CHAPTER 1

The Ball Is in Your Court

The introduction of the 401(k) plan and the related 403(b) and 457 plans has made a huge difference in the way we save for our retirement years. These defined contribution plans—so called because the amount you can contribute, and not the benefit you will receive, is defined—may be the best thing to come along in decades. These plans let you eliminate some taxes (contributions are pre-tax; they come off the top of your salary) and defer others (earnings are compounded and no income tax is due until the money is withdrawn). You usually get to choose from a wide array of investment vehicles. And you may get to invest some of your employer's money as well as your own, if your company matches contributions. It doesn't get much better in the world of saving for retirement.

And make no mistake: *you must save* for your retirement. No one else cares about your future as much as you do. Even if you still have a traditional employer-paid pension at work, no one else is going to make sure that you have enough income to sustain what may be a very long retirement indeed.

"Retirement is in the midst of a radical redefinition. It's growing longer, getting better." That's the conclusion of a new study by the

National Council on the Aging. But NCOA also asks, "Are Americans financially prepared for 30+ years of vital aging?" If you are prepared, you owe thanks, in large part, to wise management of your 401(k).

Neal Cutler, Director of Survey Research at NCOA, notes: "Retirement used to be defined by what one was no longer doing—not parenting, not working, not actively involved. Increasingly, it will be defined by what one does do—second career, volunteer work, travel, sport activities."

"What one does do," however, may be limited by the amount of money available to fund a desirable retirement lifestyle. Here, too, the NOCA study is optimistic. People tend to worry about having enough retirement income as they near retirement, but their anticipation is generally worse than the reality. More than nine out of ten of the NCOA respondents—including 84 percent of those age 65 years or older—thought not having enough money to live on was a serious problem for people over age 65. By contrast, 36 percent of those over age 65 found that it was a personal problem.

Although 36 percent is a significant portion of the over-65 population, retirees in general have seen their income increase in recent decades. For one thing, the booming bull market lifted the fortunes of retirees along with those of younger investors. But no one should count on an endless bull market. Bridget A. Macaskill, president and CEO of OppenheimerFunds, points out: "Retirement security is a moving target. . . . The low inflation and 25 percent annual stock market returns of recent years are phenomenal in every respect. From a retirement planning perspective, it's a bad idea to count on them."

It's also a bad idea to figure that you won't live very long after you retire. The 2000 Retirement Confidence Survey—cosponsored by the Employee Benefit Research Institute (EBRI), the American Savings Education Council (ASEC), and Mathew Greenwald & Associates—found that many workers may be preparing for an unrealistically short retirement. Eighteen percent expect retirement to last for no more than 10 years, and another 15 percent believe that they will spend 11 to 19 years in retirement. Yet, the report goes on, "Half of men reaching age 65 can expect to be alive at 82, and some will make it to 100 and older, while half of women reaching age 65 can expect to be alive at 86, and some will make it to 100 and older."

Life expectancies are always expressed as averages; many people live considerably longer. Remember, too, that the longer you live, the longer you can expect to live. At age 75, the average life expectancy is 11 years. At age 85, it is still six years. So it's a mistake, in the view of most financial planners, to plan retirement income as if it will not be needed beyond age 85. It's much wiser to plan as if you will live at least to age 90. Today, you can do the planning. You can take charge of your future.

Your Future Is in Your Hands

In a retirement revolution going on around the world, government and corporate retirement programs are giving way to retirement income funded and managed by workers. How well you perform these tasks—how much you contribute and how wisely you invest—will determine how well you will live during your retirement.

This might be called the third era in history, in terms of providing income during retirement.

In the first and longest period, there was no "retirement" as such because most people simply didn't live long enough. The life span was considerably shorter than it is today. In 1900, the average life expectancy at birth was a little more than 47 years. As recently as 1940, the average life expectancy at birth was just 62.9 years. As a result, most people died in the saddle. The relatively few who lived for the Biblical three-score-and-ten years either kept right on working or relied on their own savings—or, more likely, on their families' support.

