Don’t Let These 5 Obstacles Derail Your Retirement Income Plan

Retirement means a fundamental change in the way you look at your finances – switching from a mindset that’s focused on accumulating assets to one that concentrates on turning that savings into an income stream that will last for the rest of your life.

Switching from an accumulation to a distribution mindset comes with its own unique challenges. In fact, even the best retirement income plan can fall short if it doesn’t account for these five particular factors. Don’t overlook investment risk, longevity risk, taxes, inflation risk, and health-care costs including long-term care.

1 Investment risk — losing your savings

Different types of investments carry with them different risks. Sound retirement income planning involves understanding these risks and how they can influence your available income in retirement.

Investment or market risk is the risk that fluctuations in the securities market may result in the reduction and/or depletion of the value of your retirement savings. If you need to withdraw from your investments to supplement your retirement income, two important factors in determining how long your investments will last are the amount of the withdrawals you take and the growth and/or earnings your investments experience. You might base the anticipated rate of return of your investments on the presumption that market fluctuations will average out over time and estimate how long your savings will last based on an anticipated, average rate of return.

Unfortunately, the market doesn't always generate positive returns. And as recent events have demonstrated, a market drop can be sudden, severe, and unpredictable. Sometimes there are periods lasting for a few years or longer when the market provides negative returns. During these periods, constant withdrawals from your savings combined with prolonged negative market returns can result in the depletion of your savings far sooner than planned.

Interest rate risk occurs when interest rates rise and the prices of some existing investments drop. For example, during periods of rising interest rates, newer bond issues will likely yield higher coupon rates than older bonds issued during periods of lower interest rates, thus decreasing the market value of the older bonds. You also might see the market value of some stocks and mutual funds drop due to interest rate hikes because some investors will shift their money from these stocks and mutual funds to lower-risk fixed investments paying higher interest rates compared to prior years.

Reinvestment risk is the risk that proceeds available for reinvestment must be reinvested at an interest rate that's lower than the rate of the instrument that generated the proceeds. This could mean that you have to reinvest at a lower rate of return or take on additional risk to achieve the same level of return. This type of risk is often associated with fixed interest savings instruments such as bonds or bank certificates of deposit. When the instrument matures, comparable instruments may not be paying the same return or a better return as the matured investment.

2 Longevity risk — outliving your income

Living a long and healthy life is certainly something we all hope for. But what happens if you live so long that you outlive your savings and income? How long will your retirement income need to last? Longevity risk is the risk that you'll run out of income before you run out of time. For some, the fear of outliving their savings and income is greater than the fear of death. That's because we all have certain expectations for our retirement lifestyle, and nobody wants to be a burden on family members.

Longer life expectancy in general, and a broad shift away from defined benefit pension plans and to defined contribution plans such as 401(k)s has placed most of the onus of managing longevity risk on us as individuals. Most of us can rely on Social Security as a source of retirement income, but few of us are likely to find that Social Security alone is going to provide us with the level of income needed for the lifestyle we want in retirement. That means we must rely on our savings to not only generate enough income to meet expenses during retirement, but to last for what will hopefully be a very long retirement period.

3 Taxes — it doesn't all belong to you

The effect of taxes on your retirement savings and income is an often overlooked but significant aspect of retirement income planning. Taxes can eat into your income, significantly reducing the amount you have available to spend in retirement.

It's important to understand how your investments are taxed. Some income, like interest, is taxed at ordinary income tax rates. Other income, like long-term capital gains and qualifying dividends, currently benefit from special — generally lower — maximum tax rates. Some specific investments, like certain municipal bonds, generate income that is exempt from federal income tax altogether. You should understand how the income generated by your investments is taxed, so that you can factor the tax into your income strategy.

Taxes can impact your available retirement income, especially if a significant portion of your savings and/or income comes from tax-qualified accounts such as pensions, 401(k)s, and traditional IRAs, since most, if not all, of the income from these accounts is subject to income taxes. Understanding the tax consequences of these retirement plan withdrawals is important when making income projections.

If you have assets in accounts that are taxable, as well as in accounts that are tax-deferred (e.g., traditional IRAs) or tax-free, the order and timing of when you take distributions from each type of account can have a significant impact on your overall plan.

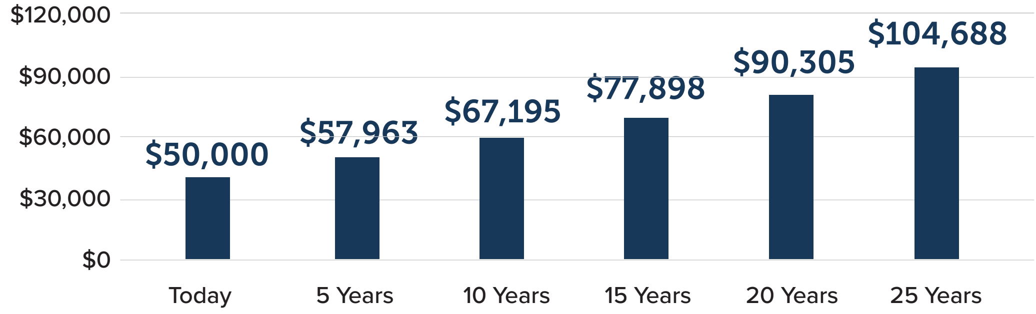
4 Inflation risk — declining purchasing power

Inflation is the risk that the purchasing power of a dollar will decline over time, due to the rising cost of goods and services. If inflation runs at its historical long-term average of about 3%, the purchasing power of a given sum of money will be cut in half in 23 years. If it jumps to 4%, the purchasing power is cut in half in 18 years.

