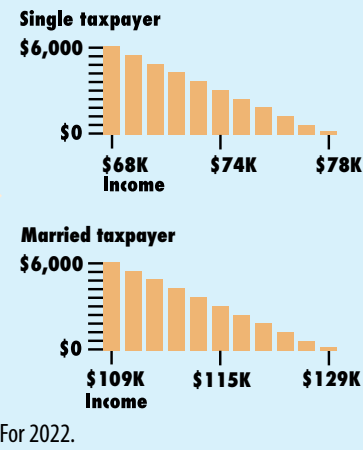
filing separate returns usually aren't eligible either to deduct contributions or contribute to a Roth.

While you can't deduct your contribution to a Roth IRA, taxes on earnings in your account are deferred as they accumulate, and you make tax-free withdrawals if you qualify. In most cases, that means you are at least 59½ and have had your account open at least five years before you withdraw.

IT'S YOUR ACCOUNT
It's easy to open an IRA. All you do is fill out a relatively simple application provided by the mutual fund company, bank, brokerage firm, insurance company, or other financial institution you choose to be **custodian** of your account.

Because IRAs are self-managed, meaning that you decide how to invest the money, you're responsible for following the rules that govern the accounts. Basically, that means putting in only the amount you're entitled to each year. You must also report your contribution to a traditional IRA to the IRS, on Form 1040

Deductions are gradually phased out if you have a retirement plan



either of you can deduct your own contribution if you are not covered by a retirement plan at work. But if either of you is covered by a plan, the other's right to a deduction is reduced gradually if your joint MAGI is over \$204,000 and eliminated if it's over \$214,000 in 2022. If you're both covered, the limits are \$109,000 and \$129,000 in 2022.

Eligibility for a Roth IRA is based on your filing status and MAGI, with higher income limits for married couples filing a joint return than for single filers. If you qualify to make a partial contribution to a Roth, you can put the balance in a traditional IRA. Married couples

if it's deductible and on Form 8606 if it's not.

You can invest your IRA money any way that is available through your custodian including individual securities, funds, and bank products. The things you can't buy are fine art, gems, non-US coins, and collectibles. And you can sell investments in your IRA account without paying tax on your gains until you withdraw from your account, but there may be transaction costs.



WHEN TO CONTRIBUTE
You have until the day taxes are due—usually April 15—to open an IRA and make the contribution for the previous tax year.

You can contribute to your IRA in a lump sum or spread the deposit out over the year. You may put in the whole amount the first day you can, January 1 of the tax year you're making the contribution for, to give your money the longest time to grow. If you're like most people, you're more apt to make the deposit on the last possible day. The most practical solution may be making contributions on a regular schedule.

Using a Rollover IRA

There's no trick to moving retirement assets.

If you're leaving your job and don't know what to do about your 401(k), you may want to choose a rollover IRA. It's an alternative that's always available if you want to keep your assets and any future earnings tax deferred. A rollover IRA also offers you the most flexibility in choosing investments. And it gives you the most control over withdrawals when you're ready to start using the money.

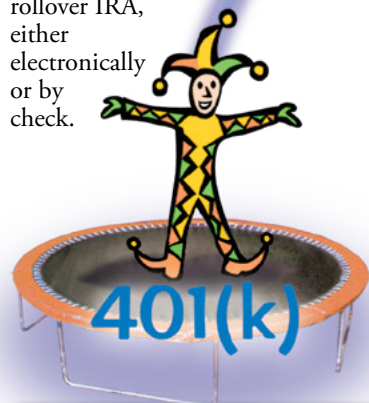
To start the rollover process, you generally fill out an application provided by the financial institution to which you plan to transfer your money. You'll get a new account number, which you'll need to complete the rollover request form provided by your old plan administrator.

When you turn in the form, the administrator liquidates your assets and transfers the cash value to your rollover IRA, either electronically or by check.

Rollover IRAs have some unique qualities. You can move any amount into your account, provided you're moving it from an employer sponsored retirement plan or another IRA. You're not limited to the annual ceiling on traditional and Roth IRA contributions.

You may be able to move rollover IRA assets into a new employer's plan if the plan accepts rollovers. While some plans may accept any IRA assets, it's smart to keep your employer plan rollover in its own account to avoid any possible roadblocks.

Rolling over keeps your earnings tax deferred



CONVERTING TO A ROTH IRA

In addition to rolling the assets in a traditional employer plan into a traditional IRA or the assets in a Roth 401(k) or Roth 403(b) into a Roth IRA, you can also convert a traditional employer plan to a Roth IRA. You owe income tax at your regular rate on any tax-deferred contributions and all plan earnings that you move. But—and it's a significant but—when you're at least 59½ and your rollover Roth IRA has been open at least five years, you can take tax-free withdrawals.

What's more, Roth IRAs do not require mandatory distributions as all employer plans including Roths and traditional IRAs do. And you can continue to contribute to a Roth IRA as long as you have earned income, even if you're 90, if your modified adjusted gross income is less than the ceiling for contributing.

The good news, though, is that there are no income limits on converting to a Roth IRA. So it's the only way that people who earn too much to make Roth contributions have access to tax-free retirement income. Before you convert, though, it's smart to consult your tax and legal advisers to evaluate the impact on your own situation.

IRA CUSTODIANS

The financial institution where you open your rollover IRA is the custodian of your account. As custodian, the institution is responsible for making the investments you authorize, keeping track of the paperwork, and reporting investment performance and account balances.

But because most IRAs are self-managed, the custodian doesn't make investment decisions on your behalf. Nor does it have fiduciary responsibility for the choice of investments you make. That means if you decide to put all your money into a risky investment, your IRA custodian isn't responsible for advising against it. The same is true if you keep all your money in a low-interest savings account.

Your custodian may charge an annual fee for handling your account—often as little as \$10 a year, and rarely more than \$50. And if your account balance reaches a certain amount, which the custodian sets, the annual fee may be dropped.

IRA TO IRA

You can roll an existing IRA from one custodian to another or convert a traditional IRA to a Roth IRA, as you can with an employer plan. You might want to simplify your recordkeeping by having just one custodian. You might want more investment options or more flexible beneficiary provisions. There's considerable variation among IRAs, and it makes sense to find the arrangement that works best for you.

A rollover IRA gives you flexibility, a range of investment choices, and control

PLAY BY THE RULES

You've got lots of leeway with a rollover IRA, but there are still some rules you have to follow.

Most IRA custodians require you to set up a new account for the rollover rather than adding the money to an existing IRA account to which you make annual contributions.

If you're moving assets from an employer plan, you can roll over your pretax contributions, your employer's matching contributions, and any earnings in your 401(k) or other qualified retirement account. But, if you've made any aftertax contributions to a traditional plan, you'll have to take that amount as a cash distribution. You can't roll it over.

