Your Retirement Plan Needs Care and Feeding

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The Morning Call (page D1)

January 20, 2002

Everybody wants to retire on Easy Street years from now. But that road is paved with smart financial decisions you make today, experts say.

And while you don't want to tinker with your voluntary retirement holdings daily, leaving your retirement planning on autopilot isn't a good idea either.

Retirement planning is an important and wide-ranging topic, but retirement plan nurturing is important, too. If you're already saving for retirement, there are some questions you should be asking yourself.

- With the wild ride the stock market has taken in recent years, are the mix of stocks and bonds in my retirement accounts still what I want?
- Which is better for me, a 401(k), a Roth IRA, or a regular investment account that doesn't have obvious tax advantages?
- Will I be affected by this year's higher limits for contributing to a retirement plans?

Maybe the most important advice is to maintain a diversified portfolio for retirement, with an eye on the long-term, experts agree. That means if it was a good plan during dot-com mania -- when your nest egg grew -- and just after the Sept. 11 terrorist attacks -- when it shrank -- it's probably still a good plan.

But it's important to make sure it's on track.

"A retirement plan is never precise. It's just a plan. That's why you should update it every year," said Christopher M. Jones, a fee-only financial planner with Keystone Financial Planning in Palmer Township.

"They can adjust it as real-life scenarios change."

BACK ON TRACK

Asset allocation is the fancy name for how much of your retirement nest egg is in stocks and how much in bonds.

Why is that important? Risk and return.

Conventional wisdom says the younger you are, the more risk you can take, which means putting more money in stocks and hoping for a higher return. Meanwhile, you'll have time to ride out the downturns of the volatile stocks.

If you're closer to retirement age, you want more conservative fixed-income investments such as bonds.

But even if you have been putting 60 percent of your retirement money in stocks and 40 percent in bonds, a typical example, your investments grow at different rates. If stock prices increased a lot, as they did in the late 1990s, you might find your retirement money is 70 percent tied up in stocks and 30 percent in bonds.

Since that's not what you intended, you might have to rebalance your portfolio by shifting money from stocks to bonds or changing where your future contributions go.

For the math-challenged among us, here's how to check your allocations:

Get out your most recent statement from your 401(k), 403(b), IRA or other retirement account paperwork.

Add up the total value of your stock funds (and individual stocks, if you have them.) Divide that by the total value of your portfolio. So, if you have $10,000 in stocks out of a $20,000 nest egg, 50 percent of your retirement money is in stocks.

What should your asset allocation be?

That's a thorny question and doesn't have a blanket answer because it depends on such things as your age, your tolerance for risky investments and how dependent you will be on the money when you retire, Jones said.

If you're 25 to 35 years old, maybe you want 70 to 80 percent of your retirement money in stocks, Jones said.

But if you're just a few years away from retiring, you probably don't want more than half of the money in stocks.

"Those are really broad, sweeping generalizations," Jones said.

And you shouldn't only diversify among stocks and bonds. You also want to be diversified in the types of stocks and stock funds you own. Mainly, that means putting some money in big companies (large cap stocks), some in small companies (small cap stocks) and usually some lesser amount in international companies.

One other point about your allocations is to avoid putting your retirement money in company stock, at least to a great extent. It's illustrated in the news recently. The retirement plans of employees at failing energy company Enron of Texas have been hurt by that company's collapse.

"Lucent is probably our best example locally," said Robert H. Brown, a financial planner with Allmerica Financial in Bethlehem.

"When you have your salary and pension tied up in the company, you already have an enormous amount of equity tied to that company."

YOUR NEST EGG'S NEST

There are several good places for stashing your retirement money, and experts don't always agree on which mix of so-called "retirement vehicles" is best.

But one thing they do agree on is accepting any free money someone wants to give you. Namely, take advantage of the employer match in your retirement plan, such as a 401(k).

If your employer matches your contributions up to a certain level, you should contribute enough of your own money to get that match. Often, it's a maximum match of 3 percent of your salary, which most companies express as half of your contributions up to 6 percent.

"That's just free money, and you want to get it," Jones said.

If you can contribute more than that, the discussion turns to taxes.

Consider a Roth IRA, said Jordan E. Goodman, author of "Everyone's Money Book" and editor of the Web site www.moneyanswers.com.

"The Roth IRAs are vastly underappreciated and underused," Goodman said.

In a Roth, you contribute after-tax money, and growth on the money is not taxed when you withdraw it in retirement. So withdrawals are tax free, as opposed to a 401(k), in which the money you put in is tax free, while withdrawals are taxed as ordinary income.

A Roth is especially good for younger adults, who have a lot of time before retirement, and therefore a lot of growth on their money, Jones said.

"Most studies show that with a long time horizon, Roths kill other investment options," he said.

And a Roth is good for people who will be in a high-income tax bracket when they retire. Withdrawing tax-free money amounts to more when you're in a high tax bracket.

Another good part about the Roth is you can choose among most any mutual funds. Most large financial companies offer them.

The bad part is you have to do it yourself. Your employer is not involved.

Goodman suggests aiming to allocate about 10 percent of your gross income each year to retirement. Of that, he would contribute 6 percent to a 401(k) to get the employer match, assuming that's the rule with your 401(k).

Then contribute another 4 percent to a Roth IRA.

"Last I saw, just 5 percent of people eligible for a Roth IRA were doing it," Goodman said. "That's just ridiculous. It's the best thing around."