The second period lasted about 50 years. Social Security, designed to provide a foundation for retirement income, came into being in 1935. And, as the average life span gradually lengthened, private employers began to provide pension plans for their workers. These "defined benefit" plans, funded entirely by the employer, provided a monthly benefit based on a formula that typically included the employee's age, income, and length of service. These traditional pensions worked well in an era when many people spent the bulk of their working life with a single employer.

Today, it's a brave new world. There are still traditional defined benefit pension plans, especially at the largest companies, but far more workers are covered under the new umbrella of defined contribution plans. The best known plan is the 401(k), named after the previously obscure section of the Internal Revenue Code that actuary Theodore Benna reportedly unearthed as he pored over the Code in 1981. 401(k) plans are now found throughout the corporate world.

Defined contribution plans have even become a global phenomenon. The United States is way ahead of the game, but the rest of the industrialized world is rapidly catching up. According to the benefits consulting firm of William M. Mercer, defined contribution arrangements account for 60 percent of all employer-sponsored retirement plans in the United States and are expected to reach 70 percent by 2003. Worldwide, defined contribution plans account for half of retirement plans in developed nations. Although the move from guaranteed pensions to employee-funded savings is a political football—particularly when it comes to handling the transition—Japan, Australia, Canada, and the United Kingdom are all moving in this direction. In the United Kingdom, a new defined contribution arrangement became available to almost everyone on April 1, 2001.

In the United States, meanwhile, defined contribution plans have outdistanced defined benefit plans and are solidly entrenched. In 1984, defined contribution plans held $92 billion in assets, according to the Profit Sharing/401(k) Council of America (PSCA). By 1999, these plans held $1.7 trillion in assets. The number of participants rose in the same period from 7.5 million to 34 million, and from under 40 percent of eligible employees to about 80 percent. The average account balance rose from $12,200 in 1984 to abut $50,000 in 1999, thanks at least in part to the long bull market in stocks. The 401(k) clearly dominates the retirement saving scene, but variations on the theme include 403(b) plans, available to employees of nonprofit entities such as schools and hospitals, and 457 plans, for employees of government agencies and some state university systems.

The defined contribution concept has spread like wildfire, for several reasons. Employers like the idea because employees put up most of the money and, not incidentally, assume the investment risk. (In almost 5 percent of defined contribution plans, according to the most recent PSCA survey, employers still make the investment decisions. As a general rule, however, employees make the decisions and assume the risk.)

Employers pay for administration and may choose to make matching contributions. Employees like being able to put up pre-tax dollars and take the entire account with them if they move. Many, although far from all, enjoy taking charge of the investment decisions. Because defined contribution plans have advantages for both employers and employees, they have made a quantum leap in the past 15 years. In 1984, there were 17,000 401(k) plans in the United States. In 1999, according to the latest PSCA survey, there were 340,000.

Recent growth, by some measures, has been even more spectacular. Assets in 401(k) plans grew an average of 18 percent a year from

1990 to 1999. The Investment Company Institute reports that $385 billion in assets in 1990 grew to an estimated $1.7 trillion at year-end 1999. Much of this money is invested in mutual funds. Combined with funds in other tax-sheltered retirement accounts, such as IRAs, a total of $1.98 trillion was held in mutual funds within retirement plans at year-end 1999. Some of that growth has been fueled by stock market growth. At the same time, this money spurs stock market growth and may be partly responsible for the unprecedented bull market of the 1990s. (It may also be partially responsible for preventing a major downturn, despite the market's enormous volatility. Employees are less likely to cash in investments made within the tax-sheltered umbrella of retirement plans.)

What does this phenomenon mean to you? You gain significant tax advantages by contributing before-tax dollars to a 401(k) plan and allowing the contributions and earnings (along with any employer match) to grow, tax-deferred. In this era of job mobility, there are also significant advantages in having a portable retirement plan. You can take your money with you to a new employer if you change jobs, or roll it over into an Individual Retirement Account (IRA). And there is a decided advantage in investing steadily through automatic payroll deductions (Table 1.1). Studies have shown that, over the long term, steady investing counts more toward returns than the selection of specific investment vehicles. (You'll find more on investing in Chapters 4 through 7.)

