AOF Financial Planning

Lesson 18

Planning for Retirement

Student Resources

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| Student Resource 18.2 | Chart: Retirement Planning |
| Student Resource 18.3 | Reading: Planning for Retirement |
| Student Resource 18.4 | Scenarios and Strategies: Exploring Retirement |
| Student Resource 18.5 | Reading: Retirement Planning Instruments |

Student Resource 18.1

Letter-Writing Frame: Me at 75

Student Name:\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_ Date:\_\_\_\_\_\_\_\_\_\_\_

Directions: Use the following frame to help you organize your description of your life at age 75. Once you have completed this frame, make any revisions that you decide to include from peer comments, and copy the information onto a blank piece of paper or type your letter using word processing software. Make sure that you clearly understand the assessment requirements before beginning your letter.

Date:

Dear [your name],

Today I… [In a few sentences, describe what you did today. This can be work, a hobby, or some activity that represents your financial state. You can also mention your spouse, your children or grandchildren, or your friends.]

I am writing to thank you for… [In this paragraph, describe your financial status in general. You can include where you live, what you drive, or any other situation that reflects your quality of life.]

My financial goals were… [In this paragraph, describe your financial goals for retirement. If you wish, you can describe how your goals changed throughout your life.]

The decisions I made before I reached retirement age have made all the difference. First, I want to mention… [Tell yourself the financial decision that has been most helpful to you in attaining financial independence in retirement. Be specific. You can include a specific change you made to your portfolio mix, and how old you were when you made it.]

Additionally,… [Write another good financial decision here. Be specific, and include how old you were when you made the decision if it’s relevant.]

[Conclude with a paragraph summarizing your feelings about the path you took to financial independence.]

Sincerely,

(Your Name)

Make sure your letter meets or exceeds the following assessment criteria:

* It offers three detailed actions you took that resulted in financial independence.
* It includes information (taken from the readings, notes, or presentation) about effective approaches to retirement planning or about investment instruments that are appropriate for retirement planning.
* It uses the correct letter-writing format (refer to the note-taking frame).
* It is neat and legible, and uses proper spelling and grammar.

Student Resource 18.2

Chart: Retirement Planning

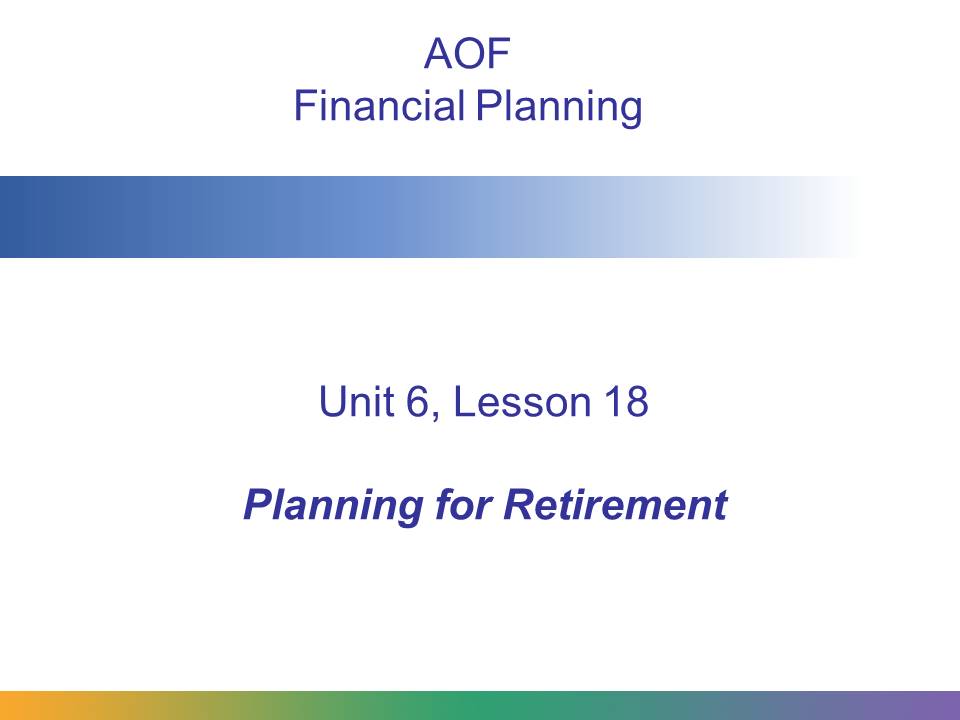
Student Name:\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_ Date:\_\_\_\_\_\_\_\_\_\_\_

