

# Opening the Door to Retirement

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*Successfully Transitioning  
from the Workforce  
into Retirement*

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by Ray E. LeVitre, CFM

## **Opening the Door to Retirement**

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## **DEDICATIONS**

Dedicated to God who has blessed me with life, experience, opportunities, abilities and the desire to live a little bit better each day. I believe that God truly inspires us with thoughts and ideas to help us succeed on our life's journey.

Dedicated to my wife, Jana, whom I deeply love and adore. I love her for her never failing support and unwavering confidence in me. Without her constant willingness to endure my often overzealous, entrepreneurial spirit, this book would never have come to fruition. Jana, thanks for believing with me that even the loftiest goals can be achieved and for making me want to be better than I am.

## **SPECIAL ACKNOWLEDGMENTS**

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*Eugene Banks* – Because you hired me and gave me the opportunity to work for the largest brokerage company in the world, I owe much of what I have learned in the financial services industry to you.

*My Clients* – A special thanks to each of you for placing so much trust in me as your financial advisor and for giving me the opportunity to help you develop a strategy to reach your financial goals. The strategies outlined in *Opening the Door to Retirement* are a culmination of my experience in working to develop fundamentally sound solutions to your unique financial situations.

And finally, I would like to thank the many companies that have invited me onto their corporate campuses and into their work sites to teach their employees how to manage a retirement plan distribution and develop a solid investment strategy.

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## INTRODUCTION: WHY YOU SHOULD READ THIS BOOK

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*Successfully Transitioning from  
the Workforce into Retirement*

Look into the future for a moment and imagine yourself on the day you retire. Will it be a day of joy or one that you don't quite feel ready for financially? Are you currently dreading the thought of it, or are you longingly dreaming about it? How well will you be prepared for the life that begins the day you give notice and leave your full-time working years behind?

If you're getting ready to retire in the near future, the pressure is on to make the right financial choices with your retirement money. The decisions you make at this critical juncture will profoundly affect your financial security and your lifestyle for the next 25 to 30 years.

Enormous amounts of money are riding on your decisions. To date, Americans have amassed over \$2.7 trillion in various types of qualified retirement plans<sup>2</sup> and assets in 401(k) plans alone have almost tripled since 1993.<sup>3</sup> Over 42 million people participate in 401(k) plans. The amount of money in transition is staggering. For example in 2001, for every dollar contributed to a 401(k) plan, 83 cents was distributed to job changers and retirees.<sup>5</sup> About \$200 billion of the money exiting corporate plans is rolled into IRA's each year.<sup>6</sup> These withdrawals are expected to soar to over \$600 billion by 2005 as the baby boomers begin to retire.<sup>7</sup>

Because so much money is at stake and many of your financial decisions are going to be irrevocable, now is the time to prepare yourself to handle the many challenges you face. *Opening the Door to Retirement* will help you successfully transition into retirement. It examines the critical decisions you will have to make about your money when deciding to end a full-time working career. It will also help you evaluate your current financial situation and do some critical planning for the future.

*Opening the Door to Retirement* is intended to be a guide book and is not necessarily meant to be read chapter by chapter. Each of the five parts of the book explain various components of retirement planning, investment options and retirement plan distribution strategies. As you read, focus on those sections and chapters that are most pertinent to you at this particular time in your life — use the other chapters as a reference. For those about to retire or who have already quit working, you will find the whole book extremely useful and may want to read each chapter in the

## OPENING THE DOOR TO RETIREMENT

order it is presented.

Part 1, Retirement Planning, will help you assess what your current retirement situation looks like and determine whether you are on track to meet your retirement goals. This section also outlines the importance of having a *written* comprehensive financial plan, how to determine a safe withdrawal rate, and what to do if you plan to retire early.

In Part 2, Sources of Retirement Income, we'll explore the issues surrounding Social Security, teach you how to maximize your company pension benefits and how to avoid the most common investor mistakes so that you can be sure not to sabotage your most important retirement income source: your investment portfolio.

Part 3 covers important investment planning techniques. After all, reaching your retirement goals will depend largely on how successful you are as an investor. This section deals primarily with how to develop successful investment strategies, including asset allocation, proper portfolio diversification, choosing investments, ongoing portfolio management, how to protect principal while investing in the stock market, and how to handle company stock positions.

Other retirement issues, such as health and long-term care insurance, are covered in Part 4. Without these safeguards in place, you could prematurely deplete all of your hard-earned assets. This section will teach you how to evaluate how much insurance you may need and when to purchase it.

Part 5 is intended to be a retirement plan distribution guide. This section deals primarily with the issues and choices facing people who, at retirement, take a distribution from an employer-sponsored retirement plan. Before making any decisions about your money, be sure to reference this section for a very detailed analysis of your retirement options.

*Opening the Door to Retirement* explains, in basic terms, highly complex financial concepts that you need to understand in order to make appropriate choices. Use it as a comprehensive information source on retirement planning and successful money management techniques. *Opening the Door to Retirement* is an important resource that can help you build a financial strategy to guide you toward the retirement lifestyle you deserve.



# Opening the Door to Retirement

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## **PART 1**

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### **RETIREMENT PLANNING**

- 1 RETIREMENT PLANNING: ARE YOU ON TRACK?**
- 2 IMPORTANCE OF A COMPREHENSIVE FINANCIAL PLAN**
- 3 DETERMINING A "SAFE WITHDRAWAL RATE"**
- 4 EARLY RETIREMENT STRATEGIES (PRIOR TO AGE 59<sup>1/2</sup>)**

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## CHAPTER 1

# RETIREMENT PLANNING: ARE YOU ON TRACK?

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When it comes to retirement planning, too many people face a reality gap. According to a recent study of American workers and retirees, 70 percent were confident they would have enough money to live comfortably during retirement. Yet that same survey revealed that only 39 percent would actually have enough money saved to enjoy the kind of retirement lifestyle they envision.<sup>1</sup>

- Are you on track to reach your retirement goals?
- How much money do you need to accumulate in your savings nest egg to generate enough retirement income to last for 20, even 30 years?
- How well have you prepared for the life that begins the day you give notice and leave your full-time working years behind?

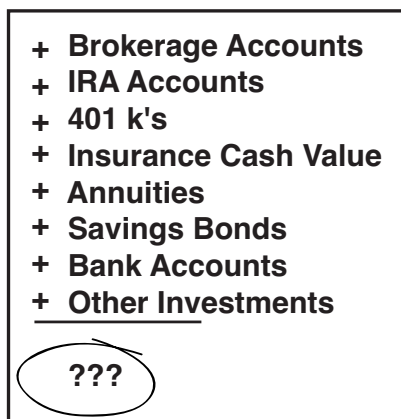
Answering these questions is vitally important. That's why this book begins with a chapter designed to help you take a good hard look at your overall retirement situation. It will help you evaluate where you are now and whether you are

on track to get where you want to go in the future by asking questions about your short-term and long-term goals.

To answer these questions, you will first need a target. What is your retirement goal? When you add up all your financial assets on the first day of retirement (see Figure 1), what does your portfolio need to total in order for you to reach your retirement target? How far are you from that goal?

Of course, the amount needed at retirement differs for everyone and ultimately hinges on your answers to the following questions:

FIGURE 1



## OPENING THE DOOR TO RETIREMENT

- When will you retire?
- What is your current income?
- What percentage of your current income will you need each year during retirement?
- How long do you estimate you will be in retirement?
- What will your income sources be during retirement?
- What will be the rate of return on your investment assets during retirement?
- What impact will inflation have on your retirement goals?

The best way to see if you're on track is to obtain a retirement analysis which is one critical component of your comprehensive financial plan (see Chapter 2). In order to develop a retirement analysis and see if your numbers add up sufficiently to meet your goals, you will need to answer the questions asked throughout this chapter. A case study (Ron and Linda Hansen) has been included with each question to help you evaluate your own retirement situation.

### WHEN DO YOU PLAN ON RETIRING?

The average American retires at age 63.<sup>2</sup>

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Worksheet Question #1:

At what age do you plan on retiring? \_\_\_\_\_

Case Study: Ron and Linda Hansen, age 50, plan on retiring at age 60.

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### WHAT IS YOUR RETIREMENT INCOME NEED?

As a general rule, most financial planners suggest having approximately 70 to 80 percent of your pre-retirement gross income in order to maintain your current standard of living. This, of course, can vary widely depending on your individual situation.

During retirement you will pay less taxes, save less, spend less on your children, and have less of a mortgage burden than you did while working. Consequently, you will be able to live on less money and maintain the same lifestyle. A person who earned \$100,000 during their working years can live on \$70,000 to \$80,000 during retirement (adjusted for inflation). Of course, a more detailed analysis of your spending habits will yield a more accurate picture of your retirement income needs.

## CHAPTER 1 – RETIREMENT PLANNING: ARE YOU ON TRACK?

Be aware that some of your expenses will increase during retirement, even as others decrease. Figure 2 outlines some of the most common changes in spending during retirement.

FIGURE 2

Expenses likely to decrease	Expenses likely to increase
<ul style="list-style-type: none"> <li>• Home Mortgage</li> <li>• Commuting</li> <li>• Financial Responsibility for Children or Parents</li> <li>• Work-related Clothing</li> <li>• Education Expenses</li> <li>• Life Insurance</li> <li>• Savings</li> <li>• Income Taxes</li> </ul>	<ul style="list-style-type: none"> <li>• Healthcare</li> <li>• Travel</li> <li>• Second Home</li> <li>• Further Education</li> <li>• Hobbies/ Recreation</li> <li>• Second Career</li> </ul>

Also, the way you decide to spend your retirement years will have an impact on how much income you will need. How do you plan to spend your time? The following poll reflects the most common desires of retirees:

FIGURE 3

Poll Results	
How do you want to spend your "retirement" years?	
Go back to school	2.1% <input type="checkbox"/>
Travel the world	19.6% <input type="checkbox"/>
Pursue creative passions	16.7% <input type="checkbox"/>
Give back by volunteering	11.3% <input type="checkbox"/>
Sit home with my feet up	10.1% <input type="checkbox"/>
Spoil the Grandkids	4.2% <input type="checkbox"/>
Keep working (I love my job)	3.4% <input type="checkbox"/>
Keep working (I need the money)	9.1% <input type="checkbox"/>
Launch my own business	3.6% <input type="checkbox"/>
Start a second career	11.2% <input type="checkbox"/>
Other	8.4%

Source: [www.mygeneration.org](http://www.mygeneration.org)

## OPENING THE DOOR TO RETIREMENT

After deciding how you are going to spend your retirement years, you should consider some of the changes that may occur in your spending habits and prepare a realistic estimate of your annual retirement costs. Figure 4 shows a list of annual expenditures for the average American couple over age 65 (column 2). How your expenses match up to these figures depends on your lifestyle, family size and income.

In the column entitled, "Your Budget Now," estimate your current annual expenses. To make it easier, take your monthly expenses and multiply by 12. Then in the last column, "Your Retirement Budget," estimate what these costs would be if you were to retire today. This exercise will give you a rough idea of the expenses you will face during retirement.

