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How Long Will You Have to Work?

Most of us have grown up in an era when the dream is to retire as soon as possible - age 65 or sooner. In fact, almost half of men retire at age 62 and half of women retire at age 60 (Source: *Financial Planning*, September 2007). But if you haven't retired yet, a whole host of trends make retiring at age 65 seem difficult:

- **Fewer individuals are covered by defined-benefit plans.** For years, the trend has been away from defined-benefit plans, which provide a guaranteed retirement benefit paid for by your employer, to defined-contribution plans, where you are responsible for making contributions. Currently, only 21% of the work force is covered by a defined-benefit plan (Source: *Fortune*, June 26, 2006). But even those workers can't be assured of those benefits. While companies can't take away benefits that are earned, they can change future benefits, which could result in significantly lower benefits than expected.
- **The Social Security system will face increasing pressure in the future.** Due to the unprecedented number of baby boomers who will be retiring in the near future, there will be fewer workers to pay the benefits for retirees. In 1950, 16 workers were paying for each retiree's benefit. Currently, there are 3.3 workers supporting each retiree, which is expected to drop to only 2 workers for each retiree in 40 years (Source: Social Security Administration, 2007). By 2041, unless changes are made to the system, benefits will need to be reduced by 25% to equal revenues collected (Source: Social Security Administration, 2007).
- **Life expectancies continue to increase.** Average retirement ages have been declining while life expectancies have been increasing. Today, at age 65, the average life expectancy is 82 years for a man and 85 years for a woman, compared to 78 years for a man and 81 years for a woman in 1960 (Source: National Center for Health Statistics, 2007). And these are just averages, meaning 50% of 65-year-olds will live longer than this. Also, retirement ages have been decreasing. Currently, the average retirement age is 62 (Source: Center for Retirement Research, July 2006). Thus, with younger retirement ages and increased life expectancies, the average retiree has fewer years to accumulate savings, but must accumulate more savings to last a longer time period.
- **Health-care costs are becoming more of a burden.** More and more companies are reducing or eliminating health-care insurance for retirees, and health-care costs tend to increase faster than overall inflation. A recent report estimates that a 65-year-old couple will need $215,000 to cover health-care expenses in retirement, including costs for Medicare Part B and Part D and supplemental insurance. This amount does not include potential long-term-care expenses. It was also estimated that a 65-year-old earning $60,000 in the year he/she retires could spend half of pretax Social Security benefits on health care (Source: PlanSponsor.com, 2007).

- **Long-term inflation rates are uncertain.** Inflation has been tame for a long time, so it's easy to underestimate its impact over a long retirement. For instance, while inflation has averaged 2.54% over the past 10 years, it averaged 4.31% over the past 30 years (Source: Bureau of Labor Statistics, 2007). And while overall inflation has been tame lately, the items retirees spend a significant amount of income on, including health care, housing, energy, and food, tend to increase faster than overall inflation.
- **Plans for retirement have changed.** A common retirement planning rule of thumb is that you'll need 70% to 80% of your preretirement income after retirement. However, that guideline assumes a relatively inactive retirement lifestyle. Increasingly, retirees view retirement as a time to travel extensively or engage in expensive new hobbies. Thus, more and more retirees are finding little change in their income needs after retirement.

So how long will you have to work before you can retire? Consider this one fact. Current retirees receive close to 70% of their retirement income from Social Security and defined-benefit pensions, while today's workers will probably only receive one-third of their retirement income from those sources (Source: Ibbotson Associates, 2007). That means you'll be responsible for saving enough to provide two-thirds of your retirement income.

For most people, that is no easy task. It is typically recommended that no more than 4% of a retirement fund balance be withdrawn each year to ensure that funds last for a long retirement. That means you need to save 25 times the amount you want to withdraw annually. So, if you want $75,000 annually from your retirement assets, you need to accumulate $1,875,000 by retirement age.

On at least an intuitive level, most workers seem to understand what a challenge this presents. More and more studies report higher and higher percentages of workers saying they plan to retire later or continue working in retirement. There is some evidence that behavior is changing. A recent study found that the percentage of individuals age 55 and older in the work force increased from 29.4% in 1993 to 38.0% in 2006. The percentage of individuals from ages 65 to 69 in the labor force increased from 18.4% in 1985 to 29.0% in 2006 (Source: *EBRI Notes*, August 2007).

If you are working, you're not drawing down your retirement funds, and you can avoid taking early Social Security benefits at reduced levels. You can also keep making contributions to your retirement savings. Once you retire, you'll spend fewer years in retirement, so your retirement funds will need to last for a shorter period. Even if you decide to retire and only work on a part-time basis, those earnings can contribute substantially to your retirement lifestyle.

