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Working Longer To Fix The Retirement Mess

Are you willing to postpone retirement by two to four years? If you want to enjoy a secure, prosperous retirement, delaying it may be the best way to get there, according to a new book published by the Brookings Institution Press. *Working Longer: The Solution to the Retirement Income Challenge* offers a sobering yet hopeful message to Americans approaching retirement age at a time of soaring health care costs, declining pensions, severely weakened retirement accounts, and shaky prospects for Social Security.

Authors Alicia H. Munnell, professor of management sciences at Boston College, and Steven A. Sass, associate director of the Center for Retirement Research at Boston College, argue that raising the average retirement age from 63 to 66 would solve many of the financial problems retirees are facing. "The key is to avoid drawing on your Social Security benefits or 401(k) plan until age 67," says Sass. Allowing your retirement assets to grow just a few years longer can significantly boost your assets, and delaying retirement means a shorter period during which you'll have to depend on retirement savings.

The nice thing about this strategy is that it won't necessarily mean enjoying fewer years of post-work life. Because life expectancy has soared while the average age of retirement has fallen, merely moving back the start could still afford you decades of doing whatever you have planned. Consider these numbers:

- The average life expectancy for a 55-year-old man in 1965 was 20 years; by 2005, it had risen to 25 years.
- For women at 55, life expectancy rose from 25 years in 1965 to 29 years in 2005.
- About 19% of men and 33% of women who survive to age 65 today will live to age 90 or older.

Meanwhile, the average retirement age for Americans fell from 65 in the mid-1960s to 63 in the 1980s, where it remains today. A major reason is that workers may start receiving Social Security benefits at age 62, even though beginning then, rather than waiting until full retirement age, reduces the amount of the monthly payments you'll receive. And while Social Security's official retirement age is gradually rising from 66 to 67, the government has opted to leave the earliest eligibility age (EEA) at 62. Sass and Munnell believe the government should push back the EEA to age 64 to encourage people to remain in the work force longer.

The declining U.S. savings rate is another strong argument for staying on the job a few additional years, suggests Sass. "For baby boomers, it's getting a little late to save," he says. "They don't have that much money in their 401(k) plans. Working longer is probably the best option."

Sass notes that the amount of your Social Security benefit is calculated using the 35 highest-paid years of your working life. "By delaying retirement, very often you'll replace a zero- or low-earnings year and actually increase your benefit level," he says. Moreover, each year you wait before starting Social Security payments will boost the amount. Work four years longer, Sass estimates, and you'll increase your monthly check by a third.

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Confidence In Your Retirement Prospects Requires Planning

Americans are losing confidence in their ability to afford a desirable retirement. The percentage of workers who believe they will have enough money to retire in comfort fell from an already low 27% in 2007 to 18% in 2008, according to the Employee Benefits Research Institute's annual Retirement Confidence Survey.

That marked the sharpest one-year drop in the 18-year history of the survey, and institute officials attributed the plunge to growing concerns about health-care costs and the economy. Confidence in achieving a lesser goal—of having a financially secure retirement—also dropped, from 41% to 29%. The declines occurred across all age groups and income levels.

Lack of retirement planning fuels this anxiety. In the EBRI survey, fewer than half of respondents said they had even tried to calculate how much they would need during retirement. And in another recent survey, by Bank of America, only one in three respondents was "on track" with retirement planning; 23% said they haven't started planning at all.

If you have a comprehensive plan for your retirement years, you're bound to feel more confident, no matter what the economy or the markets are doing at the moment. But planning for retirement doesn't end with drawing up a document. We'll be with you all along the way, monitoring your progress and making changes whenever necessary to keep you moving toward your goals.

Colleen & Rob

Financial Plans Are Meant To Be Revised

One great benefit of a financial plan is that it gives you a feeling of certainty. Designed to take into account wide-ranging scenarios, it seemingly should be able to shrug off an uptick in inflation, a bear-market stretch for stocks, or a spike in interest rates. Yet there are some circumstances —such as the recent once-in-several-decades plunge of the economy and financial markets—that even the most carefully constructed plan can't fully anticipate. Such events, as well as possible changes in your own situation, mean that every financial plan, sooner or later, will have to be revised. Preparing a financial plan is a process, not a one-time event, and making smart, timely alterations is crucial.

