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In my financial planning and investment management practice I receive the most questions about planning for retirement. So I thought I'd share some basic, general advice on the two retirement questions that are the most universal. I finish up by discussing one of my biggest pet peeves, regarding annuities.

Q How much should I anticipate spending in retirement?

A Many people think they will be spending less during retirement than they do during their working years. The old rule of thumb is that your expenses will be approximately 80 percent of your current expenditures during your retirement years. The reality is often quite different.

Some of your work-related expenses such as business clothes, commuting costs, etc., won't be necessary in retirement. In my experience, these reduced costs are usually not enough to offset the increase in discretionary expenses such as travel or pursuing an expensive hobby, especially during the early years of retirement.

However, if you have planned carefully and paid off your mortgage before retirement, your expenses may be less during your retirement years. This strategy makes tremendous sense, especially if the bulk of your investments are within tax-deferred accounts such as IRAs and 401(k)s.

If you are still paying your mortgage during retirement and have to draw more funds out of your tax-deferred accounts to pay for it, you are increasing your income and therefore moving up to a higher tax bracket. This makes more of your Social Security payments taxable and causes you to take even more money out of your tax-deferred accounts to pay the tax bill, resulting in a vicious cycle of withdrawals. So if the bulk of your assets are saved in tax-deferred accounts, try to pay off your mortgage before retirement.

If you are currently raising children, your expenses after retirement may be less. You'll have to deduct your child care spending such as clothing, allowances, sports programs, educational expenses, etc., to arrive at your estimated retirement budget.

However, many parents still aid their adult children by helping them buy their first home or car. If you anticipate helping your children in adulthood, you need to budget for these big-ticket items.

Another worthwhile exercise is to divide your expenses into two categories: discretionary and nondiscretionary. I define nondiscretionary as non-negotiable expenses such as taxes, food and property insurance.

Examples of discretionary expenses include vacations, meals at restaurants and hobbies. We've developed a special spreadsheet to help capture and categorize your expenses on our Web site (www.altamontwealth.com) under the Forms section. This spreadsheet is entitled "Discretionary and Non Discretionary Cash Flow Spreadsheet."

You will still have to use judgment to fill out this template because at a certain level of spending, a nondiscretionary item like clothing becomes more a discretionary item. After you have clarified and sifted through your expenses, focus on your discretionary expenses, since those are the ones you can control.

Here is an expense that can easily derail your retirement plan, especially in later years of your retirement. Health care costs are rising faster than the rate of inflation. As the baby boom generation ages, it will strain the health care system, making quality care more expensive. Health care expenses could severely derail your retirement plans, causing you to cut back in other areas of your life to make up the difference.

As a result of all this, I frequently see retirees spending just as much during their retirement, only on different things. Of course, everyone is different, so it is worthwhile to determine your current expenses and then project how they might vary during retirement.

Q Am I saving enough to retire, and how much can I spend during retirement?

A Now that you know how much you'd like to spend during your retirement, how are you going to fund your income needs? Are you saving enough? For most Americans the answer to this question is no.

What you want to avoid is running out of funds, especially during the last few years of retirement when declining health usually makes it impossible to focus on money issues. So it is important to start planning now.

I always ask my clients how confident they would like to be that they will not run out of money during their retirement years. It sounds like such a silly question because no one wants to run out of money, but it turns out to be a very relevant and essential question. Most financial projections are run on a particular rate of success. For instance, assuming your portfolio of \$10,000 will earn an annual compounded return of 8 percent for 20 years, you will end up with an ending portfolio value of \$46,600.

The problem with this approach is that it assumes the market generates nice even returns every year. For instance, the S&P 500 was down 22 percent in 2002, and the following year it was up 28 percent. The timing and size of these gyrations will have a substantial impact on portfolio, potentially leaving you short on funds.

You therefore need to capture the volatility of the market in your projections. If you are not working with a financial planner, I recommend trying the T. Rowe Price retirement income calculator on its Web site, www.troweprice.com.

Another approach was pioneered by Bill Bengen, president of Bengen Financial Services. Bengen concluded from his research that a safe withdrawal rate from an investment portfolio is approximately 4 percent to 4.5 percent in the first year, with subsequent withdrawals adjusted for inflation in following years.

If you are close to retirement age and don't have a pension or substantial savings, you do have a few options. One is to work longer. You don't need to keep working full time or stay in your current position. You can transition to a different career or start your own business.

Revised Social Security rules have now made working part time in your retirement years a relevant option. You can now keep working and collect Social Security when you reach your full retirement age and not be penalized.

Besides working longer, another option is to seriously analyze your expenses to determine which discretionary expenses can be reduced in order to increase your savings rate today and decrease your income needs in retirement. Remember, you should always be saving 15 percent to 20 percent of your income for retirement from the very first day you start working in order to have a seamless transition into retirement.

Finally, a pet peeve of mine:

Annuities, annuities, annuities. Why are people buying annuities?

Annuities are complicated, tax-deferred investment vehicles that make sense for only a few people in very specific circumstances. If annuities aren't the right investment for most people, then why are they being sold like produce at a farmers market? It's because the person selling them makes a huge commission, usually 5 percent of the funds you've invested. Ain't that sweet!

I have never met with anyone who owned an annuity who understood what they were invested in, why they were invested in it and what fees they were paying. After learning about their annuity's features and fees, most people are upset. If annuities were simpler to understand, most people would not buy them.

Let's be clear about the true tax consequences: Unlike a 401(k), an investor does not get a tax deduction for the money they put in, the funds inside the annuity do compound tax free, and all withdrawals are taxed as income rather than at the lower long-term capital gains rates. Finally, you can't withdraw your funds until you are over 59½, or you'll owe a 10 percent penalty plus fees, plus taxes.

A deferred annuity isn't such a good deal for your heirs either. Unlike a typical mutual fund or stock, its tax basis doesn't step up to its current value at your death, so your beneficiaries will still pay income taxes on any earnings they withdraw from the account. For more information regarding the estate tax impacts of owning an annuity, you should talk with your financial planner or estate planning attorney.

With the current lower capital gains tax rates, it is hard to justify buying a deferred annuity. Instead of being taxed at the lower capital gain tax rate of 15 percent, you are subject to the income tax rates, which reach 35 percent. The current low capital gain tax rates makes annuities a bad deal for most people when you factor in the high fees, and there are multiple layers of fees when it comes to variable and equity-indexed annuities.

What fees are you paying on your annuity? Good luck finding out. While mutual fund information is easily accessible, there are very few objective third parties that provide information on the performance and expenses of particular annuity subaccounts. The only free source of this information is the annuity company, through its Web site, your statement and their prospectus, which is only updated once a year.

Here is my final annuity tirade. Investors are frequently sold annuities within their IRAs or their retirement plans at work. If you buy an annuity, you are paying a hefty fee to save money tax-deferred.

But why would you pay extra money to put an annuity into an investment account that is already tax-deferred? Would you walk around the inside of your house with an umbrella on a rainy day? Placing an annuity in an IRA, 403(b) or 401(k) plan is ludicrous because you are already receiving the tax-deferred benefit free of charge.

All in all, annuities aren't such a great deal because of their complicated structure, high fees, absence of independent research, lack of portability and declining tax benefit in a low capital gains rate environment.

So when a financial salesman suggests an annuity, well, let's just say, "Caveat emptor, buyer beware!"
