

5 STEPS TO KICK-STARTING YOUR RETIREMENT NEST EGG

If there's one thing I've learned to regard as the gospel truth since I started in the financial planning industry 5 years ago, it's the fact that people my age (20-something) need to be extra-vigilant when it comes to saving for retirement. Why? Unlike previous generations, the retirement burden for today's 20- to 30-somethings will fall solidly on our own shoulders. Consider the current environment we're facing:

- Social Security is under-funded, and the funding gap will only increase as the ratio between available workers paying into Social Security and retirees widens. Hence, the continuation of Social Security in its current form is in doubt due to the institution's non-sustainability
- Employers are doing their best to divest themselves of long-term retirement obligations by cutting pension programs and other retiree benefits, like healthcare
- The responsibility of saving and investing for retirement is being shifted to the individual as companies opt to sponsor defined contribution plans like 401(k)s rather than pensions

Retirement funding used to be looked at as a 3-legged stool built on Social Security, employer benefits and private savings; however in the face of such uncertainty the best thing you can do is make sure you're doing enough now for and by yourself in case 2 of those 3 legs get cut off. Here are 5 steps that will help you grow your nest egg for the new retirement reality:

1. Save as much as you can as early as you can

Numbers don't lie, so consider the following scenario - suppose you can only afford to save \$2,000 a year until your retirement at age 65 and you earn 8% annually:

If you start at age	25	35	45
You would have at age 65...	\$560,000	\$245,000	\$99,000

Seems like a no-brainer, right? The earlier you start the more money you save and the more time it has to grow, which leaves you with more money at retirement. This phenomenon is known as the miracle of compounding interest (often referred to as the 8th wonder of the world). Compounding interest is our generation's best friend; if you save a little now it'll reap big rewards later.

2. Don't disregard those retirement plans

Saving for retirement can quickly become a low priority for people just starting off their careers – you may have college loans to pay off and more expenses now that you're out on your own – but as the above scenario proved, it doesn't pay to put this off. The government and even employers have pitched in by offering incentives to people who contribute to retirement accounts. Here's a breakdown of some of the most common ways to save for retirement:

Employer-sponsored plan

The most commonly offered plan today by employers is a 401(k). These are great for many reasons: 1) They have a high contribution limit (\$15,500 for 2007); 2) Contributions go into the plan on a pre-tax basis, which lowers the income for which you'll be taxed on at the end of the year; 3) and probably most important – most companies offer a matching contribution, which equates to free money invested towards your retirement. For example, in a typical plan, employers match your contribution dollar-for-dollar for up to 3% of your salary. That will automatically double any contribution you make to your 401(k) plan up to that 3%. For that reason, it is always the best idea to at least contribute enough to your 401(k) to max out your employer's matching contribution; otherwise you are leaving free money on the table. Say you make \$50,000 – in this case you would need to contribute \$1,500 to get your company's full match, and your retirement savings for the year would be \$3,000 with no extra savings on your part. What's the impact of this "free money" on your nest egg? Take a look at the table below (assumes 8% annual return and 40-year time horizon to retirement):

Your Contribution	\$1,000	\$1,500	\$2,000
Employer matching contribution	\$1,000	\$1,500	\$1,500
Total annual savings	\$2,000	\$3,000	\$3,500
After 40 years, your savings would be...	\$560,000	\$839,000	\$979,000

In addition, earnings in the account grow on a tax-deferred basis, meaning you don't have to pay taxes on gains realized in the account. This optimizes your return since you keep everything you earn. However, Uncle Sam will get his money eventually, because distributions from these accounts are counted towards ordinary income, for which you'll have to pay income taxes.

No retirement plan, then use the IRA

Some employees may not offer a retirement plan, but this shouldn't be an excuse to not save for retirement. The government has created Individual Retirement Arrangement accounts (better known as IRAs) for such circumstances. There are three types of IRAs available for you to open:

IRA TYPE	CONTRIBUTION LIMITS	DEDUCTIBILITY	RULES
Traditional IRA	\$4,000 (increases to \$5,000 in 2008)	Deductible from income	<ul style="list-style-type: none"> • Earnings grow tax deferred • 10% penalty for withdrawals out of the account before age 59 ½ • Minimum distributions required when you reach age 70 ½ • Distributions are taxed as ordinary income
Roth IRA	\$4,000 (increases to \$5,000 in 2008)	Non-deductible	<ul style="list-style-type: none"> • Earnings grow tax deferred • 10% penalty for withdrawals out of the account before age 59 ½ • No minimum distribution requirement • No taxes on qualified withdrawals if after 5 years and if withdrawal is due to: <ul style="list-style-type: none"> ◊ Age 59½ or over ◊ Death or Disability ◊ For a beneficiary or ◊ Certain first-time home buyers • Taxable distributions occur when: <ul style="list-style-type: none"> ◊ Initial Roth account established <5 years ◊ After 5 years for reasons other than the above
Non-Deductible IRA	\$4,000 (increases to \$5,000 in 2008)	Non-deductible	<ul style="list-style-type: none"> • Earnings grow tax deferred • 10% penalty for withdrawals out of the account before age 59 ½ • Minimum distributions required when you reach age 70 ½ • Distributions are partially taxed (pay tax on earnings portion)

The main difference between these IRA accounts is the tax consequences: for the Traditional IRA, you defer paying taxes now in favor of paying them later. This makes sense if you think that you will be a lower tax bracket in the future than you are now. With a Roth IRA, you pay taxes on contributions now in favor of not paying them later on distributions. It's ideal to have retirement savings that are in both types of accounts, because it gives you greater flexibility and choices for income in retirement.

