IN THIS CHAPTER

- » Understanding the importance of retirement planning
- » Seeing how retirement planning has evolved
- » Discovering the new role for employers in retirement planning
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- » Getting an understanding of why Social Security isn't enough for a comfortable retirement

Chapter 1

Retirement Planning Is Up to You

If you're like most people, you want to retire someday. You might love your job and plan to work well into your 70s. Or maybe you're part of the financial independence retire early (FIRE) crowd and want to escape your corporate ball-and-chain at 40 years old. The beauty of retirement planning is that the timing of your retirement could be up to you.

The goal of this book is to help you get excited about retirement planning. All too often, people are fearful of saving and investing for retirement. You might fear that you aren't saving enough or that you've started too late. Fear, I've found, isn't a great motivator. Instead, it causes retirement-planning paralysis.

In addition, some people get so discouraged about being off track with their retirement planning that they just give up. They figure they'll never catch up to where they think they need to be. Cautionary tales of people who have not saved enough only make people more depressed. You can find lots of those stories. Maybe people you know shared their stories with you.

Put the fear and discouragement aside for a minute. This retirement-planning book is different. I want you to embrace, not dread, retirement planning. What better way to plan for the future than picturing what you want it to look like and then making it happen? Expectations must match reality, but you might be amazed at what you can do when you set your mind to a goal.

Retirement planning is an important way to plot your financial course. And the course you set by reading this book will help make sure that your life 20, 30, 40, or 50 years from now is what you think it should be.

In this chapter, you find out why retirement planning is largely an opportunity for you to plan your own future, rather than have it dictated to you by your employer or government. You also see why getting your plan started as soon as possible pays off in a big way.

Blazing Your Own Retirement Plan

Retirement planning is simply about making sure you have resources available when you're no longer generating them from your labor. However, the financial industry hijacked retirement planning, and now it's all about deferred tax accounts, 401(k)s, and mutual funds. It wasn't always that way.

More than a hundred years ago, more Americans relied on direct labor for their basic needs. In the late 1800s, for instance, about half of Americans were involved in farming. Back then, retirement planning was "an heir and a spare." You wanted to make sure that you had enough kids to keep the farm running after you no longer wanted, or were able, to push a plow.

But now, less than 5 percent of the population touches food before it arrives at the grocery store. And people are more mobile, so your adult children are just as likely to live on the other side of the state as in your basement. In addition, birthrates are falling as more people decide against having children.

These shifts have turned money into the currency of retirement planning. Rather than having a house full of children who will take care of you in your grand old age, retirement planning is about having enough money when you can no longer work. Famous investor Warren Buffett addressed the importance of putting your money to work when he said, "If you don't find a way to make money while you sleep, you will work until you die."

Measuring Your Lifespan

Adding to the planning complexity is the fact that Americans are living much longer than they used to, as shown in Table 1-1. That news is great for humans, but it also means retirement planning for most people must stretch an additional 10 years or longer.

TABLE 1-1 Life Expectancy of Americans

Year You Were Born	Life Expectancy (Both Sexes Combined)
1955–1960	69.66
1960– 1965	70.11
1965– 1970	70.36
1970– 1975	71.43
1975– 1980	73.25
1980– 1985	74.37
1985– 1990	75.89
1990– 1995	75.65
1995– 2000	76.47
2000– 2005	77.18
2005– 2010	78.19
2010– 2015	78.94
2015– 2020	78.81

United Nations, Department of Economic and Social Affairs, Population Division (2019). World Population Prospects: The 2019 Revision; custom data acquired via website.

TIP

If you want to slice-and-dice life expectancy data to glean more precise insights about typical lifespans, you're in luck. The United Nations' World Population Prospect data query tool is a treasure trove of life expectancy data. You can see forecasts going out for decades, how females fare compared to men, and the changes to your life expectancy as you get older. Dig into this fascinating data by using the tool at `https://population.un.org/wpp/DataQuery/`.

Time to take a break from the history of retirement planning to answer the question you're probably asking now that you've read this far: How long will you live? I am not getting fatalistic. Knowing how long you can expect to live is a big part of retirement planning. After all, a person who expects to live to 90 will save and work differently than someone likely to die younger.

