

Overview of Retirement Planning

Your future depends on it

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With social security and employer provided pensions becoming more tenuous and less generous than in the past, proper retirement planning is becoming more critical for each of us. In this paper I will provide a broad overview of the steps required to properly plan for a financially secure retirement.

These steps include:

- Determining where you are in the retirement planning lifecycle
- Determining how much you will need in retirement
- Assessing your current and anticipated resources
- Determining the savings rate required to achieve your goals
- Identifying the best accounts in which to save
- Choosing a target asset allocation
- Identifying and placing investment vehicles
- Dealing with the tax man

Retirement Planning Life Cycle

Proper retirement planning begins with an assessment of where we are in the retirement planning lifecycle. The three stages of the retirement planning lifecycle are:



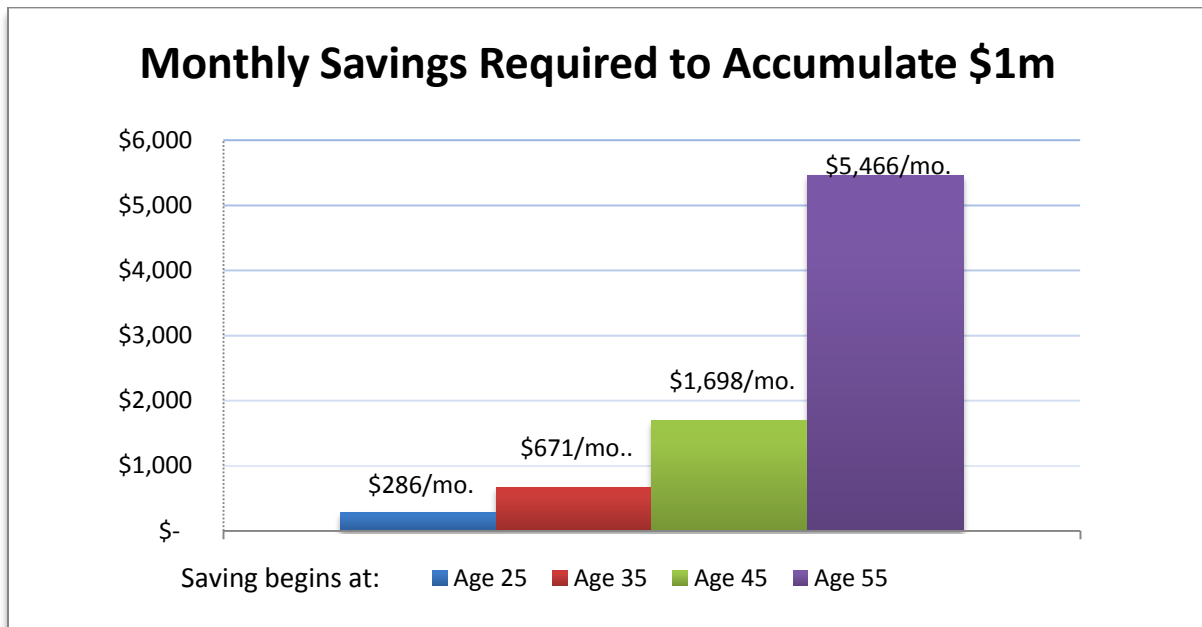
Accumulation

The accumulation stage is from age 25 through 45. This is the time when it's most optimal to saving since the earlier one begins to save the easier it is to attain one's goals. Unfortunately, young people are often faced with the problem of relatively high expenses and relatively low income. Many are also not aware of the huge opportunity the power of compounding provides during this time in our lives. Worse yet are those that do know but simply have "pie in the sky" hopes that they will somehow retire comfortably without saving.

Transition

The transition stage is ranges from age of 45 through the date one retires. It's during this stage that one **must** regularly review the status of their accounts, and then adjust saving and organize/consolidate accounts in a way that increases the likelihood of success. This stage is the last stop before retirement. It's critical it be done right!

The earlier in this stage one begins to assess their situation and possible shortfalls, the easier saving for retirement will be. The chart below shows the amount of monthly savings required to reach \$1m by age 65 assuming an 8% compounded annual return.



Retirement

Retirement is the time when your lifetime of thrift, saving, and proper planning pay off. Once in this stage you will have accumulated enough assets to carry you through the rest of your life. You will also have determined how best to organize various asset accounts as well as made proper elections on your pensions (including Social Security). Without such thrift, saving, and planning your retirement can be a rather dismal time in your life.

How much will I need in retirement?