Consider how that process works. A financial advisor takes stock of an investor's overall financial situation and asks questions about goals, comfort level with investment risks, and the timetable for using investment proceeds. Then, the advisor establishes a comprehensive plan designed to help achieve those objectives.

That requires several assumptions about how markets and the economy will behave. For example, an advisor might base a plan on a projected inflation rate of 3%, an 8% average annual return for stocks, and 4% yearly gains for bonds. Though some or all of those assumptions might miss the mark, the idea is that, taken together, they should be close enough to be useful. Yet even small inaccuracies, left uncorrected for 20 or 30 years, will leave a plan seriously out of whack.

Think of a ship setting out from New York for, say, Lisbon. The captain charts a course that should take the ship across the Atlantic to Portugal. But what if he makes a small miscalculation? Even if he's off only 1%, that could be a problem, and unexpected changes in winds and currents along the way are likely to make things worse. If he sticks to his original bearings, he could end up in Africa—or Ireland.

But that won't happen, because every good sailor understands the need for minor but constant course corrections. And a financial plan requires similar adjustments. Look at the predictions of economists, market forecasters, or the government, and you'll see that no estimate extending more than a year or two into the future will be even close. So a financial plan written to predict the feasibility of a retirement 30 years away won't—and can't—be accurate. But it can establish a starting point. Reaching your goals requires frequent adjustments to compensate for the winds and currents you meet along the way.

Once you understand that basic certainty, you can prepare by discussing how, and under what circumstances, your plan will need to be altered. We would be happy to review your plan with you to make sure it continues to move you toward your long-term goals. ●

The Tax Rules Of Buying Or Selling A Home

Though the mortgage-interest deduction may be the most obvious example of the government's largesse to home-owners, other significant breaks apply when you buy or sell a home. People buy or sell a home for lifestyle reasons and not for tax reasons. But knowing the tax rules can save you a bundle on a house sale by keeping your tax bills to a minimum. Consider these strategies.

Don't sell too soon. With the way that home prices have appreciated over time (despite the recent decline), selling your house could net you a major profit with no tax bill—unless you make your move too soon. If you've lived in a home for at least two of the past five years, you can exclude up to $250,000 of your gain from capital gains taxes; if you are married, you and your spouse can avoid taxes on a profit of up to $500,000. If you sell after just a year, however, you'll be taxed on your profit at the 15% rate for capital gains—and if you sell a place you've lived in less than 12 months, your gain is considered short-term, and taxed at your ordinary income rate of up to 35%.

Plead hardship. So-called hardship sales—necessitated by medical problems, divorce, job loss, or multiple births—could win you a tax break even if you sell before living in your home for two years. If you qualify, you'll get a reduced home-sale exclusion based on your amount of time in the house, expressed as a fraction of the ordinary two-year minimum. If you sold after 18 months, for example—three-quarters of the minimum—you could exclude a profit of up to three-quarters of the usual $250,000 or $500,000 exclusion.

Minimize your gains. If you have to pay tax on your profit, look for ways to increase your home's tax

What A Difference A Year Makes In 10-Year Returns

Would you invest in an asset that has been in the red for an entire decade? That's the question a lot of investors will be asking themselves during the year ahead. The stock market rout in late 2008 resulted in the average annual return for stocks during the past 10 years to be a negative number, and that's bound to make many people hesitate to commit the lion's share of their portfolios to such a seemingly underwhelming investment. But the future for stocks looks much brighter than the recent—and not so recent—past.

Ten-year returns don't exactly lie, but their story is much more complicated than you'd expect, according to a recent report from Vanguard Investment Counseling and Research—"The 'Lost Decade': Rational Expectations in Uncertain Markets," by Francis M. Kinniry Jr. and Christopher B. Philips. Kinniry and Philips point out that during the past decade, the stock market has gone through several extraordinary periods—first, the runaway bull market of the late 1990s, then the brutal bear of 2000 through 2002, and finally the vertigo-inducing dive during the last months of 2008. For years, the great markets of the late '90s buoyed long-term performance numbers. But now, as they fall out of 10-year calculations, the results begin to look pretty bleak.