There are some potential drawbacks to 401(k) plan participation. One disadvantage is that the investment choices may be limited. This concern has diminished as employers have added choices to the investment menu. The average plan now has 11.5 investment alternatives, up from an average of 9.6 in 1998—but some plans, especially those offered by small employers, may have only three or four choices. Another possible disincentive to saving through a 401(k) plan is that your money is tied up for a long period of time. You can get at it if you really need it (see Chapter 9), but at significant cost.

The biggest drawback may be uncertainty. When a retirement *benefit* is defined, you know exactly how much you will receive. When the *contribution* is defined—as it is in the 401(k) and its related plans—you know how much you are permitted to contribute but you don't know how much you'll eventually receive. Your retirement income will depend on how much you put in during your work years and how well the money is invested. You may have more control over

TABLE 1.1 Why Employees Participate in a 401(k) Plan

REASON	PERCENTAGE OF PARTICIPANTS SURVEYED
Concern about funding retirement	85
Company match*	67
Tax-deferred status of contributions	64
Payroll deduction	55
Ability to make a hardship withdrawal*	23
Ability to take a loan*	19
Advice of friend or family members	15
Advice from fellow employees	10

* Asked of those in plans that offer these features.

401(k) Participants: Characteristics, Contributions, and Account Activity, 2000. Reprinted by permission of Investment Company Institute (www.ici.org).

your future retirement income, but you have no way of predicting what that retirement income will be.

Your best bet is to make the most of your 401(k). Contribute as much as you can, within plan limits, and invest those contributions in a diversified portfolio of investment vehicles that blend with the investments you hold outside your tax-sheltered accounts.

Reading this book, and referring to it as questions arise later, puts you a step ahead. If you participate in a 401(k) plan, you are likely to be better educated and more financially secure than employees who opt out of the plan, according to an Investment Company Institute study of plan participants. And, as certified financial planner Michael K. Stein wrote, in the *Journal of Financial Planning*, people who take an interest in their future are more likely to outlive the average population because they are more apt to eat well, exercise, and seek proper medical care. And, of course, they are more likely to be financially prepared.

Shifting Work Patterns

How much money you will have in retirement also depends on two other factors: (1) how much job hopping you do during your work life and (2) when you retire.

Job hopping can mess up the amount received in a traditional defined benefit pension because the formula is typically based on age, income, and length of service. Many plans key the benefit to the five highest-paid years—often, the last pre-retirement years. If you don't stick around very long, you don't get much of a pension. Stay on the job for 30 years but retire early, and you may still lose out. Before you decide to retire early and take monthly checks from a defined benefit pension plan, look at the plan's provisions. You will definitely lose out by retiring early because you won't have as many years of service. You will probably lose out by not having your salary increases in those additional years factored into your pension formula. And you may lose out—you need to check this with your employer—if the company pension plan reduces pensions by a specified percentage for each year of early retirement, that is, if you leave before the company's "normal" retirement age.

But defined contribution plans are portable, right? Well, yes and no. You are always entitled to your own contributions and the earnings on those contributions. But both the date of an employer match, if any, and how long you must wait before being enrolled in a new employer's 401(k) plan can have a significant impact on the amount of money you'll accumulate toward retirement.

These red flags will be explored in more detail in later chapters, but keep them in mind if you're considering a job change. Let's say you miss out on $4,000 in contributions because you switched jobs, and you must wait a year before you can participate in the new employer's plan. Assuming annual growth of 10 percent, you lose out on almost $70,000 in your retirement nest egg 30 years down the road. This is likely to become less problematic as more employers move to immediate eligibility for plan participation. By year-end 1999, according to PSCA, 40 percent of all companies—and 57 percent of companies with more than 5,000 employees—offered newly hired employees immediate participation in the 401(k) plan. Find out the rules your new employer applies to 401(k) contributions, and try to time a move accordingly.

