

November 2010 Issue

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Retirement in the New Economy

It appears in news headlines and in speeches, in policy discussions and in water-cooler talk. It's the "new economy." The fact is that the recent recession has changed the way that we think about our money, today and into the future. It has changed the way we work, and it has changed the way we think about not working.

We all well know that this has been a very difficult few years. It's been a time of struggle and a time of worry. It's been a time of increasing unemployment and a time of decreasing home prices. It's been a time of great reflection as we pause to assess the recession's damage and how to move forward.

During this economic reckoning, financial uncertainty has impacted every generation. Young and old, we find ourselves asking, "What does this 'new economy' mean for my retirement?"

A study conducted last year by AgeWave and Harris Interactive titled, "Retirement at the Tipping Point: The Year That Changed Everything," looked into how the recession is impacting Americans' "retirement fears, hopes, attitudes, advice, and plans." They interviewed thousands of Americans across four generations to gather their data.

The results were somewhat predictable in that they unveiled overall trepidation and shifting plans, with a new outlook on the role of retirees in America. The results predict a new era of cautiousness after many saw their retirements, as they had planned them, change dramatically - or evaporate - when the Dow plunged 54% from its high in October 2007 to its low in March 2009 (though it has, of course, recovered substantially). Yet amidst all of that fear-based caution, there is also an underlying sense of hope.

Looking into the survey data further, we find:

Retirement in the new economy may mean working longer. Nearly 60% of Americans have lost money in mutual funds, 401(k) plans, or the stock market. For many, recouping those losses means pushing back retirement and working longer.

Respondents of the AgeWave/Harris Interactive survey believe it will take an average of seven years for their investments to recover. The report cites that "today's preretirees say they will need to postpone their retirement 4.2 years on average, which would be the first time in history that retirement age significantly increased in America."

Retirement in the new economy means worrying about the cost of health care. The biggest financial concern among respondents age 55 or older is being able to afford medical expenses during retirement. For them, it is the biggest unknown. Medicare coverage, though helpful, is limited. Retirees are considering supplemental insurance, known as "medigap," as the financial burden of health care can quickly deplete a person's retirement fund.

Nearly 70% of Americans over the age of 65 will need some long-term care, such as home care, assisted living, or nursing home care. In 2008, the average annual cost for a room in a private nursing home was \$76,460 a year (Source: Genworth Financial, 2009).

Retirement in the new economy means being more fiscally responsible. Only 4% of respondents strongly agreed that Americans behave in a financially responsible manner. An astounding 81% said that to "live within your means" was the most important financial advice parents could pass on to their children.

Retirement in the new economy means stabilizing your funds. Generally, you should have a larger share of your investments in equities the further you are from retirement; as you approach retirement, you should gradually decrease your equity investments and increase your bond and fixed-income assets - shifting

from growth toward income generation. In other words, dialing down the risk in your portfolio as you approach retirement is important (though many investors will need both income **and** growth investments, even during retirement, to live comfortably).

Retirement in the new economy means finding a new purpose. The majority of Americans - 60% - now say they view retirement to be "a new, exciting chapter in life" and 70% **want** to work in retirement as a way to contribute to their community and remain stimulated. It seems that a longer life span now means a longer work span . . . out of choice as well as necessity.

What's more, we want retirees to work. Nearly 75% of all survey respondents think our country would benefit if retirees were more involved in contributing their skills and experience to community and civic life.

There is no doubt that the recession created anxiety across the nation. As we all take a deep breath and assess our retirement funds, we assess with a new outlook. We have learned a lot. We have learned that working longer can create a new purpose. We have learned that our health is something we need to plan for as much as - if not more - than our retirement. We have learned that being fiscally responsible cannot be overemphasized. We have learned - again - that Americans are resilient and adaptable. We will get through this economic downturn . . . and be all the wiser.