For the decade ending June 30, 2008, the broad U.S. stock market returned just 3.53% a year—and that, of course, was before the end-of-year meltdown. That's worse than bonds, which had an average annual gain of 5.68% during the same period. But just a few years earlier, long-term stock performance looked much better, according to the Vanguard report. At the end of 2002, coming out of the most punishing bear market in 70 years, the 10-year average annual return for stocks was a respectable 8.74%, and just two years later, as 2004 came to a close, that average had risen to 11.92%. Three years later still, however, the average annual return for the preceding 10 years had plunged by almost half, to 6.29%. The reason? Returns from 1995 through 1997, three years during which annual gains averaged nearly 30%, had dropped out of the equation.

Those returns from the 1990s, though exceptional, came during a decade that saw average returns of almost 20% a year, according to the Vanguard report. That's starkly different from the 2000s, which may well produce average annual returns of less than zero. Looking at those numbers, you might logically conclude that owning stocks isn't what it used to be, and that you ought to pare back your portfolio's equities, perhaps replacing them with bonds, which have outperformed all other asset classes so far this decade.

But that would be the wrong conclusion, suggest Kinniry and Philips. There's nothing you can do about what has already occurred; what's important for investors is what's to come, and Vanguard, one of the world's biggest fund managers, is decidedly bullish on stocks. Though equities are indeed riskier than bonds, that's exactly why they tend to outperform fixed-income investments, and Vanguard's analysts believe the current market offers an equity risk premium of seven. By definition, that's a return seven percentage points higher than the return on "risk-free" Treasuries. Vanguard expects that during the next 10 years, stocks could potentially produce average annual real returns, ie., net of inflation, of 9.5%.

The risk premium is based on the idea that for investors to take on stocks' higher risks, they need the motivation of potentially higher returns. And the market's recent volatility only drives home the point that stocks do bring real risks, and that short-term returns often fall as well as rise. From 1982 through 1999, there was only one down year in the stock market. But that was an anomaly, a departure from the stock market's long history of producing a negative return one year in every four.

That fact, in turn, reminds investors of another truism—that to benefit from stocks' long-term returns, you have to be in the market long term. If you sell when stocks fall, you will have paid the price of investment risk but you won't be there for the gains that inevitably follow. To contain the risk of the market going still lower before it rebounds, a prudent strategy may be to "average" into the markets over the next six to 12 months, meaning that you should keep adding to your investments over time, rather than all at once.

Vanguard's optimism about stocks is based on several factors. Price-to-earnings ratios are low, and though the economy may not recover for a few years, the stock market typically rebounds well in advance of a return to economic growth. But there's also the fact that stocks, statistically speaking, are due for a nice run after such as steep fall.* Investors miss it at their own peril. ●

***Past performance is not a guarantee of future return.**

basis—for example, by including the closing costs you paid when you bought the house. A higher basis means a smaller gain. However, if you depreciated a portion of the house because you used it for business purposes—such as for a home office—you'll generally owe capital gains tax on some or all of the depreciated amount.

Latch onto a new tax credit. If you're a first-time homebuyer—someone who has not owned a principal residence for the prior three years—you can claim a credit of up to $8,000 for a home purchased after 2008 and before December 1, 2009. But the credit is phased out for high-income taxpayers.

Get the points. When you take a mortgage for a new home, you may pay "points" in exchange for a lower interest rate. Because the IRS considers points to be prepaid mortgage interest, you may be able to deduct them from your income for the year of the purchase. For instance, two points paid on a $500,000 mortgage—that is, 2% of the half-million—would give you a $10,000 deduction. However, if you finance the points along with the mortgage balance, you must deduct them over the life of the loan. Spread over the term of a 15-year mortgage, for example, that same $10,000 would mean a deduction of only $667 a year. ●

Federal Estate Tax Exemption... Going Up!

At long last, we're approaching the final step of a long climb for the federal estate tax exemption—the value of assets in an individual's estate that is shielded from potential estate tax liability. Under the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA), the exemption amount (also known as the *Applicable Exclusion Amount*) gradually increased to $2 million for 2008, and has finally jumped to $3.5 million for 2009.