The age at which you retire also affects how much money you'll have. Keep on working and you can keep on contributing to your 401(k) plan. Retire early, on the other hand, and you'll have to fund more years from lower total accumulations. And, inevitably, inflation will be eating away at the value of the dollars you depend on. Identifying and meeting your retirement income goals will be discussed more fully in Chapter 4.

Many people, these days, seem to want to retire early—prior to age 65. Why 65? It has been pegged as the "normal" retirement age by the Social Security Administration from its inception, but this arbitrary retirement age actually stems from a decision made by German Chancellor Otto von Bismarck when the first government pension program began. Few Germans then reached age 65, so pegging it as the age when retirement benefits would begin was a money-saving measure.

Many things have changed. As we live longer, on average, we retire earlier. It's important to note, however, that there can be a gap between expectation and actuality. Nearly half of today's workers, according to the 2000 Retirement Confidence Survey, expect to retire at age 65 or later (Table 1.2). But most retirees report actual retirement ages younger than 65. Sometimes, early retirement is planned. Sometimes it's a response to circumstances beyond the individual's control, such as ill health or company layoffs.

The average age of retirement was 66 in the late 1950s. It is now 62. At the same time, faced with fiscal pressures, Social Security is gradually extending the "normal" retirement age. The age when full retirement benefits may be obtained remains 65 only for those born by December 31, 1937. It becomes 67 for those born in 1960 and thereafter (see Table 1.4, p. 14). They can still collect reduced benefits starting at age 62, but benefits once reduced stay reduced—a fact that could pose a problem as the years go by.

TABLE 1.2 Expected and Actual Retirement Age: 2000

	EXPECTED (% OF WORKERS)	ACTUAL (% OF RETIREES)
Age 54 or younger	9	14
Ages 55–59	13	19
Age 60	12	6
Ages 61–64	10	31
Age 65	28	10
Age 66 or older	19	13
Never retire	4	NA

Sources: Employee Benefit Research Institute, American Savings Education Council, and Mathew Greenwald & Associates.

In any case, you may want to continue working—at least part-time—throughout your sixties and possibly beyond. Even if you don't need the money—and you may not, if you play your cards right—you may still want the stimulation. A recent survey of baby boomers, the segment of the population born between 1946 and 1964, indicated that more than seven out of 10 expect to work part-time in retirement. In fact, as Table 1.3 shows, earnings make up a key component of retirement income.

But Table 1.3 shows averages, across income levels. The truth is that workers in the lowest income brackets rely on Social Security for 80 percent of their retirement income. The 20 percent of retirees in the highest income brackets—those with annual pre-retirement income of $38,000 or more—receive just 18 percent of their retirement income from Social Security.

Sources of Retirement Income

This book focuses on maximizing your 401(k) benefits, but you need to analyze all of your financial resources to get a complete picture. There are other ways to beef up retirement income—you might, for example, take a reverse mortgage on your house—but the primary sources for most people are: Social Security, continued earnings and personal savings, pensions, and defined contribution plans.

Social Security

As a rule of thumb, you will need 70 to 80 percent of your pre-retirement income for a comfortable retirement. Social Security currently provides a bit less than 40 percent of the pre-retirement

TABLE 1.3 Sources of Income for Americans Age 65 and Older

Social Security retirement benefits	38%
Earnings	21
Asset income	20
Pensions	19
Other (Veterans' benefits, etc.)	2

Source: Social Security Administration.

income of an average worker, defined as someone earning about $35,000 in the year before retirement. Earn more and you'll receive a smaller proportion of your pre-retirement income from Social Security. At $80,400, the maximum earnings on which the Social Security tax (formally called FICA) is levied in 2001, the "replacement ratio" is about 25 percent. In other words, those who earned the maximum will receive no more than 25 percent of the portion of their pre-retirement pay that was subject to the Social Security tax, and nothing at all for their earnings above that level.

Put another way, the average Social Security recipient who retired at 65 in January 2001 currently receives $804 a month in retirement benefits, and the maximum benefit for a 65-year-old worker who retired in January 2001 is $1,536. "It's not a generous system," in the words of former Social Security Commissioner Kenneth S. Apfel, "although two-thirds of today's elderly live on it."