If you roll over an employer plan indirectly, which means you take a cash distribution and deposit it in an IRA within 60 days, your employer must withhold 20% of the total you ask to move. You must make up that amount from another source to maintain the tax-deferred status of that part of the rollover. Any amount you don't deposit is considered a taxable withdrawal. There's no withholding on a direct rollover, which usually makes it the preferable alternative.

ALL TOGETHER NOW

If you change jobs several times in your career, rolling over or converting assets from your employer plans into a single IRA can create a substantial account. You'll have more flexibility in timing withdrawals than you would if your assets remained in an employer plan. You're also less likely to forget about the money, as you might with assets you leave with a long-ago former employer. It may also be an advantage to have a more complete picture of where you stand financially.



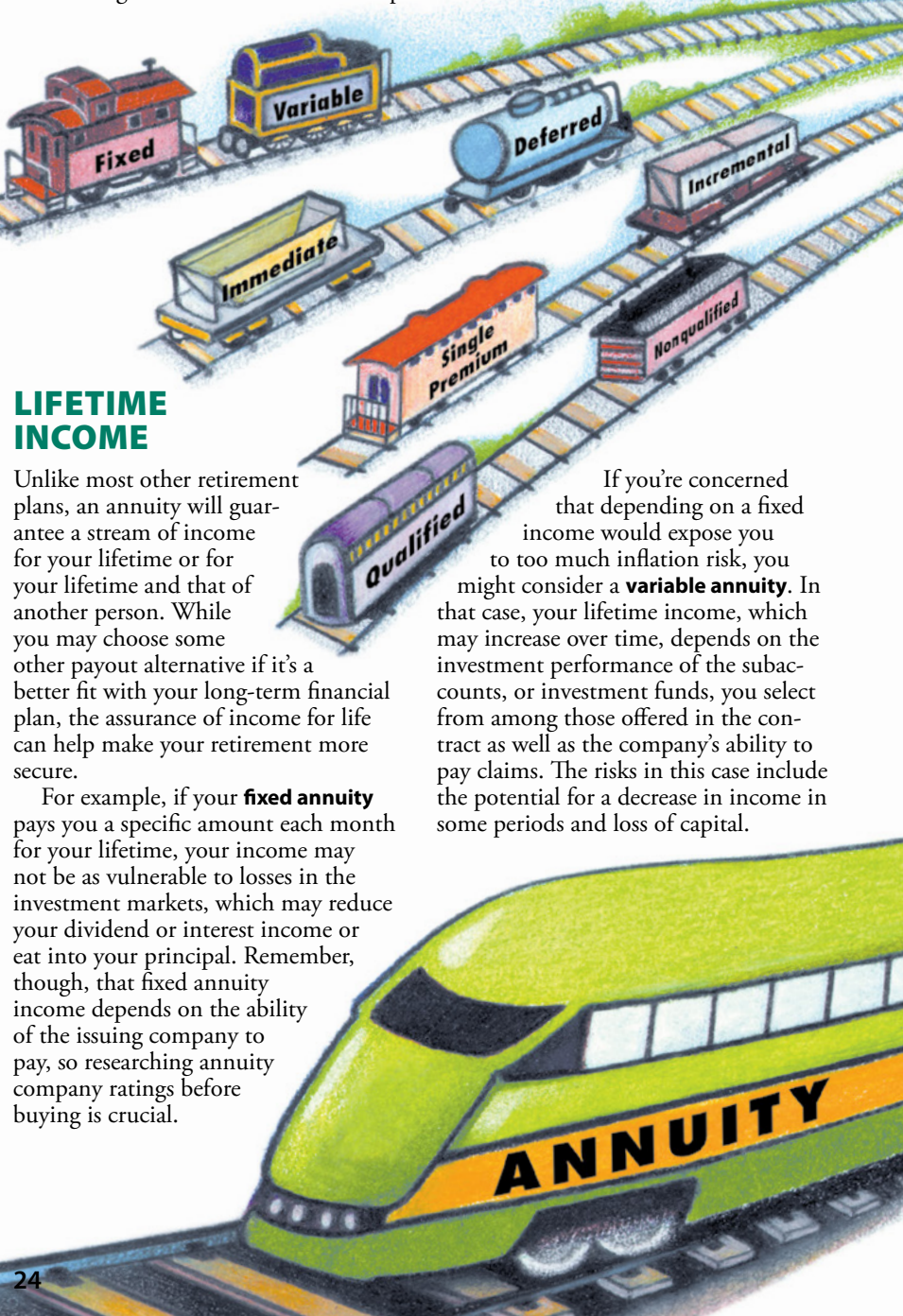
The Possibilities of Annuities

You decide on the annuity features that put you on the right track.

Annuities are insurance company contracts. The premiums you pay and tax-deferred earnings on those premiums are designed to be a source of retirement income, either in the future if you choose a **deferred annuity** or right away with an **immediate annuity**.

With a deferred annuity, the principal and earnings accumulate in the build-up

period. Eventually you can **annuitize**, which means you convert your account value to a stream of lifetime income, or you can take the money some other way. With an immediate annuity, the lifetime income you receive is based on several factors including the amount of your purchase, your age, and the interest rate.



LIFETIME INCOME

Unlike most other retirement plans, an annuity will guarantee a stream of income for your lifetime or for your lifetime and that of another person. While you may choose some other payout alternative if it's a better fit with your long-term financial plan, the assurance of income for life can help make your retirement more secure.

For example, if your **fixed annuity** pays you a specific amount each month for your lifetime, your income may not be as vulnerable to losses in the investment markets, which may reduce your dividend or interest income or eat into your principal. Remember, though, that fixed annuity income depends on the ability of the issuing company to pay, so researching annuity company ratings before buying is crucial.

If you're concerned that depending on a fixed income would expose you to too much inflation risk, you might consider a **variable annuity**. In that case, your lifetime income, which may increase over time, depends on the investment performance of the subaccounts, or investment funds, you select from among those offered in the contract as well as the company's ability to pay claims. The risks in this case include the potential for a decrease in income in some periods and loss of capital.

QUALIFIED OR NONQUALIFIED

If you participate in a retirement plan where you work, you may find that your employer includes a fixed or variable annuity, or both, in the menu of plan choices. When annuity contracts are offered through a **qualified plan** they are considered **qualified annuities**. In this case, qualified means subject to the federal rules that govern how the plans are operated.

Money you contribute to a qualified annuity reduces your current taxable salary in addition

to accumulating tax-deferred earnings. But you must begin taking required withdrawals no later than 72 and take at least the required minimum each year.

