

IQ Guide to Retirement



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Retirement!

Would you like to retire as a millionaire? It's easy—if you start planning and saving early. This guide shows you the steps.

What if you haven't started planning for retirement early? Can you still plan wisely and save a comfortable nest egg? Again, the answer is yes. No matter how late you start planning and saving, there are steps you can take to maximize your savings and resources.

No matter when you start, saving for retirement is wise. Setting realistic retirement savings goals to secure your family's future is particularly important today: Most employer-sponsored "defined benefit" pension plans are being replaced by "defined contribution" plans to which employees must contribute. In addition, there is much discussion of Social Security reform.

When you're ready, this guide can help you start to plan for retirement.



Remar Sutton

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***IQ Tip:** Before you continue reading, a reminder that our discussion and sites to which we've provided links provide information to help you understand issues related to retirement planning but the information is not intended as investment, tax or legal advice. For advice on your specific questions you may wish to consult a qualified financial, tax or legal professional.*



Preparing a Retirement Plan

How much money will you need to have for your ideal retirement scenario? Where will it come from? The recent rocky economy, talk of Social Security reform, and a few high-profile pension fund failures have many Americans thinking more seriously about how they will fund their retirement. For years, financial planners have talked about retirement income as a “three-legged stool”: Social Security, employer-related pension or retirement plans, and personal savings including tax-advantaged retirement investment accounts. Because they are healthy and active, more retirees are adding a fourth leg to that stool—part-time work.

Financial planning for retirement is about having a plan for your money. It basically comes down to five questions:

1. How much money will you need to retire?
2. How much time do you have to get there?
3. Where are you now in saving for retirement?
4. What investment vehicles give you a chance to get there?
5. How much financial risk are you willing to take in saving and investing for retirement?

Determining How Much Income You Will Need

A good way to make an accurate estimate of how much income you'll need is to keep track of your current living expenses for at least six months to as much as a year. This figure gives you a current estimate of the money it takes to maintain your current standard of living. Note your goals for retirement: Do you plan to move to a smaller home or different community? Do you plan to travel more?

Next consider what expenses will probably decrease (or go away entirely) and which may increase. Be sure to estimate these expenses for both you and your spouse. Here are some examples:

Possible decreasing expenses:

- Commuting costs and business travel
- Union and/or professional dues
- 401(k) plan contributions and Social Security tax deductions
- Business clothing
- Work-related social expenses
- Certain automobile expenses
- Income taxes
- Mortgage (depending on the duration of your mortgage)

- Child-rearing expenses
- Health insurance payments (depending on cost of employee-plan or individual plan)

Possible increasing expenses:

- Travel, entertainment, and hobbies
- Medical and dental expenses
- Medigap health insurance premiums
- Long-term care insurance
- Gifts to family members (particularly if you choose to use gifts in your estate planning)
- Volunteer expenses
- Care of elderly parents

After you have a good estimate of all projected annual expenses, including “discretionary” expenditures, estimate the total amount you (individually or as a couple) will need for your annual income.

How many years will you need that annual income? At what age do you plan to retire? 65? Earlier than 65? Later than 65? When does your spouse plan to retire? Also consider your life expectancies. Do family members routinely live into their 90s? Estimate the number of years you'll need income. Multiply the yearly income by the number of years. This will give you a rough estimate of the total amount you may need.

***IQ Tip:** Remember that inflation over the years will increase the annual income that you will need to maintain the same standard of living. In recent years inflation has remained fairly low: since 1995, rates of inflation have ranged from 1.6% to 3.8% annually according to the U.S. Bureau of Labor Statistics (with the exception of 2009 which at -.04% had essentially no inflation). But even that range of annual increase in the costs of goods and services increases the total income you need. You can use the FINRA Retirement Calculator to estimate the impact of inflation at various rates. (FINRA is the Financial Industry Regulatory Authority. apps.finra.org/Investor_Information/Calculators/1/RetirementCalc.aspx)*

Determining the Income You'll Have

To determine an estimate of the total income you have, given your current situation, you'll need to gather information from several different sources.

- **List an estimate of what you'll receive from Social Security.** Use your estimate from Social Security. If you're over 25, then you receive an annual Social Security Statement about 3 months before your month of birth (for example, if your birthday is in

April then you should receive your statement in January) If you can't find your latest statement, you can request a statement at any time. You can also use one of the benefit calculators on the Social Security website. Once you have a benefit estimate—either from your statement or from one of the benefit calculators—you can use other calculators on the Social Security web site to see how different retirement dates and situations might affect your benefits. For example, these Retirement Age Calculators show how retiring early reduces your monthly benefit: www.ssa.gov/mystatement/
www.ssa.gov/planners/calculators.htm
www.ssa.gov/planners/morecalculators.htm

- **List the estimated amounts of any assured income—pensions, disability benefits, annuities, etc.—you will receive.** (See more about pension and annuity payouts below.)

Pension Payouts

Depending on your company plan, you may choose among various pension payout options when you retire. Typically, you may elect to receive a pension either in one lump sum upon retirement or in monthly payments for either a) the remainder of your life (single life option) or b) the remainder of both your life and that of your spouse (joint survivor option). Your company human resources department should provide information to help you estimate the total amounts you may receive under various options.

Annuity Payouts

Annuities come in several types, such as deferred or immediate annuities, fixed rate or variable annuities, and fixed-period or lifetime annuities (the monthly payment is for a fixed period or for the beneficiaries lifetime). Each of the variables affects the total projected payout for the annuity. Consult your policy or annuity company to determine how to estimate the payout for your policy.

- **List the current amount of money you've already saved.** Because you desire only a rough estimate, use the total of current balances in IRAs, 401(k)s, mutual funds, and other investments.

What's the total of these potential sources of income? Note that for the purposes of this rough estimate, you need just the sum of the estimated amounts you've listed.

Determining How Much More You Will Need

You now have two figures: 1) how much you will need and 2) how much you potentially and reasonably will have on hand. The difference between the two figures is how much more you will need to save.

You can enter your figures into our IQ Retirement Savings Calculator to help you estimate the additional money you will need to save to meet your retirement income goals. Dividing this lump sum by the number of years you have left until retirement will give you a very rough idea of the amount you'll need to save annually.

A number of other websites have retirement savings calculators that let you plug in various figures to predict approximate future income based on the factors you provide. You may wish to run the numbers on several calculators in order to compare.

- The Retirement Planner from 360 Degrees of Financial Literacy (American Institute of CPAs) allows you to plug into one form many of the figures we just discussed for a rough estimate of what you'll have and what you'll need. The simple format enables you to compare many possible scenarios. (www.360financialliteracy.org/Topics/Retirement-Planning/Retirement-Planning-Basics/Retirement-Planner)
- Retirement Planner from CNN/Money. This calculator allows you to estimate more factors and takes into account potential tax rates and type of investment strategy used for retirement savings. (cgi.money.cnn.com/tools/retirementplanner/retirementplanner.jsp)
- Retirement Calculator from FINRA, the leading private-sector provider of financial regulatory services (overseeing brokerage firms and brokerage agents). (apps.finra.org/Investor_Information/Calculators/1/RetirementCalc.aspx)

Retiring a Millionaire

So you'd love to have a million dollars in savings when you retire? A million is still the magic number, even if it won't buy what it would in 1970. In fact, based on your planning from the previous section, you may have discovered you'll need more than a million. But a million is certainly a number to inspire retirement planning.

Thanks to the power of the time-value of money and compounding, becoming a millionaire is an achievable goal even if you make a modest income, as long as you start early—preferably in your 20s. By starting later, you can still achieve millionaire status, but you'll have to make larger contributions to your retirement savings.

The word time-value is a short way of saying that the longer the time you have to invest, the greater the accumulated return on the money invested. Because of the power of compounding, the more years you have to invest (wisely, of course), the more money you will make.

Compounding occurs when the return that an investment has earned is added to the principal and then the new total begins to earn. The process is best understood in interest-bearing financial instruments which earn a certain amount of interest that is calculated (or compounded) at certain intervals (such as daily, monthly, annually). Let's say you have a money market fund or a certificate of deposit earning a certain percentage compounded daily. Each day the interest earned on the principal is calculated, that interest is added to principal to form a new principal on which interest will be calculated the next day...and so on. Earning interest on interest makes the overall amount of money grow faster.

The same concept of compounding applies to other forms of return on investments (such as dividends or capital gains on stock). When they are reinvested, they continue to earn along with the original investment.

Over time, because of the power of compounding, a difference in average return of only a few percentage points can make a big difference in how much your retirement savings grow. Take a look at the following table to see what happens to \$1,000 at various rates of return (compounded annually).

Year	5%	7.5%	10%
1	\$1,050	\$1,075	\$1,100
5	\$1,276	\$1,436	\$1,611
10	\$1,629	\$2,061	\$2,594
15	\$2,079	\$2,959	\$4,177
20	\$2,653	\$4,247	\$6,728
25	\$3,386	\$6,098	\$10,835
30	\$4,322	\$8,755	\$17,449

All amounts are rounded to the nearest dollar.

