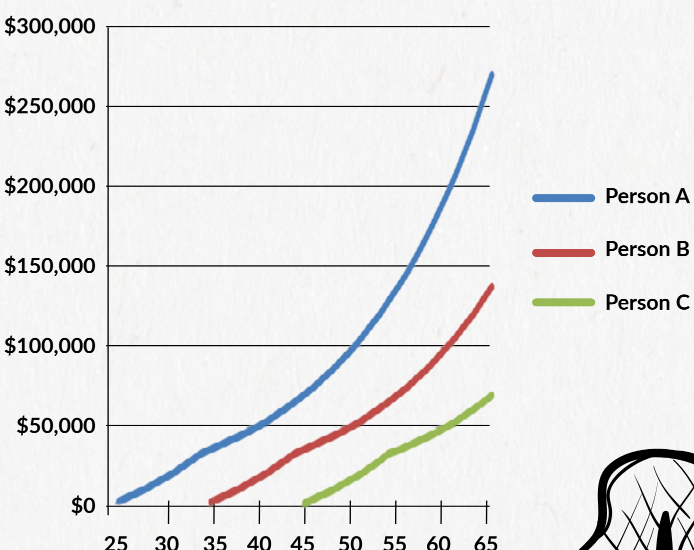
CHAPTER 5: Retirement Readiness

Did You Know?

Only 58% of us are currently saving money for retirement — and 60% of those who are, have saved less than $25,000. Thirty percent have saved less than $1,000. Most financial planners advise their clients to expect to save eight to 10 times their final annual salary for retirement.[8]

As you complete your education and enter the workforce, **retirement** may feel very far away — on average, 40 years away. But most financial planners say that you will need to have 10 times your final annual salary saved in order to retire without having to make major lifestyle changes. The earlier you start toward this goal, the more you can reap the benefits of **compound interest** — but the later you start, the more money you'll have to take out of your monthly budget in order to reach the same result.

The bottom line is that *when* you begin investing may be more important than how or how much you start with. Look at the following graph. Each person invested the same amount of money — $200/month for 10 years. Each earned an average of 7% investment returns per year. The only difference is that Person A began investing at age 25, Person B began at age 35, and Person C waited until age 45.



[8] www.marketwatch.com/story/what-matters-most-in-retirement-planning-2012-12-04

Budgeting for Retirement

Once you decide to start saving for retirement, you'll need to decide how and how much. There are a few things to consider when deciding how much.

- *Budget:* Many people believe that your expenses will be much lower in retirement than while you are working, but this isn't always the case. Your mortgage may or may not be paid off, but property taxes typically go up every few years. Many places offer senior discounts, but if you'd like to travel or pick up a new hobby, that cost will need to be factored in. Medical care is another large expense. Putting this all together, a common rule of thumb is that you will need 70-80% of your pre-retirement income per year during retirement, and that the yearly withdrawals should amount to no more than 4% of the account balance in your investment account.
- *Government benefits:* The U.S. government offers two programs to help retirees cover basic living needs and medical care — Social Security and Medicare. For most people, Social Security benefits do not provide enough income to retire comfortably. In planning your retirement budget, you can subtract your expected government benefits from your total budget to determine the amount you will need to have invested.
- **Inflation:** Ask retirees what a gallon of gas or a candy bar cost when they were your age, and you'll likely get a story about how little things cost "in their day." Costs typically increase over time due to inflation, and you'll need to budget accordingly.
- *Market fluctuation:* It's important to note that most retirement funds don't offer a guaranteed interest rate the way a savings account does. Instead, they are invested in vehicles like stocks and bonds, which fluctuate in value from year to year. It's important to consider the **risk** that you may lose money some years and budget accordingly.

Government Benefits Programs

As you know, Social Security and Medicare are funded through payroll taxes. Each year that you work and pay into these programs, you earn credits: For every $1,320 you earn (as of 2018), one credit is awarded. Workers can earn up to 4 credits per year and must have at least 40 credits in order to receive benefits. These credits are also used to determine the amount of your benefit, up to a maximum amount. For workers retiring in 2018, the maximum benefit is $2,788 for a worker retiring at full retirement age.

Throughout your working years, you will receive an annual statement that lists how much you've earned and paid into Social Security and Medicare, along with an estimate of your future benefit. This estimate is based on the assumption that you will continue to earn a consistent annual income for the rest of your working years.

Workers who are eligible to receive Social Security can begin to do so once they reach age 62 or greater, with full retirement benefits available once you reach age 67. You also have the option to wait until age 70 for an even larger monthly benefit. Look at the chart below and note the difference in monthly benefit based on age of retirement.

It is important to note that these numbers are just an estimate, not a guarantee. Each year, annual benefits are reviewed for a **Cost of Living Adjustment** (COLA) and may be increased based on the **Consumer Price Index**, which is used to measure inflation. But laws governing Social Security can change at any time. As of 2018, the Social Security Administration expects that its funds will be depleted by 2034. Workers who retire after that time will still be eligible, but their total benefit may be greatly reduced, or the management of the program may be altered.

