Investment News

Volume 4 April 2016

Why Aren't You Maxing Out Your 401(k)?

It may be the best retirement planning tool you have.

Do you have a million dollars? At the moment, probably not. But if you invest and save diligently and let your assets compound, who knows? You may be a millionaire someday. In fact, you may need to be a millionaire someday. If you stay retired for twenty or thirty years, it could take well over $1 million to fund that retirement. In fact, Andrés Cardenal, CFA and financial analyst, recommends $1.25 million if you plan to match inflation over a three-decade retirement. This is one reason why you should contribute the maximum to your 401(k) plan.[1]

Your 401(k) is your friend. For years, employers have wondered: why don't people contribute more to their 401(k)s? At many large companies, the majority of employees contribute too little, and some find it a hassle to even fill out the paperwork. Most people don't speak "financial" and don't look at financial magazines or websites. It's "boring." So they mentally file "401(k)" under "boring." But the advantages of a 401(k) should not bore you; they should motivate you.

Tax-deferred growth and compounding. The money in your 401(k) compounds year after year without tax penalties. The earlier you start, the more compounding you get. Let's say you put $2,400 annually in a 401(k) starting at age 30, and for the sake of example, let's assume you get an 8% annual return. How much money would you have at 65? You would have a retirement nest egg of $437,148 from putting in $200 per month. But if you started putting in that $200 a month five years later, you would have only $285,588. You can put up to $18,000 into a traditional or "safe harbor" 401(k), and if you turn 50 or are older than 50 this year, you can put in an additional $6,000 in "catch-up" contributions. You can contribute up to $12,500 to a SIMPLE 401(k), with "catch-up" contributions of up to $3,000 if you are 50 or older. These annual contribution limits are indexed for inflation.[2]

Potential matching contributions. Who would turn down free money? Big companies will often match an employee's 401(k) contributions. Usually, the corporate match is 50¢ for each dollar up to 6% of your salary.[3]

Reducing your taxable income. Many employees don't recognize this benefit. Your 401(k) contributions are pulled out of your wages before taxes are withheld (pre-tax dollars). So you get reduced taxable income and tax-free growth; you pay taxes on 401(k) assets when you withdraw them from the plan. With the Roth 401(k), the contributions are after-tax (no reduction in taxable income), but you can enjoy both tax-free compounding and tax-free withdrawals.

Why not take advantage? If you don't contribute greatly to your 401(k), 403(b), or 457 plan, you are ignoring a great retirement savings opportunity. Talk to your financial advisor about your 401(k) and other great resources to save for retirement.

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2016 Market Performance 01-01-2016 to 03/31/2016

DJIA ^DJI Down 1.49%
S&P 500 ^GSPC Down 0.77%
NASDAQ ^IXIC Down –2.75%
Russell 2000 ^ RUT Down –1.92%

* Index performance does NOT include any fees (Gross of fees)

Source: http//finance.yahoo.com

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College Funding Options

You can plan to meet the costs through a variety of methods.

How can you cover your child's future college costs? Saving early (and often) may be the key for most families. Here are some college savings vehicles to consider.

529 plans. Offered by states and some educational institutions, these plans let you save up to $14,000 per year for your child's college costs without having to file an IRS gift tax return. A married couple can contribute up to $28,000 per year. (An individual or couple's annual contribution to the plan cannot exceed the IRS yearly gift tax exclusion.) These plans commonly offer you options to try and grow your college savings through equity investments. You can even participate in 529 plans offered by other states, which may be advantageous if your student wants to go to college in another part of the country.[1,2]

While contributions to a 529 plan are not tax-deductible, 529 plan earnings are exempt from federal tax and generally exempt from state tax when withdrawn, as long as they are used to pay for qualified education expenses of the plan beneficiary. If your child doesn't want to go to college, you can change the beneficiary to another child in your family. You can even roll over distributions from a 529 plan into another 529 plan established for the same beneficiary (or for another family member) without tax consequences.[1] In addition, grandparents can start a 529 plan, or other college savings vehicle, just as parents can; the earlier, the better. In fact, anyone can set up a 529 plan on behalf of anyone. You can even establish one for yourself.[1]