So let's say that you begin saving \$200 every month when you're 23 and keep doing that faithfully for seven years. You average a return of 7% annually. As your income goes up, at age 30 you increase your savings to \$300 monthly at the same 7% average return. At age 37 your family income allows you and your spouse to save \$500 monthly. You continue to do this for 30 years until you retire at age 67. At an average return of 7% annually, your savings will exceed one million dollars. You will have \$1,158,719!



Retirement Planning by the Decade

Retirement Planning in Your 20s

If you're a typical 20-year-old, planning for retirement isn't even on your radar screen. Launching your career and establishing your own household are more serious priorities. Exploring independence and spending on yourself are fun too. Credit card debt and education loans may also put demands on your income. But none of this should be an excuse for you to ignore saving for your retirement. In fact, a retirement plan should be on your priority list.

Why? Time, not money, is your greatest asset when you're in your 20s. With compounding, just a few dollars saved have a chance to grow into BIG money. Financial planning experts recommend taking these steps.

- **Make a start.** Although saving 10% of your income is recommended, it may not be possible. Save what you can. Even \$25 a paycheck will mount up.
- **Sign up for your employer's 401(k) or 403(b) plan.** Contributions are tax-free. Contribute enough to qualify for total matching amounts from your employer. Consider a more aggressive growth strategy for choosing investment options because you have years to recover from market downswings.
- **Set up an individual IRA.** If your employer has no 401(k)/403(b) plan, set up your own IRA. Deposit as much as you can up to annual limits.
- **Limit debt.** Pay down existing credit card debt. Make a budget that helps you live within your means. Save toward purchases you want; don't just charge them and rack up high interest charges. Shop wisely for big purchases. For instance, shop for a vehicle that meets your needs rather than expensive "wants."
- **Build an emergency fund.** If you need funds for emergencies such as repairing your vehicle or bridging time between jobs, you don't want to tap into your retirement funds and incur penalties. Save a 3- to 6-month emergency fund. Keep that fund in a savings, money market or other accessible account.

Retirement Planning in Your 30s

Americans in their 30s have the highest levels of debt of any decade group—even though median income for households in their 30s falls between about \$52,000 (25-35 yr) to over \$67,000 (35-45 yr). Raising children and purchasing homes tend to contribute to higher debt. Thirty-somethings also have the highest rates of being late on bills. It's no surprise that saving for retirement takes a back seat to these issues. However, the 30s is prime time for getting high returns on retirement savings.

- **Pay yourself first.** Set a goal for savings from each pay period and have that deposited directly to a retirement account. Because earnings are typically much higher than in your 20s, experts recommend aiming for 8 to 10% of income. Then make a family budget for all other expenses based on your net income.
- **Pay down credit card debt.** Then use cards wisely. Using credit cards to live beyond one's income is a major reason that young families struggle with debt payments. A budget can help your family pare down expenses, prioritize purchases and pay down debt. Less money spent on debt payments means more money for necessary expenses and savings.
- **Participate in employer-sponsored 401(k) and 403(b) plans.** Matching funds from employers can increase the power of your contributions; make sure you qualify by maximizing contributions. Continue to consider a more aggressive growth strategy for choosing investment options because you still have years to recover from market downswings.
- **Buying a home?** Search for a home that meets both your needs and your budget. Buying more house than families could comfortably afford was one factor contributing to the foreclosure crisis of recent years.
- **Maintain an emergency fund.** With young families, most thirty-somethings need a 3- to 6-month emergency fund more than at any other stage of life.
- **Ensure that retirement planning is part of overall financial planning.** For example, starting a higher educational fund for young children may also be important during these years. Life insurance to protect one's family is also a consideration.

Retirement Planning in Your 40s

People in their 40s (through mid 50s) are typically reaching maximum earning power. Net worth is also substantially higher than for people in their 30s. Equity from home ownership contributes to net worth along with savings and investments. Forty-somethings typically have more credit card debt, but have less trouble paying the bills on time. Your 40s are crucial for retirement savings.

- **Assess where you are in saving for retirement.** If you established a retirement savings plan in your 20s or 30s and have stuck with it, you're probably in good shape. But assess retirement goals in light of current economic factors, your progress toward those goals, and any adjustments you might need to make.
- **Ramp up retirement savings.** This task is particularly important if your retirement savings to date is modest or if you haven't begun to save. If possible, contribute the maximum allowable in both your 401(k)/403(b) plan and an individual IRA. With 20

years to save before retirement, the maximum of \$5000 annually in a Roth IRA at a 7% return grows dramatically.

- **Assess and adjust plans for other financial needs.** This includes educational funds for your children. Because your income and your spouse are important to your financial well-being, evaluate your needs and your coverage for life insurance and long-term disability insurance. Employer-sponsored long-term disability insurance usually offers the most affordable options.
- **Pay off credit card and installment debt.** The money you save on monthly credit card debt and/or payments for a new vehicle (when your current vehicle is only 3 years old) or luxury home entertainment center (a “want” not a “need”) could go to retirement savings.

Retirement Planning in Your 50s

Reaching your 50s for most Americans means reaching your highest earning power. For many families, children are grown and independent (or nearly so). With higher net worth, including higher home equity, fifty-somethings also typically have accumulated greater savings. The 50s are the ideal time to assess where you are in saving for retirement and where you want to be, and then making adjustments in your savings plan.

- **Assess your retirement savings and plans.** When you're in your 50s, it's a good time to reassess how much you will need for retirement as you envision it and see how close you are to reaching that goal. It might be time to begin to think seriously about when you plan to retire.
- **Maximize your retirement savings.** Once you turn 50, federal regulations allow you to contribute additional funds to tax-advantaged retirement savings plans. If the amount you've saved is less than you need, these rules help you catch up. Most financial planners encourage contributing the maximum allowed if possible. That maximum, for example, is up to \$22,000 for a 401(k) or a 403(b). The limits of your individual plan may be lower. For an IRA, the over 50 maximum contribution is \$6,000.
- **Review your insurance needs.** Review your needs for life insurance and long-term disability insurance. Investigate options and rationale for long-term care insurance. Experts vary widely in their recommendation for the best time to get long-term care insurance, so pay particular attention to this decision.
- **Review your social security options.** Review projected social security income for different possible retirement dates. For example, what would projected social security income be if you retired at 62 compared to later ages such as full retirement (66 or 67)? How would different retirement dates for you and your spouse affect social security income?

- **Consider cutting back on expenses to maximize savings.** Trimming expenses as children leave the nest and while you still are earning maximum dollars can be an excellent way to increase retirement savings, according to planning experts.

Retirement Planning in Your 60s

By the time you reach your 60s, retirement is just around the corner. So it's time to start seriously planning for the transition to retirement—a transition that you choose, rather than one dictated by circumstances.

- **Keep saving.** As you hit 60, you still have a few years to maximize savings. Experts recommend continuing to use catch-up options. If you are in the 25% tax bracket, for instance, every dollar saved costs you only 75 cents. The higher your combined state and federal tax bracket, the less each dollar costs.
- **Review your retirement plans.** When would you like to retire? Where would you like to retire? Do you plan to work part time or not? What income will you require and how does your potential income from savings, pensions, Social Security and assets match up to that requirement? Have you made a detailed income plan for retirement? If you have care-giving responsibilities for parents or other older or disabled relatives, how might these obligations affect your plans?
- **Review Social Security options.** Many people would like to retire at 62, but taking early social security has an impact on what you receive monthly and on your potential lifetime income. Using the tools on the Social Security website (www.ssa.gov) can help you consider all your options.
- **Pay off credit card debt.** Americans in their 60s continue to carry relatively high levels of credit card debt. While you're still earning peak or near peak income it is a good time to pay off this debt so that it does not become a burden on your retirement income.
- **Evaluate insurance needs.** Are you planning to retire before you become eligible for Medicare at age 65? If so, you'll need to plan for health care insurance. What are your other insurance needs and options related to life insurance, disability insurance, long-term care insurance? What are your options for supplemental insurance to accompany Medicare?



Retirement

Social Security

The Social Security program in the United States is an insurance program that provides basic retirement benefits for older Americans as well as survivor benefits for minors and basic support for certain disabled individuals. The health insurance program Medicare is related to Social Security. Benefits are funded by payroll taxes paid by employers and employees and self-employed people.

What Benefits Will You Receive?

The amount of the benefit you'll receive upon retirement depends on the age at which you retire and your reported earnings for each year after you turned 21. This latter fact is one of the reasons that it's important to check the yearly statement of earnings and estimated benefits that the Social Security Administration sends out. If you would like a current statement you can request one online. (secure.ssa.gov/apps6z/iss/main.html)

How to Compare Estimated Benefits for Different Retirement Ages

If you wish to compare how benefits may differ for retiring at different ages (for example, age 62 compared to age 66), use the online Retirement Estimator: (www.socialsecurity.gov/estimator/). The Social Security website also has a useful FAQ, "When to Start Receiving Benefits," on the effect of retiring at different ages. (www.socialsecurity.gov/pubs/10147.html)

When Should You Apply for Social Security Benefits?

The Social Security Administration recommends that you apply for benefits four months before the first month you wish to receive benefits. You can fill out the application online at www.ssa.gov.