A simple example illustrates the impact of inflation on retirement income. Assuming a consistent annual inflation rate of 3%, and excluding taxes and investment returns in general, if $50,000 satisfies your retirement income needs this year, you'll need $51,500 of income next year to meet the same income needs ($50,000 x 3%). In 10 years, you'll need about $67,195 to equal the purchasing power of $50,000 this year. So, to outpace inflation, you should have a strategy in place that allows your income stream to grow throughout retirement.

The following hypothetical example is for illustrative purposes only and assumes a 3% annual rate of inflation without considering fees, expenses, and taxes. It does not reflect the performance of any particular investment.

Amount Needed to Equal Purchasing Power of $50,000 at 3% Inflation



5 Health-care costs — growing medical expenses

As the number of employers providing retirement health-care benefits dwindles and the cost of medical care continues to rise, planning for health-care costs in retirement is becoming more important. If you recently retired from a job that provided health insurance, you may not fully appreciate how much health care really costs.

Despite the availability of Medicare coverage, you'll likely have to pay for additional health-related expenses out-of-pocket. You may have to pay the rising premium costs of Medicare optional Part B coverage (which helps pay for outpatient services) and/or Part D prescription drug coverage.

It is estimated that Medicare will cover only about 50%-60% of your health-care needs. You may also want to buy supplemental Medigap insurance to provide protection against catastrophic expenses that either exceed Medicare benefits or are not covered by Medicare at all. Otherwise, you may need to cover these health-care costs out-of-pocket.

Long-term care expenses are another potential health-care cost that can quickly eat up retirement income. Long-term care may be needed when physical or mental disabilities impair your capacity to perform everyday basic tasks. As life expectancies increase, so does the potential need for long-term care.

Paying for long-term care can have a significant impact on retirement income and savings, especially for the healthy spouse. While not everyone needs long-term care during their lives, ignoring the possibility of such care and failing to plan for it can leave you or your spouse with little or no income or savings if such care is needed.

What can you do?

While your retirement income plan should be developed for your particular circumstances, there are some common goals to consider. Your plan should:

- Generate predictable income to cover your expenses
- Capture stock market growth to keep up with inflation and to cover potential health-care costs
- Grow and protect your income no matter what happens in the market
- Minimize income taxes to increase your spendable income
- Maximize Social Security income
- Ensure that your income will last as long as you (and your spouse) do

Plan now

Retirement can be a great adventure, particularly if you are well-prepared. Developing and implementing an income plan that meets your retirement goals while accounting for factors that can impact your income can be a tricky proposition. You may benefit from the guidance of a financial professional.

Although there is no assurance that working with a financial professional will improve investment results, a professional can evaluate your objectives and available resources and help you consider appropriate long-term financial strategies.

Interest earned on tax-free municipal bonds is generally exempt from state tax if the bond was issued in the state in which you reside, as well as from federal income tax (though earnings on certain private activity bonds may be subject to regular income tax or to the alternative minimum tax). But if purchased as part of a tax-exempt municipal money market or bond mutual fund, any capital gains earned by the fund are subject to tax, just as any capital gains from selling an individual bond are. Note also that tax-exempt interest is included in determining if a portion of any Social Security benefit you receive is taxable.

Money market funds are neither insured nor guaranteed by the Federal Deposit Insurance Corporation (FDIC) or any other government agency. Although money market funds seek to preserve the value of your investment at $1.00 per share, it is possible to lose money by investing in such a fund. The official statement should be read carefully before investing. The underlying mutual fund may impose a liquidity fee or suspend redemptions and that the investor should not expect the underlying fund sponsor to provide financial support to the underlying mutual fund.

All investments are subject to risk and loss of principal. When sold, investments may be worth more or less than their original cost. Mutual funds are sold by prospectus. Please consider the investment objectives, risks, charges, and expenses carefully before investing. The prospectus, which contains this and other information about the investment company can be obtained from your financial professional. Be sure to read the prospectus carefully before deciding whether to invest.

Patrick M. Carroll
Registered Representative

Carroll Retirement Plans & Investments
7877 Mackinaw Trail | Cadillac, MI 49601
Phone: (231) 876-0302 | Fax: (231) 876-0848
www.carrollretirementplans.com | carrollcs@cfiemail.com