Alternatively—or in addition—you can buy an annuity that's not offered through a qualified plan. In this case, the contract is a **nonqualified annuity**. Among the key differences are that you pay the premiums with after-tax dollars, you can contribute more than the federal limit for qualified plans, and you can postpone taking income until much later in your life if you wish.

THE WAY YOU PAY

You can buy an annuity with a **single premium** or make payments over time, on either a regular or discretionary schedule. Your payment alternatives are spelled out in the contract you sign. Immediate annuities, for example, are typically single premium purchases while payments for a deferred annuity may be made over time.

Unlike **individual retirement accounts (IRAs)**, to which you must contribute earned income, you can buy a nonqualified annuity with unearned income. For example, if you sell a business, gain an inheritance, or receive an insurance settlement, you could use that money to buy a single premium contract.

Within a variable nonqualified

annuity, you can move your assets among different funds during the accumulation period without owing income tax on any gains, as you can within an IRA or qualified retirement plan. There may be a fee for moving assets out of certain types of funds, though, or for transfers over the limit the contract allows.

THE ANNUITY DEBATE

Annuities, variable annuities in particular, have advocates and critics. The advocates feel that the insurance protection the contracts offer, the potential for growth, and the promise of lifetime income make them valuable retirement-planning products. Critics argue that annuity fees are too high for the investment and insurance benefits these contracts provide.

Deferred Annuities

Annuities are designed to provide regular retirement income.

A deferred annuity is a contract you sign with an insurance company. You pay premiums, either as a lump sum or over a period of years, building an account balance that can be converted to income or paid as a lump sum. You can use money

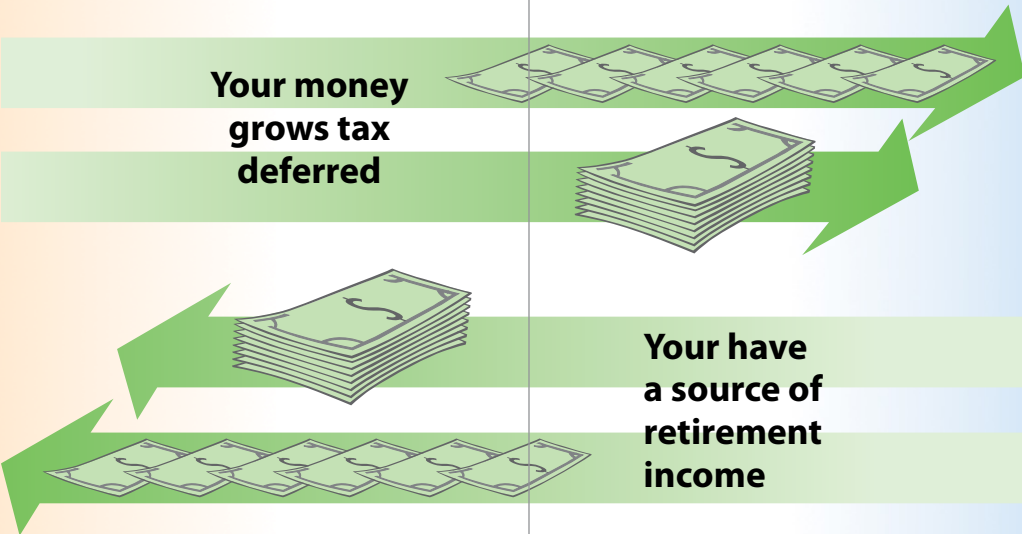
from any source to pay your premiums. It doesn't have to be earned, as it does with an IRA. The contract describes the benefits the annuity provides and the fees and other expenses that apply, which vary by type of annuity and issuer.

With a deferred annuity, you save now to have income later.

THE INVESTOR



“I agree to invest a set amount in the annuity, either in a lump sum or over a period of years.”



FIXED OR VARIABLE

If you buy a deferred annuity, you'll have to choose between a fixed or a variable contract. A **fixed annuity** is the more conservative choice. It promises a set rate of return, though the rate can be—and usually is—reset regularly. In some cases, the initial rate, or the one you're quoted when you buy your annuity, may be higher than the rate that you earn later. If the rate drops, the earnings that have been projected for your contract based on the promotional rate will decline. While most fixed annuities have a **floor**,

or guarantee of a minimum rate, it can be as low as current bank savings rates. Unlike a fixed annuity, a **variable annuity** lets you choose how your money is invested. You select among a number of alternatives, called subaccounts or annuity funds, which typically include a variety of equity and fixed-income choices. Your return isn't guaranteed as it is with a fixed annuity. Rather it depends primarily on the investment performance of the funds you choose and the fees you pay. Your return is likely to vary, up and down, over time, and there may or may not be a floor. Another difference between fixed and variable annuities is that with a fixed annuity the guarantee of future income is based entirely on the issuing company's ability to pay. With variable annuities, that's just one factor. But either way, researching annuity company ratings before you buy is crucial.

Annuities that aren't part of a qualified employer plan are described as non-qualified. Two major differences are that you can add more money each year and are not required to withdraw from a nonqualified annuity at 72.

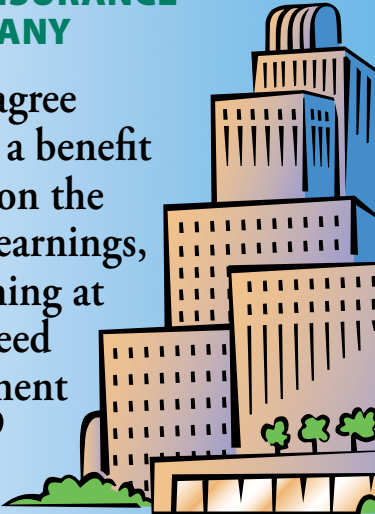
COLLECTING ON YOUR ANNUITY

After the **accumulation** phase, when your annuity investment grows, there comes a point when you start collecting—and paying the taxes you've deferred. If you're receiving regular payments, you owe tax on the earnings portion of each payout. If you take a lump sum, though, you owe all the tax that's due up front. Tax is figured at your regular income tax rate. It's also possible to begin receiving regular income before you turn 59½, taking up to 10% of the total value of your account each year. You owe tax on the earnings portion only and no penalty. If you **annuitize**, your account balance

is converted to a stream of income that lasts as long as you live, or you and a joint annuitant live. The amount depends on the balance and your age or your joint ages at the time of conversion. Alternately, you can choose regular payments of a particular amount or for a particular term. What you receive, or for how long, depends on your balance. There's no guarantee of lifetime income. You may also be able to choose a lump sum payout, but a fee may apply. You can take income without tax penalty any time after 59½, or you can wait. There's no federal law requiring withdrawals, though some states and certain policies require them, often by the time you turn 90.