Can You Continue to Work While Receiving Social Security?

Yes. But if you receive benefits before full retirement age, some benefits may be withheld if your work income exceeds certain limits. However, after you reach full retirement, these withholdings will result in a higher benefit at that time. If you have reached full retirement age before receiving benefits, you can earn as much as you like without any reduction to your benefits. For more information see "How Work Affects Your Benefits" from the SSA. (www.socialsecurity.gov/pubs/10069.html)

When Should You Apply for Medicare?

No matter when you plan to apply for Social Security benefits or when you reach full retirement age for Social Security, you should apply for Medicare benefits three months before you turn age 65. If you apply later than this time, you may end up paying higher premiums. You can apply online at www.ssa.gov. Read the online Medicare guide from SSA. (www.socialsecurity.gov/pubs/10043.html#part2)



Tax-Advantaged Retirement Plans

To encourage consumers to plan long-range, the U.S. tax code defines several types of tax-advantaged plans that enable individuals to save money for retirement and to grow those savings by investing them. Among the most common plans are Individual Retirement Accounts (IRAs) and 401(k) and 403(b) plans. Most IRAs are established by individuals while most 401(k) and 403(b) plans are sponsored by employers. But there are also some employer-sponsored IRAs as well as a Solo 401(k) option for individuals. Many individuals have both employer-sponsored and individual plans to maximize savings.

The key fact about these retirement plans is that they are not specific investments but are accounts or “shells” in which you can hold and manage a number of investments. The accounts typically offer investors considerable flexibility to match investments to their “age and stage,” and to their goals and tolerance for risk. Here’s a look at the primary features of the most common plans.



Individual Retirement Accounts (IRAs)

The most common forms of these personal savings plans are Traditional IRAs and Roth IRAs. The major difference between the two forms is that in a Traditional IRA contributions are generally tax-deductible, but later distributions from the account are taxed as ordinary income. In a Roth IRA, contributions are not tax-deductible (you pay taxes before you make the contribution)

but later distributions are not subject to income tax. Two other common types of IRAs include SIMPLE IRAs and SEP IRAs.

Although individuals set up IRAs, they are technically trust or custodial accounts and must be set up with entities approved for this purpose by the IRS. Typical organizations that offer IRAs include federally insured credit unions, banks, savings and loan associations, life insurance companies, mutual funds and other such entities. The IRA is established by a written contract.

Traditional IRAs

Traditional IRAs are also often called “ordinary,” “regular” or “conventional” IRAs. This category includes all IRAs that are not Roth IRAs, SIMPLE IRAs or SEP IRAs.

- **The tax advantage.** Annual contributions are generally tax-deductible. Earnings and capital gains of investments in the account are not taxed. Distributions are taxed as ordinary income.
- **Maximum annual contributions.** In 2011, \$5,000 annually for individuals (\$5,000 each for married individuals opening separate accounts) or 100% of earned income if it’s less than \$5,000. Persons age 50 and older may contribute up to \$6,000.
- **Who can open an account?** Any individual who has taxable compensation (usually earned income) within the year may contribute to an IRA. Individuals who have an employer sponsored retirement plan may also open traditional IRAs, though tax deductions for contributions may be reduced depending on their Modified Adjusted Gross Income.
- **Any income limits?** No. Individuals with any size income may open an IRA. The tax-deductibility of contributions may be limited for individuals who also have an employer-sponsored retirement fund, depending on their income.
- **Any age limits to open an account?** Yes. Individuals may open an account if they have not turned 70½ before the beginning of the year.
- **When penalty-free distributions may begin.** At age 59½. Before this time, distributions to pay for specific events that meet strict IRS guidelines and are carefully documented may be exempted from the penalty. Such exempt distributions, for example, may include a down payment for a first home of up to \$10,000 and certain education expenses. Unauthorized distributions face a 10% IRS penalty.
- **When mandatory minimum distributions start.** At age 70½ individuals must begin to take minimum annual distributions as defined by the IRS. Failure to do so is penalized.
- **Can you have more than one Traditional IRA?** Yes, but the limit of the maximum annual contribution applies to the total

personal contributions (as opposed to employer contributions to SEP IRAs or SIMPLE IRAs) for all IRA accounts both traditional and Roth.

Roth IRAs

Roth IRAs are funded with after-tax dollars, but for many individuals they offer advantages over traditional IRAs.

- **The tax advantage.** Roth contributions are not tax deductible. However, the fund grows tax-free and you do not have to pay tax on disbursements.
- **Who can open a Roth?** Any individual. There is not an age limit of 70½ as with traditional IRAs.
- **Any income limits?** Yes. Check IRS publication 590 for specifics, but generally singles who earn \$120,000 or more (adjusted gross income) and married couples who earn \$177,000 or more can not open a Roth IRA as of 2011.
- **When can one be opened?** At any time. You may continue to make contributions after age 70½.
- **Maximum annual contributions.** In 2011, \$5,000 annually for individuals (\$5,000 each for married individuals opening separate accounts) or 100% of earned income if it's less than \$5,000. Persons age 50 and older may contribute up to \$6,000.
- **When penalty-free distributions may begin.** After the account has been open five years, you may withdraw earnings without penalty to pay for qualified events, regardless of age. Otherwise, you may withdraw earnings tax-free starting at age 59½ as long as the account has been open five years.
- **When mandatory distributions must start.** There are no mandatory distributions. You may leave all funds in the Roth as long as you like.
- **Can you have IRAs in addition to a Roth?** Yes. You may have a Roth IRA and one or more Traditional IRAs as well as an employer-sponsored retirement plan. But the annual contribution limit applies as a total for all IRAs.

SIMPLE IRAs

SIMPLE stands for Savings Incentive Match Plans for Employees. This plan enables small employers, even a self-employed individual, to set up a tax-favored retirement account for employees. A SIMPLE IRA enables eligible employees to choose to reduce their compensation/salary by a certain percentage or specific dollar amount each month (salary reduction contributions). In addition, the employer must make either matching contributions or non-elective contributions.

- **The tax advantage.** Salary reduction contributions are tax deductible in the year they are made. The employer contributes matching funds, which are vested immediately and which are not taxed as income. No tax is owed on the contributions nor on the account's gains and earnings until distributions are made.



- **Who can open?** An employer opens these accounts for eligible employees who receive at least \$5,000 compensation annually and have received it for two years before beginning participations. Employees have the right to choose the financial institution that will serve as trustee for their SIMPLE plan.
- **Any maximum income limits?** No.
- **Maximum annual contributions.** In 2011, employees may contribute up to \$11,500 in salary reduction contributions (\$14,000 over 50) but not more than 100% of compensation. Employer matching contributions are limited to not more than 3% of annual compensation. Or the employer may choose to make non-elective contributions of 2% of annual compensation.
- **When do employer contributions vest?** Immediately. There is no waiting period as there is with most 401(k) plans.
- **When penalty-free distributions may begin.** At age 59½. Before this time, distributions to pay for specific qualifying events that meet strict IRS guidelines and are carefully documented may be exempted from the penalty. Such exempt distributions, for example, may include a down payment for a first home of up to

\$10,000. Unauthorized distributions face an IRS penalty; if you withdraw funds from the SIMPLE IRA in the first two years that penalty is 25%.

- When mandatory distributions must start. At age 70½ individuals must begin to take minimum annual distributions as defined by the IRS. Failure to do so is penalized.

SEP-IRA

SEP stands for Simplified Employee Pension. This plan enables employers, particularly a self-employed person, to establish a simple retirement plan that allows substantial contributions but does not involve as much paperwork as many other qualified pension plans. In 2011, for example, the maximum contribution allowed to a SEP IRA is the smaller of \$49,000 or 25% of an employee's compensation. Cost-of-living adjustments will apply in future years. If an employer offers a SEP plan, it must be made available to all eligible employees.

- **The tax advantage.** Salary reduction contributions are tax-deductible in the year they are made. No tax is owed on the contributions nor on the account's gains and earnings until distributions are made.
- **Who can open?** An employer opens these accounts for eligible employees. Any employee who makes at least \$550 annually is eligible to participate.
- **Any maximum income limits?** There is a salary cap against which the maximum percentage contribution is applied. The maximum in 2011 is \$245,000.
- **Maximum annual contributions.** 25% of the eligible employee's compensation up to \$46,000.
- **When do employer contributions vest?** Immediately. The SEP IRA is owned by the employee and portable.
- **When penalty-free distributions may begin.** At age 59½. Before this time, distributions to pay for specific qualifying events that meet strict IRS guidelines and are carefully documented may be exempted from the penalty. Non-exempt early withdrawals are subject to a penalty.
- **When mandatory distributions must start.** At age 70½ individuals must begin to take minimum annual distributions as defined by the IRS. Failure to do so is penalized.

401(k) and 403(b) Plans

According to the IRS, the most popular defined-contribution retirement plans sponsored by employers are the 401(k) Plans. They take their name from the section of the IRS tax code that authorized them. 403(b) Plans, which are similar to 401(k)s, are retirement plans for certain employees of public schools, employees of certain tax-exempt organizations and certain ministers.

How Do 401(k) and 403(b) Plans Work?

