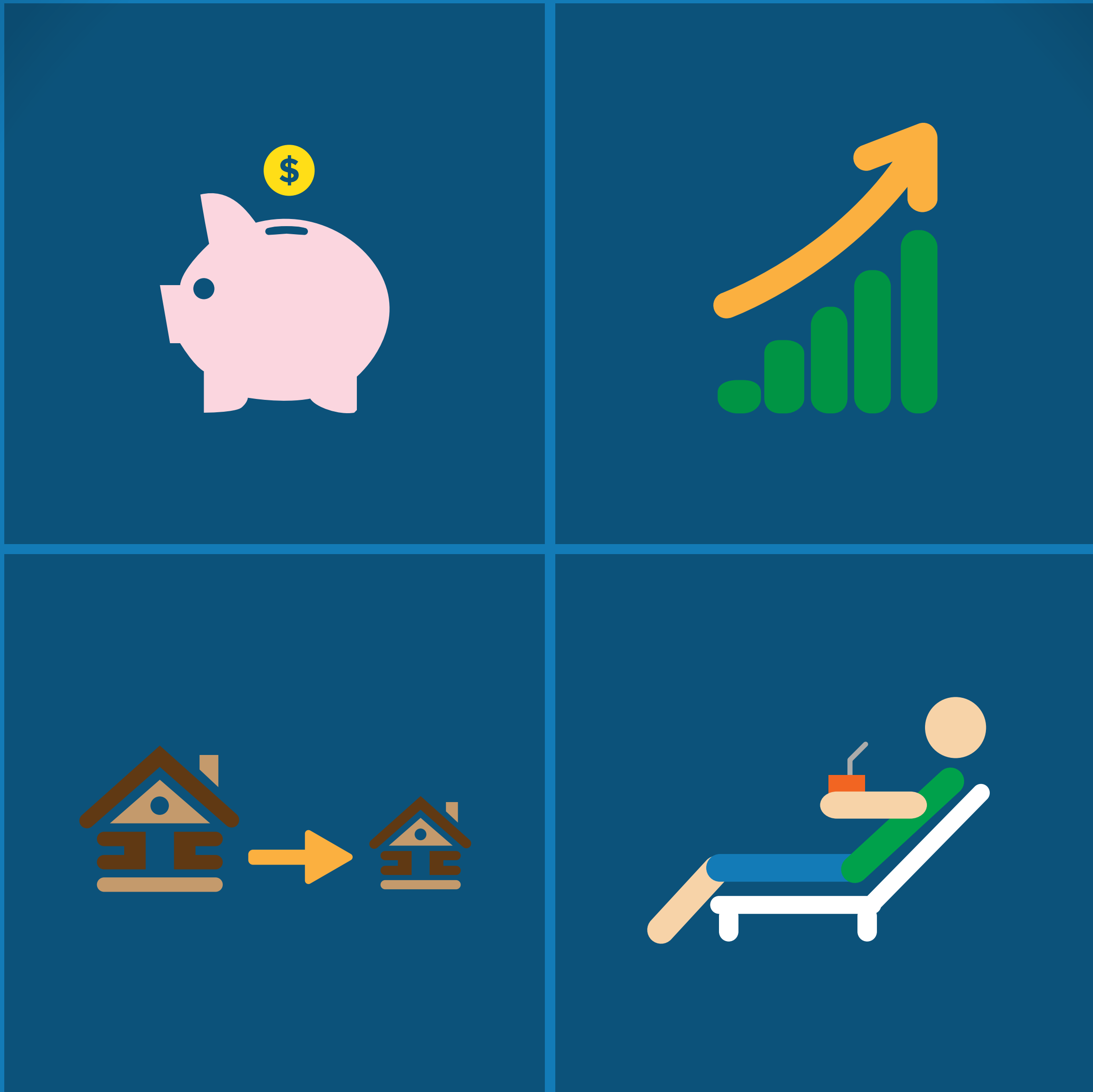

The Four Stages of Retirement Planning

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Looking at your retirement plan as stages of planning could ease the trepidation most people feel when planning their future. Here's why you need to start your retirement planning today; and how to take it one stage at a time.

Overview

Achieving financial security in retirement has never been more challenging. The old "three-legged stool" of retirement that used to consist of 1) a company pension 2) Social Security benefits, and 3) individual savings, is now teetering on one and half legs. The guaranteed incomes of company pensions are a thing of the past, and many in the younger generations are not holding out much hope for Social Security. So now, the onus falls more squarely on individuals to create their own retirement income source that can generate a reliable income for their extended lifetimes. Not only do we have to be able to accumulate capital at a rate that exceeds inflation, we must be able to sustain a rate of growth on the income it generates in retirement to protect our purchasing power. And, that is becoming increasingly difficult to do as long as interest rates on savings remain below the real rate of inflation.