Coverdell ESAs. Single filers with adjusted gross income (AGI) of $95,000 or less and joint filers with AGI of $190,000 or less can pour up to $2,000 annually into these tax-advantaged accounts. While the annual contribution ceiling is much lower than that of a 529 plan, Coverdell ESAs have perks that 529 plans lack. Money saved and invested in a Coverdell ESA can be used for college or K-12 education expenses. Coverdell ESAs offer a broader variety of investment options compared to many 529 plans, and plan fees are also commonly lower.[3,4]

Contributions to Coverdell ESAs aren't tax-deductible, but the account enjoys tax-deferred growth and withdrawals are tax-free so long as they are used for qualified education expenses. Contributions may be made until the account beneficiary turns 18. The money must be withdrawn when the beneficiary turns 30 (there is a 30-day grace period), or taxes and penalties will be incurred. Money from a Coverdell ESA may even be rolled over tax-free into a 529 plan (but 529 plan money may not be rolled over into a Coverdell ESA).[2,4]

UGMA & UTMA accounts. These all-purpose savings and investment accounts are often used to save for college. When you put money in the account, you are making an irrevocable gift to your child. You manage the account assets. When your child reaches the "age of majority" (usually 18 or 21, as defined by state UGMA or UTMA law), he or she can use the money to pay for college; however, once that age is reached, that child can also use the money to pay for anything else.[5]

Cash value life insurance. If you have a "cash-rich" permanent life insurance policy, you can take a loan from (or even cash out) the policy to meet college costs. The principal portions of these loans are tax-exempt in most instances. Should you fail to repay the loan balance, however, the policy's death benefit will be lower.[6]

Did you know that the value of a life insurance policy is not factored into a student's financial aid calculation? That stands in contrast to 529 plan funds, which are categorized as a parental asset, even if the child owns the plan.[6]

Imagine your child graduating from college debt-free. With the right kind of college planning, that may happen. Talk to a financial advisor today about these savings methods and others.

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Financial Planning with Health Insurance in Mind

How much might health care cost you someday?

"Financially speaking, what would be the worst thing that could happen to you?" If you ask a hundred people in their forties that question, you may get a dozen different answers. Some may say "my business going under" or "losing my house." Some might say "a divorce," "a lawsuit," or "being laid off." But how many would say "a severe illness?"

A catastrophic illness seems like a remote possibility to many; distant, decades away. As a result, that possibility may be overlooked in our financial planning.

The healthiest of us may need to save the most for health care. This may seem paradoxical, but think about what many people in their eighties or nineties experience: years of declining health and mobility, and accompanying high health care expenses.

Two projections of average retirement health care costs are very illuminating in this regard. Empower Institute (an offshoot of retirement plan administration firm Great-West Financial) has calculated the amount of money that 65-year-old males with particular medical conditions will need in order to absorb 90% or more of future health care expenses. A 65-year-old man with Type 2 diabetes, for example, will need $88,300 (in today's dollars) to cope with those costs, according to Empower's projection. It also estimates that a 65-year-old tobacco user will require $114,900 and a healthy, non-smoking 65-year-old male, $143,800.[1]

Why the difference? According to the Empower forecast, the 65-year-old diabetic has a life expectancy of 78, versus 81 for the tobacco user, and 87 for his healthier counterpart.[1]

How about a healthy 65-year-old woman? Empower projects she will need a retirement health care fund of $156,000, as women currently outlive men on average.[1]

Another take on all this comes from the respected Employee Benefit Research Institute. EBRI estimates that the average healthy 65-year-old today will need $124,000 to handle future medical expenses. EBRI's director of health research, Paul Fronstin, told the *Wall Street Journal* that a pre-retiree should adjust that number for inflation as follows: increase it by 5% for each year remaining until your planned retirement date. So if you are 50 right now, you will need about $250,000 to cover medical costs if you retire in 2031.[1]

The more you earn, the more you may pay for essential health benefits. Take the case of Medicare premiums. Most Medicare beneficiaries who are single filers with modified adjusted gross incomes of $85,000 or less are paying monthly Part B premiums of $104.90-$121.80 this year. In contrast, single filers with MAGIs between $85,001-107,000 are paying Part B premiums of $170.50 a month. That premium jumps to $243.60 for a single filer with MAGI greater than $107,000, and extremely high-earning individuals pay more than that. Pre-retirees should be mindful of this, and the fact that Medicare does not pay for long term care or dental care.[2,3]