In 401(k) or 403(b) plans, eligible employees may make contributions to their individual accounts which are deducted from their paychecks before taxes. In many plans, employers also make certain "matching" contributions as specified in plan documents, but they are not required to do so. Tax law sets the maximum contribution an individual may make annually. In 2011 an individual may contribute up to \$16,500. Individuals over age 50 are allowed an additional \$5,500 for a total of \$22,000.

Taxes on contributions and earnings in the account are deferred until distributions from the account are taken. Because the plans are intended for retirement savings, withdrawals before age 59½ (or age 55 in qualifying cases of early retirement) incur a 10% penalty in addition to taxes owed. However, the vested amount you have in the account is portable if you leave the employ of the sponsoring company; typically, you may roll these funds over into your new employer's 401(k)/403(b) or into an appropriate IRA. In some cases, you may leave the funds in the old plan but you can no longer make contributions to it.

Although you may begin to take penalty-free distributions from a 401(k) or 403(b) at age 59½, you are not required to begin taking distributions until you reach age 70½. If you continue to work for the company beyond age 70½, you may be able to delay distributions until you retire.

How Are 401(k) and 403(b) Plans Organized?

Although all 401(k) and 403(b) plans must operate within various federal guidelines and have basic similarities, every plan is not alike. Each employer sponsoring a plan for company employees has considerable flexibility to set certain criteria and to determine what investment options are available within their specific 401(k). If you currently participate in a 401(k) or are considering participating, you should be familiar with some basics about 401(k)s and should check out certain facts about your plan.

- **The Summary Plan Description (SPD) and the plan document.** The law says that every 401(k) or 403(b) must have these two documents. SPD describes the features of the plan such as:
 - Who is eligible to participate and when they become eligible
 - The level of employee contributions permitted
 - The company's matching or discretionary contribution
 - The vesting period—how long an employee must belong to the plan to receive part or all of the company contributed benefits (Employee contributions vest immediately.)
 - Other rules of the plan
 - What investment options are available

The SPD summarizes the detailed, legal description of the plan, called the plan document. The plan document describes the plan and benefit structure, names who is responsible for running the plan (the fiduciary or fiduciaries), and establishes how the plan will be run. Because the plan document is typically complex and written in legalese, the law requires that all employees receive an SPD. Although companies are supposed to keep their SPDs updated, not all do so in a timely manner. So make sure that you ask if there have been any changes or modifications to the 401(k) or 403(b) plan, before you enroll and from time to time thereafter.

- **Plan sponsor.** The plan sponsor is the employer. The sponsor typically decides to establish a 401(k) or 403(b) plan, determines the benefits and other features of the plan, and typically hires individuals or third-party independent service providers to operate and administrate the plan.
- **Plan fiduciaries.** These are the individuals or entities (such as an administrative committee or board of directors) responsible for operating the plan. Although the various individuals with fiduciary responsibility may work for the company or be independent service providers hired by the company, their legal responsibility is to act solely for the benefit of plan participants and their beneficiaries. Typical plan fiduciaries include the plan administrator(s), the trustees, the record keeper and the investment manager.

What Are the Investments Options Within a 401(k) or a 403(b)? What Control Do You Have Over Them?

Like an IRA, a 401(k) or a 403(b) plan is not an investment but a protective shell in which specific investments such as mutual funds, annuities or company stock options may be held. One of the characteristics of most 401(k) plans is that the investment

options available in an individual 401(k) plan were selected by the plan's fiduciary investment managers or agents. The average number of investment options offered is 17 to 18, according to the most recent survey (2004) from the Profit Sharing/401k Council of America. IRS regulations made in 2008 for 403(b) also moved more responsibility for selecting and monitoring fund investment options to employers. The goal was to make 401(k) and 403(b) plans function very similarly.

The types of investments offered typically include several kinds of mutual funds such as:

- Actively managed stock equity funds (U.S. and International)
- Balanced funds that include both stocks and bonds
- Index stock funds
- Bond funds
- Money market funds



Other options for 401(k) plans may include company stock. Options for 403(b) plans have typically included annuities and variable annuities backed by insurance contracts; some 401(k) plans also offer such options. Some plans may even allow “self-directed” brokerage accounts that allow you to select stocks, bonds or mutual funds from the wider marketplace.

Although the plan selects the investment options, the employee has the responsibility of allocating his or her account among the options. Financial planning experts recommend not placing one’s holdings all in one investment but diversifying to spread the risk. The experts also recommend checking out the investment options in the fund just as you would if you were investing for yourself in an independent portfolio.

What Are Some of the Potential Benefits of Participating in a 401(k) or 403(b) Plan?

- **Potential tax savings.** Your contributions are deducted from your paycheck before taxes are taken out. You pay no taxes on the accumulated contributions and earnings until you withdraw them—hopefully in retirement, when you may be in a lower tax bracket.



- **Employer contributions.** In the majority of 401(k) and 403(b) plans, the employer makes some contribution. You only get these contributions if you participate in the plan. It’s like a “free” raise. You don’t pay income tax on the employer contributions until you withdraw the funds.
- **Portability and rollover.** If you leave a company for any reason before retirement, you can take the money (including any vested company contributions) with you. You can take it in a lump sum or directly roll the money over into a new employer’s 401(k)/403(b) or into an individual IRA. If you are younger than 59½ you will need to roll the money over directly into another qualified retirement savings plan (not take a lump sum and open an account) or you will incur penalties.
- **Choice and control of investments.** Within the offerings of the plan, you control where you invest the money. That enables you to match risk and investment strategies to your needs and goals.
- **Loan options.** Some 401(k) and 403(b) plans allow you to borrow money from the account. You pay the loan back with interest to yourself. Such a loan doesn’t incur taxes or penalties if it meets guidelines, but there are loan limits and rules. There are also circumstances when you could have to play the loan back immediately in lump sum (for example, if you are no longer employed at a company).
- **Requires only small contributions.** You can participate in a 401(k) or 403(b) for a very modest monthly contribution.

What are Roth 401(k) and 403(b) Plans?

First, these are not separate plans. Instead, according to the IRS, “designated Roth contributions are a new type of contribution that new or existing 401(k) or 403(b) plans can accept.” Like Roth IRAs, Roth contributions to a 401(k) or 403(b) plan are made with post-tax dollars and later growth in principal and distributions is tax-free. Employees may designate some or all of their contributions as Roth contributions. You can make both Roth contributions and traditional pre-tax contributions, but the maximum contributions combined cannot exceed the limits for a 401(k) or 403(b)—in 2011 that is \$16,500 plus an additional \$5,500 catch up for individuals age 50 and over. Retirement Plan FAQs on Designated Roth Contributions from the IRS can answer many more questions. (www.irs.gov/retirement/article/0,,id=152956,00.html#1)

If you’re considering designated Roth contributions to your 401(k) or 403(b) plan, experts recommend comparing potential benefits between Roth contributions and traditional pre-tax contributions for your individual income, tax and retirement circumstances.

457 Deferred Compensation Plans

These plans are set up by certain state and local governments and non-governmental entities that are tax exempt under IRC 50. They provide a tax-favored retirement account for employees. A 457 plan allows eligible employees to choose to reduce their compensation/salary by a certain percentage or specific dollar amount each month (salary reduction contributions). Government and non-government 457 plans have different regulations for aspects of the plan; in general, non-governmental plans have more restrictions. As a result, it is important that any participant carefully review the provisions of the specific plan for which they are eligible.

- **The tax advantage.** Salary reduction contributions are tax-deductible in the year they are made. No tax is owed on the contributions nor on the account's gains and earnings until distributions are made.
- **Who can open?** An employer opens these accounts for eligible employees including contract employees.
- **Any maximum income limits?** No.
- **Maximum annual contributions.** In 2011, the employee may contribute up to \$16,500 in salary reduction contributions. Over age 50, in governmental 457 plans (but not nongovernmental), additional catch-up contributions of \$5,500 are allowed for a maximum of \$22,000.
- **Special catch-up provisions.** Three years before normal retirement age, employees may contribute the lesser of \$33,000 (for 2010) or the basic annual limit plus underutilized basic annual limit in prior years (second option not available to government 457 participants who used over 50 catch-up).
- **May participants have other retirement plans?** Participants in 457 plans may also participate in an employer-sponsored 401(k) or 403(b) plan. They may make up to maximum contributions in both accounts.
- **When penalty-free distributions may begin.** Penalty-free deductions or distributions from a 457 plan may be made before age 59½ after severance from employment. Income tax must be paid on withdrawals.
- **When mandatory distributions must start.** At age 70½ individuals must begin to take minimum annual distributions as defined by the IRS. Failure to do so is penalized.





Managing Retirement Accounts to Reach Your Goals

The first goal of investing money in retirement savings plans is usually to grow your money—to produce a profit or positive return on the money you’ve saved. The second goal, and just as important, is to protect that pot of money so that it provides dependable income for you during retirement.

Even though retirement accounts typically offer relatively conservative options, even in their “growth” options, there is always the possibility that investments will produce a loss or won’t produce the expected return or rate of return. Anyone who had a retirement fund during the economic meltdown of 2008-2009 understands that. To varying degrees, the future value of all investments is always uncertain or unpredictable. The possibility that an investment might under-perform or lose value is called “risk.”