FIGURE 4

Spending per year	Average Budget for a Married Couple 65+	Your Budget Now	Your Budget at Retirement
<b>Food</b>	\$7,333		
<b>Housing</b> (including rent/ mortgage, utilities, and furnishings)	\$16,348		
<b>Transportation</b>	\$10,214		
<b>Clothing</b>	\$2,520		
<b>Entertainment</b>	\$2,784		
<b>Personal Care</b>	\$541		
<b>Health Care</b>	\$2,200		
<b>Contributions</b>	\$1,201		
<b>Miscellaneous Family Consumption</b>	\$4,723		
<b>Insurance</b>	\$644		
<b>Social Security</b>	\$4,658		
<b>Total Spending for a Median Family in 1999</b>	<b>\$51,186</b>		

Source: Bureau of Labor & Statistics, 1999

## CHAPTER 1 – RETIREMENT PLANNING: ARE YOU ON TRACK?V

Have you considered where you're going to live after you retire? According to the American Association of Retired Persons, only one in ten Americans age 55 and over is interested in relocating when he or she retires. However, if you do plan to move to another city, you must adjust your estimated retirement spending depending on the cost-of-living differences from region to region. The cost of living, for example, in San Francisco, New York and other large cities is much greater than smaller cities like Twin Falls, Idaho, or Charlotte, North Carolina.

Use a cost-of-living index as an easy way to see how your new home will affect your living expenses. Many online sources provide this information, free of charge. For example, *www.homefair.com* is user-friendly and will perform all of the calculations for you.<sup>3</sup> Another option is the American Chamber of Commerce Research Association's index (see Figure 13 located at the end of this chapter). This is another source of valuable information. For example, if you live in Austin today and estimate your annual retirement income needs at \$100,000, the index shows that you will need \$121,900, or 21.9 percent more income to maintain that same standard of living in San Diego. These facts can be determined by performing a relatively simple calculation, using the table in Figure 13. Find the number listed next to the city where you plan to live at retirement, then subtract that number from the one listed next to the city where you currently live. The result will be the cost of living change, in percentage points.

For example, let's assume you plan on moving from Denver (105.3) to Palm Springs (116.3). By performing the calculation, you can see that living in Palm Springs will cost approximately 11 percent more than living in Denver ( $116.3 - 105.3 = 11$ ). So, if you planned on retiring on \$75,000 per year, you will need to increase this by 11 percent, or \$8,250 per year, to account for higher prices in Palm Springs.

---

Worksheet Question #2:

What is your annual retirement income goal? \_\_\_\_\_

Case Study: The Hansen's retirement income goal is \$75,000/year (today's \$).

---

### HOW MANY YEARS WILL YOU BE IN RETIREMENT?

Most financial planners assume people will spend 20 to 25 years in retirement, roughly until age 85. These assumptions are based on average life expectancies (see Figure 5). For example, a man who is currently age 65 can expect to live to age 81,

## OPENING THE DOOR TO RETIREMENT

FIGURE 5

<b>Single Life Expectancy</b>			
<b>Male</b>		<b>Female</b>	
<b>Age</b>	<b>Life Expectancy</b>	<b>Age</b>	<b>Life Expectancy</b>
50	27.7	50	31.7
55	23.5	55	27.3
60	19.6	60	23.1
65	16.1	65	19.1
70	12.8	70	15.4
75	10.0	75	12.1
80	7.5	80	9.1
85	5.5	85	6.6
90	4.1	90	4.8
95	3.0	95	3.5
100	2.4	100	2.7

Source: National Vital Statistics Report, 2002

while a 65-year-old woman can expect to reach age 84.

However, in your individual retirement planning, you may want to adjust these assumptions upward to account for any history of longevity in your family. You will also want to be conservative in your planning. In most cases, even though your family may have a history of shorter life spans, plan to be in retirement no less than the number of years listed in Figure 5. It is better to plan on a long retirement than a short one and outlive your money.

There are twice as many people — 70,000 in all — over age 100 today than there were just a decade ago. By 2050, it's estimated that over 1.1 million people in the U.S. will be over age 100. And these figures grow closer to obsolescence every day. That's because people are living much longer due to advances in science, medicine, and nutrition.

Longer life expectancies present a dilemma in developing your retirement plan. Let's assume you and your spouse are planning to retire at age 65. If you assume that you will be in retirement for 35 years, until you reach age 100, you may have to settle on a dramatically-reduced level of income in order to make your nest egg stretch for so many years. However, if you assume you will only be in retirement until age 80 or 85, as mortality tables suggest, and you or your spouse live to age 100, you run the risk of spending too much in the early years of retirement and running out of money later. In fact, some people will spend more years in retirement than they did in the labor force. Consider the example of Anne Scheiber — Anne retired from her \$3,150-per-year, IRS auditor job in 1943 and passed away in 1995 at the age of 101. She spent over 52 years in retirement.<sup>4</sup>

## CHAPTER 1 – RETIREMENT PLANNING: ARE YOU ON TRACK?

So, how do you plan to optimize your chances of making your money last?

Much like the investment decisions you have made, you must decide if you want to be a little more aggressive or a little more conservative in your planning. It is better to err on the conservative side. This can best be accomplished by adding at least five years to the life expectancy figures in Figure 5. For example, a married couple retiring this year, both age 65, should add five years to the life expectancies in Figure 5 when doing their retirement planning. Consequently, this hypothetical couple should plan to be in retirement for 24 to 25 years (19.1 years in the table, plus five) or until they reach age 90.

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Worksheet Question #3:

How long do you plan on being in retirement? \_\_\_\_\_

Case Study: Ron and Linda are planning for 30 years in retirement.

---

### **WHAT SOURCES OF INCOME WILL YOU HAVE DURING RETIREMENT?**

Now, let's take an inventory of your retirement income sources. For this exercise, exclude any income that you will derive from investments during retirement. Will any of these sources of income be adjusted each year for inflation? For example, Social Security has a cost-of-living adjustment. Your company pension may or may not adjust annually for inflation. If you own rental property, most likely you will increase the rents periodically to keep pace with inflation. This is an important element to factor into your retirement planning.

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Worksheet Question #4:

What sources of income will you have during retirement? Complete the worksheet in Figure 6 to total your anticipated retirement income sources.

Case Study: The Hansen's are anticipating retirement income of \$30,000 from the income sources outlined in Figure 6.

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### **INFLATION**

Simply put, inflation is a measure of the annual increase in the costs of goods and services. It's an unavoidable fact that the price of things you need in life will go up over time. During the past 70 years, inflation has averaged about 3 percent



## OPENING THE DOOR TO RETIREMENT

FIGURE 6

<b>Sources of Income Worksheet</b>		
<b>Annual Income Sources</b>	<b>\$</b>	<b>Inflat. Adj. %</b>
Your Social Security	_____	_____
Your spouse's Social Security	_____	_____
Your pension	_____	_____
Your spouse's pension	_____	_____
Rental income	_____	_____
Income from continued work	_____	_____
Other income	_____	_____
Other income	_____	_____
Total	_____	_____
Total income sources (excluding investments)	_____	_____

per year, as it has since 1989 (Figure 7). However, during the past 30 years, inflation has averaged 5 percent. There have also been times when the U.S. economy experienced double-digit inflation, such as the period from 1977 to 1981, when inflation averaged a whopping 10 percent.<sup>5</sup>

If you fail to factor inflation into your retirement planning, you'll find prices rising while your income remains level, and eventually you'll be forced to lower your standard of living or deplete your assets. A fixed income in a rising-cost world is slow financial suicide. In Figure 8, you can see how the costs of various products and services have increased over time and what they could cost in the future if they continue on the same inflationary course.

Of course, you don't know what the inflation rate will be during your retirement, so you must make assumptions. Here again, you have a choice between aggressive planning, in which you optimistically assume a lower inflation rate

FIGURE 7

<b>Inflation Since 1989</b>	
<b>1989</b>	<b>4.65%</b>
<b>1990</b>	<b>6.11%</b>
<b>1991</b>	<b>3.06%</b>
<b>1992</b>	<b>2.90%</b>
<b>1993</b>	<b>2.75%</b>
<b>1994</b>	<b>2.68%</b>
<b>1995</b>	<b>2.54%</b>
<b>1996</b>	<b>3.32%</b>
<b>1997</b>	<b>1.70%</b>
<b>1998</b>	<b>1.61%</b>
<b>1999</b>	<b>2.68%</b>
<b>2000</b>	<b>3.39%</b>
<b>2001</b>	<b>1.55%</b>
<b>2002</b>	<b>2.60%</b>

Source: CPI

## CHAPTER 1 – RETIREMENT PLANNING: ARE YOU ON TRACK?

FIGURE 8

Cost of Living Comparison (1900-1997)							
Year	House	Car	Milk	Gas	Bread	Postage	Income
1900	\$4,000	\$500	\$.30	\$.05	\$.03	\$.02	\$637
1910	\$4,800	\$500	\$.33	\$.07	\$.05	\$.02	\$963
1920	\$6,396	\$500	\$.58	\$.10	\$.11	\$.02	\$1,179
1930	\$7,146	\$525	\$.56	\$.10	\$.08	\$.02	\$1,428
1940	\$6,558	\$810	\$.51	\$.15	\$.08	\$.03	\$1,231
1950	\$14,500	\$1,750	\$.82	\$.20	\$.14	\$.03	\$3,216
1960	\$30,000	\$2,275	\$1.04	\$.25	\$.20	\$.04	\$5,199
1970	\$40,000	\$2,500	\$1.32	\$.40	\$.24	\$.06	\$8,933
1980	\$86,159	\$5,412	\$1.60	\$1.03	\$.48	\$.15	\$11,321
1990	\$128,732	\$9,437	\$2.15	\$1.08	\$1.29	\$.25	\$14,777
1997	\$119,250	\$13,600	\$2.41	\$1.11	\$1.62	\$.32	\$20,788
Average	House 3.56%	Car 3.46%	Milk 2.17%	Gas 3.25%	Bread 4.19%	Postage 2.90%	Income 3.66%

Source: [www.seniorliving.about.com](http://www.seniorliving.about.com)

Where prices are headed if past inflation repeats itself.

Year	House	Car	Milk	Gas	Bread	Postage	Income
2010	\$187,912	\$21,163	\$3.18	\$1.68	\$2.76	\$.46	\$33,170
2020	\$266,609	\$29,737	\$3.94	\$2.31	\$4.16	\$.61	\$47,519
2030	\$378,264	\$41,785	\$4.89	\$3.18	\$6.27	\$.82	\$68,074

than the average, or more conservative planning, using a higher inflation rate assumption. Most financial planners assume a 3-4 percent rate in their planning.

If inflation remains at 3 percent during your retirement, you will need to increase your income by 3 percent each year in order to buy the same amount of goods and services you purchased the previous year. Essentially, you should give yourself a 3 percent raise each year in order to maintain your standard of living. For example, if you need \$75,000 in the first year of retirement, you will need \$77,250 the second year, \$79,567 the third year, and so forth to maintain your purchasing power. At this rate, in the 20th year of retirement, you will need \$131,512 to purchase the same items that can be bought with \$75,000 today. Figure 9 shows the impact of inflation during retirement.

## OPENING THE DOOR TO RETIREMENT

FIGURE 9

Year	Amount Needed	Year	Amount Needed
1	\$75,000	11	\$100,793
2	\$77,250	12	\$103,817
3	\$79,567	13	\$106,932
4	\$81,954	14	\$110,140
5	\$84,413	15	\$113,444
6	\$86,945	16	\$116,847
7	\$89,553	17	\$120,352
8	\$92,240	18	\$123,963
9	\$95,007	19	\$127,682
10	\$97,857	20	\$131,512

Equivalent of \$75,000 today assuming 3% annual inflation

Because of inflation, your investment portfolio must be structured to provide you with a rising income stream during retirement. This is especially critical if your pension or other sources of retirement income don't have built-in, cost-of-living adjustments.

---

Worksheet Question #5:

What inflation rate would you like to use in your planning? \_\_\_\_\_

Case Study: Ron and Linda are using a 3.5 percent rate.