THE INSURANCE COMPANY

“We agree to pay a benefit based on the plan's earnings, beginning at an agreed retirement date.”



DEFERRED ANNUITIES—THE PROS AND CONS

Deferred annuities, both fixed and variable, can provide important retirement benefits. Despite their advantages, however, deferred annuities also have some drawbacks.

ADVANTAGES

- Tax-deferred growth
- No limit on the amount you can contribute to a non-qualified annuity each year
- A wide choice of contracts to suit your investing style and goals
- Promise of lifetime income if contract is annuitized

A side benefit of receiving income from an annuity contract is that the part that's return of principal isn't taxed because you've used after-tax income to pay your premiums. Just the income from earnings that have accumulated is taxed, at your regular rate. The same applies to income from traditional IRAs when you're not eligible to deduct your contributions.

DRAWBACKS

- Surrender fees and penalties if you withdraw early, or in some cases, if you take a lump sum withdrawal
- Minimized tax advantages for high-income taxpayers because earnings are taxed as regular income, not capital gains
- Potentially large annual fees, which reduce investment growth, a particular problem with variable annuities
- Lack of liquidity, especially in fixed annuities, though they may grow at a rate similar to cash-equivalent investments, including US Treasuries

Choosing Securities

The path to a diversified portfolio requires choosing a variety of investments for your retirement accounts.

The challenge you face in saving for retirement is choosing investments for each of the accounts in your overall portfolio while always thinking of the accounts as segments of a combined whole. In some cases, including most employer plans, you choose from a fixed menu of alternatives. With IRAs and taxable accounts, you have a broader choice. Either way, the more you know about the choices you might make, the more confidently you can decide.

MUTUAL FUNDS

- Provide diversification
- May not be focused
- May not be fully invested

INDEX FUNDS AND ETFs

- Seek to replicate index results
- Transparency
- May be more tax efficient
- Poor performance in down market

INDIVIDUAL SECURITIES

- Investments must be balanced
- Need a varied, representative sample
- Can be costly to diversify
- Performance must be monitored

MANAGED ACCOUNTS

- Professional management
- Advantage of multiple managers

MAKING A FUND CHOICE

One reason you may select actively managed mutual funds, which are common in employer plan menus, is that professional managers choose the funds' investments. They also determine when to sell holdings to cash in on capital gains or prevent potential losses—decisions based on the research from a team of investment analysts. Another appeal is that mutual funds pool assets from many investors, so they are typically able to diversify broadly, providing greater protection against certain kinds of risk.

If you are using funds, it's important to look for those that invest differently from each other. You can check each fund's prospectus for its most recent list of holdings and for a statement of its investment objective. If you own several funds invested in large-company stock, you're probably much less diversified than you want to be.

Similarly, you'll want to choose funds that invest in a way that's consistent with their stated objectives and style. For example, if you own a long-term bond fund whose manager decides to sell bonds and hold cash because he or she believes interest rates are going to rise, that move will affect the way the fund behaves.

Any **style drift**, or shift away from the investments you expect the fund to make, may provide short-term gains. But your portfolio will not behave as you expect over the long term.

THE INDEX ALTERNATIVE

One reason index funds and index-based ETFs may attract your attention is that they're designed to replicate—not beat—the results of the indexes they track. That means there is no issue of these funds making other investments—including those in a different asset class—to improve their return. As a result, they have little style drift.

In addition, index and index-based funds are **transparent**. That means you know at all times what the fund owns: the securities in the index. Further, turnover tends to be limited to transactions that reflect changes in the index itself. That keeps buying and selling within the funds to a minimum, reducing your short-term capital gains and making the funds more tax efficient than many managed funds.

Of course, index funds and ETFs have their shortcomings—including their performance in a falling market and the extent to which weighting impacts their returns. But very few managed funds outperform index funds year in and year out, and they cost more to own.

ISSUES OF COST

Since cost has an impact on your return, you'll want to compare the expense of buying and holding various investments. As a rule, no-load mutual funds with low annual expenses, ETFs that you buy for a modest or no commission and hold for an extended period, and individual securities you buy and hold in the same way are generally the least expensive.

INFINITE VARIETY

Your diversified portfolio is likely to be one-of-a-kind because the unique combination of factors that define your goals, timeframe, and risk tolerance won't be exactly the same as any other investor's.



MANAGED ACCOUNTS

You can also invest in specific asset classes through **managed accounts**. To have access to the services of a professional investment manager, you work with your financial adviser or broker to select account managers who specialize in the asset classes you want to include in your portfolio.

For example, you might select a manager for US equities, another for non-US equities, and a third for long-term debt. There are also multi-manager accounts, which allow you to spread a certain amount of money across several asset classes. Or, you might prefer a portfolio that combines managed accounts with individual securities and various funds.

CHANGING VIEWS

In the past, influential economists have suggested that between 10 and 30 individual securities were adequate for an individual investor who wanted to manage investment risk. For example, Burton Malkiel, in *A Random Walk Down Wall Street*, concluded that if you owned a well-diversified portfolio of 20 equally weighted stocks, you had as much risk reduction as you were going to achieve.

More recently, others have suggested a higher number is more appropriate, based in part on the difficulty of choosing specific securities and in part because the increased volatility of the markets as a whole makes it more difficult to anticipate returns.

ONE BY ONE

You may prefer to choose individual securities within some asset classes, or use both individual securities and funds. For example, you might create an equity portfolio of large-company stocks combined with small-company and mid-sized company mutual funds or ETFs. Or you may put together a bond portfolio of intermediate-term Treasury notes and long-term municipal bonds combined with short-term corporate bond funds.

One challenge with an equity portfolio is creating a rich enough mix of industry, **market capitalization**, or size, and **style**—that is, growth or value—so you hold some securities that are providing strong returns at any given time. To create a broad mix in a fixed-income portfolio, you'll want to consider **term**, **issuer**, and **credit quality**, since the highest-rated bonds tend to pay the lowest rates.

Once you've built a portfolio of individual securities, you're also responsible for deciding if and when to sell certain ones. Failing to shed investments that are unlikely to provide consistent future returns can be a drag on performance.

Despite the added work that may be involved, you may find this approach more rewarding personally and financially than a more hands-off investment style.

Effective Investment Strategies

A great strategy doesn't guarantee a win, but investing without a game plan compounds the risk of coming up short.

Random buying and selling—adding a few stocks here, redeeming a bond there—is rarely an effective strategy for planning retirement income. To be a successful investor, you have to follow two seemingly contradictory pieces of advice: Stick with your investment strategy but stay flexible. That means

having a long-term perspective but not getting locked into choices that don't work as you expected. By knowing how different investments can affect your portfolio, the level of income you want to produce, and how much risk you are willing to take, you'll have a stronger opportunity—though, of course, not a guarantee—of ending up where you want to be financially.