I cover this topic in more detail later, but now's as good a time as any to think about your lifespan a bit. I keep the discussion optimistic by focusing on how long you'll live (versus when you'll die). In this section I provide my favorite tools to help you make this calculation.

Social Security Administration's Life Expectancy Calculator

The U.S. government has a good idea about how long you'll live. After all, as the largest payer of income to older people, it's in the government's best interest to know this information.

The Social Security Administration's Life Expectancy Calculator at `www.ssa.gov/OACT/population/longevity.html` looks at your gender and date of birth to estimate how long you'll live.

For example if you're a 40-year-old male in 2019, you would see a table like the one in Figure 1-1 after entering your gender and date of birth. You would be expected to live until 81.7, which means at 40 you'd be just about ready for a mid-life crisis. If you were healthy enough to make it to 67, the Social Security Administration would figure that you would make it to 86.

Bankrate's Life Expectancy Calculator

You probably know that not all 40-year-olds will live exactly 81.7 years. Some lifestyle choices, such as smoking, have a bearing on how long you live. (Let's forget about George Burns, the chain-smoking comedian who lived until 100.)

Bankrate tries to capture that variability in its Life Expectancy Calculator at `www.bankrate.com/calculators/retirement/life-age-expectancy-calculator.aspx`. You enter not just your age and gender but also personal details: height, weight, whether or not you smoke and drink alcohol, and a little family history.

Let's go back to our 40-year-old male. He's 6-feet tall, weighs 150 pounds, doesn't touch alcohol, but does smoke. With that added detail, his life expectancy is now estimated to be 72.6 years, as shown in Figure 1-2.

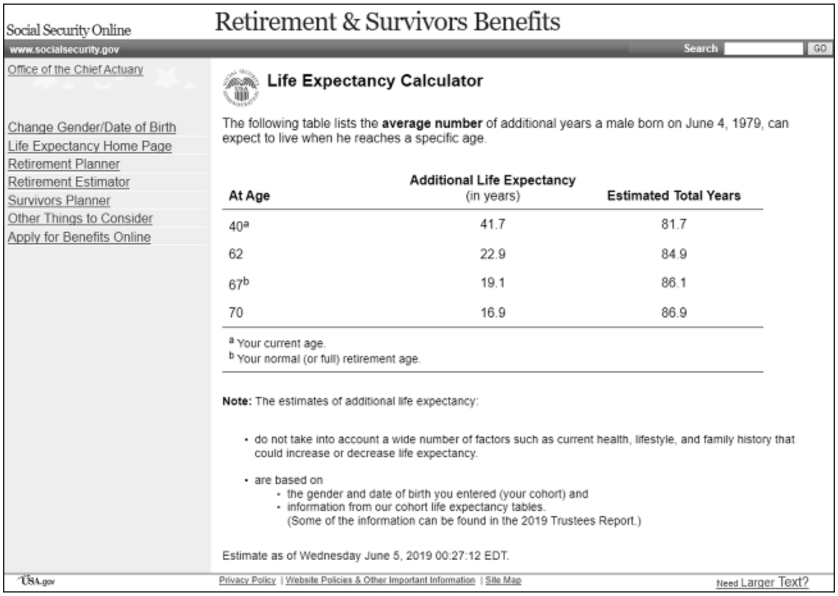

FIGURE 1-1: Social Security's Life Expectancy Calculator helps you see how your lifespan compares with others.