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Year-End Tax Planning for IRAs

As year-end approaches, now is a good time to make sure you've taken appropriate tax steps for your individual retirement accounts (IRAs). Consider these tips:

- **Decide whether you should contribute to a traditional deductible, traditional nondeductible, or Roth IRA.** While you have until April 15, 2011, to make contributions for 2010, take a look at your income now to determine which types you are eligible to contribute to. There are different eligibility rules for traditional deductible and Roth IRAs, although all taxpayers can contribute to a traditional nondeductible IRA. Decide at your leisure, so you don't have to scramble as April 15 approaches. In 2010, you can contribute a maximum of \$5,000, plus you can make an additional \$1,000 catch-up contribution if you are over age 50.
- **Consider converting from a traditional to a Roth IRA.** Amounts converted must be included in income if taxable when withdrawn (i.e., contributions and earnings in deductible IRAs and earnings in nondeductible IRAs) but are exempt from the 10% early withdrawal penalty. Starting in 2010, all taxpayers can convert, regardless of income. If you make a conversion in 2010, the tax can be paid in two installments in 2011 and 2012 with no tax due in 2010.
- **Make sure to withdraw required minimum distributions (RMD) before year-end to avoid penalties.** You must take your first RMD by April 1 of the year after you turn 70 1/2. If you wait until April 1 of the year after you turn 70 1/2 (rather than taking your first RMD that same year), you'll have to take another RMD by December 31 of that same year. After that, you'll be required to take your RMDs by December 31 of each following year. If you don't take your RMD by year-end, you are subject to a penalty tax equal to 50% of the excess of the amount that should have been withdrawn over the amount that was actually withdrawn. RMDs are not required from Roth IRAs. To calculate your RMD, your total account balance as of the preceding year is divided by your life expectancy. While RMDs were not required in 2009, they are required in 2010.
- **Beneficiaries of inherited IRAs should review those IRAs.** When there are multiple beneficiaries, it is typically best to split the IRA into separate

accounts by December 31 of the year following the original owner's death. If the account is not split, distributions must be taken by all beneficiaries over the life expectancy of the oldest beneficiary. By splitting the IRA into separate accounts, each beneficiary can take distributions over his/her life expectancy. This is especially important for a surviving spouse, who can only roll over the IRA to his/her own account if he/she is the sole beneficiary.

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Five Common 401(k) Plan Mistakes

While it's true that participation is the first step, simply putting money into a 401(k) plan won't guarantee a comfortable retirement. Consider these five common 401(k) mistakes and how you can avoid them:

1. Believing that simply contributing to your 401(k) plan is sufficient. Your goal should be to contribute the maximum annual limit - \$16,500 for people under 50 years of age and \$22,000 for investors 50 years of age or older. Contributing at that level clearly isn't realistic for everyone, and certainly some level of contribution is better than nothing. But living well within your means today can mean a more comfortable retirement tomorrow.

2. Using your 401(k) plan as a savings account. When you go through a major life event, it can be tempting to cash out your 401(k) plan to get you through that "rough patch." Withdrawing from your 401(k) plan today not only puts a dent in the balance that will compound over time, but if you're not yet at retirement age, the Internal Revenue Service may send you a hefty tax bill for withdrawing that retirement money early. To the extent that you can, leave your 401(k) alone to grow in peace until your retirement. Use other cash assets for those inevitable rainy days.

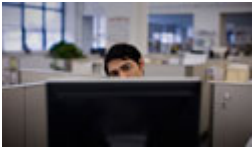
3. Fearing diversification. Diversification is a risk management technique that mixes a wide variety of investments within a portfolio. It's based on the idea that a mix of different investments may yield higher returns with lower risk than any individual investment.

A good rule of thumb is to invest more in equities the further you are from retirement, and then gradually increase your bond allocation over time to help make that shift from a growth orientation toward an income orientation. The point is this: a blend of investments is important and requires adjustments along the way.

4. Not participating in the company match program. If your bank gave you \$10 every time you deposited \$10, would you accept that? That's what many companies offer through their 401(k) matching programs. Figure out how to budget your monthly take-home pay accordingly so that you can contribute at least as much as your employer will match (most match 50 cents or \$1 for every \$1 contribution, up to a certain percentage of pay).