On the plus side, Social Security retirement checks, unlike most pension checks, are adjusted each year for inflation. And, unlike the two-thirds of today's elderly who are living on their Social Security checks, you have the decided benefit of participating in a 401(k) plan at work, thereby significantly boosting your future retirement income.

The not-so-happy news is that many recipients must now pay income tax on their Social Security retirement benefits. Half of the benefits are taxable for single recipients with "provisional income" between $25,000 and $34,000 and for married couples filing jointly with income from $32,000 to $44,000. As much as 85 percent of the benefits are subject to income tax if you earn more than $34,000 as a single person, or $44,000 as a married couple filing jointly. "Provisional income" is defined as modified adjusted gross income plus tax-exempt interest.

The tax rules are complicated (of course), but the most important fact to bear in mind may be that the interest from municipal bonds—a mainstay of many retirees' investment portfolios, and otherwise tax-free—is counted in calculating whether Social Security retirement benefits are taxable. Investment strategies appropriate for various life stages, including retirement, are discussed in Chapter 7.

In addition, if you plan to continue working after you retire—whether for the income or for the sheer pleasure of doing something you enjoy—you may be penalized. Fortunately, at the start of 2000, the earlier "earnings test" for Social Security recipients age 65 and over was repealed. Once you reach 65, there is no limit on how much you can earn; you will still receive full Social Security retirement benefits. But Social Security recipients between ages 62 and 64 still lose $1 in benefits for every $2 earned over a threshold that increases each year (in 2001 the amount is $10,680). If you decide to retire early but plan to keep on working—perhaps part-time, perhaps switching job fields—you may want to delay receiving Social Security retirement benefits until you reach age 65. Your benefits will be larger and you won't have to give any of them back because you are earning money.

How much will you receive? The Social Security Administration has begun mailing annual statements of estimated benefits to all workers, age 25 and over, who are not currently receiving benefits. You should receive your personalized statement each year, about three months before your birthday. The statement includes a summary of how much you can expect to receive at your normal retirement age as well as at earlier or later retirement dates. It also shows how much monthly disability income to expect if you should become severely disabled and unable to work, and how much your survivors would receive if you should die.

The statement is based on your current taxable earnings and assumes that those earnings will remain steady. For a tailor-made statement reflecting other retirement ages and earnings assumptions, call Social Security toll-free at 1-800-772-1213 or go online to www.ssa.gov/mystatement. You can submit a request online for a personalized statement but, until privacy issues are resolved, you'll receive the answer through the regular mail.

But can you expect to receive anything at all? Given the recent publicity about the dire financial straits of the Social Security system, many baby boomers are cynical about their future chances of receiving Social Security income. I think they *can* count on Social Security—any politician who might support its complete elimination would be in deep trouble—but in a somewhat different format than the one we know today.

Some change is necessary. The Social Security "trust fund" (a legal fiction; it is a pay-as-you-go system and no money is actually set aside) will run out of money, according to current estimates, by 2037. While today there is a surplus of income over outgo, an aging population, with fewer workers per retiree, is expected to produce revenues covering only about 72 percent of projected benefits. Suggested solutions include raising the payroll tax that funds Social Security, reducing benefits, or privatizing the system.

Another suggestion for reducing the shortfall is to tax all Social Security benefits for every recipient above a specified income level. This would make Social Security more like a welfare system instead of the entitlement it was designed to be. Still another way to reduce benefits is to further extend the age at which full benefits are paid. As shown in Table 1.4, that age is currently scheduled to become 67. Some proposals would push it to 70. A later "normal" retirement age will produce smaller benefits for people who choose to retire early.

Proposals to "privatize" the system or to place varying amounts in the stock market—whether invested by an individual or by the federal government—have been under discussion but do not appear likely candidates for implementation in the near future. Justifiable concern centers on subjecting essential retirement income to the inherent volatility of the stock market. A few years of a bull market, even an extended bull market, are not a guarantee of future returns. An extended downturn in share prices could have a serious impact on retirement income.