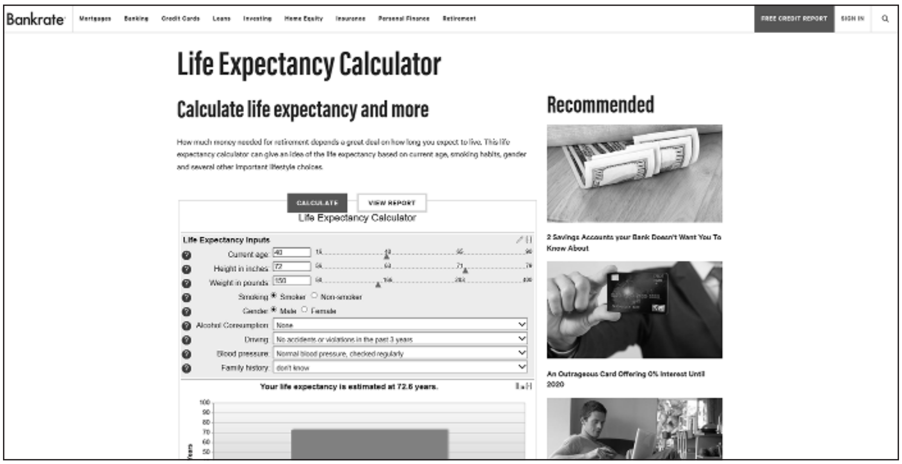

FIGURE 1-2: Bankrate's Life Expectancy Calculator factors in more details to help you figure out how long you'll go.

REMEMBER

Life expectancy calculators, like many calculators described in this book, provide estimates. Clearly, if you knew exactly how long you'd live, retirement planning would be a lot easier. Unpredictability is a key aspect that makes retirement planning — and life — an imprecise science.

Living to 100 Life Expectancy Calculator

Your life expectancy is an important input in your retirement plan. It's worthwhile to revisit this factor periodically and carefully. The Living to 100 Life Expectancy Calculator at `http://www.livingto100.com` brings rigor to this process.

The calculator, shown in Figure 1-3, asks a battery of questions covering everything from personal traits about your sleep patterns to lifestyle habits, nutrition, medical history, and family history. The calculator is free, but you need to set up an account with your email address.

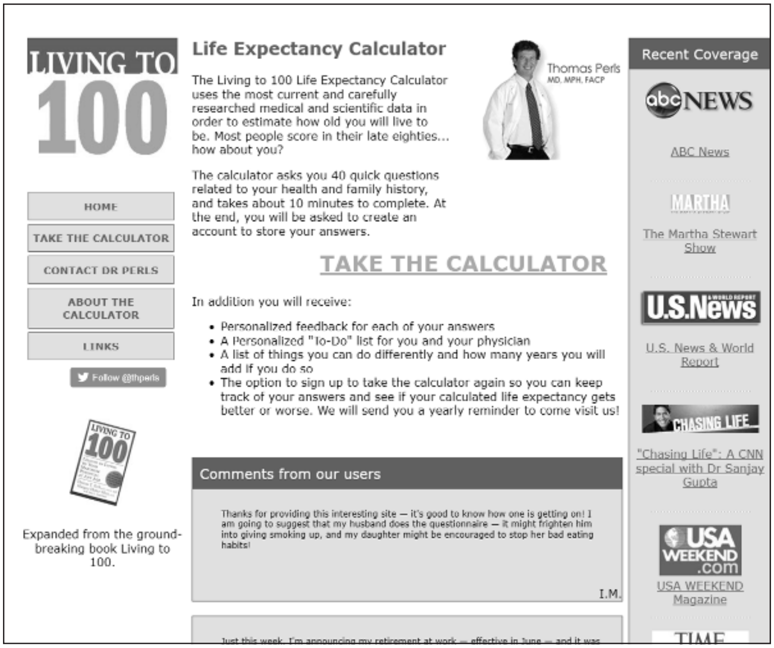

FIGURE 1-3: Living to 100 Life Expectancy Calculator quizzes you with in-depth questions to estimate your lifespan.

Retirement Planning Beginnings: The Pension

As the U.S. industrialized, and farmers hung up their bib overalls and moved to work in factories, a major shift occurred in retirement planning. Workers would sign up with a company and pretty much assume they'd stay their entire careers. Over time, workers counted on their loyalty and decades of service to result in companies providing for them their entire lives — even after they retired.

Given what you know about lifespans, you can see why it wasn't a huge deal for companies to take care of employees for life. Let's say an employee in a steel mill worked until age 65. Look back at Table 1-1 and you'll see that in the mid-1950s and the 1960s, he'd be expected to live only until 70. His company would have to provide retirement income for only five years.

Hence, the pension was born. In a *pension plan,* which is sometimes called a *defined benefit plan,* the employer commits to pay the pensioner a set amount of money each year after retirement. If employees stay with the company, they know how much income to expect.