5. Suffering analysis paralysis. Whatever your situation, it is better to be prepared for retirement than not. The mistake here is either failing to tap the benefits a 401(k) plan offers (like company matching) or setting up contributions and then failing to pay attention to how they are allocated and making necessary adjustments.

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Who Gets Paid More?

In the past, public sector wages were lower than private sector wages, so the public sector offered generous benefits to attract and retain workers. But recent data from the U.S. Bureau of Labor Statistics (BLS) indicates that the situation has changed dramatically.

Currently, 16.4% of all workers are employed in the public sector - 2.0% for the federal government, 3.7% for state governments, and 10.6% for local governments. Local government workers include teachers, police officers, and firefighters. As of September 2008, average total compensation, including benefits, was \$27.07 per hour in the private sector and \$39.18 per hour in the public sector.

Differences between the two sectors help explain some of the wage disparity. Over 40% of public sector workers are represented by a union while less than 10% of private sector workers are. The average employee tenure is twice as long in the public sector.

The occupation mix is also very different between the two sectors. Approximately two-thirds of public sector jobs are professional and administrative while 51% of private sector jobs are. Also, retail and food service jobs, which tend to be part-time, low-paying jobs account for 20% of private sector jobs but only 2% of public sector jobs (Source: The Federal Reserve Bank of Chicago, May 2009).

Benefit costs differ substantially, with the public sector paying \$13.41 per hour and the private sector paying \$7.93 per hour for benefits. The difference results primarily from health and retirement benefits, which are more prevalent in the public sector. Also, the public sector tends to provide better benefits with higher employer subsidies. For instance, 60% of part-time public employees receive pension benefits, and two-thirds of public sector pensions include automatic cost of living increases, a feature that is rare in the private sector.

It is generally believed that the decrease in private sector benefits over the years is in large part a response to economic pressures and global labor trends. Whether the public sector will find benefit costs so overwhelming that they will follow suit remains to be seen.

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Money and Marriage

If married couples can't agree on basic money issues, they can become a constant source of conflict. To help avoid money conflicts, consider these tips:

- **Discuss your views on a wide range of money issues, paying particular attention to potential sources of conflict.** Make sure you understand each other's views about earning, spending, saving, investing, and borrowing. Does one of you like to save money, while the other prefers to spend it? Does one feel comfortable with high debt levels, while the other can't stand the thought of paying interest? Different money issues will be more important at one stage of your marriage than at another. Thus, you may find you have no money disagreements for years, only to be faced with an issue you can't agree on.
- **Set basic monetary goals, and develop a written budget.** Especially if you are having conflicts over money, it can be helpful to step back and really think about what you are trying to accomplish. Where do you want to be in 10, 20, or 30 years? What are your most important goals in life, and how can you accomplish them? The process of defining goals and setting

a budget can help resolve differing views about money matters, forcing couples to compromise and make joint decisions about how money will be spent. While that might seem like a painful process, addressing these issues now can help prevent future misunderstandings. It is often easier to discuss spending preferences on a theoretical basis than it is to argue about an actual purchase.

- **Decide on joint or separate bank accounts.** Some couples prefer to pool all funds, while others feel uncomfortable losing control of their money. For couples with vastly different spending styles, separate accounts may reduce tension. A joint account can be used for shared expenses, with each spouse contributing a designated amount to the account. Any remaining funds are kept in individual accounts, for each spouse to spend as he/she desires.
- **Develop credit in each spouse's name.** Each spouse should have separate credit cards to develop his/her own credit file. This can be especially important if one spouse dies or the couple divorces.
- **Split financial responsibilities.** Decide who will handle financial tasks, such as paying bills, preparing tax returns, making investment decisions, etc. One person may be more suited for these tasks due to their background or time availability. However, the other spouse should not give up total control.
- **Discuss financial matters periodically.** Set up a formal time, perhaps monthly, to go over financial matters. This keeps both spouses fully informed and provides a designated time to discuss spending or items of concern. You then won't fret about how to bring up financial topics or let finances interfere during other times.

Money can be a source of continuing conflict or a means to help achieve your financial goals.