To determine how much you should save begins with understanding how much you will need. This isn't as difficult as it sounds. You can simply assess your current lifestyle budget, and then adjust this number up or down for various changes you anticipate such as a lower mortgage payment and more travel, for example. There's also no need to express your requirement in future dollars. A good financial advisor will be able to make these adjustments for you in their projections.

If you are under 65, there's also little need to plan out to a specific age since we should all plan on living to at least 95. As it happens, planning for 30 years is statistically no different than planning for eternity. This has to do with the standard

deviation of anticipated returns, but this is a discussion for another time. For now, you'll just have to take my word for it.

Assessing your resources

Now you will know how many years you have until retirement and how much you will need. You must then examine how much you currently have available and what other resources you anticipate having upon retirement. These would include the value of your current savings, anticipated pension payments (including Social Security), and any other resource you are confident will be available.

Determining required savings rate

Your available and anticipated resources will then help determine how much additional saving is required to meet your retirement goals. Your financial advisor will use this data, and then run a Monte Carlo simulation to arrive at a prudent required savings rate. (A Monte Carlo simulation is basically a sensitivity analysis which considers price volatility in the marketplace.)

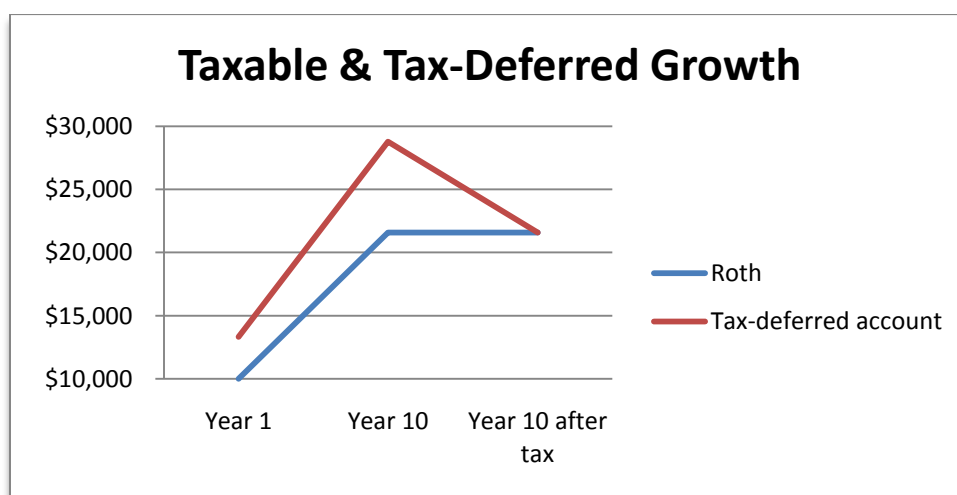
Identifying accounts to utilize

Now that you've determined how much you will need to save, the question now becomes *where* to save.

Taxable versus tax-deferred

There are two basic account types: deferred and taxable. Although tax-deferred accounts are often touted as providing greater returns due to the deferral of taxes, what matters most is your tax rate now versus in the future.

This graph depicts two scenarios assuming a marginal tax rate of 25% now *and* in the future. The blue line depicts an investor that begins the period with \$10k saved within a Roth IRA account that will never be taxed after the original investment. The red line depicts an investor that decided to invest money pre-tax, thus was able to save more in year one, but is taxable when withdrawn.



Due to a constant tax rate of 25%, each investor pocketed the same exact amount in year ten after taxes are paid!

Predicting what tax rates will actually be in the future is somewhat tenuous, but this exercise reveals to us how important planning for taxes is to the process. I do think most people are best served by investing in both Roth type and tax-deferred accounts. Doing so allows for much more tax planning flexibility in the future.

