QUARTERLY CAPSULE

Newsletter of the Alliance of Cambridge Advisors, Inc. Fall 2002

ON BECOMING A FEARLESS ACCUMULATOR FOR RETIREMENT

Bear markets are bad news for investors whose primary goal is conserving their accumulated wealth. But for those in the early stages of building their nest egg, opportunities abound. Stocks are on sale now at prices unseen since 1995. Equity markets could drop further, but if you plan to invest consistently over decades, whatever happens in the next year or two will have relatively little effect on how prosperous you are in 20 to 30 years. Build a winning strategy using these three concepts:

One: Start Saving Early

Allow me to introduce you to the Saver twins, Joan and Jill. Starting at age 25, Joan puts $2,000 per year into her IRA. After five years and with $10,000 invested, she stops making contributions, but leaves the money in the account, where it earns 10%. Jill waits until she turns 35 to start her IRA, but keeps making contributions to the plan for 30 years. Who has more at age 65? The surprising fact is that Joan's contribution of just $10,000, plus its earnings over forty years, has always amounted to more than her sister's account, even though late starter Jill pumps $60,000 into her plan over thirty years. Compound interest makes money saved when you are young much more valuable than funds saved at a later age.

In this example, Joan's contribution of $10,000 to her IRA becomes more than $300,000 by the time she turns 65. What if Joan doesn't stop her contributions at age 30? Then she would amass more than $1,000,000 by age 65, assuming the same 10% return. When you break it down, for someone with 40 years to do it, the cost of becoming a millionaire could be less than $6 per day.

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COUNTDOWN TO RETIREMENT

Are you counting down the days to retirement? Is it just around the corner? A few months, at most a few years? Consider these questions to ease your transition into the next stage of your life.

How do you want to spend your days during retirement? Many people enter retirement without a clue what they want to do. Do they want to work part time? Pursue a hobby? Volunteer? Travel frequently? Their choices have implications for the quality of their desired retirement lifestyle and have a profound impact on the cost of retirement. The earlier you can start thinking seriously about how you want to live in retirement, the better.

Will your plans work for both you and your spouse? Each spouse may have different visions about retirement, or may be retiring at significantly different times. Discuss how you can accommodate these differences well before you actually retire.

How much will I need during retirement? The rule of thumb is that you need 70 to 80 percent of your pre-retirement income to live on during retirement. The problem with this rule is that it may not closely match your needs. You may envision a very frugal lifestyle, or a high-expense one. Err on the high side. Studies indicate that people tend to underestimate what they actually spend during retirement.

Can I actually afford to retire soon? Even if you're still five years away from retirement, make an estimate of what income you can rely on during retirement. How much will you receive from Social Security? From a company pension? What do you have in your 401(k) or other retirement savings? When you actually retire, will there be enough money to fully fund your retirement? Or do you need to sock away more now, perhaps work part-time for a while after retirement or even delay retirement?

What investment decisions do I make prior to retirement? Start reviewing your portfolio five years before your planned retirement to be sure you're heading into retirement with the right mix of assets.

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Two: Create a Tax and Cost-Efficient Plan

Controlling the costs of investing can be very rewarding over time. Let's examine hypothetical cost differences between the Saver Twins' retirement plans. Say that Joan and Jill both commit $10,000 per year to their 401(k) plans from ages 25 to 65. The only difference is that the fund expenses of Joan's plan average 1.5% less than those at Jill's company. If the return over the 40 years averages 8.5% for Joan, it would be 7% for Jill, assuming equal investment results. With 1.5% higher expenses in her plan, Jill would have a balance in her account at age 65 of $1,996,351, certainly nothing to sneeze at. But Joan's account balance would total $2,956,825, almost one million dollars more. At higher market returns, the difference between the final values is even greater

We all know that a million dollars just isn't what it used to be, but I think we can probably agree that having an extra one or two million bucks would make a significant difference in the quality of life you enjoy in retirement. Choosing less-expensive and more tax-efficient mutual funds within your 401(k) can improve the results of your savings program, ultimately producing a much greater accumulation of capital.

Three: Keep Your Balance

In our previous examples we assumed that the Saver Twins each have identical and uniform investment results. That's a simplistic assumption, so let's modify it. Say that, at the beginning of their savings program, they each decide to divide their money among four or five different types of funds for diversification. Jill never gives her allocation another thought and just lets the various funds in her account grow until retirement. Joan, however, calls the fund company once each year or two to buy and sell enough shares to reset the balances among the various funds to their original proportions. Guess what? Joan's account outstrips her sister's again. This time, it is the discipline of rebalancing -- regularly selling high and buying low that does the trick. Joan has captured the rebalancing premium.

Rebalancing is a good way to maintain proper diversification in your portfolio. You don't have to worry about which asset class will be the top performer in any given year. You simply need the self-control to consistently respond to market changes in a way that protects you from big reversals and provides lots of small victories.

Now you know three things that can help you be the smarter twin. Start saving as soon as possible. Pay close attention to minimizing your costs. Keep your plan balanced. What if you know you are too likely to act like the less attentive twin or are simply put off by the difficulty or bother of doing it yourself? Your financial advisor can help keep you on track.

Chris Currin, CFP™ Dallas, TX

Tax Law Changes Benefit Public Employees

Two important tax law changes in the 2001 Economic Growth and Tax Relief Reconciliation Act (EGTRRA) may allow savvy public employees an earlier retirement or higher income during retirement. The tax law changes have made the purchase of prior service credit more affordable while also allowing increased contributions to employer-sponsored tax deferred savings plans.

Many of my clients work for public institutions, some as teachers in school districts and others at local community colleges and universities. The retirement systems that cover public employees frequently provide the option to voluntarily contribute or "buy in" qualifying service or employment that was earned in prior public employment in another system or state.