If you plan to keep working, how likely is it that you will be able to continue working? One study estimates that 15% to 20% of people in their late 50s and 60s will not be able to work due to health reasons (Source: Center for Retirement Research, March 2007). This seems reasonable compared to data on current retirees. A recent survey found that 22% of the respondents had been forced to retire an average of seven years earlier than expected. While layoffs and corporate downsizing were the most often cited reason for retiring early, other reasons included illness, injury, and family obligations. Approximately 55% of those who retired early did so before they were eligible to receive Social Security benefits. Most indicated that they were only able to save half of the amount they had wanted to save for retirement (Source: *Financial Advisor*, January 2007).

Thus, even if you intend to keep working well past the age of 65, don't use that as an excuse not to save significant sums for retirement. You should start saving as much as possible, as soon as possible, for retirement.

Encourage Your Child to Participate

Your child has finally finished college and started his/her first full-time job. What is the most important financial advice you can give?

Participate in your 401(k) plan as soon as you are eligible. A recent survey by Hewitt Associates found that less than half of those in their 20s contribute to their 401(k) plan, while 40% of those who do participate don't contribute enough to receive their employer's full matching contribution.

The quality of your children's retirement will largely be determined by the amount of money they save, and a 401(k) plan is a great place for them to start. Before marriage, a new home, and other obligations consume their entire paycheck, get them into the habit of saving. Because the contributions are deducted before they even see their paycheck, it is a great way to get them into the habit of saving on a regular basis.

Having trouble convincing them this is a good strategy? Perhaps some numbers will make the point. Assume your child starts contributing to his/her 401(k) plan at age 25, contributing $6,000 per year (substantially below the maximum contribution in 2007 of $15,500), with matching employer contributions of $3,000. If he/she earns 8% annually, he/she could have a balance of $2,331,509 at age 65, before the payment of any taxes. What if he/she waits until age 35 to start contributing? At age 65, the balance could be $1,019,549, still a substantial amount, but $1,311,960 lower than if he/she started at age 25. Contributions for the first 10 years make a substantial difference in the ending account balance. *(This example is provided for illustrative purposes only and is not intended to project the performance of a specific investment vehicle.)*

What if your child still isn't convinced? Consider reimbursing him/her, as part of your annual gift tax exclusion, for any 401(k) contributions. You can reimburse the entire amount or offer to make a partial reimbursement.

Don't let your child procrastinate because there are too many decisions to be made. Just encourage him/her to start contributing, reassuring him/her that none of the decisions are permanent. He/she can review contribution levels, investment choices, beneficiary designations, and other matters at a later date.

If your child has the option to contribute to a regular 401(k) plan or a Roth 410(k) plan, he/she should evaluate the Roth 401(k) plan carefully. Employer matching contributions will still be made to a regular 401(k) plan, but your child's contributions can go to the Roth 401(k). Your child won't get a current tax break for contributions made, but he/she will owe no taxes on the contributions or any earnings when withdrawals are taken. Generally, investors who are in a higher tax bracket at retirement relative to their current tax bracket while making contributions to a Roth 401(k) will benefit more than an investor who is in a lower tax bracket at retirement. There are several differences between a Roth 401(k) and a Roth IRA, so make sure your child understands the basics before he/she starts contributing.

What if your child doesn't have a 401(k) plan at work? Encourage him/her to contribute to an individual retirement account (IRA). Although contributions are limited to $5,000 in 2008 compared to $15,500 for 401(k) plans, IRAs are still a good way to save for retirement. Again, suggest a Roth IRA rather than a traditional deductible IRA. While your child won't get a current-year tax deduction for contributions made, qualified withdrawals can be taken with no tax consequences.

Narrowing the Wage Gap

For decades, we have heard that men earn more than women for the same type of work. While that is still true, the gap between wages for men and women has narrowed significantly. In the 1960s, women earned approximately 60 cents for every dollar men earned. By 2006, that amount had increased to 81 cents (Source: *Economic Letter*, May 2007). More sophisticated analysis that accounts for variables such as education, work experience, occupation, and family factors, however, show even greater progress in reducing the wage gap. For instance, one study found that women between the ages of 35 and 43 earn 97.5% of what men earn (Source: *Economic Letter*, May 2007).

While women still lag behind men in many job-related measures, they have made substantial progress over the past two generations in several areas:

- **Education** - Individuals with college degrees typically earn substantially more than workers without a college degree. College graduates now make up 30% of the U.S. population over age 25. In 1950, women obtained 24% of all bachelor's degrees, but that percentage rose to 57.5% by 2004. Women in the workplace are now more educated than men - approximately 19.8% of working women and 18.3% of working men are college graduates.
- **Higher-paying occupations** - Women have also shifted their job preferences to better-paying jobs. For instance, 19% of women received bachelor's degrees in business in 2004, up from 2.9% in the early 1970s. The percentage of women obtaining degrees in education, on the other hand, decreased from 36.1% to 10.4%. Currently, women earn 3/4 of all veterinary medicine degrees, 2/3 of all pharmacy degrees, 1/2 of all law degrees, 1/2 of all medical degrees, 40% of all MBAs, and 40% of all dentistry degrees. By 2004, 33% of women earned more than their husbands. Despite these gains, a large number of women still obtain degrees in areas more compatible with family responsibilities that also tend to have lower pay. For instance, women received more than 60% of bachelor's degrees in health professions, social services, education, English, and foreign languages.
- **Less labor intensive work** - Women have also benefited from the economy's transformation from manufacturing to services. Men are much more likely to work in manufacturing jobs. Women have moved into formerly male-dominated occupations that typically aren't physically demanding.
- **Businesses** - Women have also increasingly become entrepreneurs. In 1972, women only owned 4.6% of U.S. businesses. By 2002, women owned at least a half interest in nearly 40% of all U.S. businesses. However, women-owned businesses tend to be small - 80% of women-owned businesses had $50,000 or less in receipts and 85% employed fewer than 10 people in 2002.
- **Corporate executives** - Women are increasingly taking on jobs as corporate executives. In 1972, 17.6% of management jobs were occupied by women, which increased to 37.2% by 2004.