Directions: Use the chart below to record information about the retirement instrument you read about or learned about from the PowerPoint presentation (Teacher Resource 18.2) or Student Resource 18.3, Reading: Planning for Retirement. Later, record information about the other instruments based on what the other members of your group report back. As you work, make sure you have what you need to complete the writing assignment and meet the assessment criteria.

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| **Instrument** | **Pros** | **Cons** | **Other** | **Right for retirement planning?** |
| **Stocks** |  |  |  |  |
| **Mutual Funds** |  |  |  |  |
| **Bonds** |  |  |  |  |
| **Annuities** |  |  |  |  |
| **401(k) Plans** |  |  |  |  |
| **Other** |  |  |  |  |

Student Resource 18.3

Reading: Planning for Retirement



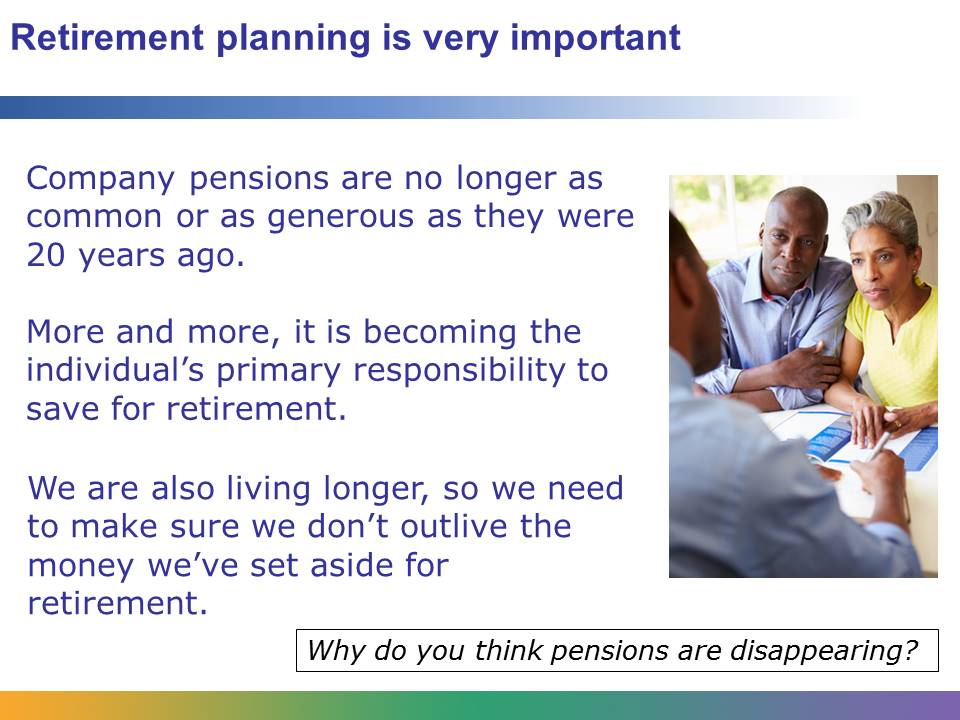
This presentation covers some of the most important aspects of retirement planning:

* Why investment planning is important
* Our government safety net
* Key retirement planning strategies



Most experts agree that you should strive to keep earning at about 70% of your preretirement paycheck during your retirement. As we live longer and healthier lives, some are suggesting that 100% of your preretirement paycheck is a better goal to try for.

