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## Title – Planning Early Retirement

### In partial fulfillment of ‘Your Degree’

Submitted by - Dean Terry

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## **Planning Early Retirement**

As a college student, have you ever thought about investing for your retirement? Although it may seem too early to even think about retirement, especially since you probably haven't even started your career yet, it just might be a good idea. In the aftermath of hurricane Katrina, serious questions have been raised about social security system in our country. It seriously dented credibility of the world's only super power to deal with its own people seeking help. It showed how elder people are more vulnerable to such disasters than the young ones as they lost their entire livelihood and are back to square in the twilight of their lives. They cannot rejoin the work force to earn what they lost. The whole situation emphasized the importance of personal savings.

### **Why to save and why to start it early**

The most potent question is why to save in today's plastic society. We can credit on finger tips, jobs market is decent and social security is still functioning. The answer is the society won't remain the same, the economy won't remain the same and certainly our priorities won't remain the same. Let's try to peek into future and analyze what are factors which will play their part in our decision making.

### **Demographic factors**

As the American society is getting older the pressure on the social security will keep on increasing in the times to come. As the baby boomers are growing old the pressure when our generation will join the work force will be immense. There will be considerable more percentage of people on social security vis a vis working population in times to come.

As with the advancements in the medicines the life expectancy of an average American is steadily growing. It will lead to pressure on social security system plus personal retirement saving has to last more than at present. Secondly the health bill will also increase which further will take away a chunk from savings.

## **Economical factors**

### Employment scenario

As Carly Fiorina former CEO of Hewlett Packard rightly put it 'Today no job can be taken as an American birth right'. Outsourcing has put tremendous pressure on the job market. Companies are transporting jobs to inexpensive places abroad to maintain the bottom line. We have already seen what has happened to textile workers in seventies and eighties, back up office services at the turn of the century. Information technology is defining new ways of doing things and it has already made significant forage into death of distance and time. An American credit card holder today sorts out all the account related queries from an Indian sitting in far off places like Bangalore at one fourth the amount an average American worker charges.

Today the glorious days of fat corporate pensions and generous employers contribution has started to become the thing of past. Companies like Wal-Mart are not even allowing workers to form union. The only buzzwords in corporate sectors are restructuring, outsourcing and retrenchment. Technology is replacing people at work and making business a lean and mean machine, better than ever before.

### Sluggish stock market

Historically stock market use to give around 6-9 % return on the investments but as the economy has been stabilized the return has been lower. The future doesn't look as promising as it was in

the beginning of the turn of the century when dot com boom was at its peak. The crude is about to touch mid seventies high with most anti American countries controlling it. As the largest energy consumer in the world our expenses will spiral towards north than south.

## **Social Factors**

Apart from demographical and economical factors there are lifestyle factors which are influencing the savings pattern. Today saving for retirements seems to be the last option on our minds but it needs our urgent consideration. Talking to various people suffering from lack of money in their retirement years I try to fix the puzzle –

- Most people start late – Holistically most people in twenties have priorities like owning their own house, or finding a new job. In their thirties they worry about their kids' school and college expenses. And in late forties when they realize the importance of saving for post retirement years it is already too late and they end up building an insufficient buffer for years to come.
- Changing lifestyle - Today increasing divorce rate and growing tendencies of couples 'living in' will leave more people living alone in twilight of their life then ever before. With less company, people have to save more so that they can be well taken care of.

Sluggish economy, stagnant stock market, not so promising job scenario and social & personal factors will take a lot out of one's savings in the latter years. To avoid such situations our generation has to start saving earlier for our post retirement years than the previous ones.

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Savings doesn't have to be "all or nothing!" one doesn't have to choose between present financial obligations and saving for retirement years. Saving small amounts while paying for obligations can put compounding and tax-deferred growth to work for you. Just to put things in perspective – If someone begins saving \$500 monthly at 40 and earns an annualized 8 percent return. At 65, they would have about \$457,000. If that same person started saving instead at age 30, they would have that \$457,000 10 years earlier, and even if they didn't add another penny over the next 10 years, their retirement fund would grow to just under \$1 million. Obviously it is a simplified example, but it states that the sooner you get started the more you save, the more the power of compounding return can help your balance grow.

### **Making a retirement plan**

Making a retirement plan in twenties is lot different from charting one when you are in your mid forties. According to the Fidelity401k.com site, experts estimate that "every one of us will need between 60 to 80 % of our final annual working income every year that we're retired. Since Social Security usually provides only 40 percent of the average retiree's income, many of us will need to rely on our own savings and investments".

In a recent survey ABC/USA Today poll, few workers are saving barely adequate to afford a comfortable retirement. 69% of workers surveyed on the issue of retirement responded "running out of money" as their biggest worry. Less than half of all workers have correctly estimated how much they will need to support a long, comfortable retirement. For a couple to live comfortably on, say, \$50,000 a year for 20 years will require \$1 million in savings. And that doesn't include the expense of assisted living, medical care, prescription drugs, or nursing home costs. To start early we can keep following aspects in mind while charting a retirement plan.