Planning for a secure retirement must now begin at the earliest possible stage of a person's life, and it also requires constant assessments, analysis and adjustments to ensure that it remains on track throughout your lifetime. Sound like a daunting endeavor? It should be, because your financial future depends on it. However, the earlier you start planning then the greater the advantage of time you'll have.

Retiring in Stages

Procrastination is a retirement dream killer. Most people resist retirement planning because they simply don't know where to start and they're intimidated by the process. There's no reason to try to eat the whole retirement planning pie all at once. By slicing it into smaller pieces, it's much easier to digest, and you'll never get that awful feeling of never wanting to eat that pie again.

If you can think of your retirement plan as four distinct stages or quadrants, it's easier to plan sequentially using just the knowledge, resources and mindset needed for each one. Rather than aiming for some distant target which is likely to change periodically, you can establish more meaningful benchmarks with shorter timelines. By planning for a secure retirement in stages, you can set more achievable goals and gain confidence and motivation with more frequent accomplishments.

Stage One (20s and 30s): Build the Foundation

- Recognize that If It is to Be, It is Up to Thee
- Set Achievable Goals
- Understand the Time Value of Money – Save Early, Save Often

Recognize that If It is to Be, It is up to Thee

Realistically, it's very difficult for young adults to envision their lives in retirement, let alone plan for it. There is so much that needs to be accomplished between the here-and-now and a life stage they can't clearly define. Immediate or near term priorities such as buying a home, starting a family, saving for college, etc., will compete with longer term needs for the next decade or two. However, all one has to do is consider the plight of today's new retirees – the Baby Boomers who were, by any measure, the most prolific money earners of any generation – nearly 50 percent of whom are not confident that they have sufficient capital to meet their lifetime income needs.[1] Many Baby Boomers will be forced to work - if they're healthy enough - well into their "retirement" to make up for decades of over-consumption and under-saving.

True financial independence means having the choice of continuing to work, starting a business, or living a life of leisure. Young adults have an enviable opportunity to build a path of confidence based on creating lifetime income sufficiency and accumulating some surplus that will enable them to live a good life in retirement. However, if it is to be, it is going to be up to thee.

Set Achievable Goals

Although retirement is a ways off for young adults, there's nothing wrong with setting a goal, especially if you have some vision of what you want. For younger people, the pressures of balancing their careers and family while trying to gain control of their personal finances can make long-term goal planning seem like an exercise in futility. Short term needs are often much more pressing than needs that are far off on the horizon. However, they require just as much planning and discipline to ensure that they don't put you in a deep hole which could put your long term goals further out of reach.

Examples of Short-Term Goals:

- Paying off expensive debt
- Creating an emergency fund to cover 12 months of expenses
- Buying or renting a bigger house (or adding a room) for a growing family
- Buying a new car
- Taking special vacation
- Paying for a private school
- Starting a business

With short term goal planning, you don't have the luxury of time. And, the more time that passes before you gain control of your short term financial future, the more costly it can be to achieve both your short and long-term goals. These three key steps will enable you to quickly gain the upper hand:

1. Clearly define and prioritize your short term financial goals
2. Budget seriously
3. Set Short term benchmarks for your short term goals

In the short term, it is essential to gain control over your personal finances and create the safety nets that will prevent a financial calamity if the worst should happen. Life happens, and young families need to guard against events that can seriously damage their finances. Job layoffs, unexpected illnesses or accidents, natural disasters, and other surprises catch most people off guard, and some never recover financially.

Understand the Time Value of Money – Save Early, Save Often

Time is of the essence with goal setting. The only resource available to us, over which we have some element of control, is time. However, it is a wasting resource if it is not optimally utilized. Each day that passes, without some contribution of money, either in savings or interest, the cost of the financial goal increases. As time marches on, the obstacles to achieving goals of any time horizon become increasingly insurmountable.

The Cost of Waiting

The more time money has to work, the less it needs to grow. Given enough time, money will let compounding interest work its exponential magic thereby eliminating the need for higher returns and the greater risks associated with them. When it is necessary to assume greater risks in order to overcome the loss of time, financial goals can be jeopardized.

The Cost of Waiting

The cost of waiting is best illustrated with a comparison of two savers – John and Karen.

John invests $20,000 per year from age 25 to 45, before he stops making any more contributions to his retirement plan.

Karen doesn't invest from age 25 to 45, but then contributes $20,000 per year from age 45 to 65.

Assuming an investment return of 6%, by age 65, John would have $2,500,000, whereas Karen would only have $790,000!