The money you have to invest

STRATEGIC DECISIONS

Whether you are investing a little or a lot of money, it's always important to:

- Save for retirement
- Create a plan to meet your goals
- Monitor your progress
- Make adjustments as necessary

MOVING IN NEW DIRECTIONS

If your emphasis has been on building an equity portfolio, you may want to consider starting to invest in income-producing investments, including intermediate and long-term bonds and bond funds.

Among the factors to consider are the bonds' ratings—unless they are US Treasuries—their terms, and the interest rates they pay. A question with longer-term issues is whether you're willing to commit your principal at the current market rate if rates seem likely to increase in the future.

While they're not right for all investors, limited partnerships, real estate investment

trusts (REITs), or equipment leasing programs may be possible income producers.

DRAWING ON PRINCIPAL

While preserving principal is critical while you're investing for retirement, there's nothing wrong with planning to use some of the principal—say 3% to 4% a year—after you retire. But, you need a plan for tapping your resources, similar to a withdrawal schedule for your IRA, and a sense of which investments to liquidate.

A maturing CD, for example, can become a source of current income. When it comes due, you can deposit the principal in a money market or savings account to draw on as you need cash. That might be smarter than withdrawing money from an investment that's doing well, like a stock fund, or selling real estate when prices are low.

IMPATIENT—
OUT OF
MARKET
TOO SOON

RANDOM
BUYING

APPROACHES TO PLANNING

There's no way to protect yourself completely from market volatility without taking on inflation risk. But there may be ways to produce a stream of income while maintaining some long-term growth. One approach is to deposit dividends or distributions from certain equity investments into a spending account. That's a departure from the strategy of reinvesting all earnings to buy additional shares, which is appropriate as you build your retirement savings. But this regular source of income can supplement your living expenses or pay for extras.

At a certain point—which is different for different people—you may also begin selling certain stocks or stock mutual funds that have increased in value and reinvesting the money in income-producing investments. If you ladder, or stagger, the maturity dates

of the bonds and CDs you purchase, you can either redeem them when they come due and add the principal to your spending account or buy a replacement.

Remember, though, that there are no guarantees in investing. While the markets could be strong in any period, you could also have flat or falling returns and even lose principal.

The money you need when you retire

CHASING
HOT STOCK
TOO
LATE

INFLEXIBLE
STRATEGY

ANTICIPATING INCOME FOR THE LONG TERM

The amount you can withdraw from your retirement accounts depends on the size of your account, the return it provides from year to year, and the number of years you need income. Losses early in the withdrawal period seriously limit long-term return.

Maximum monthly withdrawal to provide income for different periods*

| | 10 years | 15 years | 20 years | 30 years |
|-----------|----------|----------|----------|----------|
| \$50,000 | \$580 | \$448 | \$386 | \$332 |
| \$100,000 | \$1,160 | \$896 | \$772 | \$668 |
| \$150,000 | \$1,740 | \$1,340 | \$1,160 | \$999 |
| \$200,000 | \$2,320 | \$1,790 | \$1,550 | \$1,330 |
| \$250,000 | \$2,900 | \$2,240 | \$1,930 | \$1,660 |
| \$300,000 | \$3,480 | \$2,690 | \$2,320 | \$1,990 |
| \$350,000 | \$4,060 | \$3,138 | \$2,706 | \$2,322 |

*This hypothetical example is for illustrative purposes only and is not intended to represent or imply the actual performance of any specific investment. It assumes a constant 7% return compounded monthly. It is important to note that any investment involves risks that may result in the loss of principal and there is no guarantee that the strategies illustrated will produce positive investment results.

Portfolio Planning

You don't have to reinvent the wheel to plan your asset allocation. It's already been done.

Allocating and diversifying your portfolio isn't a one-time decision. It's the ongoing process of seeking the strongest possible return that's consistent with your investment goals, timeframe, and risk tolerance. An appropriate allocation when you're in your 30s may no longer be the best choice in your mid-50s. In most cases, you're the one who must make the adjustments.

CASH IN THE BANK

A cash investment is a way to have money available for emergencies and for new investment opportunities. While keeping the bulk of your money in a regular savings account has serious limitations as a long-term investment strategy, the logic behind a cash reserve makes a lot of sense. If all your assets are invested in stocks and long-term bonds, and you need to **liquidate**, or turn them to cash quickly, you may take a loss if the market is down. That doesn't happen if they're already in cash.

TAKING STOCK

In an asset allocation model, stocks represent growth. While some stocks pay dividends that provide a regular income, stocks are essential to long-term invest-

LOOKING AHEAD*



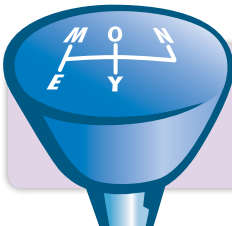
ment planning because historically they have increased in value. While it's always possible to lose a lot of money in the stock market in any one period, stocks in general—though not every individual stock—have characteristically rebounded from past losses to provide long-term gains.

You may have as much as 80% of your total portfolio in stocks (or stock funds) while you're in your 20s and 30s. That means every time you invest \$1,000, \$800 of it would go into stocks, mutual funds, or ETFs. However, as you get older, say in your 50s and 60s, the percentage of stocks in your portfolio is usually scaled back. Generally the greater the risk a particular stock carries, the more suitable it is for younger investors or those with substantial assets elsewhere.

STASHING THE CASH

| Option | Characteristics |
|---------------------------|--|
| Bank money market account | <ul style="list-style-type: none">Instant accessBetter interest rates than savings accountMay reduce cost of checking accountCheck-writing privilegesFDIC-insured |
| CDs | <ul style="list-style-type: none">Money available (with early withdrawal penalty possible)Interest rate slightly higher than money market accountsDue dates can be staggered for convenienceBank CDs FDIC-insured |
| US Treasury bills | <ul style="list-style-type: none">Easy to purchaseLittle inflation riskCan be sold any time, though at a potential lossExtremely safe |

* These hypothetical allocations are intended only as illustrations and do not predict the return of any specific portfolio.