---

### HOW MUCH SHOULD YOU ALREADY HAVE ACCUMULATED IN ORDER TO REACH RETIREMENT GOALS?

Do you currently have enough money set aside to be on track to reach your retirement goals? The chart in Figure 10 will tell you if you are in the ballpark. Simply multiply your current annual income by the factor that best represents your situation.

For example, if you are a "moderate investor" making \$100,000 per year and planning to retire in five years, you will need approximately 7.73 times your current annual income to maintain your pre-retirement standard of living during retirement. In order to reach this goal you will need to have \$773,000 already accumulated in your various investment accounts. This assumes you will spend 25 years in retirement, save 8 percent of your income each year prior to retirement, reduce your exposure to equities at retirement, experience 4 percent inflation, and exhaust all of your savings during retirement. (Figure 10 does not take Social Security or pensions into account.)

Alternatively, if you're an "aggressive investor" planning to retire in ten years and currently have a \$50,000 per year income, you would need to have accumulated \$231,500 by now to be on track, using the same assumptions as above.

## CHAPTER 1 – RETIREMENT PLANNING: ARE YOU ON TRACK?

FIGURE 10

Are You On Track?			
Years to Retirement	Aggressive Investor	Moderate Investor	Conservative Investor
0	9.57	10.46	11.48
5	6.75	7.73	8.90
10	4.63	5.58	6.76
15	3.07	3.93	5.05
20	1.93	2.68	3.69
25	1.09	1.72	2.61
30	.48	.98	1.74
35	.03	.42	1.05

Source: Wall Street Journal

### HOW MUCH DO YOU HAVE INVESTED?

How much do you currently have invested in stocks, bonds, cash, or other investments that you plan on using to finance your retirement? Are you on track?

Take an inventory of all your investments and group each into asset classes. The retirement computer programs used by professionals and those you can take advantage of personally will make interest rate assumptions for each investment you own.

Worksheet Question #6:

How much do you have invested? Complete the worksheet in Figure 11.

Case Study: The Hansen's have accumulated \$500,000.

Their portfolio consists of 65 percent stocks and 35 percent bonds.

### AT WHAT RATE WILL YOUR INVESTMENT PORTFOLIO GROW?

To determine if you are on track to reach your retirement goal, you must assign a reasonable rate of return to your portfolio. Forecast the rate of return you expect to achieve between now and retirement, and the return you anticipate after you begin retirement. In Chapter 11 we will examine, in more detail, the expected growth rates of various investment portfolios.

For our purposes here, let's keep it simple: Since 1925, stocks have averaged a 10.7 percent rate of return, bonds, 5.3 percent, and Treasury bills, 3.8 percent.

## OPENING THE DOOR TO RETIREMENT

FIGURE 11

<b>Retirement Accounts (IRA's 401k's, Profit Sharing Plans, Etc.)</b>			
Stocks or stock mutual funds	\$	_____	
Bonds or bond mutual funds	\$	_____	
Cash Equivalents	\$	_____	
<b>Non-Retirement Accounts</b>			
Stocks or stock mutual funds	\$	_____	
Bonds or bond mutual funds	\$	_____	
Cash Equivalents	\$	_____	
<b>Total Investment Assets (retirement and Non-Retirement Assets)</b>			
Stocks or stock mutual funds	\$	□□□□ _____	_____ %
Bonds or bond mutual funds	\$	□□□□ _____	_____ %
Cash Equivalents	\$	□□□□ _____	_____ %
Total	\$	□□□□ _____	<b>100</b> %
<b>What is the sum of all of your investment assets \$ _____?</b>			
<b>What percent of your portfolio is invested in stocks, bonds, and cash?</b>			
Stocks	_____	%	
Bonds	_____	%	
Cash	_____	%	

Figure 12 illustrates how different mixes of stocks, bonds, and cash performed, on average, from 1926 through 2001. Which portfolio most resembles your own? What is the expected rate of return? Now you need to ask the most important question: If your investments grow at this rate, will you reach your retirement goals? Developing a retirement analysis will answer this question.

You may find yourself behind in your retirement savings. If this is the case, you may need to reposition your investments to improve your long-term rate of return, save much more aggressively, or reduce your retirement income goal. If you are

## CHAPTER 1 – RETIREMENT PLANNING: ARE YOU ON TRACK?

FIGURE 12

Asset Allocation (Annual Returns 1926-2001)	
% Stocks/Bonds/Cash	Average Return
90/0/10	11.77%
80/10/10	11.06%
70/20/10	10.34%
60/30/10	9.63%
50/40/10	8.91%
40/50/10	8.19%
30/60/10	7.48%
20/70/10	6.76%
10/80/10	6.04%
0/90/10	5.04%

Source: Ibbotson and Associates

ahead of the game and don't need to seek a high rate of return, you may want to reposition your investments more conservatively. Why take additional and unnecessary risk if you are able to reach and exceed your goals without that risk?

What will your investment returns be during retirement? Most investors reposition assets during retirement in order to reduce risk. Although

a 7-10 percent rate of return is possible, it is recommended that you remain conservative in your planning and assume a rate no higher than 7 percent per year.

---

### Worksheet Question #7:

At what rate do you expect your investment portfolio to grow *between* now and retirement? \_\_\_\_\_

At what rate do you expect your investment portfolio to grow *after* retirement? \_\_\_\_\_

Case Study: Ron and Linda expect their portfolio to grow at a rate of 9 percent before retirement and 7 percent during retirement.

---

### HOW MUCH SHOULD YOU BE SAVING EACH YEAR TOWARD YOUR RETIREMENT?

Hopefully you answered this question many years ago and have been saving aggressively toward retirement.

As a general rule, you should save no less than 10 percent of your gross income toward retirement; if married, 10 percent of your combined income. In most cases, you should work toward saving 15 percent. To accomplish this goal, control your expenses and strive to live within your means. The recent best-selling book, "The Millionaire Next Door," outlines characteristics of America's millionaires. The

## OPENING THE DOOR TO RETIREMENT

book's authors, Thomas Stanley and William Danko, conclude that the reason most millionaires accumulated so much wealth was due to their high savings rate and ability to live within their means.

How much would you guess the average American saves per year? Unbelievably the average savings rate is just over 1 percent of gross income. This is obviously far less than what is needed to enjoy a comfortable retirement. To be a good saver, you need discipline and consistency. The best way to do this is to set up a systematic savings plan, and have money drawn directly out of your bank account or paycheck and deposited into an investment account on at least a monthly basis.

Here's a simple rule: If you can't get your hands on it, you won't spend it. That's why company-sponsored retirement plans work so well, because the money is invested even before you receive your paycheck.

---

Worksheet Question #8:

How much of your income (combined income, if married) are you currently saving each year? \_\_\_\_\_

Case Study: The Hansens save 10 percent of their income, or \$10,000 per year.

---

### **WOULD YOU LIKE TO LEAVE AN INHERITANCE TO YOUR FAMILY OR A CHARITY?**

It's natural to want to leave an estate to your heirs, or to an organization or cause about which you care deeply. Be sure to incorporate this into your retirement planning. Determine how much you wish to leave; this is the amount of your financial portfolio you will not spend during retirement.

---

Worksheet Question #9:

How much of your total investment portfolio (financial assets) would you like to leave to your heirs or a charity? \_\_\_\_\_

Case Study: Ron and Linda are not planning to leave an estate to their heirs.

---

## CHAPTER 1 – RETIREMENT PLANNING: ARE YOU ON TRACK?

### SUMMARY OF RON AND LINDA HANSEN'S CASE STUDY

How did Ron and Linda do?

- Ron and Linda, both currently age 50, are planning to retire in ten years.
- They need \$75,000 per year of retirement income (in today's dollars).
- They will need this income for 30 years of retirement.
- They are expecting income from various sources to provide them with \$30,000 per year leaving a \$45,000 annual shortfall. This shortfall will have to be made up from their investment assets.
- They have accumulated a \$500,000 investment portfolio made up of 65 percent stocks, 35 percent bonds.
- They save \$10,000 per year.
- They've assumed an inflation rate of 3.5 percent per year and are anticipating their investments will grow at 9 percent annually between now and retirement, with a 7 percent growth rate assumed during retirement.

Based on these figures and assumptions, Ron and Linda are on track to reach their goal. In fact, if they choose, they could retire even earlier than planned, as early as age 58.

### **ARE YOU ON TRACK TO REACH YOUR RETIREMENT GOALS? LET'S CRUNCH THE NUMBERS.**

Okay, now you have all the information you need to determine if you're on track to reach your retirement goals. There are a couple of ways to crunch the numbers.

The first involves simple linear equations in which you assume a constant rate of return on your investments throughout retirement. This approach is easy and works well, as long as you assume a conservative rate of return and you still have ten or more years until retirement. If you are investing for the long-term, chances are you will enjoy a rate of return that is close to the long-term averages.

The second is a little more complex. It involves probability calculations to determine the chances of reaching your goals, given the fact that rates of return will fluctuate from year to year during retirement. This approach is referred to as Monte Carlo analysis and is more appropriate for those on the immediate verge of retirement and those already retired, who do not have as many years to invest and who could be devastated by an unexpected and extended market downturn. Monte Carlo analysis will provide a more accurate view of whether or not you are on track,



## OPENING THE DOOR TO RETIREMENT

given the returns produced by hundreds of differing market conditions.<sup>6</sup>

Financial advisors have access to planning tools and software that can take into account the many variables that will change during retirement. These factors can include a spouse who plans to work several years after you retire, changes in tax rates, the impact of inflation on some income sources (which doesn't affect others), and different interest rate assumptions for each of your investment assets.

If you have a large asset base or if your financial situation is more complex, it is highly recommended that you seek the counsel of a professional financial advisor to develop a retirement analysis. Otherwise, you can simply utilize one of the many retirement calculators on the Internet — go to any search engine and type in key words like “retirement calculator” or “retirement worksheet.” Whether you decide to work with a financial advisor or develop a retirement plan on your own, you will need the answers to the questions asked throughout this chapter to complete your retirement analysis. Following is a sampling of some Web sites that offer easy-to-use retirement planning calculators:

- Quicken: [www.quicken.com/retirement/planner/](http://www.quicken.com/retirement/planner/)
- Smart Money: [www.smartmoney.com/retirement/planning/](http://www.smartmoney.com/retirement/planning/)
- Kiplinger: [www.kiplinger.com/tools/retcalc2.html](http://www.kiplinger.com/tools/retcalc2.html)
- NASD: [www.nasdr.com/retirement\\_calc.asp](http://www.nasdr.com/retirement_calc.asp)
- T. Rowe Price: [www.troweprice.com](http://www.troweprice.com)
- U.S. News: [www.usnews.com/usnews/nycu/money/morecal.html](http://www.usnews.com/usnews/nycu/money/morecal.html)

Now back to the burning question: Are you on track to reach your retirement goals? If not, you may need to save more money each year, adjust your investment portfolio to obtain better returns, retire later, or retire with less than you had originally planned.

Determining if you are on track to reach your retirement goals depends on how honest you are with yourself in answering the important questions posed in this chapter. It also requires a long-term “big picture” view of your overall financial situation. Having the courage to look at where you are today and where you need to be in the future will go a long way to making your retirement all that it should be.