The reality of risk is one important reason that you should regularly review the investment options in your retirement account. Your goals should be to make sure that the investments are diversified and balance your goals for growth or income and the level of risk you can tolerate related to those goals.

Different Degrees and Sources of Risk

Different types of investment options have different degrees of risk, generally quantified as low risk, medium risk, and high risk. Risk also comes from several different sources, not all of which affect every type investment equally. For example, **inflation risk** will decrease the value in purchasing power of every type of investment from a “low risk” passbook savings account to a “high risk” growth stock fund. However, the **market risk** associated with a sharp loss of value on the stock market does not decrease the value of the principal placed in the savings account. But it very well may decrease the value of the principal invested in a growth stock mutual fund. The more common types of investment risk include inflation risk, market risk, interest rate risk, credit risk (the

potential for non-payment on investments offering fixed income such as corporate bonds), business risk (the potential for businesses invested in to decline or fail), and liquidity risk. Read more on types of investment risk in the box below.

The Reward/Risk Tradeoff

The risk of loss and the potential reward of return have a direct relationship for investments. In general, the higher the risk to the money you’ve invested, the greater the potential return. Conversely, investments that have lower risks typically offer smaller returns. This differential exists because investors are not likely to put their money in riskier ventures unless they know there’s the possibility of a greater reward.

Considering Risk in Retirement Funds

How much risk you are willing to tolerate for growth in your retirement accounts will typically depend on how long you have to invest before retirement.

In your 20s and 30s, it usually makes sense to choose a balance of options that emphasize growth rather than income. For example, an index stock mutual fund contains a selection of individual stocks that reflect one of the stock market indexes. The goal is to match the growth of the capital value of the underlying stocks in addition to any dividends the stocks may pay. At the same time, the stock fund is more volatile—more likely to go up or down in value. On the other hand, a money market mutual fund is composed of investments that pay interest; the capital value of the underlying investment instrument does not grow. It has lower risk of declining in value, but also less opportunity for growth.

As you near retirement and have less time to recover from any market losses, most experts recommend that you consider a balanced selection of options that are lower risk and income producing.

Types of Investment Risk

When most people think of investment risk, they think of falling stock or bond market values. But “market risk” is just one of several sources of investment risk. A number of risks, such as the following, can affect an investment’s value.

Market risk—how much the general trend of the market up or down affects the investment’s value

Interest rate risk—the impact of interest rate changes. Interest rate changes can affect not only “cash equivalent” savings/investment vehicles such as passbook accounts or CDs but they can also affect the value of bonds. If you purchase a 5-year bond one day at 7%, for example, and the next day the interest offered on similar bonds goes up to 7.5%, then your bond is worth less on the market if you wish to trade it (rather than hold it to maturity). The rise and fall of interest rates also indirectly affects the stock market.

Inflation risk—the impact of rising prices can erode the buying power of the money. For example, if a CD is earning 1.7% annually but inflation is running at 2% annually (its recent level), then even though the nominal dollar value of the CD is increasing, the purchasing power represented by those dollars is actually declining because the interest earned is not keeping pace with or exceeding inflation.

Credit risk—the potential for default or nonpayment on investments offering fixed income. For example, one of the reasons that junk corporate bonds are considered high risk investments is their credit risk.

Liquidity risk—the possibility that the investment can not be sold as quickly as desired causing the asset to lose value. If you own real estate, for example, you may not be able to sell it as quickly as you like or at the price you desire, while expenses still continue.

Business risk—the possibility that a company you’ve invested in will not do well.

Understanding Types of Investments in Retirement Plans

Investment plans provide a variety of investment options. This section gives you an overview of some of the types of investment options that are typically offered and the underlying investments that are part of some options such as mutual funds or annuities. The more you know about investment options and vehicles, the better able you will be to work with a financial planner or to manage your own retirement accounts.

The many types of investment vehicles fall into two categories:

- Investments in which you own an asset or a portion of one, also called equity investments. Equity or “ownership” instruments include shares of stocks or mutual funds, real estate and other physical property such as art and collectibles (including gold coins, antiques, stamps and the like).
- Investments in which you loan money to a corporate or government entity for a fixed rate of interest for a fixed term. Such “debt” instruments include interest-bearing savings accounts, money market funds, certificates of deposit, government and corporate bonds, and savings bonds.

To make the distinction between equity and debt investment vehicles easy to remember, some financial media like to call them “ownership” and “loanership” investments.

This chapter provides a very basic overview of several common types of investments that play a role in most investment accounts.

Cash Equivalents

Money Market Funds

Money market funds are open-end mutual funds. They are required by law to invest in short-term, liquid, low-risk debt instruments such as Treasury bills, other government securities, certificates of deposit and commercial paper of companies. Money market funds pay dividends that reflect short-term interest rates. Each share typically represents a constant \$1.00 net asset value (NAV) while the dividend yield fluctuates. Unlike money market accounts offered by credit unions or banks, money market funds are not insured, but the risk of losing any of the principal invested is extremely low. Money market funds are very liquid and easily bought and sold. The SEC* recommends that before investing in any money market fund, an investor should “carefully read all of the fund’s available information, including its prospectus, or profile if the fund has one, and its most recent shareholder report.”

Share Certificates or Certificates of Deposit

A share certificate or certificate of deposit (CD) is a vehicle for investing a fixed amount of money for a fixed term on which the

issuing financial institution agrees to pay a specific interest rate. Originally CDs were fairly simple: the depositor contracted to deposit money for a fixed period of three, six or 12 months or more and in return the financial institution agreed to pay a fixed amount of interest. If the depositor withdrew the funds before maturity, they paid an “early withdrawal penalty” or forfeit a portion of interest earned.

The variety and complexity of CDs, however, has grown. For instance, there are now adjustable rate CDs and long-term high-yield CDs that the issuing financial institution can call in early. CDs offered by credit unions, banks and thrifts are federally insured. Many brokerage firms and independent salespeople also now offer a type of CD called a “brokered CD”. These come in a wide variety and are not federally insured.

Because the interest can be paid in different ways resulting in different yields for the same annual percentage rate (APR) and maturity, it is smart to also compare the annual percentage yield (APY), not just the APR, of CDs of the same maturity.

Mutual Funds

What are Mutual Funds?

A mutual fund is an investment vehicle that is made up of a pool of funds collected from many investors for the purpose of investing in securities such as stocks, bonds, money market instruments and similar assets. For investors, owning shares in the mutual fund represents owning a proportional amount of the underlying assets (stocks, bonds, etc.) of the mutual fund’s holdings. As a consequence, mutual funds enable their shareholders to invest in a greater number and diversity of securities for a smaller amount of money than they could if they invested directly in stocks, bonds or other securities.

As with any public company stock, mutual fund shares can be bought and sold. Mutual funds are highly liquid because by law the mutual fund must buy your shares back if you wish to sell. But that doesn’t mean that you’ll get what you paid for the shares—your investment may have grown or it may have declined in value.

Because the value of the underlying securities of a specific mutual fund fluctuates daily, the price, or Net Asset Value (NAV), of that fund’s shares also fluctuates. The price is called Net Asset Value because the expenses and liabilities of the fund are subtracted from the total value of the portfolio before being divided by the number of outstanding shares to arrive at the value per share, the NAV or price. Unlike company stocks that fluctuate continuously during the day, the NAV of a mutual fund is fixed once daily at the end of the day’s trading. That means that if you buy or sell mutual fund shares on a particularly day, you do so at the closing NAV.

*SEC. “Money Market Funds” www.sec.gov/answers/mfmmkt.htm

Mutual funds invest the fund's money in accordance with goals and strategies that, by law, are spelled out in the fund's prospectus. Funds also must report in financial statements how the fund's investments fared.

Mutual funds gain in value in two ways:

1. Growth in value (appreciation) of the underlying securities
2. Income: interest or dividends from the underlying securities

By law mutual funds must annually distribute income earned through the sale of securities or from dividends to shareholders in proportion to their holdings. Such capital gains and dividends, even if reinvested in the fund, are taxable in the year they are distributed unless the mutual funds are held within in a tax-deferred retirement plan (or other tax-advantaged plan) or are composed entirely of tax-exempt securities such as certain types of bonds.

What Types of Mutual Funds are There?

Mutual funds are typically categorized by the type of securities in which they primarily invest. Common types of funds include:

Stock funds. Stock mutual funds, which are also known as “equity” funds, invest in corporate stocks. Individual stock funds may be further differentiated by the specific investment objectives and strategies they use for selecting the stocks the fund invests in.