The purchasing of prior service credit in public retirement systems entitles members to earlier retirement or higher retirement income. If the cost of the purchase (often many thousands of dollars) is justified by the increased benefits or prospect of earlier retirement eligibility, the remaining question is how to fund the purchase.

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Countdown, continued from page 1

You don't want to be overloaded with company stock, yet you don't want to abandon stocks entirely as you near retirement because you'll still need some growth to stay ahead of inflation.

What should I do with my 401(k) or other tax-deferred plans? You may want or need to roll assets out of your company retirement plan upon retirement, or shift other retirement assets. Plan your tax and allocation moves before you retire. Managing retirement resources can be critical to the survivability of those assets over your retirement lifetime.

Should I set up a spending plan before retirement? Couples approaching the last five years before retirement tend to experience what's been called "lifestyle creep." With their income often at maximum and many of their traditional expenses such as children and a mortgage gone, they tend to spend the surplus. Consequently, they have a higher pre-retirement lifestyle to maintain during retirement, when income is typically lower. Instead of spending surplus funds during the last of your working years, sock away most, if not all, of it for retirement. And evaluate your debt. Carry as little consumer debt as possible into retirement because you'll likely have less income to pay it off.

What if I want to move after retiring? If you are thinking of moving for retirement, try to spend as much time as possible there, in all types of weather conditions, before you actually move. Rent before you buy a home.

What other things should I do before retiring? In addition to checking out new living locations, try out other aspects of your envisioned lifestyle before actually retiring: hobbies, travel, time with your spouse (spend a week's vacation just at home together with no plans). Live on your retirement budget for a couple of months!

What about health insurance? Retiring before Medicare kicks in at age 65 may leave you without health care coverage. Have coverage in place when you retire. This may be a continuation of your employer's group plan under COBRA (you pay all of the costs) or perhaps a short-term major medical policy. You will also need a Medigap policy when you reach Medicare age.

Should I consider long-term care insurance? Most persons nearing retirement should strongly consider buying a long-term care insurance policy. The federal government provides only limited free long-term care under Medicare and you must be impoverished to qualify for nursing home care under Medicaid. A private policy will typically provide far better options.

This column is produced by the Financial Planning Association, the membership organization for the financial planning community, and is provided by Karen Folk, CFP ™ Urbana, Illinois, a local member in good standing of the FPA.

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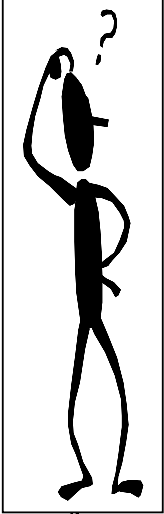
Luckily, federal law now allows payment for purchase of prior service credit with transfers from other types of tax-deferred accounts. This means that if you have contributed to an IRA, 403(b), 457, or 401(k) plan, you can use a transfer of these funds to purchase service credit without owing any tax on the transfer.

The administrator of your public retirement plan may not allow transfers if you are currently contributing to the plan so it is important to check first to determine your eligibility. But many employers are in the process of modifying their retirement plan documents to allow "in service transfers". In service transfers are not an issue for those using Traditional IRAs to purchase credit.

The other benefit of the new tax law is that employees of state universities can contribute to all deferred compensation plans available to them and may be able to significantly increase annual contributions. For example, if you can voluntarily contribute to both a 403(b) and 457 plan, you may be able to put away as much as $22,000 in 2002 ($11,000 to each of the 403(b) and 457 plans) in addition to the mandatory contribution to the State retirement plan. An additional $1,000 can be contributed to each plan if you are age 50 or older as a "catch up" amount. Maximum limits increase over the next four years to a maximum of $15,000 to each plan in 2006 (plus a "catch up" in 2006 of $5,000 per plan for those age 50 or older).

Lee Bridges CFP™ Homewood, Illinois

Ask An Advisor: My friend Steve says he wants to retire at 60 instead of 65. That sounds good to me, too. How do I know if I can?



Five years earlier sure does sounds better, but those extra years can be costly. Let's look at Steve's situation.

Steve is 30 and expects to live until about age 85 -- he's in good health, both his parents are still living, and his grandparents all lived to their early seventies. So instead of just 20 years in retirement (age 65 to age 85), he's planning on 25 years of living on just his savings (he doesn't have much faith in Social Security). He wants to draw $30,000 per year in today's dollars throughout retirement. He estimates an average 9% annual return on his savings before retirement, 7% after retirement (because he will not be as aggressive with his investments) and 4% annual inflation.

Now, if Steve were to retire in 35 years at age 65, he'd only need to save about $623 per month. But to retire five years earlier at age 60, he will need to put away about $965 per month. He has to save over 50% more each month, to fund just 25% more time in retirement. The difference is so large because there's a financial double-whammy to early retirement. First, you need a larger nest egg (since you're paying for more years of paycheck-free living). Second, you also need to save the nest egg in less time and with less time for compound earnings to work their magic. That is not to say it can't be done. But you should start saving as early as you can.

Of course, the flip side is a bit more positive. Some people are disappointed that they do not have the money to retire early, but they are surprised at how much it helps to delay retirement by even a few years. Of course, this is because they are now saving for fewer retirement years, and they have more time in which to do it.

To get an idea of how much you need beyond other income in retirement (pension, Social Security, part-time earnings), take a look at the "Ballpark Estimate" provided by the American Savings Education Council, on the internet at www.asec.org. You can calculate your required savings on-line, or print out their simplified form and do the math yourself. But whatever you do, take the time now to get the answers to these very important questions. It could mean that you will have the option of retiring earlier rather than later. And most importantly, start saving today.

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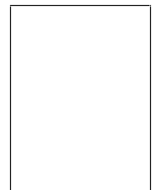

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