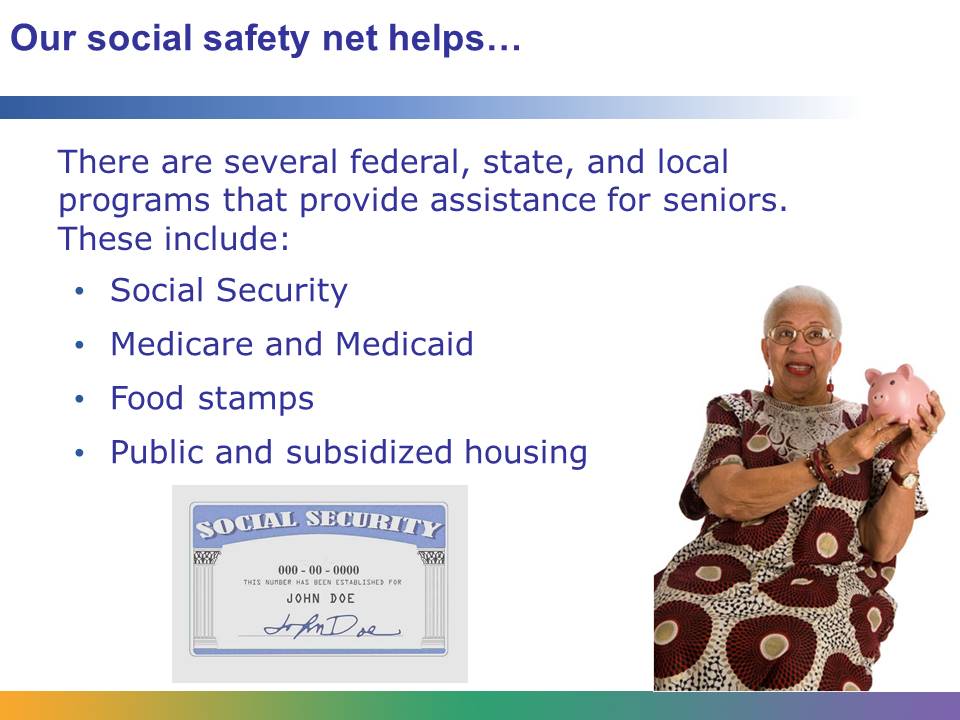
In either case, you need to be aware of inflation, which reduces the amount that your money can buy each year.



In the recent past, many large employers offered retirement plans as a benefit of employment. These plans, known as defined benefit plans, guaranteed a specified income to qualifying employees, depending on how long they worked at the company and how much they were making when they left.

Today, more and more companies are moving to defined contribution plans, where each employee is responsible for choosing how to invest retirement savings using such tools as IRAs (including Roth IRAs) and 401(k) accounts. Most of these plans have tax advantages and are often matched by employer contributions.

Defined contribution plans have limits as to how much can be invested each year. These limits are rising regularly.