SHIFTING GEARS FOR SHIFTING GOALS
As retirement gets closer, you might want to shift from seeking growth toward providing income.

| STOCKS | BONDS | CASH |
|---|---|--|
| 80% Stocks have the potential to grow in value over time and may pay regular dividends. | 15% Bond issuers pay interest, usually on a regular schedule, and promise to repay principal at maturity. | 5% Cash in insured accounts preserves principal and provides regular if typically modest income. |
| 60% You may gradually reduce your allocation somewhat to reduce portfolio volatility. | 30% You may gradually increase your bond holdings as you reduce your stock holdings. | 10% You may start taking profits on stock and adding to your cash reserve. |
| 40% Stock always has a role to play in your investment portfolio. | 40% Bonds tend to be less volatile than stock and provide a larger annual yield. | 20% You may want to have two or three years worth of income available in cash. |

THE BOND'S THE THING

Bonds have traditionally been seen as income-producing investments. If that's your goal, you buy a bond, hold it to maturity and receive a regular interest payment every six months or year. Then you get the principal back when the bond matures. As an added plus, bonds issued by the US government have limited credit risk so there's unlikely to be a **default**, or failure to pay what's due. That's one reason these bonds appeal to investors—often those nearing retirement—who are looking for steady income and don't want to risk losing their principal.

On the other hand, like other bond investments, they are subject to **market risk**. This means if demand is down, perhaps because newer bonds are paying a higher rate of interest or because people are selling bonds to invest in the stock market, your bonds may be selling for less than par value. If you bought at issue and sell before maturity, you could lose some of your principal.

Whatever your age, you'll probably want to consider investing in bonds—or bond mutual funds or ETFs—because they can help reduce the overall volatility of your portfolio. For example, you might buy some mix of government,

corporate, and municipal bonds of different maturities and with different ratings.

The advantage of bond funds or bond ETFs over individual corporate or municipal bonds is that it's easier to achieve greater diversification at lower cost.

However, with a fund, there's not a fixed interest rate, since the fund owns bonds with varying rates, and there's no maturity date, as it owns funds with different terms. In addition, there's no promise to return your principal, though it's possible that you may be able to sell your shares at a higher price than you paid to buy them.

OTHER FIXED INCOME

Pass-through securities are another type of fixed-income investment. They are created by bundling together a group of loans, such as mortgages or student loan debt, a process known as securitization. Among the best known are the mortgage-backed securities called GNMA's, or Ginnie Maes, which are insured by the Government National Mortgage Association. As borrowers repay the principal and interest on the underlying loans, those payments are passed along to investors. Most individuals invest in Ginnie Maes by buying a GNMA fund.

Reallocating and Rebalancing

Rethinking your investment mix is a critical part of smart investing.

When you use an asset allocation strategy, you select a mix of investments to help you achieve your financial goals. Making this approach work for you requires your attention from time to time. For example, you may need to reallocate your assets to reflect changes in your goals, time frame, or the risks that concern you most. In addition, you'll almost certainly have to rebalance your portfolio over time to keep it aligned with your allocation strategy.

THE RIGHT MIX

It can be easy to confuse reallocating and rebalancing. Both involve modifying the way your portfolio is spread across a variety of asset classes. And you make the modifications in similar ways, often by selling some investments and

buying others. But the two serve quite different purposes.

When you **reallocate**, you alter the mix of asset classes in your portfolio to be more appropriate for your new investment focus. The change typically involves assigning different percentages of your account value to particular asset classes and sometimes adding new classes.

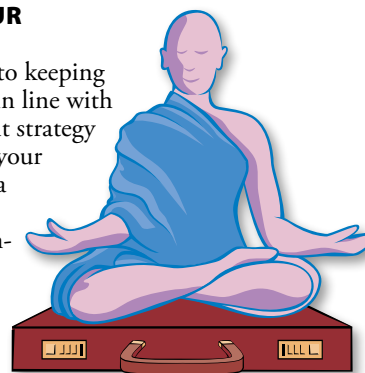
When you **rebalance**, you bring your portfolio back in line with the asset allocation you have chosen as an appropriate way to meet your goals. Without this readjustment, you could drift into an allocation mix that exposes you to greater investment risk, or one that is likely to provide a lower return, than you had anticipated.

a major market downturn in the years just before you start withdrawing the money. You might also include asset classes you hadn't focused on before, including real estate investment trusts (REITs) on the equity side and certificates of deposit (CDs) and US Treasury bills and notes in the cash category.

You can also modify your allocation by directing the new money you invest into income-producing or asset-preserving investments. This might allow you to hold on to some investments that have served you well over the years, and that you'd prefer not to sell, while still altering your asset mix.

KEEPING YOUR BALANCE

One approach to keeping your portfolio in line with your investment strategy is to rebalance your portfolio once a year as part of an annual financial assessment. Alternatively, you may want to rebalance only when



your portfolio's strongest asset class exceeds your target allocation by a specific percentage, say 10% or 15%. This approach reduces transaction costs and potential capital gains taxes.

You can rebalance your portfolio in a number of ways, similar to the ways you reallocate: selling off some holdings in the asset class that's currently strongest or shifting new investments to the lagging class. Since the lagging class is likely to outperform in the next phase of the market cycle, you want to posi-

tion yourself to take advantage of the opportunity to buy low now so you can sell high later.

LOOKING AT HIDDEN COSTS

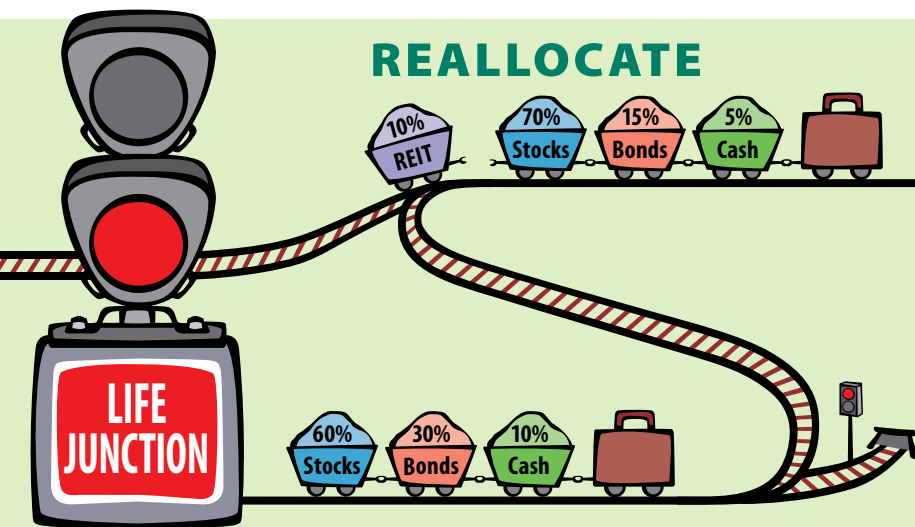
With online access to your portfolio, you may be able to reallocate or rebalance as often as you wish. But there are a number of potential drawbacks to constant trading.