## CHAPTER 1 – RETIREMENT PLANNING: ARE YOU ON TRACK?

FIGURE 13 • Average City 100.0

<p style="text-align: center;"><b>AL</b></p> <ul style="list-style-type: none"> <li>• Birmingham 99.1</li> <li>• Huntsville 95.2</li> <li>• Mobile 91.8</li> <li>• Montgomery 92.4</li> </ul> <p style="text-align: center;"><b>AK</b></p> <ul style="list-style-type: none"> <li>• Anchorage 125.9□</li> <li>• Juneau 136.2</li> </ul> <p style="text-align: center;"><b>AZ</b></p> <ul style="list-style-type: none"> <li>• Phoenix 99.9□</li> <li>• Scottsdale 103.1□</li> <li>• Tucson 99.7□</li> </ul> <p style="text-align: center;"><b>CA</b></p> <ul style="list-style-type: none"> <li>• Bakersfield 106.1</li> <li>• Fresno 105.8□</li> <li>• LA/Long Beach 122.0</li> <li>• Palm Springs 116.3</li> <li>• Sacramento 114.0</li> <li>• San Diego 122.8</li> <li>• San Francisco 144.7</li> </ul> <p style="text-align: center;"><b>CO</b></p> <ul style="list-style-type: none"> <li>• Boulder 108.5</li> <li>• Col. Springs 96.8</li> <li>• Denver 105.3</li> <li>• Pueblo 92.5</li> </ul> <p style="text-align: center;"><b>CT</b></p> <ul style="list-style-type: none"> <li>• Hartford 121.8</li> </ul> <p style="text-align: center;"><b>DE</b></p> <ul style="list-style-type: none"> <li>• Dover 101.5□</li> <li>• Wilmington 108.1</li> </ul> <p style="text-align: center;"><b>DC</b></p> <ul style="list-style-type: none"> <li>• Washington, DC 132.0</li> </ul>	<p style="text-align: center;"><b>FL</b></p> <ul style="list-style-type: none"> <li>• Ft. Myers 97.2</li> <li>• Jacksonville 95.4□</li> <li>• Miami/Dade Co. 104.5□</li> <li>• Orlando 97.0</li> <li>• Pensacola 93.6□</li> <li>• Tallahassee 100.1</li> <li>• Tampa 97.8</li> <li>• West Palm Beach 104.7</li> </ul> <p style="text-align: center;"><b>GA</b></p> <ul style="list-style-type: none"> <li>• Albany 90.5</li> <li>• Atlanta 97.4</li> <li>• Columbus 93.9</li> <li>• Macon 95.1</li> </ul> <p style="text-align: center;"><b>ID</b></p> <ul style="list-style-type: none"> <li>• Boise 102.7</li> <li>• Pocatello 99.8</li> <li>• Twin Falls 95.9</li> </ul> <p style="text-align: center;"><b>IL</b></p> <ul style="list-style-type: none"> <li>• Bloomington 101.4□</li> <li>• Chicago (suburb) 121.6□</li> <li>• Joliet 108.7</li> <li>• Quad Cities 97.5</li> <li>• Rockford 103.6</li> <li>• Schaumburg 123.3</li> <li>• Springfield 95.1</li> </ul> <p style="text-align: center;"><b>IN</b></p> <ul style="list-style-type: none"> <li>• Bloomington 98.6</li> <li>• Fort Wayne 93.3</li> <li>• Indianapolis 94.9</li> <li>• South Bend 90.9</li> </ul> <p style="text-align: center;"><b>IA</b></p> <ul style="list-style-type: none"> <li>• Cedar Rapids 100.7</li> <li>• Des Moines 94.7</li> <li>• Dubuque</li> </ul>	<p style="text-align: center;"><b>KS</b></p> <ul style="list-style-type: none"> <li>• Lawrence 95.1</li> <li>• Wichita 94.8□</li> </ul> <p style="text-align: center;"><b>KY</b></p> <ul style="list-style-type: none"> <li>• Lexington 95.9□</li> <li>• Louisville 92.8</li> </ul> <p style="text-align: center;"><b>LA</b></p> <ul style="list-style-type: none"> <li>• Baton Rouge 98.5</li> <li>• New Orleans 94.5</li> <li>• Shreveport 94.9</li> </ul> <p style="text-align: center;"><b>MD</b></p> <ul style="list-style-type: none"> <li>• Baltimore 102.3</li> <li>• Cumberland 102.0</li> </ul> <p style="text-align: center;"><b>MA</b></p> <ul style="list-style-type: none"> <li>• Boston 136.8</li> </ul> <p style="text-align: center;"><b>MI</b></p> <ul style="list-style-type: none"> <li>• Ann Arbor 115.1□</li> <li>• Grand Rapids 102.1□</li> <li>• Kalamazoo 108.6□</li> <li>• Lansing 102.9</li> </ul> <p style="text-align: center;"><b>MN</b></p> <ul style="list-style-type: none"> <li>• Minneapolis 99.7</li> <li>• Rochester 97.5</li> </ul> <p style="text-align: center;"><b>MS</b></p> <ul style="list-style-type: none"> <li>• Jackson 94.3</li> <li>• Laurel 90.7</li> </ul> <p style="text-align: center;"><b>MO</b></p> <ul style="list-style-type: none"> <li>• Columbia 93.1</li> <li>• Kansas City 96.1</li> <li>• St. Louis 97.4</li> <li>• Springfield 94.5</li> </ul>
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Source: American Chamber of Commerce Research Association

## OPENING THE DOOR TO RETIREMENT

### MT

- Billings 102.7□
- Great Falls 102.5□
- Missoula 101.8

### NE

- Lincoln 88.8
- Omaha 92.3

### NV

- Las Vegas 105.6
- Reno/Sparks 111.8

### NH

- Manchester 108.8

### NJ

- Morristown

### NM

- Albuquerque 102.8□
- Carlsbad 92.8
- Las Cruces 98.7
- Santa Fe 119.7

### NY

- Albany 109.7
- Binghamton 97.3
- New York 226.5
- Rochester 110.4□
- Syracuse 102.9

### NC

- Asheville 100.0□
- Charlotte 96.8□
- Greensboro 97.5
- Raleigh-Durham 97.3
- Winston-Salem 97.8

### ND

- Bismarck 99.9□
- Fargo 100.8

### OH

- Akron 96.3
- Cincinnati 101.1□
- Cleveland 106.0
- Columbus 101.4
- Toledo 96.9

### OK

- Oklahoma City 90.2
- Tulsa 89.4

### OR

- Eugene 108.9
- Portland 107.3
- Salem 103.3

### PA

- Allentown 104.4
- Erie 101.6
- Harrisburg 104.9
- Philadelphia 127.4
- Pittsburgh 113.3
- Wilkes-Barre 97.5

### SC

- Charleston 95.2
- Columbia 94.2
- Greenville 95.9
- Myrtle Beach 97.4

### SD

- Rapid City 100.2□
- Sioux Falls 96.6

### TN

- Knoxville 93.8
- Memphis 95.3
- Nashville 91.7

### TX

- Abilene 91.8□
- Amarillo 90.0□
- Austin 100.9

- Corpus Christi 93.6□
- Dallas 101.8
- El Paso 95.0
- Fort Worth 94.6
- Houston 96.8
- San Antonio 99.6
- Waco 92.1

### UT

- Provo/Orem 96.3
- Salt Lake City 100.9

### VT

- Montpelier 109.6

### VA

- Norfolk 100.5□
- Prince William 113.3
- Richmond 102.0
- Roanoke 93.0
- Virg. Peninsula 95.0

### WA

- Bellingham 103.4□
- Seattle 119.7
- Spokane 106.7
- Tacoma 102.6

### WV

- Charleston 96.6
- Huntington 100.8

### WI

- Green Bay 97.0□
- La Crosse 98.5
- Milwaukee 107.5

### WY

- Casper 101.4
- Cheyenne 96.0□

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## CHAPTER 2

# IMPORTANCE OF A COMPREHENSIVE FINANCIAL PLAN

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In Chapter 1 you learned the importance of evaluating your retirement goals to see if you are on track to reach them. With this newfound awareness of your actual retirement situation, you may believe that you have your financial future all mapped out in your head. But without a *written* “map” to which you can refer often, it can be very easy to start down the wrong path and never arrive at your desired destination. In this chapter, we will learn the importance of having a written financial plan that will help you stay on track not only in your retirement planning, but in other important areas of your financial life as well. If you want to reach your long-range goals, here’s one of the most important tips anyone can give you: Write them down!

Here’s a proven fact: People who develop written financial plans increase their wealth. Whether you are changing jobs, retiring, or simply looking toward your foreseeable future, now is a good time to develop a comprehensive financial game plan that addresses every component of your financial portfolio.

These components include:

- Retirement
- Investments
- Taxes
- Liabilities
- Budgeting
- Insurance
- Asset Protection
- Estate Protection
- Children’s Education
- Long-Term Care

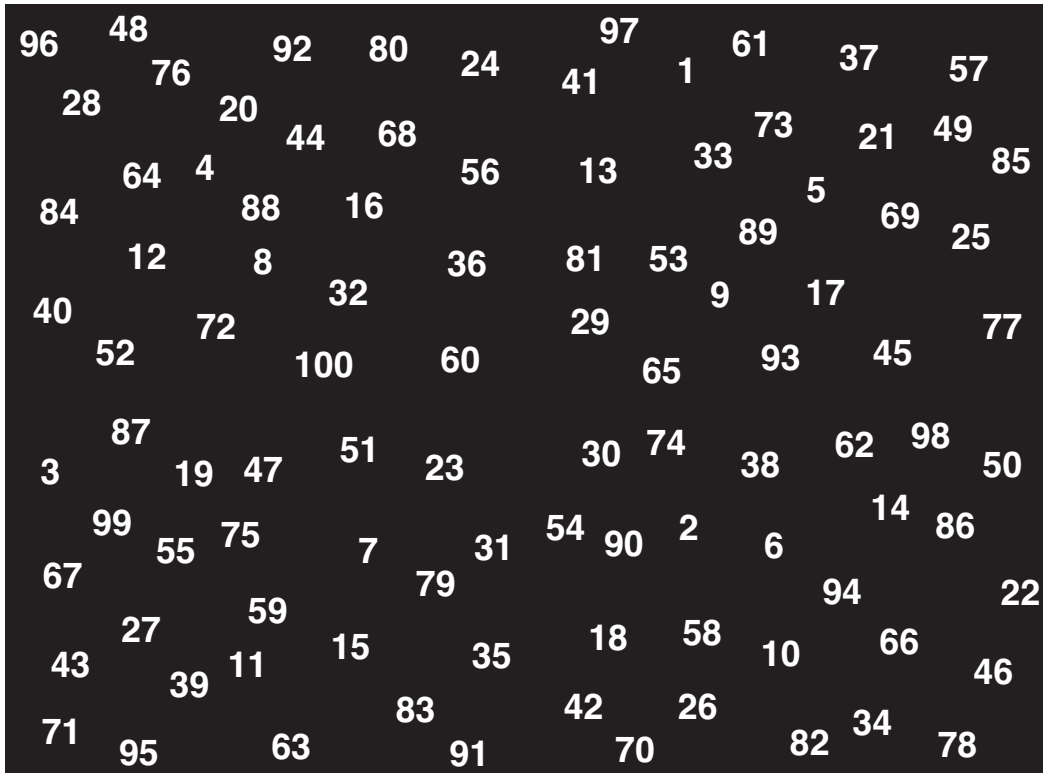
A comprehensive financial plan will help you establish goals in each of these areas and outline specific strategies for accomplishing each of them.

The exercise on the following page illustrates the importance of having a strategy. Take a look at the numbers placed randomly from 1 to 100 in Figure 1. Time yourself for 30 seconds and see how many numbers you can find in succession, beginning with the number 1, moving on to 2, then 3, and so on.

## OPENING THE DOOR TO RETIREMENT

Start timing yourself now....and go!