Your Estimated Benefits

***Retirement** You have earned enough credits to qualify for benefits. At your current earnings rate, if you continue working until...
your full retirement age (67 years), your payment would be about .... $ 1,840 a month
age 70, your payment would be about .... $ 2,294 a month
age 62, your payment would be about .... $ 1,268 a month

***Disability** You have earned enough credits to qualify for benefits. If you became disabled right now, your payment would be about .... $ 1,664 a month

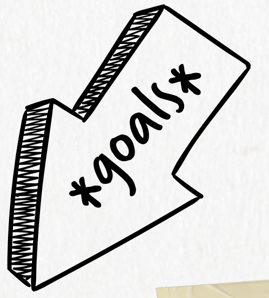
***Family** If you get retirement or disability benefits, your spouse and children also may qualify for benefits.

***Survivors** You have earned enough credits for your family to receive survivors benefits. If you die this year, certain members of your family may qualify for the following benefits:
Your child .... $ 1,284 a month
Your spouse who is caring for your child .... $ 1,284 a month
Your spouse, if benefits start at full retirement age .... $ 1,712 a month
Total family benefits cannot be more than .... $ 3,176 a month
Your spouse or minor child may be eligible for a special one-time death benefit of $255.

Medicare You have enough credits to qualify for Medicare at age 65. Even if you do not retire at age 65, be sure to contact Social Security three months before your 65th birthday to enroll in Medicare.

* **Your estimated benefits are based on current law. Congress has made changes to the law in the past and can do so at any time. The law governing benefit amounts may change because, by 2034, the payroll taxes collected will be enough to pay only about 79 percent of scheduled benefits.**

We based your benefit estimates on these facts:
Your date of birth (please verify your name on page 1 and this date of birth) .... April 5, 1978
Your estimated taxable earnings per year after 2018 .... $50,041
Your Social Security number (only the last four digits are shown to help prevent identity theft) XXX-XX-1234



Social Security is the single largest employee benefit plan in the U.S. The government relies on actuaries to monitor and evaluate the cost impact of proposals related to Social Security in addition to reviewing the soundness of the balance between the benefits obligations being built up and the Social Security taxes being collected. Actuaries spend a great deal of time researching short-term and long-term demographic and economic trends, analyzing mortality and morbidity rates, and preparing reports and special studies on the financial aspects of the Social Security system that are of concern to the Congress and the general public.

Activity 1

PART 1: STARTING EARLY

To avoid playing catch-up, and still have enough money to live comfortably after you stop working, it is critical to put money aside *now*. To see this in action, consider the case of the Three Friends.

Three high school friends each put $200 a month into their retirement investment accounts. Assume that each account has an annual interest rate of 7%, compounded annually, and that each of the friends plans to retire at age 65.

- Friend A starts investing at age 25.
- Friend B starts at age 35.
- Friend C starts at age 45.

1. How much will each of the friends have saved when they are ready to retire at age 65? Use the compound interest calculator at www.investor.gov/additional-resources/free-financial-planning-tools/compound-interest-calculator to find out.

   A: $______________ B: $_____________ C: $_____________

2. How much would C have to invest each month in order to have the same ending balance as A? Use the savings goal calculator at www.calcxml.com/do/savings-goal-calculator-how-much to find out.

   $______________

3. Assuming C has an after-tax salary of $75,450 per year with monthly fixed expenses totaling $3,000, how much would this high level of retirement saving leave him/her for variable expenses and spending money?

   $______________

4. Imagine that B falls ill at age 60 and decides to retire early. Would he/she have enough in retirement savings to live comfortably? Use the compound interest calculator to find out how much B will have saved up by age 60. Then assume that B will receive an income of $1,300 per month from Social Security and plans to withdraw 4% of the retirement account balance each year.

   B's retirement savings at age 60: $______________

   B's annual income after retirement at age 60: $______________

   Do you think this is enough income to live comfortably? Why or why not?

   ____

   ____

   ____

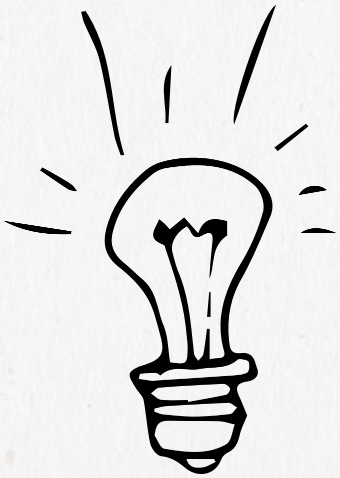
Activity 1

PART 2: ADD IT UP

To determine how much you should start saving today in order to afford the lifestyle you want in retirement, you'll need to create a budget and work backwards. Use this chart to practice.