During an employee's working years, his or her employer would contribute to a fund. It was the company's responsibility to not only add to the fund but also to prudently manage it with investments on the employees' behalf. The company was required to hold and protect sufficient amounts of funds to pay pension proceeds. If the fund got low, typically because money was paid out faster than the fund grew, the company had to use part of its profits to refill the reserves. As you could imagine, investors weren't happy when this happened.

If you've recently joined the workforce, pension plans probably sound strange. But in the 1950s through the 1980s, most employees, especially those working for large companies, expected a pension. Pensions are still common for public employees but have largely vanished for everyone else. As of 2011, only 18 percent of private sector employees participated in a pension plan, according to the Bureau of Labor Statistics. That amount dropped to just 15 percent in 2017, according to an updated estimate from Pension Rights Center (`www.pensionrights.org/publications/statistic/how-many-american-workers-participate-workplace-retirement-plans`), and to 11 percent in 2018 according to the Employee Benefit Research Institute (`www.ebri.org/docs/default-source/ebri-press-release/pr-1244-retplansff-6jun19.pdf?sfvrsn=98a83f2f_4`).

So how are you supposed to plan for retirement if you don't have a pension plan? That's where our story takes us next.

Changing Times: The 401(k)

Those of you who were around in 1978 probably recall the debut of the Garfield comic strip. Another big milestone in 1978 was the end of production of the Volkswagen Beetle. But something far more important for retirement planning happened that year: The 401(k) was born.

The 401(k) is practically synonymous with retirement planning now because this plan is the predominant way most people save for retirement, especially those relatively new to the workforce. This popular retirement plan has steadily replaced the pension plan.

REMEMBER

Employer-sponsored defined contribution plans are typically called 401(k)s. But they have close cousins at different employers. Employees at nonprofits access 403(b) plans, government workers have 457(b) plans, and some schools have 401(a) plans. The letters and numbers are different, but the plans are essentially the same as 401(k)s in terms of taxation.

As mentioned, pension plans are defined benefit plans. The plan sponsor, typically the employer, promises the retiree a certain monthly or annual income in retirement. In contrast, 401(k) plans are *defined contribution plans.* The only thing that's set is how much will be contributed to the plan. Typically, employees make most of the contributions. Contributions for standard 401(k) plans are generally made by paycheck deductions using pre-tax dollars; I cover exceptions in Chapter 4. (When you contribute to a 401(k), you lower your tax bill.) Many employers then make additional contributions, usually a matching percentage of what the employee puts in.

REMEMBER

The amount that you will get out of a defined contribution plan is not guaranteed. You can select how your money will be invested, as I describe in later chapters, but you can take out only what's in the account. This is an important difference from defined benefit plans such as pensions.

Why is the traditional 401(k) so powerful? The company match, if available, is great, but the main benefit is the tax-deferred contribution. Suppose you earn $100,000 and elect to contribute $10,000 to your 401(k). The $10,000 would be taken from your paycheck and not immediately taxed. Assuming that you're in the 24 percent tax bracket, you would not pay the $2,400 in tax that would have ordinarily been due the year the money was earned. Instead, the money is taxable in the future when you withdraw it in retirement. This deferral is a powerful tool in retirement planning.

REMEMBER

Contributions to a 401(k) offer tax deferral, not tax elimination. With most traditional retirement plans, you don't pay taxes now, but you do pay taxes eventually. The idea, though, is that when you pay taxes down the road, when you're not working, your tax rate will be lower.

MEET THE FATHER OF THE 401(K)

Not many sections of the Internal Revenue Service's tax code are famous. But the 869-word paragraph k added to Section 401 of the Internal Revenue Code in 1978 is a rock star. And we can thank not a forward-looking Congressperson but a detail-oriented lawyer in Pennsylvania named Ted Benna.

Benna created the first 401(k) plan — and revolutionized retirement planning in the process. He's known as the "Father of the 401(k)." Benna, a benefits consultant, was working with a bank, hoping to find a better way to keep employees that didn't involve handing out fat annual (and taxable) bonuses. The bank wanted a profit-sharing plan that would keep them competitive with other banks in terms of compensation — and give them a tax break on the contributions.