Over the past couple of decades, women have made choices that have prepared them well for the current job situation. While there is still a gap between wages earned by men and women, that gap has narrowed substantially.

Paying Off Your Mortgage

There are advantages and disadvantages to paying off your mortgage. On the positive side, any extra money sent with your mortgage payment is applied to the outstanding principal, which can significantly reduce your total interest cost. This reduces your interest expense deduction on your tax return, but you are paying most of the cost anyway. For instance, if you're in the 25% tax bracket, you save 25 cents in taxes for every dollar of interest, but you're still paying the remaining 75 cents.

When paying down principal, you are effectively earning a pretax return equal to your mortgage interest rate, which is a guaranteed return with no risk. Most mortgages allow you to add as much to the payment as you like, whenever you like, making it an easy way to use excess funds. However, check with your specific lender to determine if prepayment penalties apply.

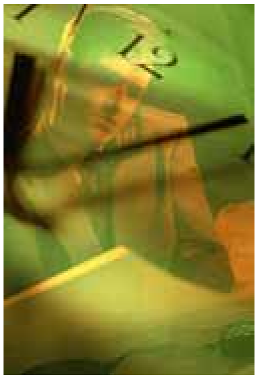
On the other hand, instead of prepaying your mortgage, you might want to use additional funds to invest in investments with the potential to earn higher returns. Also, once you make the additional mortgage payments, the only way to access that money is to sell your home or take out a home-equity loan, usually at higher rates than the original mortgage.

Consider the following factors before prepaying your mortgage:

- **Are all components of your financial plan in place?** Before prepaying your mortgage, make provisions for things like disability insurance, life insurance, and an emergency reserve fund.
- **Is all your consumer debt paid off?** Consumer debt typically carries interest rates that are higher than your mortgage rate, and interest payments are not typically tax deductible, unless it's a home-equity loan. Thus, you should probably pay off your consumer debt in full before making additional payments on your mortgage.
- **Are you maximizing contributions to qualified retirement plans?** Make sure you are contributing the maximum to your 401(k) plan, especially if your employer matches funds, or are fully funding other qualified plans and individual retirement accounts.
- **Have you investigated other investment alternatives?** Look into other investments whose potential returns may exceed the return from prepaying your mortgage. However, make sure you actually make those investments. You don't want to just spend any money that could have gone toward your mortgage.
- **Are you nearing retirement?** As you approach retirement age, the idea of entering retirement with no debts may make prepaying your mortgage a more attractive alternative. Or you may like the certainty of positive returns that comes from prepaying your mortgage.

If you decide to prepay your mortgage, consider these strategies:

- Switch from a 30-year to a 15-year mortgage. By paying the mortgage off 15 years sooner, you save a significant amount of interest.
- Pay half your mortgage payment every two weeks. Over the course of a year, that equals 26 payments or 13 monthly installments. Check with your lender to make sure this option is offered.
- Add additional amounts to your monthly mortgage payment. This option is the most flexible, since you decide on a monthly basis how much to add to your payment.



The Basics of Dollar Cost Averaging

If you find it difficult to decide when to invest, consider a dollar cost averaging strategy. Dollar cost averaging involves investing a set amount of money in the same investment on a periodic basis. For instance, instead of investing $48,000 in one stock immediately, you might decide to invest $4,000 in that stock at the beginning of each of the next 12 months. Thus, you don't need to think about when to invest. You just follow your strategy and continue to invest on a periodic basis.

Dollar cost averaging is a defensive strategy that can help protect you from making a major investment when prices are high, especially during volatile periods. If the investment increases in value over that time, you still will have purchased some shares at lower prices.

Since you are investing a fixed amount of money, you purchase more shares when prices are lower and fewer shares when prices are higher. Thus, your average cost per share is typically lower than the average market price per share.

While dollar cost averaging is a good strategy for developing the habit of regular investing, it does require the discipline to invest consistently. However, it neither guarantees a profit nor protects against loss in a prolonged declining market. Because dollar cost averaging involves continuous investments regardless of fluctuating price levels, investors should carefully consider their financial ability to continue investing through periods of low prices.

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