FIGURE 1



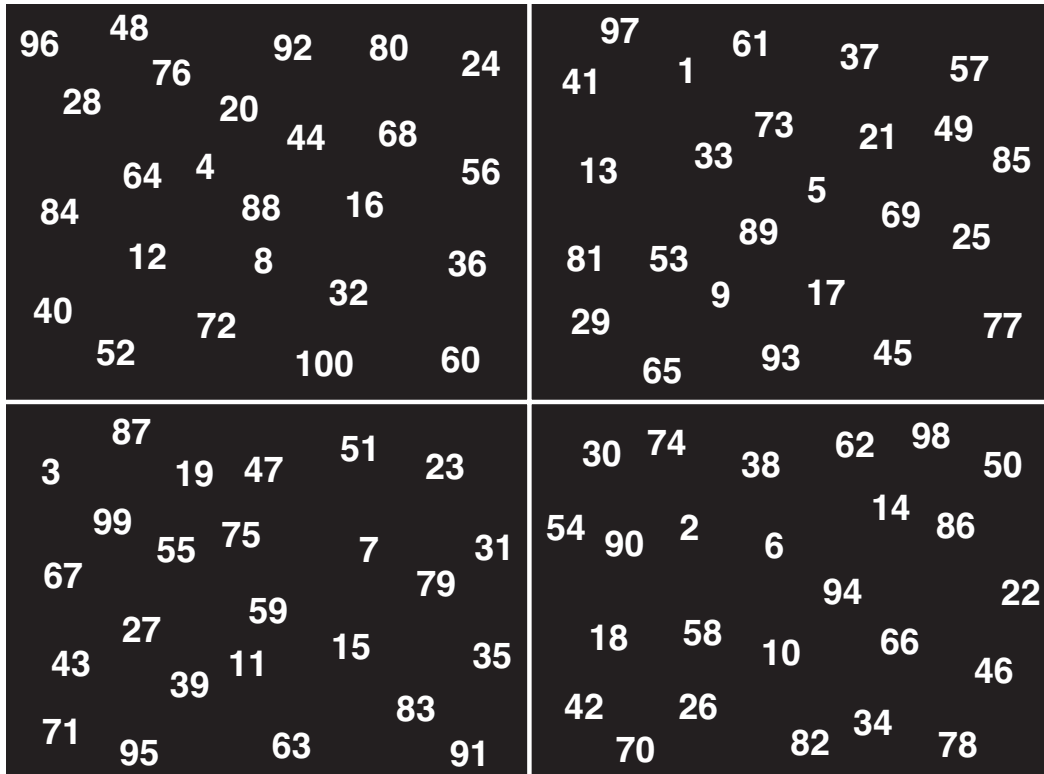
How far did you get? Remember your score.

Now, we're going to try the exercise again, with a strategy for improving upon your first score. The strategy is simple: In Figure 2 on the next page, a line has been placed down the center and across the middle of the chart, dividing it into four quadrants. The number "one" is located in the top right quadrant. The number "two" is in the bottom right quadrant. Number "three" is in the bottom left, and number "four" is in the top left. The numbers are sequentially located clockwise, moving from quadrant to quadrant.

Now, time yourself for another 30 seconds to see if you can beat your first score.

## CHAPTER 2 – IMPORTANCE OF A COMPREHENSIVE PLAN

FIGURE 2



You improved, didn't you?

In many cases, people find they can double their score in the second exercise and it's all because they have a strategy. In the same way, having a financial strategy will dramatically help you improve your financial situation.

Strong evidence supports this idea. According to a 1998 study conducted by the Securities and Exchange Commission, investors with financial plans reported having twice as much in savings and investments as those without plans.<sup>1</sup> One report went so far as to say, "People who stick with written plans to govern their investments, on average, wind up with five times as much money during retirement as those who don't have a plan."<sup>2</sup> Like the exercise you just completed, if you have a financial game plan, you are going to do better over time than if you don't.

## OPENING THE DOOR TO RETIREMENT

Figure 3 further illustrates this point. Notice that U.S. households with written financial plans have more money in savings than those who don't. This is true at every income level. Surprisingly, despite this evidence, only one of three savers has a plan to guide their financial decisions. You would do well to be part of that savvy one-third.

FIGURE 3

<b>HOUSEHOLD INCOME</b>	<b>MEDIAN SAVINGS (WITHOUT A PLAN)</b>	<b>MEDIAN SAVINGS (WITH A PLAN)</b>
<b>\$20,000-\$39,999</b>	<b>\$14,300</b>	<b>\$28,500</b>
<b>\$40,000-\$99,999</b>	<b>\$41,500</b>	<b>\$89,650</b>
<b>\$100,000 and up</b>	<b>\$201,100</b>	<b>\$325,500</b>

Source: Consumer Federation of America and Nations Bank Survey

Many studies have been conducted to determine the impact of written goals. For example, Yale University asked their 1945 graduates how many of them had written down their goals after graduating. They found that only 3 percent of the grads had actually put their goals on paper. In 1975, it was discovered that the 3 percent with written goals were worth more financially than the other 97 percent of their Yale peers combined!<sup>3</sup>

To develop a financial plan, begin by taking inventory of your current financial portfolio. Include the details of all of your assets and liabilities, and outline your financial goals. Then write them down! You can purchase software that will provide you with some components of a comprehensive financial plan. Be aware, however, that these programs, in most cases, fall short of completely meeting your needs. They don't provide the much-needed interpretation of the financial analysis which includes specific recommendations and help implementing the outlined strategies. These facets of a financial plan are more important than the number of pages of analysis you can generate. A software package is indeed a good starting point for a less sophisticated financial situation, but in most cases you should also seek the assistance of a financial advisor.

Once you record your goals and objectives and map out a strategy to accomplish each goal, you will immediately and dramatically increase your chances of reaching them. Like the Yale graduates who achieved tremendous success, you will do better financially with a plan than without one.

---

## CHAPTER 3

# CHOOSING A "SAFE" PORTFOLIO WITHDRAWAL RATE

---

Here's a critical question: After you retire, how much can you safely withdraw from your investment portfolio without incurring the risk of running out of money? A miscalculation could mean you outlive your assets and have to live on Social Security alone. This chapter is designed to help you choose a withdrawal rate that will be as safe as possible in the face of unknown life expectancies and ever-changing economic conditions.

When you try to calculate a safe withdrawal rate, you face two major obstacles: First, there is no way to know exactly how long you will live. Second, it is impossible to predict the exact rate of return your portfolio will generate during retirement. Inflation and taxes also have an effect.

Bottom line? In most cases, a 4 percent withdrawal rate is the maximum you should plan on each year, assuming you adjust your income upwards for inflation. To obtain the returns you need in order to maintain an acceptable income level, you must, in most cases, invest a portion of your assets into stocks and bonds. However, this brings with it a certain level of unpredictability because there's no way of knowing the future rate of return of stocks and bonds. Consequently, knowing how much to withdraw each year without risking the depletion of your assets is extremely difficult.

Ideally, you should have a portfolio large enough that you can rely solely on interest and dividends for the annual income you need without ever touching your investment principal. Most retirees, however, will never have that luxury. In the majority of cases, they must rely on interest, dividends, *and* a piece of their investment principal each year to generate a comfortable income.



## OPENING THE DOOR TO RETIREMENT

On the surface, it doesn't seem like it should be that difficult to determine a safe withdrawal rate. If you invest 100 percent of your portfolio in stocks — which have averaged approximately an 11 percent annual rate of return since 1926 — it would make sense that keeping your withdrawal rate below 11 percent means never having to dip into your principal.

Peter Lynch, the former manager of the Fidelity Magellan fund (you've seen him on TV commercials), used this logic when he suggested that an investor who stays completely invested in stocks for the long run, could withdraw 7 percent annually without depleting any assets.<sup>1</sup> If you run the numbers, Mr. Lynch's advice looks pretty sound. For example, if your \$500,000 portfolio provides a constant 10 percent annual return from which you withdraw just 7 percent (or \$35,000) each year, the results are astonishing (Figure 1).

FIGURE 1

<b>\$500,000 portfolio growing at 10% annually. Investor withdrawing 7% (\$35,000) annually.</b>	
Year	Portfolio Value After Withdrawals
1	<b>\$515,000</b>
5	<b>\$770,255</b>
10	<b>\$1,261,871</b>
15	<b>\$2,053,624</b>
20	<b>\$3,328,750</b>
25	<b>\$5,382,353</b>
30	<b>\$8,689,701</b>

In this example, we didn't even come close to touching the investment principal. There's one problem with this simple scenario, however; stocks do not provide consistent returns. While stocks may average 10-11 percent growth over the long run, they often make for a very bumpy ride along the way.

For example, the annual investment results for the portfolio in Figure 2 would also provide a 10 percent average annual return over five- and ten-year periods.

### CHAPTER 3 – DETERMINING A “SAFE WITHDRAWAL RATE”

FIGURE 2

Hypothetical Portfolio Year 1 through 10.

<b>\$500,000 portfolio growing a 10% average annual return, investor withdrawing 7% (\$35,000) annually</b>			
<b>Year</b>	<b>Portfolio Return</b>	<b>7% Annual Withdrawal</b>	<b>Portfolio Value at Year End</b>
1	-25%	\$35,000	\$340,000
2	35%	\$35,000	\$424,000
3	-15%	\$35,000	\$325,400
4	25%	\$35,000	\$371,750
5	30%	\$35,000	\$448,275
6	-25%	\$35,000	\$301,206
7	35%	\$35,000	\$371,628
8	-15%	\$35,000	\$280,884
9	25%	\$35,000	\$316,105
10	30%	\$35,000	\$375,936

However, notice what happens to the \$500,000 portfolio if the return varies from year to year if the same 7 percent per year (\$35,000) is withdrawn.

This figure shows that after only a couple of years, these modest annual withdrawals are already eroding the principal. In year eight, the nest egg that was supposed to last 30 years has been cut nearly in half. By year ten, the balance is \$375,936, a far cry from the \$1,262,871 balance remaining in the Figure 1 scenario.

While it seems perfectly logical to focus on average annual rates of return in the stock and bond markets when making your withdrawal decisions, these assumptions could lead to the total depletion of your investment assets. Actual returns, as opposed to average returns, vary from year to year. Taking this variance into account when deciding how much you can safely withdraw each year is crucial to your retirement planning.

## OPENING THE DOOR TO RETIREMENT

Studies have been conducted to help determine a safe withdrawal rate. In what is known as the “Trinity Study,” three Trinity University faculty members back-tested the effect of various withdrawal rates on five different portfolios of stocks and bonds over 15, 20, 25, and 30-year rolling time frames.<sup>2</sup> They used the actual returns of stocks and bonds from 1926 through 1995, rather than average returns. A success rate was calculated for each portfolio, time frame, and withdrawal rate. One hundred percent success was defined as having money remaining in the account at the conclusion of the specified withdrawal period.

For example, a retiree with a \$500,000 portfolio consisting of 50 percent stocks and 50 percent bonds who plans to be in retirement for 30 years should be 100 percent successful if he withdraws less than 5 percent, or \$25,000, annually. (See Figure 3, *Portfolio Composition: 50% Stocks and 50% Bonds*.) From 1926 to 1995, there were 41 thirty-year periods measured. This investment mix was successful in every thirty-year time frame, even those that included the Great Depression.

Before factoring in inflation and deflation, this same portfolio was 98 percent successful when the withdrawal rate was increased to 6 percent (\$30,000/yr.), and 90 percent successful when the withdrawal rate jumped to 7 percent (\$35,000/yr.). However, once inflation and deflation are added to the equation, this same retiree shouldn’t plan on withdrawing any more than 4 percent, or \$20,000, from the initial portfolio each year.

