

## **Chapter 1**

### ***The Importance of Saving for Retirement***

*Most of us have a pretty clear idea of the world we want. What it takes is an understanding of how to go about getting it.*

*Hugh Gibson*

A dramatic change is taking place across working America. The country is realizing that traditional sources of retirement income from pension plans and Social Security are quickly diminishing. Soon, all retirees will be dependent on personal savings and part-time work for a majority of their income. This means Americans must save an adequate amount prior to retirement, and make intelligent investment decisions with those savings. In a sense, the future of America rests on the ability of workers to save and invest properly.

Unfortunately, most investors do not have the information or experience needed to make the best investment decisions, and that includes professional financial advisors. We are inundated with investment information and advice from hundreds of sources, each promising higher or safer rate of returns. Over the years, the chore of selecting suitable investments has become increasingly difficult as markets expand around the globe and the burgeoning financial services industry expands with it. Wise investors try to develop a simple strategy that makes managing their money simple and profitable.

Before looking at the problems and solutions pertaining to retirement savings, this chapter provides some background information about saving for retirement. Many of the terms explained below are used throughout this book.

#### ***Who are Individual Investors?***

The financial services industry typically divides investors in two categories: institutional and individual. Institutional investors include banks, trust companies, mutual fund companies, insurance companies, large corporate and government pension funds, endowments, charitable organizations, and other entities with sizable pools of money. Institutions hire professional money managers on a full time basis to evaluate investment opportunities and manage large portfolios. Basically, institutional investors manage other people's money.

In contrast, individual investors are responsible for managing their own money, and possibly a small business retirement plan, family trust, or estate. These people are not professional investors and are not paid for managing investment portfolios or evaluating investment options. Most individual investors

control assets of less than \$100,000. As a result of their smaller size, individuals tend to pay much more for investment products and services, but typically get a lot less for their money. The great gains that you often hear about on Wall Street are not those experienced by the average individual investor. Part I of this book explains that fact in full detail.

It is worth noting that stockbrokers, financial planners, insurance agents, and other personal investment advisors are not institutional investors, although they do manage other peoples money. Generally, these advisors act as middlemen between individuals and institutional investors. In truth, they are product salespeople. These advisors are typically paid a fee or commission for selling the products and services of institutions, such as mutual funds or insurance.

### ***How We Will Pay for Retirement***

Americans are becoming increasingly responsible for their own retirement well being. The prospect of living off a company pension and Social Security check is rapidly diminishing. Recent retirees are already relying less on traditional sources of income and more on savings and part-time work. For future retirees, the situation will get worse. As a result, the desire to build a large nest egg for retirement has been replaced by the need to build one.

In the 1960's, a monthly employer retirement check and benefit payments from Social Security accounted for over 50% of a retiree's income. By 1992, those traditional sources of income had dropped to less than 30%. When millions of baby boomers begin to retire in 2010, income from traditional sources may approach 10%. The shortfall in income must be made up through a combination of personal savings and part-time work. Those who do not save for retirement may find their Golden Years are spent flipping burgers at the Golden Arches.

#### **How People Will Pay for Retirement**

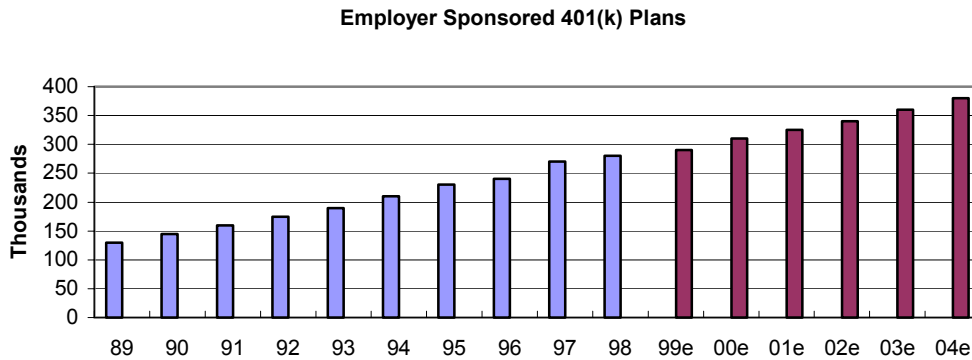
	Traditional Pension	Federal Programs	Personal Savings	Part-time Work
1992	8%	19%	46%	27%
2029	4%	7%	48%	41%

Source: Fortune magazine

### ***The Growth of Individual Retirement Accounts***

America's answer to the retirement savings problem seems to be the employer sponsored 401(k) or similar plan. Over 270,000 corporations offer employees a 401(k) tax-deferred savings plan and thousands of public employers offer 403(b) plans to hospital workers, teachers, and government employees.