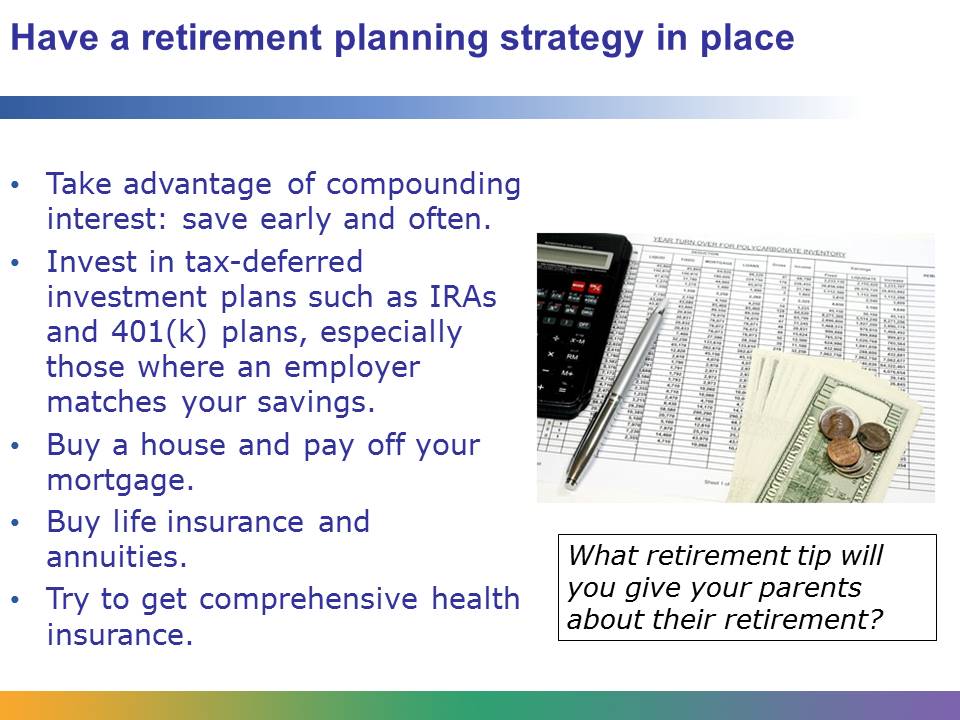


For those people who have not prepared for retirement or who experienced some financial hardship and no longer have sufficient funds for retirement, there are some safety nets in place.

In the United States, all workers pay into the Social Security system. Through this system, we receive monthly income when we retire, depending on how long we work and how much money we put into the Social Security system during our working life.

While the regular income from Social Security is helpful, for most people it does not provide for all their expenses during retirement. There are some questions about whether the Social Security system may go through some changes in the future, because there currently is not enough money in the system to provide coverage at current levels as the baby boomer generation enters into retirement.

For people who do not have adequate income for retirement, many cities have special subsidized senior housing developments.



The sooner you begin saving for retirement, the easier it will be to be ready when it comes.

By letting the power of compound interest work for you, your money will grow rapidly over the years. Also, take advantage of your employer’s contributions to your retirement plan. Some companies will even match your savings, which is a really great benefit. There are several types of plans, known as IRAs and 401(k) accounts, that allow you to invest money and pay taxes only when you withdraw.

One way to reduce housing costs in retirement is to pay off the mortgage. Many retired people only pay their homeowners insurance and property taxes. Others sell their home and buy a smaller one, keeping the difference to help fund their retirement. There is a special tax law that allows people to sell their home and not pay any taxes on the gains (up to $250,000 for single owners and $500,000 for married couples).

Annuities are an insurance product that you pay into during your earning years and that pay out a regular amount, or annuity, when you are retired.

Health care costs can be one of the largest expenses. Having a health care plan in place that covers unexpected costs is one of the most important steps in retirement planning. Most Americans over the age of 65 are eligible to participate in Medicare. Those premiums are then deducted from your Social Security check. Something everyone should keep in mind is that the recent Patient Protection and Affordable Care Act (sometimes referred to as Obamacare) requires that all individuals have health insurance or face a penalty tax.

Student Resource 18.4

Scenarios and Strategies: Exploring Retirement

Student Names:\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_ Date:\_\_\_\_\_\_\_\_\_\_\_

Directions: In this activity you will read the stories of how four different people or couples live in retirement. You’ll notice that there are many different ways to retire! Begin by reading the four scenarios listed on the left side of the worksheet. After you read the four scenarios, match each scenario with the retirement strategy (listed on the right) that it most likely followed. Draw a line from the scenario to the appropriate strategy.

|  |  |
| --- | --- |
| **Scenario 1:** This working class couple lives in a small house in Queens, where they have lived for more than 30 years. They brought up their daughter in this house. In fact, because they don’t have enough money to make ends meet each month, they’ve invited their daughter and her unemployed husband to live with them. While the extra money is handy, the situation in the house is tense, as the father doesn’t get along with the son-in-law. Mostly, they think about the good times they had when they were younger. | **Strategy 1:** Company pension from factory, but the pension payments are not growing as quickly as the inflation rate. Also has a health care plan through company, but husband’s high stress level requires that he take expensive medications that are not covered. Earns extra income by renting rooms to family members. |
| **Scenario 2:** This single man lives alone in a run-down hotel in San Francisco’s Mission District. Throughout his hard life, he worked a variety of jobs—on the railroad, picking fruit in California’s Central Valley, even working in the circus for a while. But none of the jobs ever lasted longer than six months. These days, the man worries what the future holds for him, now that he is no longer strong enough to work. | **Strategy 2:** Saved money regularly, investing in IRA and mutual funds. When spouse died, life insurance policy of $500,000 was left. Pays for own health insurance plan, which, while expensive, brings peace of mind. Sold the family house and moved into a very nice smaller apartment, investing the rest of the money in mutual funds and bonds. |
| **Scenario 3:** This woman lives alone, single since her husband died 15 years ago. She lives in a charming cottage on the shore of Lake Michigan, near her daughter and son, who live a few miles down the road. She is enjoying her retirement, especially her trips out to a local park to practice her watercolor painting. | **Strategy 3:** No retirement plan. Did not hold a job that provided a pension. No health care coverage. Currently survives by living in subsidized housing and by getting Social Security checks and food stamps. Gets health care at local clinic and public hospital emergency room. |
| **Scenario 4:** This couple lives in a housing development for seniors. They both like to travel, especially to visit their daughter who now lives in Germany. They get a regular income each month, enough so that they are still able to help their kids financially whenever trouble arises. | **Strategy 4:** Company pension and health care. Invested money in real estate, and now houses are paid off. Receive monthly rents that pay for all expenses and provide extra money each month. |