As you plan ahead for retirement, count on Social Security as a foundation of your retirement security. But develop your own retirement savings as well. Center them around your employer-sponsored

TABLE 1.4 Eligibility for Full Social Security Retirement Benefits

IF YOU WERE BORN IN:	YOU MAY RECEIVE FULL BENEFITS AFTER AGE:
1937 or before	65
1938	65 and 2 months
1939	65 and 4 months
1940	65 and 6 months
1941	65 and 8 months
1942	65 and 10 months
1943–1954	66
1955	66 and 2 months
1956	66 and 4 months
1957	66 and 6 months
1958	66 and 8 months
1959	66 and 10 months
1960 and thereafter	67

retirement plan and your personal savings, to make up what will probably be a very large shortfall.

Continued Earnings and Personal Savings

"Retirement" is associated with "leisure," but, for many retirees, it also means ongoing employment, either full-time or part-time. Of all the retirees surveyed in a Retirement Confidence Survey, 25 percent reported working full-time and 22 percent part-time. Three-quarters of those working said, they enjoyed work and wanted to stay involved. But 30 percent also wanted money to buy "extras," 21 percent needed money to make ends meet, and 25 percent were eager to retain job-related health insurance or other benefits. Whatever the reason, you may be wise to keep working. "Inactivity is one of the greatest threats to the physical and mental health of older people," says Dr. Robert Butler, president of the International Longevity Center-USA.

Whether or not you plan to work after retirement, you'll want a personal savings program alongside your tax-sheltered retirement contributions—to pay for college for your kids, or to buy a house, or to pay for a trip around the world, as well as to supplement your retirement income.

There are various tax-sheltered and taxable ways to invest. When you've maxed out your contributions to tax-sheltered retirement plans at work, take a look at the tax-sheltered retirement plans available to individuals, detailed in Chapter 3. Then start a taxable savings program as well. Chapters 6 and 7 discuss blending your tax-sheltered and taxable portfolios and allocating your assets among specific investment vehicles.

Pensions

Traditional defined benefit pension plans appear to be dinosaurs; their number dropped by more than half from 1987 to 1997. But they are still offered by many large U.S. corporations, often in tandem with defined contribution plans. These pension plans offer monthly checks based on salary and length of service. Most pension benefits are fixed once they start, although some are indexed to inflation.

Traditional pensions are governed by federal regulations that stipulate how benefits must be paid. If you are married, for example, your pension must be paid in the form of a joint-and-survivor annuity guaranteeing lifetime benefits to your surviving spouse. The only way you can elect a (typically larger) pension based on your individual life expectancy is if you and your spouse both sign a waiver provided by your employer. (Additional discussion of distribution options can be found in Chapter 11.)

Traditional pensions also have a distinct advantage over defined contribution plans: most of them are insured. (Defined benefit plans offered by church groups, governments, or professional service firms with fewer than 26 employees are not covered.) If a company terminates its pension plan because it no longer has the financial resources to support the plan, the Pension Benefit Guaranty Corporation (PBGC) steps in.

If your plan is terminated, you won't earn any additional benefits. But the PBGC will provide a pension based on the plan's provisions, the form of your benefit, and your age. That pension is clearly better than nothing, but it may be less than you would have received if your employer's plan had continued. The maximum amount that PBGC guarantees changes each year. For the year 2001, the maximum guaranteed amount is $3,392.05 per month ($40,704.60 per year) for a worker retiring at age 65. There is no cost-of-living adjustment; once established, a PBGC pension is fixed. And the guarantee is lower for someone who retires early or whose pension includes survivor benefits.

For more information on guaranteed defined benefit pensions (including a Pension Search Program that can help you connect with a missing pension from a former job), go online to www.pbgc.gov or write to PBGC, 1200 K Street NW, Suite 930, Washington, DC 20005-4026. If you are writing about a missing pension—after first trying to contact the plan administrator or the company where you earned the pension—include as much information as possible. At a minimum, include your name, address, daytime telephone number, Social Security number and date of birth, and the name and address of the employer. If possible, include the dates of employment, the name of the pension plan, the nine-digit Employer Identification Number, and the three-digit Plan Number.