The limit this year for contributions to a Roth IRA is $3,000, up from $2,000 last year. But you don't have to contribute the maximum of $3,000, and you don't have to do it all at once. Many mutual funds allow you to open an account with a minimum of $100 to $1,000 and make regular contributions, which can be automatically transferred from a bank account.

"Most people will fund it monthly," Brown said.

You can't contribute if your taxable income is more than $160,000.

There's also a traditional IRA, where contributions can be deductible, depending on your income now. Unlike the Roth IRA, plans like the 401(k) are good because you contribute money before it's taxed. That's especially important for people who are in a high income bracket now, because your untaxed initial contribution will be so much more, Jones said.

"One generalization you can make across the board about it is the higher income tax bracket you're in, clearly the more the 401(k) and similar plans will be of value because of that first-year income-tax reduction," Jones said.

Another advantage is it's easy to participate, using your employer, and the money comes out of your paycheck before you see it. And you can contribute a lot more ($11,000) than in a Roth ($3,000).

The disadvantage can be the choice of mutual funds and other investments offered in such plans, Jones said. Often the choices are limited, unlike the Roth IRA or traditional IRA, where the choices are almost endless. And some 401(k) plans include mutual funds that have high costs built in, which can lower your overall returns.

While no financial planner would dismiss the value of a 401(k), for example, there are some reasons why a regular investment account with no built-in tax advantages might be best.

That's because of taxes when you withdraw money.

"It can be negative sometimes to have all your retirement income from retirement accounts. It's a very common mistake," Jones said.

Withdrawals from tax-deferred accounts, like a 401(k) are taxed as ordinary income, which might be 30 to 40 percent. Meanwhile, capital gains from normal after-tax investment accounts are taxed at a lower capital gains rate, around 20 percent.

"So there's a real benefit to having a mixture of taxable and tax-deferred investments," he said.

And a word of warning from several experts regarding variable annuities, a complicated retirement planning vehicle, usually with a life-insurance component:

"When it comes to retirement, people need to be very careful when it comes to variable annuities," said Jack E. Payne, a certified financial analyst and chief investment officer with Michael Joyce & Associates in Bethlehem.

"They're instruments that are sold very aggressively. In a lot of cases they do make sense, but you have to be very careful you understand all of the fine print."

Often variable annuities are more expensive than other retirement accounts -- even charging fees to get in and out of the investment, he said.

But a new wave of variable annuities from such big names as Vanguard, Fidelity and TD Waterhouse are more competitive on costs, he said.

While wading through details of these different types of retirement plans can be taxing, pun intended, it's not the most important thing. Neither is choosing the very best investments within those plans.

The most important thing is to start saving now with regular contributions.

"The problem is that people are at a dinner party and they're talking about the hot stocks or hot mutual funds when in actuality that's not what wins the game for most people, Brown said.

"The average person who successfully retires tends to be disciplined and consistently saves, whether it's in the top mutual fund or not.

"They'll do better than the guy who's trying to chase the No. 1 stock fund fund from the last quarter."

TAX LAW CHANGES

The new tax law passed last summer changed the rules for many retirement plans. If you want the details, go to the Internal Revenue Service Web site at www.irs.gov. Also useful is Tax Planet at www.taxplanet.com.

Here are the highlights:

- The 2002 limit for contributing to 401(k), 403(b) and 457 plans is $11,000 this year, up from $10,500 last year. (It's up from $8,500 for state and local employees' 457 plans.) It will continue to increase $1,000 a year until 2006, when it reaches $15,000. If you're 50 or older, there's a "catchup" provision, allowing those nearing retirement to contribute more. For 2002, those 50 and older this year can contribute an additional $1,000, or $12,000.
- The limit for contributing to a Roth or traditional IRA is $3,000, up from $2,000 last year. For people 50 or older, the limit is $3,500.
- Contributions to small-employer plans called Savings Incentive Match Plans for Employees (SIMPLE) rise to $7,000, from $6,500. It goes up to $7,500 for those age 50 and older.
- Self-employed workers using a Simplified Employee Pension (SEP) or Keogh plan will see contribution limits of $40,000, up from $35,000.
- Also new for 2002 is a tax credit for low-income workers as an encouragement to save for retirement. The credit ranges from 10 percent to half of the contribution, depending on the worker's taxable income, which has to be less than $50,000 for joint-return filers and $25,000 for singles. The maximum annual contribution eligible for the credit is $2,000.

WHEN YOU ASSUME...

If years ago, you sat down and made a retirement plan, it might be a good time to reassess the assumptions you made, experts say.

Long-term planning always includes a slew of assumptions that may or may not be accurate. And as you get older, you might have a better idea of what you want in retirement, or maybe you know some of the assumptions are off-base.

A lot of it comes down to figuring out how much spending money you will need in retirement. Has your risk tolerance changed? Will the house be paid off when you retire? Do you plan to travel a lot or mostly stay home? Will you be in a higher or lower tax bracket when you retire?

Other assumptions are built into retirement calculators you can use yourself or ones used by your financial planner. Those assumptions include what inflation is going to be like and what taxes rates might be. Another unknown is just what kind of return your investments will yield. Over a long period, a half percent difference in average return or inflation translates to thousands of dollars.

This all speaks to voluntary retirement planning -- the part you have to manage yourself. In assessing your whole retirement picture, don't forget to account for Social Security benefits (www.ssa.gov), pensions and other factors.

"My experience in making retirement plans is it's important to make conservative assumptions," Jones said. "You just have to be prepared. I try to look at the worst-case scenarios and make sure they can survive them."

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