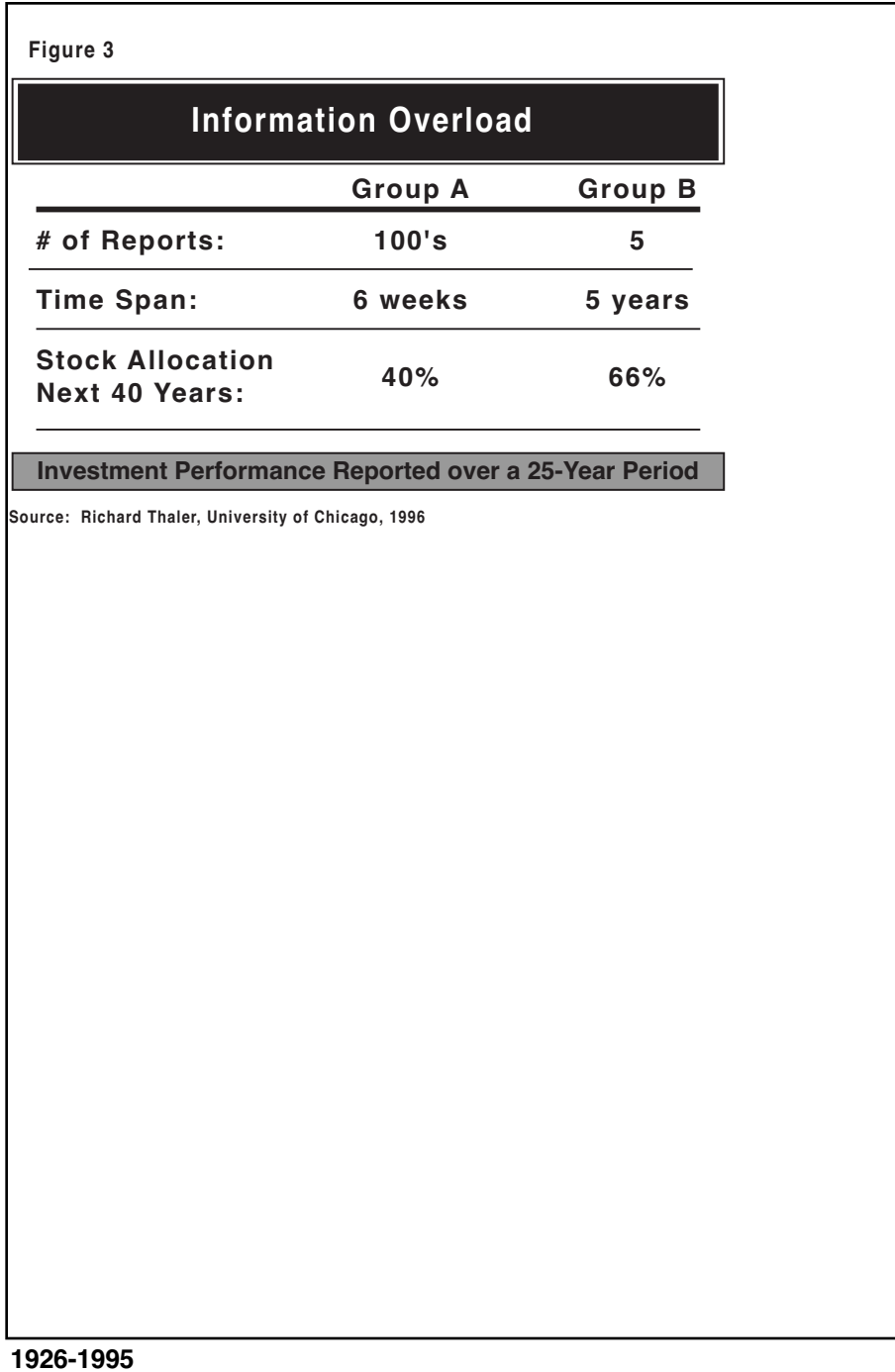
Most retirees will need to adjust their incomes upwards throughout retirement in order to cope with the rising costs of goods and services. At a 4 percent withdrawal rate, this portfolio was successful 95 percent of the time, when adjusted for inflation, but it had only 76 percent success when the withdrawal rate was increased to 5 percent.

What is your “safe” withdrawal rate? The tables in Figures 3, 4, and 5 on the following pages will help you answer that question. To use these tables, first determine what percentage of your portfolio will be invested in stocks and bonds during retirement. Second, estimate how many years you will be in retirement. Finally, choose a withdrawal schedule that has been successful at least 80 percent of the time. After examining the charts, you will notice that most of the portfolios could sustain a 4 percent withdrawal rate. Higher withdrawals will usually deplete the portfolio assets before your retirement period is over.

Note also, that the odds for success increase dramatically if, instead of using withdrawal tables that include the Great Depression (see Figure 3), only the markets in post-war periods are examined. The post-war results in Figure 4 are not adjusted for inflation, while the results in Figure 5 are.

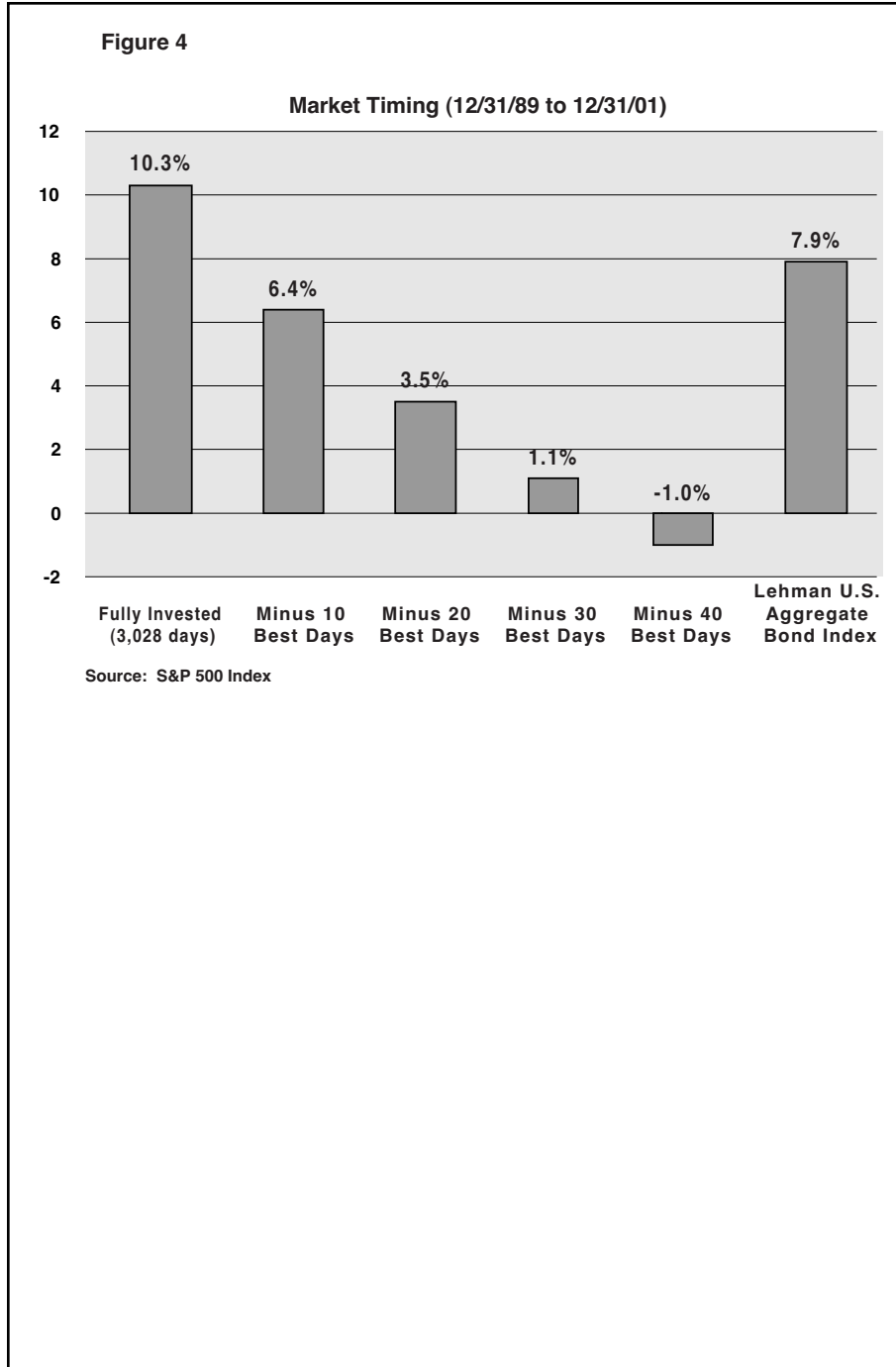
### CHAPTER 3 – DETERMINING A “SAFE WITHDRAWAL RATE”