Your income level may also affect how much you pay for health coverage before you retire. As an example, a Texas household of four that expects its 2016 income to be between $24,300 and $60,625 can go to the Health Insurance Marketplace and qualify for health plans with relatively low premiums, plus savings on deductibles and copayments. A similarly sized Texas household with income higher than $97,000 cannot qualify for any such savings and must pay full price for their health coverage at the Marketplace.[4]

So looking ahead, is a Health Savings Account a good idea? For the future, it may be. HSAs must be used in conjunction with high-deductible health plans, but even with that requirement, these accounts can give pre-retirees a nice, dedicated savings vehicle to plan for future health care expenses. An HSA may become an important part of a long-run financial strategy.[5]

The annual contribution limit on an HSA is currently $3,350 for individuals, $6,750 for families. Contributions are 100% tax-deductible. (You can even make $1,000 catch-up contributions beginning in the year you turn 55, as long as you are not a Medicare recipient.) You can also optionally invest the money within the account. An HSA is tax-advantaged: assets get tax-free growth, and withdrawals are tax-free if you use the money to pay for qualified health expenses. HSAs also have another nice feature: once you turn 65, you may use withdrawals from them for non-medical purposes, though such withdrawals will be taxable. If you enroll in Medicare, you can no longer contribute to an HSA – so it is vital to fund these accounts for some years before retiring.[5,6]

It is only prudent to factor potential health care costs into your financial plan. Some healthy pre-retirees may assume that they will need only a five-figure rather than six-figure sum to address them. That assumption may be flawed.

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Should You Plan to Retire on 80% of Your Income?

Examining a long-held retirement planning assumption.

A classic retirement planning rule states that you should retire on 80% of the income you earned in your last year of work. Is this old axiom still true, or does it need reconsidering?

Some new research suggests that retirees may not need that much annual income to keep up their standard of living.

The 80% rule is really just a guideline. It refers to 80% of a retiree's final yearly gross income, rather than his or her net pay. The difference between gross income and wages after withholdings and taxes is significant to say the least.[1]

The major financial challenge for the new retiree is how to replace his or her paycheck, not his or her gross income.

So concluded Texas Tech University professor Michael Finke, who analyzed the 80% rule last year and published his conclusions in *Research,* a magazine for financial services industry professionals. Finke noted four factors that the 80% rule does not recognize. One, retirees no longer need to direct part of their incomes into retirement accounts. Two, they no longer involuntarily contribute to Social Security and Medicare, as they did while working. Three, most retirees do not have a daily commute, nor the daily expenses that accompany it. Four, people often retire into a lower income tax bracket.[1]

Given all these factors, Finke concluded that the typical retiree could probably sustain their lifestyle with no more than 77% of an end salary, or 60% of his or her average annual lifetime income.[1]

Retirees need to determine the expenses that will diminish in retirement. That determination, rather than a simple rule of thumb, will help them realize the level of income they need.

Imagine two 60-year-old workers, both earning identical salaries at the same firm. One currently directs 25% of her pay into a workplace retirement plan. The other directs just 5% of her pay into that plan. The worker deferring 25% of her salary into retirement savings needs to replace a lower percentage of their pay in retirement than the worker deferring only 5% of hers. Relatively speaking, the more avid retirement saver is already used to living on less.

New retirees may not necessarily find themselves living on less. The retirement experience differs for everyone, and so does retiree personal spending.

As a recent Employee Benefit Research Institute study noted, household spending typically declines 6% in the first two years of retirement, with additional declines thereafter. This is not the story for all retirees; EBRI also found that almost 46% of retiree households *increased* their spending in the initial two years of retirement. On the other side of the scale, nearly 40% of the retiree households EBRI studied saw their expenses fall by at least 20% within two years of retiring.[2]

A timeline of typical retiree spending resembles a "smile." A 2013 study from investment research firm Morningstar noted that a retiree household's inflation-adjusted spending usually dips at the start of retirement, bottoms out in the middle of the retirement experience, and then increases toward the very end.[2]

A retirement budget is a very good idea. There will be some out-of-budget costs, of course, ranging from the pleasant to the unpleasant. Those financial exceptions aside, abiding by a monthly budget (with or without the use of free online tools) may help you to rein in any questionable spending.

Any retirement income strategy should be personalized. Your own strategy should be based on an accurate, detailed assessment of your income needs and your available income resources. That information will help you discern just how much income you will need when retired.

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