One thing to be aware of – contributions into any combination of IRA accounts cannot exceed the year's limit. For example, if you are eligible to contribute to both a Roth and a Traditional IRA, your combined contributions to both for 2007 must not be more than \$4,000.

Cash to spare, open a taxable investment account

Say you've tapped out your retirement savings, but still have a little of the ready to spare. If you're the ultimate saver, you can always sock this money away in a taxable investment account. Sure the earnings won't grow tax-deferred as in retirement accounts, but for the most part, you can avoid a major tax burden by buying tax-

efficient investments, such as exchange-traded funds (ETFs – for more on ETFs, see #3 below). Most ETFs mirror an index, so very little changes in their investments, avoiding end-of-the-year capital gains distributions that mutual fund investors may encounter. As an added bonus, money saved in a taxable account can also double as source for emergency funding, so you don't feel compelled to tap into your retirement accounts when something critical comes up.

Bottom line, there are plenty of ways to save for retirement available – the point is to start.

3. Invest appropriately

On a basic level, there are three types of investments to choose from: stocks, bonds and cash. On the risk spectrum, stocks are the most risky, with bonds and cash offering lower-to-no risk. An investment's return is commensurate with its risk (the higher the risk, the higher the potential return). That is seen by the fact that historically, stocks have grown at an annual rate of 10%, while bonds have returned 5% and cash 3%.

Furthermore, consider the following data gathered about the stock market's return over certain time periods in the table below:

Ibbotson Study of S&P500 Index (1926-2006)			
Holding Period	Number of Periods	Times Positive	% Positive
1 - Year Returns	81	58	72%
5 - Year Returns	76	66	87%
10 - Year Returns	71	69	97%
15 - Year Returns	66	66	100%
20 - Year Returns	61	61	100%

Past performance is no guarantee of future results

The numbers make a compelling case for anyone with a time horizon of 10 years or longer to invest heavily in stocks – out of 71 10-year periods since 1926, stocks have had a negative return in only 2; stretch the period out 5 more years and there has never been a negative return for stocks.

So what does that all mean? If you are just starting your career, you have way more than 10 years before anything you save for retirement will be used. Therefore you can afford to take more risk by having a portfolio heavily weighted in equity, so no less than 80% of your savings should be invested in stocks (a very small portion could still be invested in bonds for diversification purposes – see below). As history has shown, this will pay off by maximizing the growth potential of your portfolio. Moreover, while you may experience a lot of short-term volatility, this is no reason to panic. As the table above shows, a long time horizon means you have the time to ride out the ups and downs of the market so that end result is positive growth. Additionally, you have the wherewithal to replace losses with continued savings.

You can also hedge against the risk of loss by diversifying your investments. Essentially, you want to own as many different types of asset classes as possible; this is a message that will hold true throughout your lifetime. This means you may hold some investments that go up while others are going down, with the end result being steady growth of your entire portfolio. To best avoid wild swings up and down, steer clear of buying a single stock and look to mutual funds or ETFs, tradable vehicles made up of sometimes hundreds of different investments in widely varying quantities. They could be made up entirely of stocks, bonds, a combination of both or simply track the market by holding equal amounts of all shares in a given index, known as an index fund. In addition, don't forget that the United States only makes up about ¼ of the world's economy, so any good portfolio should also be invested internationally.

4. Check your investments (at least annually)

You've done the set up and all the work it entails, but your job is not over. It's always a good idea to take a look at your portfolio at least annually. It gives you the opportunity to keep track of how your money is doing and make any changes necessary, such as getting rid of a lagging investment choice, reallocating funds to investment opportunities that further diversify your portfolio, and rebalance your portfolio when it has drifted away from its target.

5. Help your portfolio grow

In addition to shrewd investing, you can help your portfolio grow by continually contributing to your retirement plans. Employers make it easy by automatically deducting contributions from your paycheck – just make sure you set up your elective deferral choice with the plan. If you don't have a plan, avoid the temptation of spending your income by setting up automatic deposits into your savings accounts, whether it's an IRA or a taxable account. This provides the same disciplined savings plan set up by a 401(k) and allows you to spread an IRA contribution over the year so you don't have to come up with the money for one at tax time.

Furthermore, don't whittle your account away by taking early withdrawals, especially from 401(k) plans or IRAs. Not only will you have to pay taxes on the money withdrawn, but you'll also be dinged with a 10% early withdrawal penalty. Tapping into retirement savings should be an absolute last resort; as it's often said, you can take a loan out for almost anything, but you can't take one out for retirement.


Start on the path

It's easy to understand why retirement is so far down the list of priorities for someone who's starting off their career. It seems like such a distant prospect and you feel like you have plenty of time to get ready for it. Unfortunately, that complacency can really put you "behind the 8-ball" with regards to retirement savings, as demonstrated above. The sooner you do start planning for retirement the better off you'll be. It all begins at step 1: save as much as you can as early as you can. Everything that follows will help you build a nest egg you can count on when you're ready to quit the daily grind for good.

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