If you are covered by a traditional pension plan, find out how much you can expect to receive under that plan and then develop your other retirement savings toward your income needs. A worksheet in Chapter 4 will help you identify how much income you will need in retirement.

But be prepared for change. To their dismay, many employees are finding that amendments to their plan can reduce a pension benefit

Ceilings on Monthly Guarantees from PBGC

YEAR PLAN TERMINATED	MONTHLY LIMIT AT AGE 65	MONTHLY LIMIT AT AGE 62	MONTHLY LIMIT AT AGE 60	MONTHLY LIMIT AT AGE 55
2001	$3,392.05	$2,679.72	$2,204.83	$1,526.42
2000	3,221.59	2,545.06	2,094.03	1,449.72
1999	3,051.14	2.410.40	1,983.24	1,373.01
1998	2,880.68	2,275.74	1,872.44	1,296.31
1997	2,761.36	2,181.47	1,794.88	1,242.61
1996	2,642.05	2,087.22	1,717.33	1,188.92
1995	2,573.86	2,033.35	1,673.01	1,158.24
1990	2,164.77	1,710.17	1,407.10	974.15
1985	1,687.50	1,333.13	1,096.88	759.38
1980	1,159.09	915.68	753.41	521.59

Source: Pension Benefit Guaranty Corporation (www.pbgc.gov/ygptabl.htm).

they thought was fixed. The *Wall Street Journal* reported, in July 2000, that many large companies are cutting pension benefits to improve their bottom line—in other words, favoring shareholders over employees.

Defined benefit pensions, as noted above, are typically based on salary and length of service. But the formula usually includes a "multiplier," set by the employer, which can be changed. Let's say you have 30 years of service and your average annual salary was $70,000 for the last three years. If the multiplier is 1.5 percent, your annual pension at age 65 (30 × $70,000 × 1.5 percent) will be $31,500. If the multiplier is reduced to 1.2 percent, your pension becomes $25,200.

The other elements of the formula can also be changed. Instead of counting all of your income—including bonuses—toward the pension calculation, the company may change the formula to reflect only your base pay. Instead of basing the pension on average salary in the last three years of employment—typically the highest-paid years—the plan may reflect average salary over 5 or 10 years or over your entire job tenure. Including your lower paid years in the calculation reduces the amount of the pension.

Some big companies are replacing traditional defined benefit pension plans with new hybrid plans that may produce lower annual pensions for some workers. Cash balance plans are among these hybrids.

CASH BALANCE PLANS

Cash balance plans, a new kid on the retirement block, look like defined contribution (DC) plans because the accumulated benefit is described as a "cash balance" in terminology that resembles an individual account balance under a DC plan. But cash balance plans are actually defined benefit plans; the benefit is calculated as a percentage of compensation plus annual interest credits at a rate set by the employer. The rate is typically the same as or similar to the yield on 30-year Treasury bonds. If the plan's investments earn less, the employer makes up the difference. If the investments earn more, the company keeps the excess. Despite surface similarity, cash balance plans are fundamentally different from defined contribution plans. The investment risk rests with the employer, but so do the profits.

In contrast to traditional pensions, however, cash balance plans usually provide higher benefits to young mobile workers. If you're going to change jobs frequently during your career, a cash balance plan will probably provide you with higher retirement benefits. And because cash balance plans are portable, you can take the money with you if you change jobs.

The flip side of the coin, however, is that conversions to cash balance plans from traditional pension plans often hurt older workers who have devoted their working lives to one company. Employees who leave at the time of conversion can get their full pension but, if they're older, they may find it tough to find another job. Older workers who stay may find pension benefits stuck on a plateau for a number of years after the new plan is put in place, thanks to built-in "wear-away" provisions, before increases take effect. Following a lot of negative publicity about the impact on older workers, the Internal Revenue Service began a study of cash balance plans and wear-away features. Its report, when issued, may be a catalyst for change.