Student Resource 18.5

Reading: Retirement Planning Instruments

Directions: Divide the sections of the reading below among your group. Then read the section assigned to you and use what you learn to complete the corresponding section of the chart in Student Resource 18.2. When all the members of your group have finished reading their section, report what you’ve learned about your investment instrument to the other group members.

Everyone should read the introduction.

Introduction

Investment risk can be very rewarding financially, and portfolios should be diversified to include high-risk, high-reward investments as well as those considered safer. Young investors in particular can recover from a risk that doesn’t pan out—they have the time before retirement to reinvest and grow their money. As investors age, however, they must adapt their portfolios to the realities of time. Individuals just a few years from retirement are not in a position to risk their savings, because they may not have time to recover from a loss.

Most investors recognize the need to transition their portfolios over time so that their overall investments have lower returns but have less risk of loss. They rebalance their portfolio mix to increase the ratio of low-risk to high-risk investments.

Below are investment instruments, some of which are appropriate for older investors.

Stocks

Individual stocks might be the bedrock upon which retirement wealth is built. As retirement nears, however, the risk of loss without a chance to recover becomes too great. A common mistake is to have too much invested in stock; if the market fails, the retiree could be devastated financially without the time to earn income to replenish portfolio losses.

Pros

* Stocks typically have potential for higher returns compared with other types of investments over the long term.
* Some stocks pay dividends, which can cushion a drop in share price, provide extra income, or be used to buy more shares.

Cons

* Stock prices can rise and fall dramatically.
* There is no guaranteed return.

Mutual Funds

Life expectancy has been on the rise for many years, with more people living into their 90s and beyond. This, together with inflation, has made growth a necessary preoccupation in early retirement. One way to combine growth with safety of principal is by investing in mutual funds. A mutual fund is a professionally managed portfolio that pools money from many investors and invests it in [securities](http://en.wikipedia.org/wiki/Security_(finance)) such as [stocks](http://en.wikipedia.org/wiki/Stock), [bonds](http://en.wikipedia.org/wiki/Bond_(finance)), and short-term [money market](http://en.wikipedia.org/wiki/Money_market) instruments.

Mutual funds should comprise the bulk of investment assets in youth and middle age. In retirement, they should represent no more than a significant minority of a portfolio.

Pros:

* A single mutual fund can hold dozens to several hundred different securities. This diversification considerably reduces the risk of a serious monetary loss due to problems in a particular company or industry.
* You can begin buying shares with a relatively small amount of money.
* Mutual funds are managed by professionals who are experienced in investing money and who have the education, temperament, skills, and resources to research diverse investment opportunities.
* Mutual fund shares can be bought and sold any business day (that the market is open), thus providing investors with easy access to their money.

Cons

* The return on investment depends heavily on the skill and judgment of the professional manager handling the fund, and studies have shown that few portfolio managers are able to outperform the market.
* Fees for fund management services and various administrative and sales costs reduce the return on investment. Fees are charged whether the fund performs well or not. Mutual funds are required to report their investment performance results after subtracting all fees and expenses so the investor can easily compare one fund to another.
* Redeeming a mutual fund investment in the short term could significantly impact return due to sales commissions and redemption fees.