Retirement Planning Practice	
1. Determine your annual budget. Assume you will need $65,000 per year to live on.	$
2. Calculate what you expect to get annually from Social Security. Assume you will receive the average benefit, which is $1,404 per month.	$
3. Deduct Line 2 from Line 1	$ 0.00
4. Many experts suggest that 4% is a reasonable amount to take out of your retirement account per year. Using this guideline, calculate what your account balance needs to be the year you retire. (Line 3 ÷ .04)	$ 0.00
5. Use a calculator to find out how much you would need to save per year (excluding interest) to reach that total by age 67, if you start saving:	
40 years before retirement	$
30 years before retirement	$
20 years before retirement	$

Once you have begun working and paying into Social Security, you can check your expected benefit on the Social Security Administration's website at www.ssa.gov/benefits/retirement/estimator.html. Keep in mind that this is just an estimate, and can change over time.



Investing for Retirement

Once you've established when and how much to invest for retirement, you'll need to consider *how*. Start by exploring the different types of investment accounts specially designed to encourage retirement saving.

Individual Retirement Accounts (IRA)

Many people select **Individual Retirement Accounts (IRAs)**, which offer valuable tax benefits. There are several types of IRAs, but the most popular are the Traditional and the Roth.

- A traditional IRA is **tax-deferred**, meaning you don't pay taxes on the money you put into it. When you begin withdrawing money from the account during retirement, you will pay taxes on the money that you take out. This can be beneficial if you expect your tax rate to be lower in retirement than while you are working.
- With a **Roth IRA**, you pay taxes on the money you put into it, but the money you take out is not taxed. This can be beneficial if you plan to invest for a long period of time and accrue a large amount of interest, or have a high retirement income.

With both traditional and Roth IRAs, the government limits the amount of money that can be contributed to the account each year. Depending on the age of the investor, this can range from a total annual contribution of $5,500 to $6,500 (as of 2018).

Since IRAs are designed to encourage long-term investing, people with these types of accounts are generally not allowed to withdraw their money until they reach the age of 59½. If funds are withdrawn before this time, significant penalties and taxes are imposed.

Employer-Sponsored Accounts

Many employers offer a **401(k)** or **403(b)** investment option to their employees, which provides another way to save money tax-deferred. Non-profit organizations such as schools, hospitals, and religious groups typically offer the 403(b) option, while traditional, for-profit employers usually offer a 401(k). Both options usually offer a choice of investments, such as mutual funds, stocks, and bonds. Those who want to minimize risk can usually choose a fixed interest rate investment, which allows employees to know exactly how much interest they will earn, although the rate is typically lower than riskier alternatives.

Some companies "match" employee contributions to 401(k)/403(b) accounts. This may be a percentage or dollar match established by company policy. For example, the employer may contribute one dollar for every dollar the employee invests in the plan up to $1,000, or up to a fixed percentage of the employee's salary. Taking advantage of these employer-matching opportunities is an excellent way for employees to build extra money for their retirement.

Pensions

A few employers may offer employees a **pension** plan. These are traditionally found in union-based industries, such as police departments and the shipping industry. A pension plan is not an investment option but a financial commitment the employer makes to its employees as a retirement benefit. The amount paid to the employee from a pension can vary greatly and is usually a percentage of the employee's annual salary. While pensions offer employees guaranteed income for life, the amount can be small and, if the company has financial difficulty meeting its obligations to the pension plan, the pension can be reduced or eliminated. Nonetheless, where available, pension plans offer a valuable retirement benefit.

Activity 2

RETIREMENT READINESS

Practice choosing how to invest in your retirement, whether through an employer-sponsored program or independently, as you read the scenarios below and answer the questions.

Scenario 1: You are investing $4,000 per year in a 401(k) and you have a 30% annual employer match.

- What formula could you use to add up both your deposit and your employer's match?
  ____
- Over the course of 5 years, you invest $20,000. How much does your employer invest?
  $______________
- If your employer offered a match of $1,000 per year instead of 30%, which would be a better option?
  ____
  Would that always be true? ______________________________

Scenario 2: You have accepted a job offer and are excited to take advantage of compound interest by investing immediately in a retirement fund. You are 25, have an annual starting salary of $31,000, and there are two plans you are considering:

- Your employer offers a 401(k) account that averages 4% annual interest. This account is tax-deferred and your employer will match 50% of your annual contribution to the account.
- You also found a Roth IRA that you really like because its average annual interest rate is 4.25%, but your employer would not match investments in this account. Deposits into this account are taxed, but you would not pay tax on the final distributions.

Use the compound interest calculator at www.investor.gov/additional-resources/free-financial-planning-tools/compound-interest-calculator to calculate how much your account will grow if you contribute $1,200 per year into each of the retirement account options for the next 10 years.

1. What will the total value of each account be at the end of the 10-year period?
   a. 401(k): $______________
   b. IRA: $______________
2. If you continue depositing this same amount into each account throughout your working years, what will be the total value of each account when you retire at 65?
   a. 401(k): $______________
   b. IRA: $______________