Financial Planning News

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Tough Retirement Years Ahead for Americans

Many Americans are heading for delayed and/or difficult retirements, and may not be able to maintain their current standard of living. A new poll conducted by Harris Interactive for the American Institute of CPAs found that there is a significant gap between reality and what the public thinks regarding their chances of achieving their retirement goals.

Almost half of the poll's respondents, 46%, expect to fund their retirement through Social Security and pensions, and an equal number expect that their retirement funds will last them for 10 to 20 years. The fact is, people are living longer these days, and they should plan on living for perhaps another 30 years, or more, after they retire. In addition, Social Security was intended to be nothing more than a supplement to retirees' income – not their main source of income. On top of that, more and more companies are eliminating, or reducing, their pension benefits.

Americans are also underestimating how much they will need to fund their retirement years. 39% of survey respondents believe that as little as $500,000 will be sufficient. However, if trying to make this amount last over the course of 30 years, withdrawing more than just $20,000 per year puts a retiree at increased risk of outliving his/her savings. Many people will need to save far more than they anticipate, based in part on the following issues:

- Our life spans are increasing;
- Healthcare costs are increasing faster than the rate of inflation;
- More and more companies are eliminating or curtailing retiree healthcare benefits; and,
- Projected funding shortfalls for Medicare and Social Security.

The bottom line is that many Americans are in denial about their chances of achieving their retirement goals, and should take a serious look at how on track they are to retire when they'd like to do so. It's better to start "bridging the gap" now, because waiting any longer will only make the problem more difficult in the future. Mentor Capital provides comprehensive retirement planning advice to our clients, and we'd be glad to help you, too. Give us a call when you're ready to get serious about planning for your retirement.

Mutual Fund Expenses Explained

Q: I want to put some money into a mutual fund but after looking at the company's web site I'm confused by all of the fees. Can you explain them in laymen's terms?

A: Mutual Fund companies certainly don't go out of their way to clarify their expenses. Except for a few companies known for their low expenses, such as Vanguard, most would prefer that you focus on their performance. But fees and expenses can have a significant impact on your total return.

Broadly speaking there are two categories of fund expenses, operating expenses and sales charges.

Operating expenses are generally paid out of the fund assets and cover manager and analyst salaries, statement and prospectus printing, call center staff, marketing expenses, computer systems, accounting and all of the other myriad costs of running a business. You won't see these costs directly – they serve to reduce your investment return. For example, if the fund's investments earned 10% but the fund's expenses totaled 1.2%, your return would be 8.8%.

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Potentially Higher Tax Rates During Retirement Pose Risks

For many years, defined contribution plans, such as a 401k or 403b, have flourished based on the assumption that pre-tax savings would result in substantial tax benefits in retirement. The assumption in this case is that participants would make pre-tax contributions while working, reducing their income taxes in a period of presumably higher marginal tax rates. They would then pay income taxes on withdrawals of this money during retirement, presumably at lower tax rates.

What if income tax rates are higher during your retirement than they are now? Income tax rates have been relatively low in recent years; since 1980, the top marginal federal tax rate has fallen from 70% to a current 35%. Don't be shocked if Congress increases tax rates – perhaps substantially – at some point in the future, in part because of the projected funding shortfalls for Medicare and Social Security.

The chance that you could be in a higher tax bracket during retirement is a good reason for "tax diversification" – owning both pre-tax (traditional IRA, 401k, 403b, etc.) and tax-free (Roth IRA, Roth 401k/403b) savings in an

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Fund Expenses

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Sales charges are commissions paid to the broker that sold you the fund. Funds often have different classes of shares that comprise the same investment pools but differ only in how you pay the commission or "load". There is no naming standard for these classes, but many companies adhere to the following designations:

Class A shares have a front-end load, which is deducted immediately from your investment. So if the load is 5% and you invest $10,000, $500 goes to the salesman and only $9,500 is actually invested.

Class B shares have a back-end load, charged when you redeem shares, that typically declines over time. For example, you may be charged 4% if you redeem within the first year, 3% in the second year and so forth, with no charge after 4 years.

Class C shares have a level load, say 1% annually, that never goes away.

Of course, many fund companies do not charge any load. At Mentor we never recommend load funds to our clients, since there are plenty of good no-load funds available.

Tax Rates

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effort to hedge against the risk of tax changes in retirement.

The recent introductions of the Roth 401k and 403b (effective January 1st of this year) provide an easy way for many American workers to choose between making contributions on a pre-tax or after-tax basis, or a combination of the two. Unfortunately, most employers have not yet adopted the Roth 401k or 403b plans for their employees.

As for the Roth IRA, recent tax law changes make it easier for many Americans to build up tax-free retirement savings. We'll discuss this in more detail next month.

Your decision on whether to diversify your tax risk hinges on many factors and assumptions, too many to list here. Mentor Capital can advise you on this important issue as a part of our comprehensive financial planning process. If you would like to learn more about whether tax diversification would be good for you, give us a call.

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