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Define your goal – Goal definition is in nascent form right now, between twenty and thirty years one should look to find a continuous job and contribute small and consistent amount of money.

Make personal retirement goals – Have a good idea about how much you like to have in your nest when you retire and plan accordingly. As you will reach the peak of your career in forties so make timely provision year wise that will help you from lack of liquidity in twenties and thirties and making an enormous contribution later in your career. Try to achieve a balance.

Account for large one-time expenses - At this stage you must have taken education loan or paying home installments so make sure you make provision for them.

Make conservative estimates of return on investments – Most people falters on a good retirement nest just because overestimate the return on their investments or try saving late. So to avoid this pitfall making the future income estimation and inflation rate should be taken on conservative side.

## **Where one can invest**

Mostly there are two ways of having retirement savings

### **1. Defined benefit plan**

A Defined Benefit Plan promises the employee a specific monthly benefit at retirement and can be fixed in exact dollar amount. A participant in the plan is generally not required to make contributions in a private sector fund but generally public sector funds require employee contributions. Though most companies today are not providing it, Defined Benefit Plans guarantee retirement income security for workers, do not involve

investment risk to participants, do not depend upon workers ability to save and defer taxes.

## **2. Defined Contribution Plan**

A Defined Contribution Plan provides an individual account for each participant in the plan. The benefits depend upon the amount contributed by participant and affect his income, and performances of his investments. Some most popular defined contribution plans include 401(K) plans, 403(b) plans, employee stock ownership plans (ESOPS) and profit sharing plans. Under Defined Contribution Plan workers have a certain degree of how much they can save, it can be funded through payroll deductions, even lump sum distributions is eligible for special 10 year averaging and above all workers can benefit from good investment results.

As companies are struggling to secure bottom line and outsourcing various functions to cut cost, most companies mostly offer contribution plans these days. These plans are also favored by workers as they can define their savings limit and have an option of taking the money out, when needed. The most popular contribution plan is 401(K) and Individual Retirement Account (IRA).

### **What is a 401k plan?**

A 401(k) is an employer-sponsored contribution plan. it allows the employee to divert some of his salary into a fund which is supported and contributed in some part by the employer.. the portion contributed by employee will not be considered part of his taxable income. In other words, that employee has lower taxable income than. The portion of salary saved and contributed into the 401(k) gets invested in different ways, usually into mutual funds , bonds and equity. Those investments grow on a tax-deferred basis, which means that the compounded growth of

the investments is also not added to taxable income. It will only become taxable when it is withdrawn. Most employers contribute to their employees' 401(k) accounts as an added benefit, by matching employees' contributions in different ratios, and the most common arrangement is that the employer contributes 50 cents for each dollar an employee contributes, usually up to 6 percent of the employee's salary.

### Advantages of 401 (K)

Matching contributions is free money so one must at least contribute enough to make the employer pay his contribution.

You can roll it into your IRA once you decided to leave the job or can cash it even though it is not a preferred option. Using a Rollover IRA to maximize your eligible distribution from your employer's plan provides significant benefits and protects your savings from current taxes and penalties.

You can withdraw your money just paying one time tax after reaching 59 and half years, or you can withdraw money after 5 years by paying 10 percent penalty. This can help if you are planning to start your own venture in early thirties.

### **Individual Retirement Account (IRA)**

There are two IRA plans: Traditional IRA and Roth IRA.

#### Traditional IRA

Anyone who works or receives alimony can have to an individual retirement account ( IRA) .

The employer has no role to play with this account. It is opened and maintained by the individual

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and usually opened with a investment company. For most people, the maximum contribution each year is \$2,000. The cap may be lower if you have a retirement plan at work or your income reaches certain limits. One thing an IRA has in common with a 401(k) and IRA is the age to withdraw funds without penalty, in both the cases it is 59-1/2.

### Roth IRA

The difference between the Roth and the traditional IRA is that Roth is not deductible, the funds must be held for at least five years and If withdrawn are made prior to that, there is a 10 percent penalty. If you hold the funds in a Roth for at least five years and make your withdrawals after you reach age 59-1/2, your withdrawals will not be taxable. Neither your contributions nor the interest, dividends on investments, capital gains are taxable.

### Advantages of IRA

Spousal Accounts - There is an important exception to the rule that you must have compensation to have an IRA. If you have a job but your spouse does not, you can contribute up to \$3,000 of your income to a spousal IRA for him or her.

There is no minimum age limit - There is no minimum age for IRA participation. If your 10-year-old has compensation from working in a family business through paper route, you can pay up to the limits in an IRA.

### Conclusion

Times are changing for Americans today, Americans companies are facing unprecedented competition and to cut cost companies are either to restructure or pay less like Walmart. As the economy will get more sophisticated protecting our future will be an ongoing task rather than a

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last ditch effort. Investing in plans like 401 (K) makes sense as they not only inculcate a saving habit among us but also gives us freedom to chart the route of our future. Saving habits today can serve both us and the country in long run as historically saving rates usually defines the growth rate of countries.

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