Most buying and selling comes with a price tag,

which includes not only potential commissions or sales charges but also transaction costs. And, unless you're trading in a tax-deferred account, you'll owe capital gains taxes on any profits you realize. If you've owned an investment for less than a year before selling, those taxes are calculated at the same rate as on your ordinary income.

So there is a real risk that you may be spending more to make portfolio changes than you earn from making them.

REALLOCATE

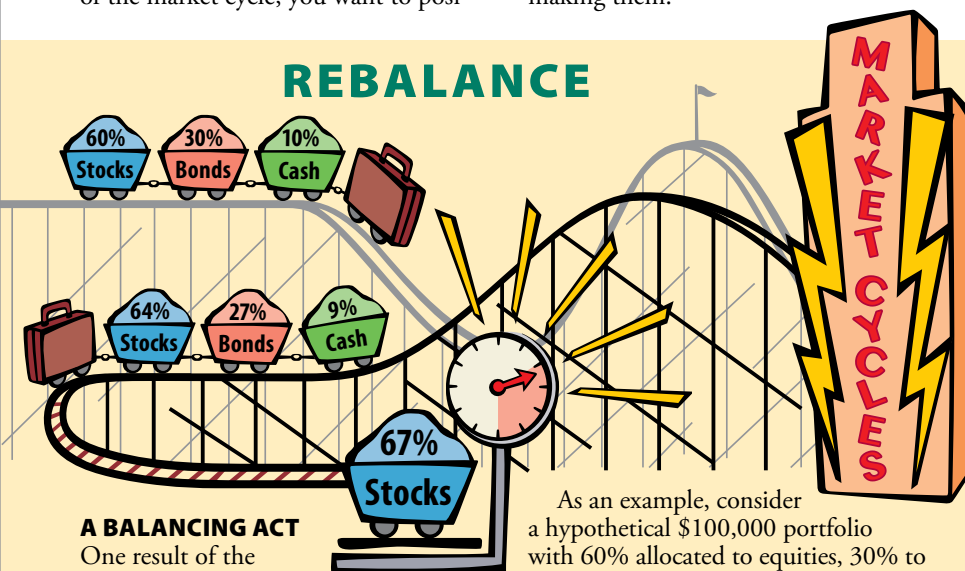


A NEW PERSPECTIVE

By gradually increasing the proportion of insured and income-producing investments in your portfolio mix as your child gets ready to start college or you're starting to think about retirement, you can help protect what you've accumulated and put new emphasis on owning assets that pay out regular interest or dividends.

You might want to begin reallocating by identifying some higher-risk, often more volatile, investments that have increased in value. By selling them and reinvesting the proceeds in a timely way, you can help protect against the risk of

REBALANCE



A BALANCING ACT

One result of the normal ups and downs of the financial markets is that, at any given point, your actual portfolio allocation may be significantly different from the one you have chosen and would prefer to maintain.

This is because the various asset classes move through constantly recurring performance cycles. As a result, the return on equities is stronger in some periods and weaker in others. The same is true of debt and cash investments. And when one asset class is strong, the others often lag. This, in turn, affects the proportional weight of the asset classes within your portfolio.

As an example, consider a hypothetical \$100,000 portfolio with 60% allocated to equities, 30% to long-term debt securities, and 10% to cash. If stocks, ETFs, and mutual funds provide a one-year total return that's higher than the average historical rate while the return on fixed-income and cash investments is lower than average, the balance of the three asset classes in the portfolio shifts, perhaps to something closer to 64%-27%-9%.

While this shift isn't particularly dramatic, another year or two of similar returns could increase the equity allocation to closer to 70% while reducing fixed income to 22% and cash to less than 8%. At this point, your portfolio is clearly more aggressive than you intended.

Creating an Income Stream

Investment income depends on the amount and the variety of your investments.

The amount of income your investments will provide after you retire depends on how much you've put away over the years and the kind of return your investments pay.

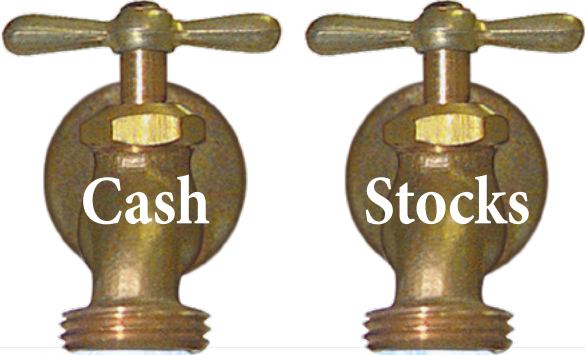
LOOKING AT SPECIFICS

Let's look at a hypothetical example. Bob and Mary have an income of \$100,000 a year before they retire. Since they estimate that they'll need 80% of their current income to maintain a similar standard of living, they'll need income of roughly \$80,000 from various sources.

Assume they'll receive \$35,000 a year from Social Security and another \$35,000 from an employer-sponsored plan. That means even in the first year of retirement, before inflation is a real factor, they'll have \$10,000 less than they need.

Depending on the investments they've made, they'll either have access to enough income to meet their living expenses and have something left for pleasure, or they'll have to take other steps, including continuing to work, cutting back where they can, liquidating principal, or selling their house.

Assuming that they have accumulated assets worth \$600,000, here's a look at the income their diversified portfolio could produce if it were allocated in different ways. However, remember that these allocations are hypothetical illustrations and are not intended to predict the return on specific investments.



Bob and Mary invest \$100,000 in bank certificates of deposit (CDs) earning interest of 1% a year, or a total of \$1,000 before taxes.

They also have the choice of liquidating part of the principal each time they roll over a maturing CD.

| | |
|-----------------|-----------|
| CDs | \$100,000 |
| Annual interest | x .01 |
| Annual income | = \$1,000 |

Advantages

Their investment is insured against loss of principal by the FDIC.

Pitfalls

If they liquidate principal, they'll have less to re-invest. The interest they earn will decline because it's being paid on a smaller principal. Similarly, if interest rates decline, their interest earnings would be eroded even if no principal is liquidated. If both were true, they'd earn even less. The risk of keeping more than 20% of a portfolio in cash is the likelihood of earning less than the rate of inflation, so that the interest buys less each year.

Bob and Mary invest \$250,000 in stocks and stock funds, with an average dividend yield of 3%. If they take dividends as cash they'll have \$7,500. But taxes will be due on dividends and any capital gains.

| | |
|---------------|-----------|
| Stocks | \$250,000 |
| Annual return | x .03 |
| Annual income | = \$7,500 |

Advantages

Equities have historically grown in value and have been less vulnerable to the effects of inflation than other investments.