In 1979, Benna knew that IRS code 401(k), passed in 1978, was going into effect in 1980. Although many accountants knew of the provision, they paid little attention to it because it was intended to serve a different purpose. But Benna saw how employees could contribute all or a portion of their bonus into a 401(k) and get immediate tax relief. To sweeten the pot, Benna added a matching contribution option for the bank.

Benna's bank client took a pass on his invention, afraid to do something new and worried that the Internal Revenue Service would reverse it. So Benna created a 401(k) plan for his own company, The Johnson Company (not Johnson & Johnson as widely believed).

Did Benna make a fortune creating this retirement-planning tool? He told me he did fine consulting with firms looking to create 401(k) plans. But since 401(k) is an IRS tax code statue, he couldn't trademark the retirement account structure. It wasn't long before the Fidelities and Vanguards of the world rushed in.

In Benna's book, *401(k) Forty Years Later,* he acknowledges that 401(k)s aren't perfect. He laments the high fees charged by financial companies that administer these plans (this book will help you with those). But he also takes issue with the idea that pensions were better. "There is a widely held myth that we once had a wonderful retirement system that is now corrupted," he writes in his book.

He points out several problems with pensions, most of which 401(k)s solved or at least addressed:

- **Restrictive inclusion rules:** Many pension plans would not allow you to participate until you were 30 or older. This restriction delayed the accrual of benefits to workers when time was on their side. 401(k) plans are typically open to employees after a month or a year at the longest.

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- **Onerous vesting rules:** In many pension plans, you had to stay at the company until you reached 60 before you vested. Leave before then and you got nothing. Some employers would try to dump employees before they vested, saving them a pension liability. 401(k) plans vest, too, but employees are always entitled to the funds they contributed. Employers can hold back employees' access to only the matching funds. Typically, vesting happens gradually, with a maximum holding period of six years.
- **Limited availability:** Benna says only a third of non-farm workers in the private sector had access to a pension plan. Employees at large companies had pensions, but they were rare in smaller firms. Lower costs of 401(k)s make them much more feasible for more companies.
- **Risk of failure:** For many years, the rules were lax as to how fully companies needed to keep pension plans funded. Many companies simply didn't put the necessary funds in the pension, so retirees couldn't collect the money they thought was coming. 401(k)s are filled with actual contributions, not promises of future payments. Employees can always check their 401(k) balances and see how much they have.

"The truth is that the private pension system of the 1960s was far different than the image that is commonly presented today. It was far from ideal and may have, in fact, been much worse than what we have today," Benna writes.

TIP

If you think your tax rate will be higher when you retire, consider a Roth IRA or Roth 401(k) plan. These plans tax your retirement contributions immediately, but you take out already taxed money later. For more on these Roth plans, see Chapter 4.

The rise of defined contribution plans changed retirement planning forever. Employers shifted to employees the responsibility of generating and providing future retirement income.

Although employees take on more risk and responsibility, they also gain some freedom. They can decide how much, if any, to contribute to the plan. They're also less beholden to their employer. If they get another job offer, they're free to pick up their 401(k) and go elsewhere. They can *roll over*, or transfer, their 401(k) to a personal retirement account or to their new employer's 401(k) plan. The only catch is that employees can tap only the part of the 401(k) that they contributed or is vested. *Vesting* is described later in this book, but for now just know that employers can hold back some of their contributions to a 401(k) if the employee doesn't stay a certain number of years.

Behold the power of the 401(k)

To build a nest egg that will help them live the life they want in retirement, most people take advantage of the 401(k). For example, assume that in 1988 you were a 35-year-old worker. You decided to put the maximum allowed into your 401(k) that year and every following year until you turned 65. The money was invested aggressively for the first 10 years, with 80 percent stocks and 20 percent bonds. The risk was dialed back in following decades, with 70 percent stocks and 30 percent bonds from age 45 to 55, and 60 percent stocks and 40 percent bonds going forward. (At this point, don't worry about the mix of stocks and bonds.)

As Table 1-2 shows, you never contributed more than $24,500 to your 401(k). But after more than 30 years of saving, you end up with $1.4 million! Now that was worth the sacrifice, wouldn't you say?