- Value funds follow the principles of “value investing”. Fund managers typically select stocks for such funds that, according to their analyses, show growth potential and have lower price/earnings (P/E) ratios that represent a bargain. Stock picks may also provide an income-stream from dividends. As a group, value funds tend to be less volatile than growth funds.
- Growth funds select stocks of companies that are growing strongly (substantial revenues) or are thought to have the potential to do so. The emphasis is on capital appreciation, not dividends. Aggressive growth funds take the same approach as regular growth funds but are willing to take greater risks in companies selected for investment and may trade more frequently.
- Sector funds invest in stocks of companies that represent a specific industry, such as technology, financial services, transportation, health care, and pharmaceuticals. Any fund that invests at least 25% or more of its funds in one industry is considered a sector fund. Many sectors funds may place all their funds in a single sector. Because of their limited focus on one industry (or a small group of industries), sector funds tend to be very volatile compared to other types of funds.
- Cap size funds distinguish themselves by the size company that they target for investment. The size is determined by market capitalization. The most common designations include small

cap, mid cap and large cap funds, although there are other funds such as micro cap funds. Generally speaking, the smaller the size of the companies in which the fund holds stock, the greater the risk and the more volatile the fund.

- Index funds invest in stocks that mirror the stocks represented in a market index such as the S&P 500 or Nasdaq 100. Fund managers do not actively analyze and pick stocks for the fund. Because there are many different types of indexes, however, there are many different index funds.



In addition to these major types of stock funds, there are funds that blend these approaches or seek to realize other specific goals. Each fund's objectives and strategies are spelled out in its prospectus.

Bond funds. Bond funds invest in a portfolio of bonds to produce income. The specific objectives and strategies of individual bond funds determine the types and maturities of bonds in which the fund invests. For example, an individual bond fund might hold a broad selection of municipal, corporate and Treasury bonds, or it might focus its portfolio very specifically on one type of bond, such as short-term, high-yield junk bonds. Some common types of bond funds include Income, Corporate, Global, National Municipal, State Municipal, Mortgage (Ginnie Mae), and U.S. Government (Treasury). Index bond funds are not actively managed but hold bonds that mirror a specific bond index. Of course, there are many other types and within these broad types funds adopt specific goals and strategies.

Aspects of bond funds that investors must consider include:

- **Average portfolio maturity.** Because a bond fund holds many different bonds, it does not have a specific maturity date. But the bonds within the fund will have an average maturity. Some bond funds focus specifically on short-term, mid-term, or long-term bonds.
- **Quality of creditworthiness.** What is the general bond credit rating for the fund? For example, does it invest in “high grade” bonds, whose AA and AAA credit rating indicate a low risk of default or does it specialize in “junk” bonds, whose BB or lower credit rating indicate a relatively high risk in the judgment of the rating agencies? The lower the average credit quality of a fund the higher its yield typically is and the higher the risk.
- **Taxable or tax exempt.** The income distributed by most bond funds is taxable as ordinary income, but some funds specialize in tax-free municipals. Bond funds may also distribute income from the sale of securities they have held more than one year as capital gains. For all bond funds, investors must take the tax consequences into account in judging which bond fund will help them meet their investment objectives.

Balanced or hybrid funds. Some mutual funds seek to balance their portfolios and diversify their risk by investing in both stocks and bonds and sometimes other securities.

Money market funds. Although money market funds are mutual funds, they are usually considered “cash equivalents” because they invest in very secure, short-term, income-producing securities. Typical holdings are 1-day to 1-year Treasury bills, commercial paper, and certificates of deposit. Although there is a very small risk that a money market fund could fail, historically they have been a very safe place to save money.

What is a Fund Family?

One company may create and manage many separate mutual funds under the umbrella of the parent company. Each mutual fund is a separate portfolio. All the funds managed by one parent company form a fund family. For example, Fidelity and Vanguard are representative of large parent companies who offer large fund families.

What are the Potential Benefits and Risks of Mutual Funds?

Potential Benefits	Potential Risks
Diversification of investments and of risk	Market fluctuations and volatility affect the values of mutual funds just as they do individual stocks and bonds
Investors can begin to invest with very small sums of money, even as low as \$50 per month	Depending on the focus of the portfolio, some mutual funds may have a high risk
Transaction fees are typically lower overall than trading in individual stocks	Mutual funds have taxable distributions
Liquidity	

What’s the Difference Between “Open-end” and “Closed-end” Mutual Funds?

Most mutual funds sold today are “open-end” funds. That means that the fund has no set number of shares but issues as many or as few as the marketplace demands. Generally speaking, there is no limit to how many shares a fund can have or how many one investor may hold.

“Closed-end” funds, when they open for business, issue only a fixed, predetermined number of shares. After the initial offering is sold to investors, only these shares can be bought and sold. Closed-end funds, which trade like stocks, are sold through brokers. They’re typically smaller than open-end funds and most costly to manage.

Sometimes, an open-end fund may close to new investors, but existing investors can still buy more shares. The open-end fund, therefore, is still considered open-end because the volume of shares can rise and fall.

What’s the Difference Between a “Managed” and an “Index” Fund?

Many mutual funds are actively managed by fund managers. These managers analyze many aspects of various companies, their industries, the markets, and other factors to help them select the equities in which the mutual funds invests. This analysis also helps them make ongoing buy and sell decisions. The cost for management is subtracted from the value of the funds’ holdings before the NAV is established.

An index fund is passively not actively managed. Instead, fund holdings mirror the securities of a particular market index, such as the S&P 500. Portfolio decisions are, therefore, automatic and take place relatively infrequently. Management fees are usually lower than actively managed funds.

What's the Difference Between a "Load" and "No Load" Fund?

Generally speaking a "load fund" is a mutual fund sold by a broker that charges a commission, or load, for buying or selling shares. Front-end load funds charge the commission when you buy the mutual funds and back-end load funds charge the commission when you sell. These commissions, or loads, can range from 1% to 8.5%.

"No load" funds are sold directly to investors by the mutual fund company, typically over the phone or online. Because of different terminology and "positioning" of funds, the best way to be sure that a fund is truly a "no load" fund is to carefully check the fund's prospectus for all sales charges and other fees.

What Fees and Charges are Associated with Mutual Funds?

Mutual funds may have several fees or charges, which vary from fund to fund. The only way to determine the specific fees and expenses of a particular fund is to read the prospectus. Among the more common fees are these:

Shareholder Fees

- **Sales commissions or loads.** Money paid to the brokers who buy or sell a fund for the investor.
- **Purchase and Redemption fees.** Some "no load" funds may charge a fee that is paid directly to the fund when an investor purchases or redeems (sells) shares in the fund. These are not considered "sales loads" because they are paid directly to the fund, not to a broker.
- **Exchange fees.** Fees charged when an investor transfers (or exchanges) into a different fund within the same fund group.
- **Account fee.** Some funds will charge a separate fee regarding your account "maintenance."

Annual Operating Expenses

- **Management fees.** Money paid out of fund assets to pay the fund's portfolio advisors and managers.
- **Marketing and advertising expenses—12b-1 fees.** These include fees paid out of fund assets to cover expenses for distribution of the shares, marketing and advertising costs (including literature such as prospectuses), and sometimes expenses for "shareholder service" (such as paying for the customer service staff that answer investor questions). They are named for the SEC rule that allows funds to charge them.
- Other expenses may include custodial expenses, legal expenses, account expenses and other such administrative costs.

The Securities and Exchange Commission provides online an excellent discussion of Mutual Fund Fees and Expenses and how you may expect to see them presented in a prospectus. (www.sec.gov/answers/mffees.htm)

Considerations in Evaluating Mutual Funds for Potential Investment

In evaluating whether you wish to invest in specific mutual fund, the Investment Company Institute sponsored by the mutual fund industry (www.ici.org) suggests that investors research several key aspects of the fund.

- **Consider the fund's goal.** Is it growth, income or a combination?
- **Consider the fund's investment strategies as presented in its prospectus.** It should describe the range and types of securities in which it invests.
- **What are the risks in its investment strategies and how has the fund performed in the past?** Investors should always remember that past performance does not guarantee future performance.
- **What are the fund's fees and expenses?** It is required to list these in its prospectus in a standardized table format. Is the fund no load, front load or back load? How does it compare to other funds in its class?
- **If the fund is an actively managed fund, as opposed to an index fund, who's the manager and what is their performance record?**
- **At what sources can the fund be bought and sold?** You may buy many funds directly or through third parties such as brokers, financial institution representatives or financial planners. Some funds may be bought only through third party representatives.
- **How does the fund handle distributions and taxes?**
- **Does the fund offer other specific services?**

What Ways Can You Buy Mutual Funds?

Mutual funds may be purchased in a number of ways:

- **Within a retirement plan.** Most retirement plans such as 401(k)s or IRAs offer a selection of mutual funds from which plan participants may choose. Before allocating their assets within their retirement funds, investors should research their options thoroughly. Plan administrators may provide access to some research data and tools but investors are free to use other sources as well. Some investors may have self-directed IRAs and would certainly consider mutual funds in planning asset allocation.
- **Directly from the investment company.** Many investment companies offer their mutual funds directly to investors. Many companies offer a large family of mutual funds that invest in

different asset classes, and follow different investment strategies and allow investors to purchase multiple funds in one account.

- **Through a full-service or discount brokerage.** Brokerage services of all types offer mutual funds. Some mutual funds are available only through brokers or other representatives.
- **Through other third-party representatives.** Financial institutions' investment representatives, some insurance agencies, and some financial planners or advisors may also sell mutual funds.