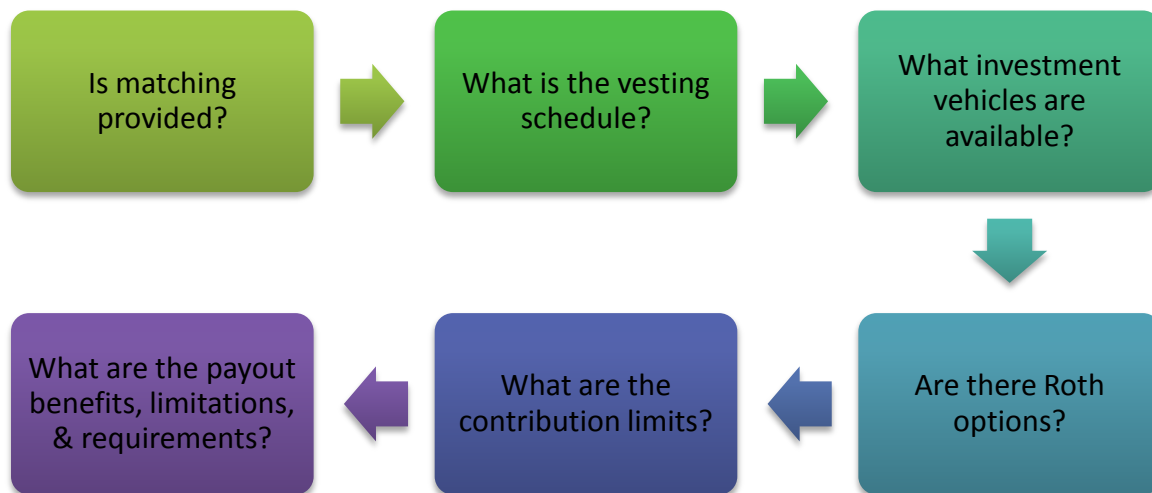
Unlike Roth type accounts, taxable accounts can create tax each year into the future. I will discuss strategies to minimize this tax in *Dealing with the Tax Man*, below.

Employer versus non-employer

Employers generally offer Roth type and tax-differed retirement savings accounts to their employees, the most common of which are:

- 401(k)
- 457
- 403(b)
- 415(c) (Thrift Savings Plan)

I utilize this process to assess the benefits and drawbacks specific employer provided plans:



If the employer provides a match it's generally a slam dunk to contribute at least up to that match. None of the other findings would determine whether or not to contribute, but should all be taken as a whole when weighed against other alternatives.

The self-employed can utilize Roth type and tax-differed retirement savings accounts as well. The most common of which are:

- SEP IRA
- Simple plan
- Solo 401(k)
- Keogh

The process for reviewing these alternatives is much like that for employer plans, but administrative issues, filing deadlines, contribution limits, and the client's tax situation do cause the review process to be much more complex.

Individuals can also contribute to traditional deductible & nondeductible IRAs and Roth IRAs. Which of these are best is generally determined by the client's current and anticipated future tax rate. Traditional deductible and Roth IRAs are also subject to IRS limitations, so higher income taxpayers may not be able to contribute.

Making the decision

Once you have reviewed the pros and cons of the various each type of retirement saving accounts, you can then develop a targeted contribution amount for each account that's found to be most optimal.

At this point you will know how much will be saved in each of your retirement accounts. The next step will be to choose your targeted asset allocation.

Choosing a target asset allocation

The adoption of an appropriate targeted asset allocation is critical. I cannot stress this enough. If you do not develop an appropriate allocation, then you are setting yourself up for failure. This result occurs because the plan will likely be abandoned or will be inappropriate given your true risk tolerance and time horizon.

Once you have assessed your risk tolerance and time horizon, the next step is to identify the appropriate mix of stocks and bonds. The decision is the single most important factor in determining the portfolio's volatility (i.e., risk). You can read a in-depth discussion of this subject by clicking [here](#).

You can then begin to fill your targeted bond allocation targets with the vehicles both within and without employer and self-employed retirement plans.

Identifying and placing investment vehicles

I make no bones about the fact I like index funds. Index funds allow the investor to focus on controlling the most important aspects of portfolio management: allocation targets, taxes, and fees. Active management is a quite lengthy discussion, but you can read more on this subject by clicking [here](#).

You should now begin to also develop your sub-allocation bond and stock targets. This means that you will have exposure to several different funds within both your bond allocation and your stock allocation.

The discussion of which vehicles to use and where is unique to each situation, but these are the general rules:

- Tax-deferred plans and traditional IRAs should generally hold income producing and other tax-inefficient assets
- Roth-type accounts should generally hold assets with a high anticipated growth rate
- Taxable accounts should generally hold the most tax-efficient assets

Dealing with the tax man

As mentioned previously, it's generally best to contribute to both tax-deferred and Roth type plans. This will allow the client to adjust future withdrawals to maximize after-tax returns. The client should also review his accounts annually in order to determine if there are opportunities to convert tax-deferred accounts to either Roth type accounts and/or taxable accounts in a relatively tax-efficient manner. This strategy can lead to huge increases in returns realized over the long term.

No one who pays taxes likes them, but taxes are inevitable. Therefore, strategies should be implemented to deal with them as such.

Summary

Properly planning for retirement is quite complex and challenging, but when done right pays off handsomely. I highly recommend you be diligent in your planning. For most of us this is most efficiently done with the aid of a financial advisor. If you do decide to hire a financial advisor I highly recommend you seek an independent NAPFA registered financial advisor who is also a CFP® professional.