Bonds

Bonds are well suited to retirement investing. As credit instruments, their principal is comparatively safe. Many bonds are rated; their safety can be gauged. Their periodic coupon interest payments dovetail with the income needs of retirees.

Only investment-grade corporate bonds or government bonds should be chosen.

Pros:

* Bonds tend to rise and fall less dramatically than stocks, which mean their prices may fluctuate less.
* Certain bonds can provide a level of income stability.
* Some bonds, such as US Treasuries, can provide both stability and [liquidity](http://retire.americanfunds.com/help/glossary-popup.htm#liquidity).
* Bond prices go up when interest rates go down.

Cons:

* Historically, bonds have provided lower long-term returns than stocks.
* Bond prices fall when interest rates go up. Long-term bonds, especially, suffer from price fluctuations as interest rates rise and fall.

Annuities

Annuities are a special form of investment that is a contract between the investor and the issuing insurance company that states that the insurance company will pay you a series of payments for either a specific period of time or for the rest of your life. Annuities act in opposition to life insurance. While life insurance protects you financially against an early or unexpected death, annuities protect you from the financial risk of living too long and outliving your money.

There are different types of annuities including immediate, deferred, fixed, and variable. All meet the purpose of annuities, which is to provide guaranteed income for life or a specified period of time. This makes them a perfect fit for retirement. The retiree no longer earns income and needs it; an annuity can provide guaranteed lifetime income.

The ideal time to purchase the annuity is a decade or so prior to anticipated retirement in the case of a deferred annuity, or coincident with retirement in the case of an immediate annuity. Lengthening of life expectancies makes annuities a better retirement investment instrument with the passage of time.

Pros:

* Once you select monthly payments (or annuitize your annuity contract), the insurance company will guarantee you (and your spouse, should you desire) the income payment for the rest of your life or the specified period of time.
* In certain states, annuities are a shelter from creditors.
* Many variable annuities let you benefit from stock market gains while shielding you against stock market losses, though such guarantees are expensive and come with many strings attached.
* Just like a 401(k) or IRA, contributions and earnings can grow tax-deferred until funds are withdrawn.

Cons:

* Once the contract goes into effect, it is difficult or impossible to get the lump sum back or even pass it to other beneficiaries.
* Once an annuity contract goes into effect, access to the funds will likely result in surrender penalties. But these surrender penalties do decline during a period of years, specified in the annuity contract.
* A withdrawal from an annuity is treated as ordinary income, so there are no tax advantages unless the funds used to originally invest in the annuity were post-tax dollars (i.e., income tax was paid on the money prior to investing it).
* If the insurance company goes bankrupt, the annuity may evaporate.
* Commissions, annual fees, administrative charges, and surrender charges can be very expensive.

401(k) Plans

A 401(k) is a retirement savings plan sponsored by an employer. It lets workers save and invest a piece of their paycheck before taxes are taken out. Taxes aren’t paid until the money is withdrawn from the account.

401(k) plans arose during the 1980s as a supplement to pensions. Most employers used to offer pension funds. Pension funds were funded and managed by the employer, and they paid out a steady income over the course of the retirement. But as the cost of running pensions escalated, employers started replacing them with 401(k)s, which are funded by both the employer and employee.

With a 401(k), you control how your money is invested. Most plans offer a choice of mutual funds that comprise stocks, bonds, and money market investments. The most popular option tends to be target-date funds, a combination of stocks and bonds that gradually become more conservative as you reach retirement.

Pros

* 401(k)s allow you to postpone paying taxes on your money until you take the money out.
* Some employers match employees’ deposits, effectively doubling the amount being saved.
* A 401(k) retirement plan requires investors to save money each month.

Cons

* 401(k) plans are meant for retirement. Extra fees are charged by the federal government if you tap into it before age 59 1/2.
* The dollar amount that can be deposited annually in a 401(k) plan is limited.
* When you invest in 401(k) plans your money is often invested in low risk, low-return investments.
* Income tax rates could be higher when you retire than they were when you originally invested the money.