As the exemption has risen, the top tax rate for estates has declined to 45% in 2009, and under EGTRRA, the federal estate tax is scheduled to be repealed completely for 2010, only to return at pre-EGTRRA levels in 2011. While that still might happen, there's a growing consensus for congressional compromise that would keep the estate tax but with a high exemption level—perhaps 2009's $3.5 million.

With these changes afoot, it makes sense to take a fresh look at immediate and long-range estate plans. At a minimum, you should consider the implications of the higher estate tax exemption amount for 2009.

Prior to EGTRRA, the federal estate tax exemption for 2001 was only $675,000. But EGTRRA raised the exemption to $1 million for 2002 and started scaling back the highest tax rate from 55%.

Estate Tax Exemption In Flux

Tax Year	Estate Tax Exemption ($)	Maximum Tax Rate (%)
2009	3.5 Million	45
2010	Unlimited	0
2011	1 Million	55

If the estate tax makes its scheduled exit in 2010, which many believe is unlikely, another change will complicate tax planning. Under current law, people who inherit assets are allowed to "step up" the assets' cost basis to their market value at the owner's death. That step-up is supposed to go away in 2010, with heirs instead inheriting the original cost basis. That could increase capital gains tax liability when the assets are sold, and could force heirs to have to go through years of old documents to determine their basis. But there will be two key exceptions—a one-time $1.3 million step-up in basis, and an additional $3 million step-up for assets inherited from a spouse.

While much about the future of the estate tax remains up in the air, it's important to have your will and trust documents revised to reflect the 2009 change to a $3.5 million exemption. Wealthy couples may also want to keep up to $3.5 million in assets in each spouse's name to make the most of the estate tax exclusion. A credit shelter trust, for example, may use the maximum exemption to establish how much goes into the trust when the first spouse dies. But using the new, higher amount could shortchange the surviving spouse unless special provisions are made.

One strategy the new exemption level doesn't affect is your ability to reduce your taxable estate through lifetime gifts. The annual gift tax exclusion increased in 2009, to $13,000 per recipient from $12,000 per recipient in 2008.

We can work with you and your estate planning attorney to determine whether your estate plan should be revised to factor these and other possible changes in estate laws. ●

Fix The Retirement Mess

(Continued from page 1)

Consider a man who made an average of $150,000 a year during his highest-paid 35 years at work. If, rather than retiring at age 62, he keeps going four more years at that same average salary, his benefits will go up more than 30% compared with what he would have received at 62, not taking inflation into account, Sass says.

If the same man had earned an average of $150,000 but had worked only 31 years, his 35-year Social Security average would be lower. (The exact figure is calculated based on the Social Security wage base limit, which changes annually and stands at $106,800 in 2009.) Retiring at age 66 instead of 62 would add four more years to the average (at the wage base limit), thus increasing his benefits somewhat more than the automatic 30%.

For a person earning an average salary of $40,000 a year, adding four more years to a 31-year average would make the increase in benefits rise from 30% to 45%, according to Sass. For higher earners to receive a similar extra boost, the wage base limit would have to be increased significantly above the $106,800 level.

The recent meltdown in the stock market just adds one more reason to think about delaying retirement by a few years. Most nest eggs have suffered, and to begin withdrawals from a beaten-down retirement account may sharply reduce the size of annual distributions that can be taken without depleting the account during a long retirement. We can revisit your retirement plan with you and help you choose a retirement age that will support your goal of a long and comfortable life after work. ●

Be Prepared

How to get ready to delay your retirement.

- Make sure your skills are in demand and you're in an industry that is healthy.
- Remain flexible and responsive on the job; "think young."
- Stay healthy by adopting good habits such as eating well and exercising regularly.
- Make sure your employer knows your target retirement date.
- If you're thinking about working longer, stay up to date in your field.
- Consider changing careers. You could choose something related to personal passions—for example, if you like fishing, you might work at a boat shop or a resort.

Source: ***Working Longer: The Solution to the Retirement Income Challenge***

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