Contributions are made to these plans through regular payroll deductions, and some employers match a portion of those savings<sup>1</sup>. According to the Department of Labor, over 40 million workers are covered under a 401(k) or similar plan. At the beginning of 1999, there was more than \$1.0 trillion invested in these plans, and that amount is expected to grow to \$2.0 trillion by 2003<sup>2</sup>.



In addition to 401(k) type plans, Individual Retirement Accounts (IRA) have also flourished. This has happened for a couple of reasons. One is employee turnover and the second is tax law changes.

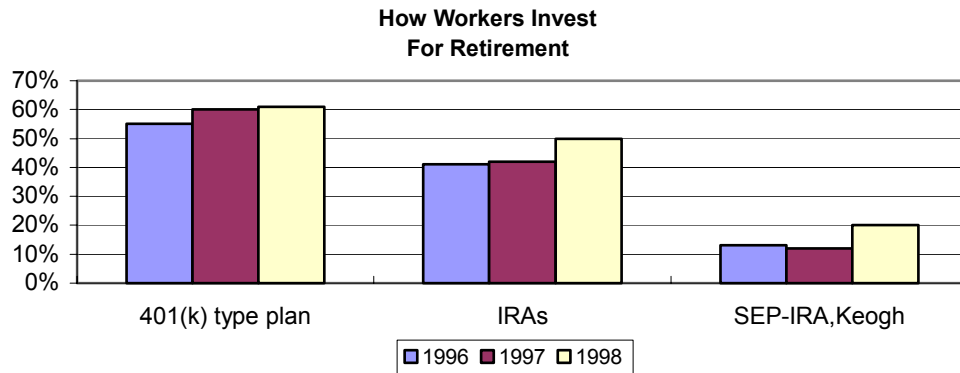
Only a generation ago, a large percentage of workers spent most of their adult life at one company, retiring after decades of service with a gold timepiece and a monthly pension. Times have changed. The Current Population Survey shows workers have become much more transient. Back in 1983 the average middle-aged male worker stayed on the job for 13 years, by 1996 that was down to 10 years. Women average only 7 years at each company they work. The decrease in service time is a result of corporate downsizing, productivity gains, and a fundamental shift in the economy from a manufacturing base to a service base.

The increase in job turnover has resulted in tens of millions of IRA rollover accounts. When a person leaves an employer, they typically roll their portion of a pension plan into an IRA to avoid income taxes. Since the person has just lost their old job, or is just taken a new one, they have more to worry about than investing this money properly. As a result, many workers take the simplest rollover option and place the money at a custodian that was recommended by someone at their previous employer. After several years in the work force and a few jobs later, most people have numerous IRA rollovers scattered all over at various investment firms, banks, and mutual funds. Many of these accounts are not in the optimal place, nor the most efficient investments. Without consolidating this money and investing properly, the accounts can remain stagnant for years, earning below market returns and resulting in less money at retirement.

<sup>1</sup> Over 90% of large plans have an employer match according to the Bureau of Labor Statistics, *Data for Large Business*, 1995; and Buck Consultants, *Survey Report on Plan Design*, Ninth Edition, 1997

<sup>2</sup> Spectrum Group-Access Research (Windsor, CT)

In addition to IRA Rollovers, many people have a contributory IRA. Prior to 1987, all wage earners could contribute up to \$2,000 per year pre-tax into a contributory IRA. Congress changed the tax law in the late 80s and many people lost the opportunity to contribute. However, the accounts still exist on



the books. Like IRA rollovers, much of the contributory IRA money is neglected, stashed away in some forgotten investment from yesteryear.

By 1997, there were over 140 million IRA accounts nationwide holding \$500 billion in assets<sup>3</sup>. However, this did not stop congress from creating new IRA's. The Taxpayer Relief Act of 1997 included two new accounts called the Roth IRA and the Educational IRA. Under both plans new accounts need to be opened, adding to the mountain of existing paperwork. Both the Roth and Educational IRA's have gotten a lot of public interest.

### *Lot's of Accounts to Keep Track Of*

Individual investors have a lot of information to keep track of. I recommend using a spreadsheet program like *Microsoft Excel*® or a financial planning program like *Quicken*® to help organize the data. Some Internet web sites offer a free service, which allows you to type in account positions and track the portfolios on a daily basis. Since we are involved in so many accounts, it is not hard to understand how investors can lose track of their investments. Putting all this information in one place is a beginning step toward increasing your investment results.

### **Summary**

During his 1999 State of the Union Address, President Clinton acknowledged the impending crisis in Social Security. As Americans become more responsible for their own retirement income, investment skills must improve. Contrary to popular belief, there is no secret formula to investing in the markets. This

<sup>3</sup> Department of Labor statistic, 1997

book dispels many myths about investing and the investment process. Following a few simple rules and sticking with them for a lifetime is what earns a secure retirement. The strategies outlined in Part III of this book are simple, low cost, and offer a tax friendly solution to a serious problem facing us all.