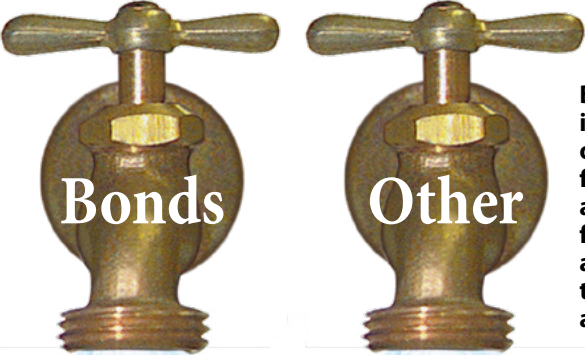
Pitfalls

The past is not a predictor of the future. While stocks have performed strongly over time, they do have bad years. If the value of the stocks were to drop, either because of a weak market or a problem with the underlying business, their return would also drop. Bob and Mary might have to sell stock to make up the difference, locking in a loss and reducing the stock portfolio they need to generate future income.

VARIETY IS BETTER

When you're planning for retirement income, diversification is important though it doesn't guarantee you'll have all you need. One moderately conservative mix when you retire

is 40% of total assets in equities, 50% in fixed income, and 10% in cash. But what's right for you depends on your age, the amount and variety of your accumulated assets, and your risk tolerance.



Bob and Mary might invest their nest egg in other ways, including fixed or variable annuities, mutual funds, and real estate, and arrange to turn that investment into a source of income.

If Bob and Mary invest \$250,000 in long-term US Treasury bonds, which have an average 2% return, they'll receive an annual income of \$5,000 before taxes to help fill in the difference between their Social Security and pension and their projected living expenses.

| | |
|-----------------|-----------|
| Bonds | \$250,000 |
| Annual interest | x .02 |
| Annual income | = \$5,000 |

Advantages

Their investment is presumed safe because it's an obligation of the US government and the payments will be made on schedule.

Pitfalls

Inflation again. Because Bob and Mary are locked into the interest rates the various bonds in their portfolio pay, their buying power will be eroded if inflation rises to a significantly higher level. In addition, the principal amount, when returned, would have reduced value, though they could reinvest it in another similarly priced bond.

ANNUITIES

They could annuitize the assets in a deferred annuity or buy an immediate annuity that would begin paying income right away. If they selected a fixed payout, they would know from the start how much they would receive for the period of time they chose, which could be as long as their joint lifetimes. If they chose a variable payout, the amount of income might not be guaranteed, because it would be based on the performance of their investment portfolios. But they would be assured of some income throughout the term they chose. The advantage of fixed income is its regularity, while the advantage of variable is that it has the potential to increase over time.

MUTUAL FUNDS

They might arrange with a mutual fund company to pay out their investment in regular installments for the next 20 years. The amount, which they would determine with the mutual fund company, based on the return on the fund, could provide a basic income each year, which could increase if the fund enjoyed strong returns or decrease if performance slowed. In addition to a shortfall, the problem is that one or both of them could live longer than 20 years, outliving this asset.

REAL ESTATE

It's difficult to predict return on a real estate investment because it depends on where the property is, whether it's producing income, and how much they pay annually to keep it up. Unless they're invested in REITs, which may pay a healthy dividend, or in income-producing property such as apartments or timberland, real estate can be difficult to convert to a stream of cash.

DOING MENTAL ACCOUNTING

Another decision they have to make is whether they want to preserve some of their assets to provide income for the surviving spouse, transfer wealth to their heirs, or make gifts to charities. If those things are important to them, they might plan to withdraw from accounts designed for retirement income, such as IRAs and annuities, while holding on to investments such as stocks that have no built-in mechanism for liquidating assets.

Asset allocation is a strategy for managing certain types of investment risk by investing specific percentages of your investment principal in different asset classes, including stocks, bonds, and cash. However, asset allocation does not guarantee a profit or protect you against losses in a falling market.

Benchmark is a standard against which investment performance or other variables are measured. A market index or average whose gains and losses reflect the changing direction of the market segment it tracks may serve as a benchmark for individual securities or mutual funds.

Compounding occurs when your investment earnings are added to your principal, forming a larger base on which future earnings may accumulate. As your investment base grows larger, it has the potential to compound faster.

Debt securities, also called notes and bonds, are investments that involve lending money to an issuer, such as a corporation or government, in exchange for interest payments for the use of your money and the promise that your principal will be returned at the end of a specific term.

Diversification is an investment strategy for managing certain types of investment risk that involves buying a number of different securities, mutual funds, or exchange traded funds (ETFs) in different categories or subclasses within a single asset class. However, diversification does not guarantee a profit or protect you against losses in a falling market.

Equity is ownership, and equity investments give you ownership shares. In the case of stock, for example, you own shares of the corporation that issues the stock.

Financial plan is a list of the things you would like to be able to afford in the future, your timetable for achieving those goals, an estimate of what they will cost, and a strategy for investing that's designed to help you achieve them.

Index is a list of securities that share a relevant characteristic, such as asset classification, market capitalization, or investment objective, and whose collective performance is taken as a sign of how that segment of the market is faring.

Market capitalization, or market cap, is one way to measure the size of a company and is often used to anticipate its potential for investment return and the types of risk it may pose to investors. Market cap is calculated by multiplying the current price of a share of the company's stock by the number of outstanding shares.

Portfolio is the group or collection of investments that you own. Each time you purchase a new investment, you expand your portfolio, ideally making it more diversified.

Principal is the amount you invest. When your investment account is insured, as bank accounts are, your principal is guaranteed. If the account is not insured, you could lose some or even all of that money.

Return is the profit you make on an investment, usually expressed as a percentage of your investment cost. It includes any increase or decrease in the value of the investment plus any earnings you receive from the investment.

Risk is the possibility that you could lose money or buying power by making particular investments or that you might not realize the level of return you had hoped for or expected from your investments.

Rollover IRA is an IRA that holds assets you have moved from an employer's retirement plan or another IRA. The advantages of a rollover IRA are that you maintain the tax-deferred status of your savings but are likely to have more control over how your assets are invested and how you manage required withdrawals if they apply.

Taxable means you owe income or capital gains tax on investment income or the profit from the sale of an investment for the tax year in which the income is paid or the profit realized.

Tax deferred means you postpone paying income tax on earnings and in some cases on contributions to an investment account. You pay tax on your withdrawals at your regular tax rate unless the account is a Roth IRA, 401(k), 403(b), or 457. Those withdrawals are tax free if you are at least 59½ and your account has been open at least five years.

Tax exempt or tax free means that no income tax is due. In most cases, the terms apply to earnings from specific investments, such as municipal bonds, or investment accounts, such as a Roth IRA.

Yield is the income you receive annually from an investment, expressed as a percentage of the price you paid to buy it.

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