Annuities

Annuities are financial contracts with an insurance company designed to be a source of retirement income. They are often marketed as investment options. Many financial planners recommend that consumers evaluate annuities, specifically fixed annuities, along with other investment options, in planning for a diversified portfolio. Annuities are offered as options in some 401(k) and 403(b) retirement plans.

Annuities come in two basic varieties: fixed and variable. Both types can be purchased with a single lump-sum premium (single-premium) or with a series of regular payments over time (flexible-payment). Both may also be “deferred” or “immediate”.

- **Fixed annuities promise a specific rate of return for a specific time period.** This means that a fixed annuity pays out a fixed

amount of money during the disbursement period. The disbursement period may be for a fixed number of years or for the beneficiary's lifetime. Most fixed annuities offer a low-risk investment. The security of the annuity is tied to the financial health of the insurance company that issues it.

- **Variable annuities usually have a range of funding options—such as stocks, bonds and money market accounts.** In a sense they are a tax-deferred investment plan wrapped in an insurance wrapper. The principal and the rate of return of a variable annuity are not guaranteed—they can go up or down. Some variable annuities have a fixed account that guarantees both the principal and the interest—giving you the option of dividing your money between the low-risk fixed account and the higher-risk options. In the recent past, variable annuities have been the focus of much criticism because in some instances poorer products were marketed heavily to individuals for whom they were inappropriate investments. Anyone considering a variable annuity should do their homework carefully.
- **Deferred annuities** are usually tax-deferred vehicles which have a pay-in period during which the purchaser makes payments which are added to the principal and a disbursement period which begins sometime in the future. The earnings grow untaxed until you receive payments.
- **Immediate annuities** are purchased with a single-premium payment and the payments to the beneficiary begin immediately. Many consumers who consider immediate annuities are about to retire and wish to preserve capital while guaranteeing a specific income stream. Such annuities may be one option for older individuals who are retiring and rolling-over their 401(k) retirement plans.

Annuities typically have sales commissions, some of which may be fairly high compared to other tax deferred investments options. If you are considering buying an annuity, be sure to consider these costs as you would for other investments.

Other Popular Retirement Investment Alternatives

Real Estate

For many Americans, their largest investment is the home they own. The real estate boom in the early to mid-2000s sparked huge interest in real estate investment among ordinary Americans. The consequent real estate bust has quieted interest. Nonetheless, many individuals are still interested in real estate investment as a potential way to increase savings for retirement. This section presents a brief overview of types or methods of real estate investment other than primary home ownership. (See the IQ Home Buying Guide for more about home ownership.)

Real Estate Investment Trusts (REITs)

Like mutual funds, real estate investment trusts are companies that use the pooled capital of the investors to invest in real estate income properties, typically commercial properties, and/or in mortgages. Investments in income properties are called equity REITs and investments in mortgage loans are called mortgage REITs. REITs shares are traded on exchanges just as stocks are. Because they are exchange-traded REITs offer the benefit of liquidity compared to other ways of owning property. They also enjoy some tax benefits. Income, losses and some tax consequence are passed through to investors. The value of REITs shares may or may not move up or down with the larger stock market so investors must pay attention to factors more likely to affect property or mortgage markets.

Rental Property

Residential rental property offers another way to invest in real estate. Investing in one or more residential rental properties can offer a reasonable return when undertaken with appropriate due diligence. Most experts in real estate investment also advise that rental property is usually more suitable for long-term investment. Among the questions and factors that should be considered by a wise investor are the following:

- What is the demand for rental property in the locale where you would like to invest?
- Are you prepared to take the time and do the legwork to locate and investigate potential properties?
- What is the potential cash flow on the property (projected rental income minus operational expenses, taxes, mortgage interest, and depreciation)? Is the projected cash flow positive or negative? If negative can you afford to cover the gap?
- Do you have the willingness and temperament to be a landlord? If you plan to place the property with a property manager, did you figure those costs in the projected cash flow?

Potential investors should also note that real estate does not have great liquidity. If it becomes necessary to sell the property, it might

take many weeks or months to sell and realize the investment's growth or even salvage the principal invested.

Successful investors in rental properties note that benefits include having investments that potentially finance themselves while increasing in value and the possibility of positive cash flow in the short-term or long-term. But there is no guarantee that rental properties will make money. Investors who have not paid careful attention to the details or have experienced unexpected downturns in the rental market or other economic problems have been forced into bankruptcy.

“Flipping” Real Estate

All too recently magazine articles and books and popular television shows made flipping real estate sound like a fun way to make a sizable chunk of money in a short time. Flipping originally described the process of placing a contract on a home then finding a buyer who will pay a higher price and selling the home to that buyer and pocketing the profit. Flipping in popular terms now may describe a) buying a property (often a fixer-up property) at a “good” price (less than surrounding properties if possible), renovating and upgrading it as necessary, and selling it for a much higher price than the cost of purchase and renovation or b) buying a property (often a fixer-upper), holding it without renovation, and later selling at a profit. Some investors with the appropriate skills and experience certainly have done well with this approach to investing in real estate. But many more investors, caught by the collapsing real estate market and declining home values, have gone bankrupt. Such investments tend to be very risky not least because they typically tie up a fairly large amount of capital and credit in an investment that is highly illiquid and that is full of potential pitfalls.

Here's some issues potential real estate flippers should consider:

- Do you have in-depth knowledge or are you willing to devote considerable time to learning about real estate investment issues? And there are many issues, including: location and evaluation of suitable properties, local real estate laws and ordinances, creating an appropriate business plan and budget for purchase, renovation, and marketing, doing the renovations (if any) or contracting for them.
- What is the current real estate market in the area in which you plan to invest?
- What potential impact will taxes have on your profits?
- What is your skill level in renovating properties or overseeing renovations? If you have to totally contract out this aspect of your project, have you planned and budgeted for these expenses and contingencies?

- Could you financially cope with time delays and cost overruns on your project? Can you financially cope if you are not able to resell the property as quickly as you planned?

Precious Metals

From early in human history and in many different cultures, precious metals such as gold and silver have served as a basic source of value. Although precious metals are used to produce goods, their intrinsic value is much less than the value people have placed on these metals. The metals typically are rare and, so far, enduringly valuable. As a result, people have bought gold and silver and, to a lesser extent, platinum, as a hedge against inflation and economic downturns or instability. In recent months, for example, the media have been filled with advertisements offering to buy and sell gold and silver.

Some investors for purposes of asset diversification also include some precious metals in their portfolios or as part of their strategy for saving. It may be possible to include investments in precious metals through certain vehicles in self-directed IRA accounts, for example. However, experts advise that extreme caution and expert knowledge are musts.

There are a number of ways to invest in precious metals:

- **Bullion bars or bullion coins.** International metal refiners produce gold, silver or platinum bullion bars of various weights and sizes that have a certified purity. Various countries also produce bullion coins that have a nominal face value and are legal tender in their country of origin but whose real value is the precious metal content. For example, leading gold bullion coins include the U.S. Golden Eagle, Canadian Maple Leaf, and South African Kruggerand. Investors may take delivery of bullion bars and coins and arrange for secure storage (such as safety deposit box) or opt for other storage arrangements provided typically by the seller.
- **Precious metal certificates.** Rather than buy the actual metal, particularly gold or silver, the investor buys a certificate that entitles them to demand and receive delivery of the actual metal. These certificates are more liquid than the actual metal, but should the need for the actual metal arise, delivery could take several days.
- **Accumulation plans.** Such plans allow an investor to accumulate a holding in the precious metal by investing a certain amount of money at regular intervals. The amount may be as little as \$100 for gold, for example. The financial institution or broker issues regular statements of the investor's account. The actual metal is held in a pool with other investors.

- **Mining shares.** Individuals may invest indirectly in precious metals by buying shares of mining company stock. Such investment has the possibility to produce income and/or appreciation but also shares the typical risks of the equities market.
- **Mutual funds and exchange traded funds (ETFs).** Investors may also purchase shares in mutual funds or shares of exchange traded funds that invest in precious metals.
- **Futures contracts and options.** Precious metals futures are another type of indirect investment.
- **Collectible coins.** Many individuals have bought collectible, older, gold and silver coins because they feel that in a time of crisis they might be more secure (less likely to be confiscated by the government). Most investment experts in precious metals point out that the value of the metal in the coin is usually considerably less than what the investor will pay for the coin. They advise that if they are investing as a hedge against inflation or economic instability, that it may be unwise to pay, for example, \$350 for a coin that as a precious metal has a value of only \$150.
- **Jewelry.** Experts advise that in the U.S. buying gold, platinum or silver jewelry as an investment is a mistake because the typical mark-up on U.S. jewelry over the value of the metal is usually 500% or more. If you desire the jewelry for other reasons, buy it. But if you wish to invest in precious metals, these experts advise, pick another vehicle.