FIGURE 3



## OPENING THE DOOR TO RETIREMENT

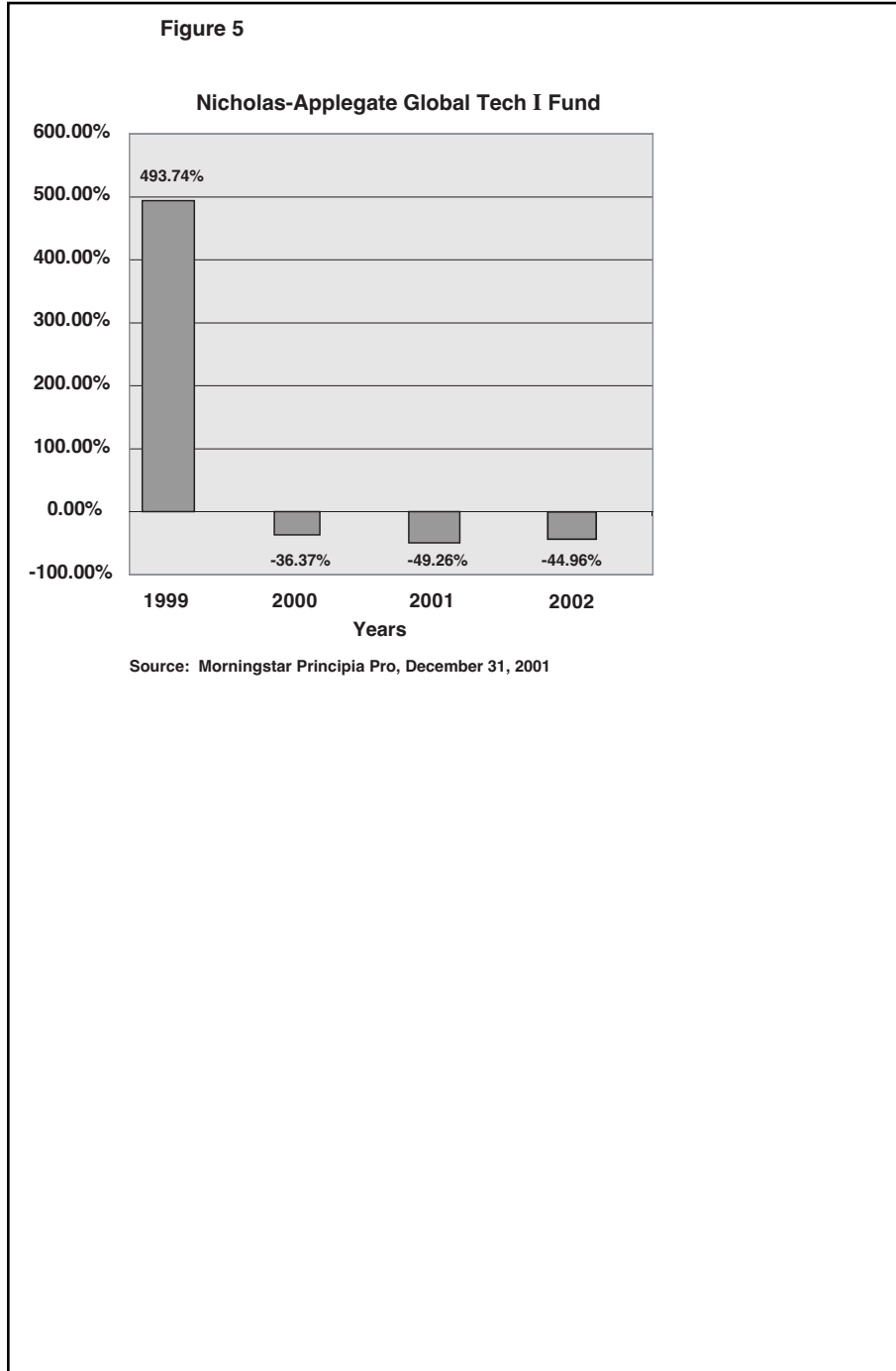
FIGURE 4



“Post War” 1946-1994

### CHAPTER 3 – DETERMINING A “SAFE WITHDRAWAL RATE”

FIGURE 5



“Post War” 1946-1994 adjusted for inflation

## OPENING THE DOOR TO RETIREMENT

Which chart should you use? It depends on whether you choose to be conservative or aggressive. Conservative investors will make sure their portfolios survive even in worst-case scenarios like the Great Depression. If, however, you believe the market could not possibly suffer that kind of downturn in the future, use the post-war charts in setting withdrawal rates. These post-war charts do include the deep recessions of the mid-70's and early 80's, the 1987 stock market crash and other down markets like those of 1990 and 1994. The post-war charts indicate that you could withdraw up to 6-7 percent annually before inflation from most portfolios, and 4-5 percent after inflation, without the risk of running out of money.

You could use Harvard University as an example of how much to withdraw. In 1973, Harvard was interested in determining how much of its endowment portfolio could be withdrawn each year without depleting principal. University researchers determined that a portfolio made up of 50 percent stocks and 50 percent bonds could safely support a 4 percent annual withdrawal rate, adjusted for inflation.<sup>3</sup>

In summary, determining a safe withdrawal rate will help you avoid every retiree's worst nightmare — the premature exhaustion of portfolio assets during retirement. In this chapter we have examined a number of ways to determine that rate in light of fluctuating personal and economic conditions. To help you further in that quest, check out the resources offered by T. Rowe Price at its Web site, [www.troweprice.com](http://www.troweprice.com). The site offers financial planning tools, including an easy-to-use Monte Carlo retirement income calculator. This calculator can help you determine a "safe" withdrawal rate. From the "tools" section on the site, go to the retirement income calculator. It will only take a minute to enter the requested data. Indicate the success rate you would like to obtain and run the analysis. This site lets you enter different variables so you can review possible alternatives.

The following worksheet will further assist you by allowing you to record various retirement assumptions and withdrawal rates based on your analysis of the charts in this chapter:

Retirement Planning Assumptions	
a) Years in retirement	_____
b) Amount of income to sustain lifestyle	_____
c) Portfolio value at retirement	_____
d) Withdrawal rate desired (best case)	_____
e) Safe withdrawal rate (85-90% success)	_____

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## CHAPTER 4

# EARLY RETIREMENT STRATEGIES (PRIOR TO AGE 59<sup>1/2</sup>)

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If you're fortunate enough to be able to retire prior to age 59<sup>1/2</sup>, a hearty congratulations to you! Early retirement, however, can throw some challenges your way for which you need to be prepared with regard to taxes and penalties. This chapter will address those challenges and how to effectively deal with them.

Accessing the investment assets you have locked up in qualified retirement accounts (IRAs, 401(k)s, profit sharing plans, etc.) is usually the biggest issue to consider if you're planning to retire early. Each of these retirement plans carry a 10 percent penalty on withdrawals made prior to age 59<sup>1/2</sup>. This poses a dilemma: You've accumulated enough money to retire comfortably, but all, or at least a large part of that money is invested in retirement plans that limit access to your money.

There are a couple of solutions to this problem that allow you to access your retirement savings prior to age 59<sup>1/2</sup> while avoiding early withdrawal penalties.

### **SECTION 72T DISTRIBUTIONS: SUBSTANTIALLY EQUAL PERIODIC PAYMENTS**

Section 72T of the Internal Revenue Code (IRC) states that premature withdrawals (those occurring prior to age 59<sup>1/2</sup>) are exempt from the 10 percent early withdrawal penalty if the distributions are structured as a series of "substantially equal periodic payments."<sup>1</sup> To avoid the early withdrawal penalty, you must strictly adhere to the following rules as outlined in Section 72T:

1. The distributions must be a part of a "series of substantially equal payments" made on a regular basis, at least annually.
2. The amount withdrawn each year must be calculated using one of three IRS-approved distribution formulas: amortization, annuitization or life expectancy.
3. Distributions must continue for five years or until the recipient is 59<sup>1/2</sup>, whichever is longer.<sup>2</sup>



## OPENING THE DOOR TO RETIREMENT

### QUALIFYING FOR 72T DISTRIBUTIONS

Anyone who has not yet reached age 59 1/2 and who has an individual retirement account (IRA) is eligible for penalty-free distributions. Distributions can begin at any age and for any reason. The 72T distributions can even begin while you are still employed.

In fact, many people trim their work hours back to part-time as they approach full retirement. They then begin using 72T distributions to supplement their earned income. Your annual distribution amount is based largely on the size of your retirement account and your life expectancy (or if married, your joint life expectancy if you choose). Consequently, 72T distributions are typically better suited for those nearing retirement (between ages 50 and 59 1/2) with relatively large retirement balances. If you're younger or have a smaller account balance, your annual distribution amounts will be lower.

### DISTRIBUTION FORMULAS

To determine how much you can withdraw annually from your IRA without penalty, you must choose one of three approved formulas: life expectancy, amortization or annuitization. Each calculation will produce a different result even though the input assumptions are the same. (A worksheet is provided in Figure 1.)

FIGURE 1

#### Information Required to Perform 72T Calculations

1.  Your age \_\_\_\_\_
2.  The balance in your retirement plan on Dec. 31<sup>st</sup> of the previous year \_\_\_\_\_
3.  The first year of your distribution \_\_\_\_\_
4.  An interest rate assumption if you are using the annuitization or amortization methods (between 4% and 12 %) \_\_\_\_\_
5.  Determine if you would like to use single or joint-life expectancy? Using joint-life expectancy will lower the annual distribution amount. (Single or Joint)
6.  The age of your beneficiary, if you use joint life expectancy \_\_\_\_\_ (life expectancy and amortization methods only)

## CHAPTER 4 – EARLY RETIREMENT STRATEGIES (PRIOR TO 59½)

The best way to determine which formula to use is to plug several combinations of variables into a 72T distribution calculator and compare the results side by side. One of the most user-friendly 72T calculators on the Web is offered by KJE Computer Solutions ([www.dinkytown.com](http://www.dinkytown.com)). Once on the site, go to the Retirement Savings and Planning section under “more” calculators. Your tax or financial advisor also can perform these calculations for you.

### *Method One: Life Expectancy*

This formula will produce the lowest annual payment. To calculate the life expectancy distribution amount, simply take your previous year-end retirement account balance and divide it by your life expectancy or joint life expectancy. Your life expectancy can be found in the IRS Life Expectancy Tables at [www.irs.gov](http://www.irs.gov) (search for Publication 590). The 72T calculators will do this number crunching for you automatically. You must recalculate your life expectancy annually and, thus, your yearly distributions will vary somewhat from year to year.

As you get older and your life expectancy decreases, your annual distribution will typically increase. This occurs, however, only if your IRA grows faster than the rate at which you are taking money out of your account.

### *Method Two: Amortization*

This formula provides a substantially higher distribution amount than the “life expectancy” method. This method amortizes your IRA balance over your life expectancy and assumes your account will grow at a reasonable rate of return. In addition, the annual withdrawal amount is determined in the first year before the first payment is made and remains fixed for the remaining distribution years. You cannot increase the amount to combat inflation or reduce it to offset the negative impact of a down year in the stock or bond market; doing either will trigger penalties.

### *Method Three: Annuitization*

This method will typically provide the highest annual payout. The formula computes payments using a different life expectancy table, the 1984 Up-Mortality Table, and a reasonable assumed rate of return. With this method, the retirement account balance is divided by an annuity factor to determine the penalty-free distribution amount. As in the amortization method, the withdrawal amount is fixed in year one and does not change from year to year.

## OPENING THE DOOR TO RETIREMENT

### REASONABLE INTEREST RATE

What is a reasonable interest rate assumption? The IRS allows flexibility in determining this. It approves using a rate under 120 percent of the Federal Mid-term rate. For example, if the 10-year U.S. Treasury Note is yielding 5 percent, any interest rate under 6 percent would be considered acceptable. An even higher rate may be considered reasonable by the IRS if the rate can be justified by the expected performance of your investment portfolio.<sup>3</sup> If you choose a rate greater than 120 percent of the Federal Mid-term rate you should obtain a private letter ruling from the IRS.

Private letter rulings by the IRS have allowed the use of a 10 percent or higher interest rate. It must be stressed, however, that these rulings were made for individual cases. A private letter ruling is applicable only for the person who requested the IRS opinion. It does, however, give an indication of the agency's position on the topic. If you wish to assume a higher rate than the long-term federal rate, obtain your own private letter ruling from the IRS. Your tax advisor can assist you with this.

Be cautious here. If you use an interest rate assumption that is too high and deplete your IRA prior to completing your required withdrawals, there are severe penalties. These include both an interest penalty and the 10 percent early withdrawal penalty you had tried to avoid. These penalties are retroactive on all previous 72T distributions.

### AN EXAMPLE OF A 72T DISTRIBUTION

Michael Henderson's company is experiencing some corporate downsizing. At age 54 he is offered an early retirement package. The offer includes a one-time, \$500,000 lump-sum distribution from the company's pension plan. With that money and the \$400,000 balance he has accumulated in his 401k plan, he decides to retire now at age 54.

To obtain \$60,000 per year of income, he needs to begin taking withdrawals from his \$900,000 retirement portfolio. A \$60,000 withdrawal represents 6.67 percent of his total investment portfolio. Because he is not yet age 59 1/2, distributions from his retirement plans would be subject to a 10 percent premature withdrawal penalty. However, if Michael follows the formula outlined in Section 72T, he can avoid the penalty and begin taking withdrawals.

Let's examine the three distribution methods to determine how much he can withdraw annually without penalty. Figure 2 provides an overview of his options:

## CHAPTER 4 – EARLY RETIREMENT STRATEGIES (PRIOR TO 59½)

FIGURE 2

Single Life Expectancy, 7% Interest Rate Assumption			
Age at Year End□	Life Expectancy Payout	Amortization Payout	Annuitization Payout
54	\$30,508	\$72,907	\$78,809
55	\$30,831	\$72,907	\$78,809
56	\$33,181	\$72,907	\$78,809
57	\$35,706	\$72,907	\$78,809
58	\$38,419	\$72,907	\$78,809
59	\$41,332	\$72,907	\$78,809

As you can see, Michael can easily accomplish his retirement income goals using 72T distributions. By changing the interest rate assumptions in the calculation, you can change the resulting distribution amounts. For instance, if you apply a 9 percent interest assumption, instead of the 7 percent used in Figure 2, the results would change as shown in Figure 3:

FIGURE 3

Single Life Expectancy, 9% Interest Rate Assumption			
Age at Year End□	Life Expectancy Payout	Amortization Payout	Annuitization Payout
54	\$30,508	\$87,918	\$91,650
55	\$30,831	\$87,918	\$91,650
56	\$33,181	\$87,918	\$91,650
57	\$35,706	\$87,918	\$91,650
58	\$38,419	\$87,918	\$91,650
59	\$41,332	\$87,918	\$91,650

As you manipulate the interest rate assumptions, you can dramatically vary the annual distribution amounts. This flexibility is available only when you initially perform the calculations. When using the amortization and annuitization methods, you cannot change the amount once you begin receiving distributions.