Source: Bank Rate Savings Calculator. BanRate.com

Stage Two (40s and 50s): Accumulation

- Define Your Ambition for a Good Life in Retirement
- Firm Up Your Retirement Plan
- Establish a Long-Term Investment Strategy You Can Follow
- Getting the Max from Your 401k

Define Your Ambition for a Good Life in Retirement

Numerous surveys point to the low number of working adults who have yet to establish a clearly defined retirement goal, generally about half, but the more stunning revelation came from a Charles Schwab survey of 1,000 adults, 55 to 70 years of age, with $100,000 or more in investable assets. More than a third had yet to determine what their essential living expenses in retirement would be. As a correlation to that, nearly half were uncertain about how to invest their money to maximize their retirement income.[2]

Generally, people without clearly defined objectives, or who view the future with unrealistic notions of time and money, will lack the confidence necessary to adhere to a long-term strategy. Investment plans based on the hope that past performance will prevail as future results produce ungrounded or "hope based" confidence, as does the notion of planning toward the accumulation of a capital need using arbitrary or out-dated rules and assumptions.

The cost of living in retirement has been steadily rising for decades due, in part, to increasing life spans, as well as general rising prices. Many people think that their expenses will actually go down during retirement. But, when you factor in rising health costs, the possibility of caring for aging parents, the possibility of subsidizing struggling children, the possibility of carrying a mortgage into retirement, and the probability of requiring some kind of long term care assistance, your retirement living costs may actually be higher than your working years.

Establish a Long-Term Investment Strategy You Can Follow

Having accumulated some assets in your retirement accounts, it's now time to develop a serious long- term investment strategy that you can follow. The key to successful long-term investing is to formulate a strategy around sound investment principles and practices and have the discipline and the patience not to break the strategy. One of the main reasons why many people fail to achieve above-average returns is they succumb to behavioral instincts that drive them to making mistakes, such as investing too conservatively or too aggressively; trying to avoid risk; trying to time the market; following the herd or chasing returns.

Without a well-conceived investment strategy based in sound principles and practices, investors are more likely to succumb to the emotions of greed or fear which causes them to act in ways that are counter to their long term needs. It must start with a goal, a targeted objective with a specific time horizon so you can determine how much you need to invest, what rate of return is needed on your investment and how much risk you will need to take in order to achieve that rate of return.

Stage Three (50s and 60s): Preparing for Retirement

- Planning for a Life in Retirement
- Smooth Out Your Consumption

Retirement Income Planning Requires Realistic Spending Assumptions

For many years, financial planners have espoused general formulas for determining the amount of income retirees will need, the most popular being the "70 percent rule" which suggests that retirees will need to replace just 70 percent of their pre-retirement income to provide for their living needs in retirement. That may have been an effective guideline a few decades ago when the rule was established; however, for many retirees, relying upon it today may be fraught with financial peril. It's a very different world today, and old guidelines based on conditions that existed 30 years ago don't necessarily reflect real costs of aging today which include:

- A male turning 65 years old today can be expected to live another 19 years versus 11 years in 1970; for women, they can expect to live another 23 years[3]
- The chances of retirees or an elder family member requiring some form of long-term care is 7 in 10.[4]
- Many of today's retirees are carrying some form of debt into retirement, including mortgages, consumer debt and student loans.[3]
- Although inflation has moderated somewhat since the 1970s, lifestyle costs, such as housing, food and transportation consume a larger portion of a retiree's budget today.[5]
- Although health care cost increases have slowed, the rate of cost increases continues to be well above the general rate of inflation. [6]

For many retirees, the 70 percent income replacement rule might be an acceptable baseline for planning; however, with the risk of inflation compounded by longevity risk now confronting retirees, income planning should be based on the realities of aging today. It's not inconceivable that, for some retirees, their income replacement need could be as high as 100 percent.

Essential Steps to Take within 15 Years of Retirement to Enhance Lifetime Income Sufficiency

Track your expenses now. You should begin to track your living expenses and gradually adjusting your budget to smooth out your consumption between your living requirements now and your requirements in retirement.

Start living like a retiree now. Taking it a step further, you could take the approach of changing your lifestyle now to reflect how you expect to live in retirement. That might mean downsizing your home now, reducing your leisure travel, driving more efficient cars, and generally adopting a more frugal mindset.

Increase your savings. Any combination of the first two steps should generate steady increase in excess cash flow which should be saved for retirement. Pre-retirees within 15 years of retirement should target a minimum of 20 percent of their earnings for contributing to their retirement.

Start exploring your Social Security options. Retirees who are able to postpone their Social Security benefits until age 70 can significantly boost their lifetime income; and additional Social Security planning for spousal benefits could increase it further.