TABLE 1-2 **Maxing Out a 401(k)**

Year	Age	Contribution Limit (Including Catch Up)	Ending Balance
1988	35	$7,313	$7,313
1993	40	$8,994	$63,243
1998	45	$10,000	$232,431
2003	50	$14,000	$315,963
2008 (U.S. stocks fell 37% this year)	55	$20,500	$459,908
2013	60	$23,000	$937,733
2018	65	$24,500	$1,414,942

Based on actual contribution limits from 1988 to 2018. Stock returns indexed to the Standard & Poor's 500 and bond returns, while 10-year Treasury bond yields used for bond allocation.

TIP

Don't let the fear of market volatility scare you from saving for retirement. As you can see in Table 1-2, some years the market declined and hurt the portfolio's balance, but remaining in the plan and maintaining contributions won out. Also, keep in mind that the government lets you make *catch-up contributions*, or additional money you can put more in your 401(k) after you turn 50.

An opportunity to save

Looking at Table 1-2, you no doubt appreciate why contributing to your 401(k) is powerful. But this contribution is a sacrifice because you need to give up spending now so you can put your money to work for you tomorrow.

Most employees don't contribute the maximum to their 401(k) plans, but they still benefit. During the first quarter of 2019, the average 401(k) contribution from customers at giant asset management firm Fidelity was $2,370, which implies a contribution of $9,480 a year. But by adding the average company match during the quarter — $1,780 — the total yearly contribution becomes $16,600. This amount is an all-time high savings rate of 13.5 percent, says Fidelity (`www.fidelity.com/bin-public/060_www_fidelity_com/documents/press-release/quarterly-retirement-trends-050919.pdf`).

Social Security: The De Facto Safety Net

I cringe when someone says, "Why do I need to plan for retirement? I have Social Security."

Yes, Social Security, the nickname for Old-Age, Survivors, and Disability Insurance (OASDI), is designed to prevent you from ending up on the street after working your entire life. But don't you have higher hopes for your retirement than just scraping by?

Social Security isn't a savings plan. All the money you pay into the system isn't in an account with your name on it, like a 401(k) plan. It's a *pay-as-you-go* system. In other words, the money you pay in as you're working is used to pay income to people in retirement now. When you retire, you don't withdraw the money you paid into the system. Your retirement income will be paid by people in the workforce at that time.

As a general rule, Social Security replaces 40 percent of a retiree's income (`www.ssa.gov/planners/retire/r&m6.html`). The number is lower for wealthier people who need to keep the gas tank full in their yachts.

WARNING

Social Security is a fine safety net, but don't bank a comfortable retirement on it. Your retirement-planning strategy needs to be more than just Social Security for three reasons:

- **Social Security is just one leg of a four-legged stool for retirement income.** Social Security was designed not to replace your income in retirement but to reduce the odds that you will starve in your old age. Social Security is intended to be accompanied by a pension, if you have one, retirement accounts, and personal savings.
- **The funding future of the program is uncertain.** The curious structure of the Social Security program — where current workers pay the benefits of current retirees — doesn't leave much room for error. When you have a big wave of retirees, as you do with Baby Boomers retiring now, the system is strained.

  Starting in the late 2010s, the cost of Social Security is expected to outstrip its income for the first time since 1982 (`www.ssa.gov/oact/tr/2018/tr2018.pdf`). Some of the shortfall can be made up with a small amount of reserves. But until the system is reformed, the reserves are forecast to be depleted in 2034, at which point they could pay 77 percent of scheduled benefits. When you hear the word *reform,* that likely means either workers will pay more in or retirees will get less out.

  Meanwhile, the full retirement age to get the entire payout from Social Security has changed from 65 to 66 and now to 67, as follows:

Birth Year	Full Retirement Age
1937 or earlier	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 later	67

» **You receive reduced benefits if you retire early.** The earliest you can claim retirement benefits is age 62. But if you do that, your benefit is reduced by 30 percent. Even if you retire at 65, which many people think of as retirement age, your benefit is reduced by 13.3 percent. The following lists the benefit reductions when retiring early.

Retirement Age	Retirement Benefit Reduction
62	About 30%
63	25%
64	20%
65	13.3%
66	6.7%

So you can see why Social Security isn't your ticket to retirement riches. It's up to you to plan for retirement. Now it's time to find out how.