### **SUBSTANTIALLY EQUAL PAYMENTS**

The method you choose for your distributions isn't as important as adhering to your set schedule. In order to satisfy the "substantially equal payment" rule, you must choose one of the three methods discussed above and withdraw the calculated amount at least annually.

## OPENING THE DOOR TO RETIREMENT

Failure to withdraw the calculated amount will result in a 10 percent early withdrawal penalty tax, plus an interest penalty. The tax and penalty are imposed, retroactively, on all withdrawals previously received. Additionally, if you have been receiving payments and suddenly take a distribution amount that either exceeds or is below your annual distribution requirement, you will be penalized on every distribution you have received to date.

While this distribution structure is very rigid, it is also very easy to set up a systematic withdrawal program from your IRA. Most financial institutions allow you to establish automatic monthly, quarterly, or annual distributions from your IRA for a set number of years. By setting up a systematic withdrawal plan, you will not need to worry about deviating from the required distribution amounts or how frequently you receive them.

Again, once you begin taking distributions, you must continue to do so for the next five years, or until you are 59 <sup>1</sup>/<sub>2</sub>, whichever is longer. For example, if you begin taking distributions at age 52, you must continue for seven and a half years. However, if you begin distributions at age 57, you must continue for five years until you are 62. With this in mind, a 40-year-old man would not be wise to begin taking distributions. Many changes could occur in his financial life in the years prior to reaching age 59 <sup>1</sup>/<sub>2</sub>. For example, if he decides to go back to work and no longer needs the income generated from distributions, he cannot stop them without incurring the 10 percent early withdrawal penalty. Of course, this man could redirect his 72T distributions into a non-retirement investment account and earmark the funds for retirement.

Once you fulfill the five-year or age 59 <sup>1</sup>/<sub>2</sub> requirement, you can withdraw any amount without incurring penalties.

### TAX CONSIDERATIONS

The distributions from your IRA are penalty-free if you follow the guidelines outlined above. They are not, however, free from income tax and will be taxed as ordinary income. Each year after receiving distributions, you will receive a Form 1099R from your IRA provider indicating the amount of taxable withdrawals taken during the previous year. A distribution code "2" will be placed on the Form 1099R. This indicates that the distributions are part of premature withdrawals with a known exception — "substantially equal payments." If a code "2" does not appear on your 1099R form, the IRS will view your distributions as premature and apply penalties. In situations where this occurs, don't be alarmed. Simply file a Form 5329 along with your 1040, indicating that you are taking a series of substantially

## CHAPTER 4 – EARLY RETIREMENT STRATEGIES (PRIOR TO 59½)

equal payments according to the rules set forth in Section 72T of the IRS code. These forms and the instructions for completing them can be found at [www.irs.gov](http://www.irs.gov).

Additionally, when you begin taking distributions from your IRA, you should, in most cases, have taxes withheld. Otherwise, you'll be facing a large tax bill when you file your taxes at year-end. Withholding taxes from your distribution is similar to the taxes withheld from your payroll check while working. Your IRA provider has a tax withholding form that allows you to specify the percentage of your distributions you want to withhold to pay federal and state income taxes. When determining your distribution amount, consider up front how much money you will need for taxes and living expenses.

### **FUTURE FLEXIBILITY: SPLITTING YOUR IRA**

Before you begin taking distributions, consider the following important questions. First, do you anticipate needing to take withdrawals from your IRA in future years larger than your calculated 72T payments? And, second, will your scheduled 72T distributions require you to continue taking withdrawals past age 59½ to satisfy the mandatory five-year withdrawal period? If the answer is "yes" to either of these questions, you may want to consider the following strategy.

If you have a large enough portfolio balance, split your IRA into two separate IRA accounts prior to starting 72T distributions. Both accounts will be in your name but will have different account numbers. Remember, there are no limits to the number of IRA accounts you can open.

In the first IRA account, deposit only the amount necessary to provide you with the income you will initially need, according to the 72T calculations. By manipulating the account balance and the interest rate assumptions in the distribution formulas discussed above, you can determine the minimum amount necessary to deposit into IRA #1. Be conservative in determining how much to deposit; deposit a little more than is needed so that you avoid the risk of depleting your IRA prior to completing your scheduled distributions.

Let's return to the example of Michael Henderson, who took the early-retirement package, to see how this strategy works. To accomplish his goal of a \$60,000 annual income, he would be required to deposit approximately \$700,000 of his \$900,000 portfolio into IRA #1. If he chose an 8 percent interest rate assumption and the annuitization method, he would receive a distribution of \$60,000 per year. He could then deposit the remaining \$200,000 into a second IRA, deciding initially not to take any withdrawals from this account (see Figure 4). If, in the second year of his retirement, Michael decides he needs more income, he can simply repeat the

## OPENING THE DOOR TO RETIREMENT

same process as with his first IRA and begin taking 72T distributions from the second account.

Let's assume he needs an additional \$1,000 per month. He has \$200,000 in IRA #2 but would only need \$150,000 to generate the desired extra income using 72T calculations. He could then direct the remaining \$50,000 to a third IRA, which would be available for future needs. Splitting your IRA when taking 72T deductions gives you income flexibility in the future. If Michael had kept all his money in one IRA account and had begun taking 72T distributions, he would not be able to make any changes for five years, or until he turned 59 1/2, whichever was longer.

FIGURE 4

	Year 1	Year 2
<b>IRA #1:</b>	<b>Deposit \$700,000. Begin taking 72T distributions of \$62,450 per year. This could be accomplished using the annuitization method and an 8% interest rate assumption.</b>	<b>Continue taking \$62,450 annual 72T distributions</b>
<b>IRA #2:</b>	<b>Deposit \$200,000. No distributions will be <input type="checkbox"/> taken in the first year.</b>	<b>Transfer \$50,000 from IRA #2 to IRA #3. With remaining \$150,000 in IRA #2 begin 72T distributions of \$12,000 per year. This could be accomplished using the amortization method and an 8% interest rate assumption.</b>
<b>IRA #3:</b>		<b>IRA #3 Now has a \$50,000 balance. <input type="checkbox"/> No distributions are being <input type="checkbox"/> taken from this account.</b>

Splitting your IRA also makes sense if you will turn 59 1/2 during the mandatory distribution period. Remember, normal IRA distributions (non-72T) can begin at age 59 1/2 without penalty. However, if Michael begins taking distributions at age 57, he must continue doing so until he reaches age 62 — the mandatory five-year period — to avoid the penalty. If three years after he starts taking his 72T distribution he decides to purchase a condo and needs a lump sum of money, what can he do? With only one IRA his options are limited because of the 72T rules. Until age 62, he would be unable to take any additional withdrawals beyond the 72T distributions. However, if he split his retirement money into two IRA's, the first account could provide him income through his 72T distributions and the second would be

## CHAPTER 4 – EARLY RETIREMENT STRATEGIES (PRIOR TO 59½)

available after age 59 ½ in any amount, without penalty. Thus, he could use the money in IRA #2 to purchase the condo. Remember, however, to do this he would have to split the IRA initially, prior to beginning any 72T distributions.

If you die during the distribution period, your beneficiary is not required to continue receiving distributions. If the IRA beneficiary is your spouse, he or she has the option to roll the money into their own IRA account.<sup>4</sup>

### **PENALTY-FREE, LUMP-SUM DISTRIBUTIONS FOR THOSE OVER AGE 55**

If you are over age 55 but under age 59 ½ and leave your company, you are eligible for a one-time, lump-sum cash distribution from your employer-sponsored retirement plan without incurring the 10 percent early withdrawal penalty. In order to avoid the penalty, you must meet the following requirements:<sup>5</sup>

- You must reach age 55
- You must separate from your employer
- You must request a lump-sum cash distribution

This exception to the early withdrawal penalty only applies to distributions taken directly from an employer-sponsored plan, not from an IRA. The employer must, however, withhold 20 percent of the distribution amount for taxes (see p. 233).

This distribution strategy works particularly well if you know you're going to need a large sum of money immediately upon leaving your company — to launch your own business, for example, buy resort property, or take an exotic vacation. In these instances, a penalty-free, lump-sum payment can be especially useful.

Upon separation from your company, you can request to have all or part of the lump-sum distribution sent directly to you free from penalty. Any portion not distributed directly to you can be rolled over into an IRA. This way, you avoid taxes and penalties on money you don't need immediately.

Be aware, however, that even though the early withdrawal penalty is avoided, there are still distinct disadvantages to this distribution method. First, the amount you withdraw will be taxed as ordinary income and a large distribution may launch you into a higher tax bracket. Second, your employer is required to withhold 20 percent of your distribution amount to pay taxes. If you owe more, you will be required to pay additional taxes when you file.

The biggest disadvantage, though, is the loss of tax deferral and future compound interest on both the amount you withdraw and spend, as well as the portion



## OPENING THE DOOR TO RETIREMENT

of the distribution that goes to pay taxes. The severe impact of this approach is discussed in the Cash Distribution section of Chapter 19. A cash distribution early in retirement that greatly reduces the size of your retirement nest egg may hamper your ability to reach your long-term retirement goals. It is highly recommended you seek professional advice before taking a cash distribution to make sure you have enough money to fund your retirement goals. Most investment advisors will recommend you take out as little as possible in the form of a lump sum so you don't undermine your ability to enjoy your golden years.

### **IN-SERVICE WITHDRAWALS**

To maintain company benefits, especially health insurance, many people work part-time as they ease their way into retirement. This move from full- to part-time employment usually means a significant drop in income. To compensate, many employees take in-service withdrawals from their company-sponsored retirement plans to supplement their income and maintain an acceptable standard of living.

As the name suggests, this distribution method allows an employee to take a withdrawal from the company's retirement plan while still an active plan participant. This distribution can initially be rolled over into an IRA to avoid taxes and penalties. Once in the IRA account, distributions can provide additional income. Remember, the usual taxes and penalties will apply to your IRA distributions. Consequently, if you are not yet age 59 <sup>1</sup>/<sub>2</sub>, you should consider implementing a 72T distribution plan to avoid the 10 percent early withdrawal penalty.

This is a sound strategy if a substantial portion of your retirement savings are invested in your company-sponsored retirement plan and you need additional income. In-service withdrawals are not permitted by all company-sponsored retirement plans. If, however, the plan allows in-service withdrawals, plan provisions will specify the portions of the plan available for distribution. Typically, vested employer contributions are available for distribution. Contact your retirement benefits administrator to determine if this withdrawal method is available and to determine the portion of your plan balance that can be withdrawn.

In conclusion, if you're thinking of retiring early, don't be intimidated by the penalties associated with withdrawals from retirement plans. By applying the strategies and tactics discussed in this chapter, you can avoid pitfalls that often harm early retirees. With foresight and savvy financial planning, you can develop a strategy to minimize the impact of penalties on your hard-earned nest egg.