Lesson 16

Investing for Retirement

Key Terms

- 401(k) Plan
- Annuity
- Defined-Benefit Plan
- Defined-Contribution Plan
- Employer-Sponsored Retirement Plan
- Individual Retirement Account (IRA)
- Keogh Plan
- Pension
- Retirement
- Roth IRA
- Social Security

What is Retirement?

- You are no longer a part of the **workforce**
- You are depending on your retirement savings and/or other retirement plans for your living **expenses**
- You can "**retire**" at any age
  - You will not receive full government-sponsored retirement benefits until age 67

What Is Social Security?

- ***Social Security*** is a payroll tax that is deducted automatically from your paycheck.
  - You are eligible to receive after you’ve worked and paid into the system for 10 years.
  - The age at which you retire will affect how much you receive.

What Is Social Security?

- ***<u>Social Security</u>***
  - Reduced benefits available as early as age **<u>62</u>**
  - Full benefits available at age **<u>67</u>**
    - If you start drawing social security benefits before age 67, your benefit does not automatically increase when you reach age 67
  - It’s an average of 35 years of indexed earnings.

- Federal Insurance Contributions Act (FICA) is how social security is **funded**
  - Must pay in for minimum of **10 years** to be eligible for any benefits
  - The more you pay in to social security during your life, the more you will be eligible to receive in benefits
- Social security will, on average, only cover ***40%*** of your pre-retirement earnings
  - Financial planners say you need ***70 – 80%*** of your pre-retirement earnings as income once you retire
  - Need your own retirement plan

What Is a Pension?

- ***<u>Pension</u>*** is a fixed sum of money paid to you when you reach retirement age
  - your employer continues to pay you after you retire
  - ***<u>Defined Benefit Plan</u>***
    - You have a guaranteed amount you will be paid
- Very expensive for companies
  - Must be taking in enough money from current employees and company profits to be able to pay for retired employees
  - Most companies are eliminating pensions for workers and using other retirement plan options

Pensions

- Most pensions now only available in the public sector
  - **<u>Military</u>**
  - **<u>Education</u>**
  - Other government employees
- Pensions are taxed when the money is withdrawn in retirement (aka <u>tax deferred</u>).
- Best to start contributing early to allow the pension to grow over your career.

What Are Employer-Sponsored Retirement Plans?

- Employer **sponsors** plan that allows you to build savings in investments of your choice
- Normal features
  - The money you contribute to the plan is automatically deducted
  - Your contributions are not taxed
  - Your employer may match some or all of your contribution
  - You may be able to borrow some of the balance without a high interest rate or penalties
  - Your money is safe from creditors trying to collect a debt

The 401(k)

- Named after the section in the US Internal Revenue Code
- ***Defined Contribution Plan***
  - The amount of your benefit depends on how much you contribute and how well your investments do
  - You are ***not*** guaranteed a specific amount upon retirement
  - Only available through an employer
- You choose where/how the contributions are **invested**

- You are normally permitted to change your investments throughout the year
  - If an investment is performing **poorly**, or you are worried about its future performance, and there is another one you want to move it to, you can
- You pay no **taxes** on the money you contribute, or the money you make on those investments, until you withdraw the money at retirement
  - Reduces your taxable income for a working year (less paid in income taxes that year on your earnings)
- You pay taxes on the money when you withdraw it during retirement.

- Many employers match some or all of your **contribution**
  - Example: your employer will match your contribution up to **3%** of your earnings
    - If you contribute less than 3% of your earnings, they match your amount
    - If you contribute more than 3%, they will only contribute an amount equal to 3% of your earnings
- Current limits on tax-deductible contributions
  - **$15,500** per year
  - Any additional contributions will be taxed as part of your regular income

- ***<u>Vesting</u>***
  - The percent of your employer's contribution you actually get should you leave the company
    - Normally have **<u>minimum</u>** number of years you must work for the employer to get their contribution
  - Vesting may be on a scale
    - The longer you have been there, the larger percentage of their contribution you have "vested"
    - Ex: you may need to work somewhere for 3 years to be 50% vested, 5 years to be fully vested
- 401(k) **<u>goes with you</u>** if you leave an employer
  - All of your contributions, and the vested portion of your employer's contributions, goes with you
  - You can "cash out" and take a lump sum portion, but you will have to pay taxes on it

- The amount you need to save in your 401(k) depends on several factors:
  - Where you plan to live in retirement
  - What you plan to do in retirement (read and relax or lots of vacations?)
  - Do you own your home or rent/pay mortgage?
  - Inflation of goods

What Are Individual Retirement Accounts (IRAs)?

- Retirement plan not tied to an **employer**
  - Available through banks, investment firms, stock brokers, or financial advisers
- Allowed **pre-tax** contributions vary based on age and income level
  - You will claim this IRA deduction on your tax return to reduce your taxable income
  - Higher income thresholds result in either partial or no deduction
  - The IRS publishes thresholds and amounts annually
- You choose what investment(s) you want that IRA to be composed of

Traditional IRA

- Can begin withdrawing from it at age **59**
- **10% penalty** for early withdrawals (with some exceptions)
- Can set up through bank or other financial institution
- Some or all of contributions **tax deductible**
- Earnings not taxed until they are withdrawn

Roth IRA

- Similar to traditional **IRA**
- Contributions are **not** tax deductible
- Can withdraw your principal investment (not the earnings) at any time without penalty
- When you reach retirement, all withdrawals, even earnings, are tax-free
- Not everyone qualifies to set up Roth IRA
  - Income limits cannot exceed
    - $95,000 for a single filer
    - $150,000 for married joint filer

What If I’m Self-Employed?

- Keogh Plan
  - Designed for self-employed professionals or owners of small businesses & their employees
  - Two types
    - Defined benefit
    - Defined contribution
- Have same tax advantages as 401(k) plans
  - Contributions tax-deductible
  - Don’t pay income tax on earnings until you withdraw it
- Can contribute more than with IRAs

Retirement Annuities

- Something available if you have already reached maximums in IRAs and 401(k)s/Keogh
- **Tax-deferred** investment contract
  - Don’t pay taxes on earnings as long as they stay in annuity
- Money invested with life insurance company
  - Pay them either lump sum or make periodic payments
- **Annuity** issuer pledges to make payments to your or your beneficiary at some point in the future
  - Can receive lump sum or receive payment for specified period or remainder of your life

- Type of annuity depends on how soon you want your payments to start & how you want your money invested
  - **Immediate** annuity: receive payments shortly after you purchase it
  - **Deferred** annuity: won't receive payment until significant time in the future
  - **Fixed** annuity: guarantees a particular interest rate on the annuity
  - **Variable** annuity: gives you option of how money is invested
    - Can earn more money
    - Risk of losing money

Retirement Considerations

- <u>Inflation</u> (increase in the price of goods and services over time) can impact how much you:
  - Earn
  - Spend (milk gets more expensive!)
  - Save
  - Invest

Creating Wealth

- Start saving <u>early</u>
- Earn capital <u>gains</u> (interest)
  - Start young with a "risky" investment portfolio
  - Become more conservative as you get close to retirement age
- Make profits on the sale of goods
  - Antiques/collectibles
  - Real estate
- Invest in a <u>diverse</u> portfolio
  - Stocks, bonds, mutual funds, property, etc.