Don't invest too conservatively. Although the natural inclination is to reduce your exposure to risk-based investments like equities the closer you are to retirement, reducing your exposure by too much, too soon could stunt the growth of your capital. To ensure lifetime income sufficiency, today's retirees should always have some exposure to equities. A broadly diversified, well-balanced portfolio of equities, bonds and cash offers the best opportunity to maintain the necessary growth of capital needed while minimizing volatility over the long-term.

Regardless of your planning method or process, it would be a mistake to succumb to standard formulas or a generalized approach to retirement planning. Right now, your retirement vision, formed by your specific needs, wants, attitudes and beliefs, rests in your mind, and it will undoubtedly change as your outlook and priorities change, but you should always base your income needs on realistic assumptions.

Stage Four (60s 70s): Retire!

- Gather Your Retirement Income Sources
- Create a Secure Retirement Income Foundation
- Maximize Income through Retirement Tax Saving Strategies

Gather Your Retirement Income Sources

Your retirement income planning should begin well before your retirement date. In addition to determining how much income your assets will generate, there are several important factors to consider, including the sequence of withdrawals from your various income sources and the tax implications of your withdrawals, both of which can impact the lifetime income sufficiency of your assets. It is strongly recommended that you seek the guidance of a financial advisor who specializes in retirement income planning, and who has expertise in Social Security benefits planning.

Social security benefits: You have more options for receiving your Social Security benefits than you know. In fact, depending on your circumstances, there are several dozen options or combination of options available. Choosing the wrong option could cost you a significant amount of money over your lifetime. It would be very important to seek the guidance of a financial professional with extensive knowledge of Social Security.

Pension income: Within six months of retirement you should meet with your pension plan administrator to explore your options.

401k distributions: As part of your income planning, you need to fully explore the tax implications of your retirement plan withdrawals. Depending on your particular circumstances, it may be better if you can delay the taxable withdrawals from your 401k plan; but you also have to be cognizant of the Required Minimum Distribution (RMD) rule to avoid additional t taxes and penalties. Work with an experienced retirement income advisor to determine your best course.

IRA distributions: Taxation of IRA distributions depends on the type. For traditional IRAs, the withdrawals are fully taxable. For Roth IRAs the withdrawals are tax exempt if they meet the withdrawal requirements (first withdrawal made five years after first contribution, and after age 59 ½).

Non-qualified investments: Investments made outside of a qualified plan are generally going to yield taxable income; however, investments held long-term are generally taxed at the more favorable capital gains tax rate. Working with a retirement income advisor, you need to determine whether it makes sense to access these investments before you access your qualified plans.

Create a Secure Retirement Income Foundation

The greatest challenge facing retirees today is in ensuring that their income sources last longer than they do. So what is a retirement investor to do?

The answer may very well be to build your own three-legged stool by creating a guaranteed income foundation, much like the pension plan of old, and layering on a range of investments that can combine to create capital growth and increasing income. Social Security is most likely always going to be the third leg although it could get a bit wobbly, so it's best to try not to place a lot of weight on it.

With an income foundation, that is, an income that you can count on regardless of the market conditions, you will feel more secure about taking some risk with your other capital sources for the purpose of achieving growth and an increasing income. The only investment vehicle that can replicate the guarantee of a pension plan is an immediate annuity. Annuities are contracts with life insurance companies that, in exchange for a lump sum of capital, will provide a stream of income that you cannot outlive. The income payment is based on the amount of capital invested, your life expectancy and a guaranteed interest rate. Once your income payment is set, it is fixed for as long as you live. Most immediate annuity contracts also offer an inflation rider that will adjust your income payments based on an inflation index.

It's Never too Early to Get Started

Retirement planning today has taken on many new dimensions that never had to be considered by earlier generations - we're living longer; the cost of retirement is increasing; we must rely on our own capital to provide lifetime sufficiency – which requires more time, effort and knowledge to ensure a secure retirement.

The unfortunate reality is that the majority of Americans continue to procrastinate planning for their retirement, if they plan at all. And the fact that more than a third of today's retirees cannot afford to stop working is a testament to that trend.

Maybe we should stop calling it "retirement" because many people no longer look at it as a final stage of life; rather they view it as a new cycle of life full of opportunities. But, in order to fulfill that vision, it requires a level of financial independence that allows for choice and new opportunities. Otherwise, it's nothing more than working to pay the bills, and the reality is that most people won't be able to work forever.

We're often told that it's never too late to get started in planning for retirement. While that may be true to a certain degree for those who have procrastinated, younger adults should heed the lessons of the older generation and realize that it's never too early get started.

While it is always recommended that you enlist the help of a qualified, independent financial advisor in formulating and implementing your retirement plan, taking a staged approach will enable you to acquire the requisite knowledge in more manageable pieces so you can be in control of your financial future at each stage of the process.

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