A Word About Precious Metal Investment Scams

Because gold and silver are associated in the popular imagination with protection against economic crisis, many Americans are vulnerable to the misleading claims of disreputable dealers and the scams of con artists. These sales pitches are advertised in print, on radio, and TV and come in phone calls and emails. The hucksters often use scare tactics, and claim you can double your money in just weeks or months. The thieves often claim that they are storing the metal for you, but have never purchased any. This advisory from the United States Commodity Futures Trading Commission details some of the tactics and dangers. (www.cftc.gov/enf/00orders/enfposting5-metals.htm) If you are interested in investing in precious metals, ignore these "offers" and do your homework and deal only with reputable financial institutions, brokerages and precious metal dealers.

Art, Antiquities and Other Collectibles

In the investment arena, the term “Collectibles” is used to describe a very broad class of assets that includes almost any physical artifact that may increase in value because it is rare or people value it and collect it. Common collectibles include stamps, coins, sports cards or memorabilia, comic books, toys, figurines and the like. Fine art and antiques are also collectibles, although many tend to think of them separately. In fact, collectibles is a very broad and elastic asset category.

One of the drawbacks to treating collectibles as investments is inherent in the very looseness and breadth of the category. For most collectibles there is no fixed or formal market that helps determine value and price, and prices can vary widely among markets. In addition, the value of many collectibles is faddish; prices rise rapidly as popularity peaks and then fall just as quickly. Remember Beanie Babies? Even collectibles that have staying power, such as fine art and antiques, typically take a long time to appreciate. One positive aspect of proven collectibles, however, is that their value tends to keep pace with inflation.

Most individuals, investment experts advise, should acquire collectibles first because they enjoy the artifacts, and their pursuit and acquisition, and only secondarily as an investment.

Fine Art and Antiques

Among collectibles, fine art and antiques have the longest, most respectable performance as investments. But even in these areas, the successful investor must typically possess very expert knowledge and a long-term view of possible appreciation. Although Antiques Roadshow and other shows have led some people to imagine that anyone can unearth a treasure, the time-honored advice to individuals without specialized expertise and experience has always been: buy what you like and want to live with, but do not buy primarily as an investment.

Because of the value of many fine arts artifacts and antiques, fraud and forgery also present a constant danger to inexperienced and experienced collectors alike.

Because offering simple tips here might be dangerously misleading, our best advice if you are interested in fine art or antiques is to begin to read widely and deeply in the area of your interest. Museum websites and websites produced by reputable galleries that specialize in certain artists or fields offer good places to start.

Stamps, Coins and Other Collectibles

During the recent recession, a variety of articles have made the claim that perennially popular collectibles, stamps, coins, comic books, and trading cards, have outperformed the stock market.

For some highly experienced, knowledgeable and dedicated professional collectors that may be true. For most ordinary collectors and hobbyists, the picture is surely more mixed. One reason is that value tends to rise for the rarest items and these are beyond the budget and expertise of most garden-variety collectors.



If you are an amateur collector of stamps or coins, for example, you will typically pay more to buy a collectible item than you can sell it for. Why? Usually, you buy at retail but must sell at wholesale. Although you can collect contemporary coins and stamps for a modest cost, large numbers are minted or printed, and they do not appreciate very quickly above their face value, if they ever appreciate at all.

Financial planners advise that if you enjoy collecting, then do so. But understand that for most collectors any substantial increase in value is a bonus, not a primary reason to collect.



Working on **Your Plan** with a Financial Planning Professional

Would using a well-qualified professional financial planner help you do a better job of personal financial planning including retirement? Before answering that question, you must understand what kinds of financial planners and services are available, the potential advantages and dangers of using a planner, and how to evaluate individual planners' qualifications. Many financial planners who help you create an overall plan also make specific recommendations on investment plans and types of investments. This is particularly true of planners who earn all or part of their income from commissions on products they sell to you. Our focus in this chapter, however, is on overall financial planning, of which retirement planning is an important part.

Why is it Critical that You do Your Homework First?

There are two primary reasons:

1. In most states, lack of regulation means that anyone can call himself or herself a “financial planner,” “financial advisor,” or “financial consultant” and go into business without any training, experience, or other qualification. In contrast, federal and state laws require that individuals and firms who sell securities be registered and/or licensed. These individuals may be called “investment advisors,” “stockbrokers,” or other titles. But because many, if not most, financial planners also advise on investments or sell securities, the overlapping designations and functions can be confusing.
2. Knowledgeable, well-trained financial planners may have several different types of professional certification related specifically to financial planning. Each certification has different criteria for education, experience and different tests. Some types of certification may indicate different emphases in specialization as well.

For these reasons, it is important to first educate yourself about the role of financial planners. Then, it's important to carefully check out the background of any financial professional with whom you are considering working.

What are Most Common Types of Credentials for Financial Planners?

Among the most common are the following:

- **CFP stands for “Certified Financial Planner”.** Professionals with this certification have a minimum of 3 to 5 years experience, have taken specific courses, have passed a 10-hour, two-day

comprehensive exam covering a wide range of financial planning topics, and take continuing education. This certification is issued by the Certified Financial Planner Board of Standards (www.cfp.net). Planners so certified must agree to abide by the standards set by this board. Many consumer experts consider this certification to have the most rigorous standards.

- **AICPA/PFS stands for Certified Public Accountant with Personal Financial Specialist qualification.** The credentials are issued by the American Institute of Certified Public Accountants (www.aicpa.org). In addition to CPA training and certification, CPAs who have passed a 6-hour exam in six financial planning areas and have met substantial financial planning experience requirements may be certified as Personal Financial Specialists. Continuing education is also required.
- **ChFC stands for Chartered Financial Consultant.** This professional designation is issued by the American College (www.amercoll.edu) upon completion of a course of study and examinations. Chartered Financial Consultants maintain certification issued by the Society of Financial Service Professionals (www.financialpro.org). Many of these planners specialize in Insurance and estate planning.
- **CLU stands for Chartered Life Underwriter.** This professional designation is issued by the American College (www.amercoll.edu) upon completion of 10 college-level courses and examinations in insurance and related fields. CLU credentials typically specialize in life insurance sales and planning. Chartered Life Underwriters maintain certification issued by the Society of Financial Service Professionals (www.financialpro.org).
- **CFA stands for Chartered Financial Analyst.** This credential and program are administered by the CFA Institute (www.cfainstitute.org). Professionals holding this designation specialize in portfolio management and investment analysis. Candidates must have three years experience, membership in AIMR, and pass three levels of exams. No continuing education is required for maintaining the credential designation.

How are Financial Planners Paid?

Financial planners may be compensated by fees only, by commissions or by a combination of commissions and fees. There are many reputable, experienced, able financial planners who are compensated by each of these methods. In selecting a financial planner, ask directly for the way in which they are compensated. Here's a brief rundown of what each method of compensation means.

- **Fee-only.** Financial planners receive compensation only from fees paid by their clients, not from commissions for products sold or from any other source. The fees may be a flat fee for a certain project (such as developing a comprehensive plan for an individual), an hourly fee, a percentage of assets under management, or a percentage of income from investments managed.

- **Commissions.** Many financial planners receive their income entirely from commissions on the products they recommend and sell. Financial planners who work entirely for commissions may offer low-cost or “free” planning services.

IQ Tip: These advisors stand to gain financially from their recommendations, which can color some advisors’ recommendations. Don’t be shy about questioning any specific recommendation.



- **“Fee-based” or “Fee-offset”.** Some financial planners receive both fees and commissions. “Fee-based” typically means that the planner receives a fee from the client and commissions on any products or services sold to that client. If a planner appears to be using “fee-based” to suggest that they are “fee-only”, experts recommend avoiding them. “Fee-offset” means that the planner charges a fee that is then subtracted from the cost of a product’s or service’s sale if the client purchases the recommended product.

Find More Information About Selecting Financial Planners

The following websites and organizations provide a variety of information and tools, such as checklists of questions to ask prospective financial planners, that can help equip you to make a more informed decision.

- **“Your Rights as a Financial Planning Client”** (www.pueblo.gsa.gov/cic_text/money/fprights/fprights.htm), from the Securities and Exchange Commission (SEC), offers an informative, succinct discussion of pointers to keep in mind in evaluating and working with a financial planner.
- **The Financial Planning Association** provides information from and about Certified Financial Planners, also called CFP Professionals. (www.fpaforfinancialplanning.org/) They make their case for how using a Certified Financial Planner can help and provide a thorough checklist you can use to interview potential planners, (www.fpaforfinancialplanning.org/FindaPlanner/ChoosingaPlanner/QuestionstoAsk/). The site also provides referrals to Certified Financial Planners.
- **The National Association of Personal Financial Advisors (NAPFA)** (www.napfa.org/ConsumerServices) is an organization of “fee-only” financial advisors and planners. The site presents the benefits they feel are offered by fee-only planners. NAPFA’s website provides discussions of what’s involved in various financial planning service arrangements and provide a checklist of questions to use in interviewing a Financial Planner.

How Can You Find a Knowledgeable Financial Planner?

Most experts recommend starting with recommendations from family, friends and co-workers who have used financial planners successfully. Other professionals, such as accountants or lawyers, with whom you have a business relationship may also have recommendations. Finally, most of the professional organizations that provide credentials or certification also provide referral services; just check their websites above.

Because no two people have the same financial planning needs, you are the best judge of whether or not you need a financial planner. But be an educated judge and consumer of financial services—do your homework, then double check it!

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