New cash balance plans don't hurt anyone because all employees start off on equal footing. But, according to a report by Aon Consulting, employers rarely design and install a cash balance plan from scratch. Instead, they convert existing pension plans by adding cash balance features. Benefits build steadily instead of increasing sharply in the last few years before retirement, and, unless a transition or "grandfather" arrangement preserves their benefits, this is where older workers get hurt. Some companies try to cushion the blow by beefing up matching contributions to 401(k) plans. Others give slightly larger annual pay credits to older workers, based on age. And some allow workers over a specified age or within a few years of retirement to choose between the old plan and the new.

Considerable negative publicity has made corporations conscious of the need to make long-time employees whole through some adequate transition measure. If your company is adopting a cash balance plan, ask for a detailed comparison of benefits under the old plan and the new plan. And, if you're on the far side of age 40, find out what transition features will be in place.

Defined Contribution Plans

With Social Security in trouble and defined benefit pension plans biting the dust, your best hope for comfortable retirement income lies in defined contribution (DC) plans. Although the primary focus of this book is the 401(k) plan, because it is by far the most popular, DC plans actually come in several flavors:

- The 401(k) plan allows corporate employees to contribute pretax dollars. Many employers also match a portion of employee contributions—typically, up to a specified limit.
- The 403(b) plan, available most often to employees of nonprofit institutions such as schools and hospitals, follows the 401(k) model in being funded by employee contributions with an employer match permitted.
- The 457 plan is for government workers. It is funded by employees, with annual contribution limits below those of 401(k) and 403(b) plans—although a measure introduced in Congress in 2000 and again in 2001 would—if passed and signed by the president—equalize contribution levels at the higher amount.
- Savings and thrift plans permit employees to contribute a percentage of earnings to an individual account. Employers may provide matching contributions—either a fixed percentage of employee contributions or a varying percentage based on length of employee service, the amount of employee contributions, and other factors. These plans are designed for long-term savings, but may permit pre-retirement loans or withdrawals.

- Profit-sharing plans are funded by voluntary employer contributions and permit eligible employees to share in company profits. Most plans are deferred arrangements; the money is held in employee accounts until the employee retires, becomes disabled, or dies. Some profit-sharing plans are cash plans; employer contributions are paid directly to employees as cash or company stock. Distributions under cash plans are immediately taxable as ordinary income.
- Money purchase pension plans are funded by fixed employer contributions, typically calculated as a percentage of employee earnings and allocated to employee accounts. Employers may also make profit-sharing contributions to these plans, if they choose to do so, but employees do not have to contribute.
- Employee stock ownership plans (ESOPs) use employer contributions to buy shares of company stock, which are then distributed to employees.
- Stock bonus plans take contributions from the employer alone, or from both the employer and employees, and invest the money in a trust fund that then invests in various securities.

These plans have many features in common, but one is really significant: As a participant, you can defer income tax on your contributions and your earnings until the money is withdrawn.

At the heart of your retirement savings program is your 401(k) plan. To make the most of this golden opportunity to build a retirement nest egg, contribute as much as you possibly can, up to the limits set by your plan. Select your investments wisely, monitor their performance, and pay attention to legislative and regulatory changes.

Coming attractions, to be addressed throughout this book, include:

- Higher limits on contributions and "catch-up" contributions to let older workers boost their retirement savings.
- Increased portability so that moving from the corporate world to a job in the nonprofit sector, or vice versa, won't mean locking prior retirement benefits in place.
- Elimination of waiting periods so that you can participate in a 401(k) plan as soon as you take a job.
- Automatic enrollment so you won't even have to make a choice about participating in your 401(k).

- Liberalized vesting requirements, so that employer contributions will belong to you in three years instead of five.
- More investment choices, so that you can adequately diversify your retirement portfolio.
- More self-directed brokerage accounts, so that you can choose from an investment menu that encompasses virtually every individual security and mutual fund on the market.
- More investment education and advice. Employers currently offer education but shy away from advice, except through impartial third-party providers. A bill recently introduced in Congress would permit employers to provide full access to investment advice.