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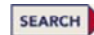

Think Long-Term

Retirement planning requires a disciplined approach, an understanding of risk tolerance and a defined goal.

By Robert Sberna

As banter at holiday parties, discussing investment tenets such as "asset allocation" and "risk tolerance" may not thrill the punch-bowl crowd. But in the financial services arena, experts say it's more important than ever for investors to become familiar with these and other basic investment principles.

For those who are investing to build their retirement portfolios, an informed and disciplined approach can mean the difference between living comfortably in their senior years or just scraping by.

Given today's economic uncertainty and the turbulence in the financial markets, it's vital that people have a clear investing strategy and a defined retirement goal, says Julie Jarvis, a certified financial planner in Columbus. "The first thing that people should realize is that they have to gauge their risk tolerance for investing," she explains. "We all know that the stock market is going to go up and down. Nevertheless, a lot of people say they can handle a 10 percent decline in their portfolio value, but the first time they get a statement with a negative result, they want to sell."

Retirement planning illustration
Illustration by Ken Orvidas

To avoid panic selling, Jarvis says it's crucial that investors work with a competent financial professional to determine their true risk tolerance. "People need to assess their ability to tolerate risk and invest according to their own comfort level," she explains.

Once the investor's risk tolerance is determined, an appropriate asset allocation can be formulated. The technique of asset allocation can reduce overall portfolio risk by spreading an investor's money among various investment classes such as stocks, bonds, real estate and cash. "When the market slumps, people should stay with their investment plan," Jarvis says. "You shouldn't get nervous and change your allocations. If you do, you'll be selling investments when the prices are low, and that's the opposite of what you want to do. Instead, you want to hang in there and realize the markets will go up again. If you want to benefit from the market's upside, you have to be able to tolerate the downside."

As a general rule, the asset mix of a financial portfolio should reflect the age of the investor and the number of years until retirement, says Tim Fogarty, an accounting professor and associate dean at Case Western Reserve University's Weatherhead School of Management.

"The closer someone is to retirement, the more they may want to weight their portfolio toward more conservative investments such as bonds and cash," Fogarty says. Conversely, younger people who are focused on building a retirement nest egg will want to include a higher proportion of equities (stocks) in their portfolios, he adds. While inherently more volatile than fixed-income instruments, stocks have traditionally provided the best returns over the long term.

"Even in a declining market, equities are the way to go," says Fogarty. "Throughout the history of the stock market, the market has [generally] been up over any five-year or 10-year period. And when it goes down, it doesn't go down in a sustained way. Even if the market goes down a lot, it then tends to go up a lot to compensate."

While touting the long-term performance of stocks, Fogarty recommends the purchase of mutual funds, rather than individual stocks. "With mutual funds, you get a diversified portfolio, which helps to avoid the ups and downs of individual stocks," he explains. "The only people that should be buying individual stocks or trying to 'time the market' are people who have money they want to play with. In addition, most people don't want to spend a large amount of time doing research to pick their stocks. You can make intelligent stock choices, but it's a lot of trouble. Sure, playing the stock market is more fun than going to Las Vegas, but don't bet your retirement kitty on it."

Start Early, Save Plenty

Most financial professionals will tell you that the "how" of investing for retirement may not be as important as the "when."

According to Chris Cooper, a Toledo-based financial planner, retirement planning should begin at birth. "That's not silly; it's the truth," he says. "A baby born today has a life expectancy of 80. So the earlier you begin to contribute to a retirement plan, the better."

Cooper notes that young people who set aside even small amounts on a regular basis can accumulate a significant retirement fund — thanks to the wonders of compound interest. "It's a lot easier to build that nest egg when you start at age 22 than when you start in your later years," he says. "When it comes to accumulating money, time works against you. If you wait until you're close to retirement age, it's too late. You're playing catch-up."

No matter your age, one of the best ways to save for retirement is to invest in a 401(k) plan, which is offered at many workplaces and has pretty much replaced the traditional pension plan. The increasingly popular 401(k) and its cousins, the 403(b) and 457(b) plans (which are offered to teachers and other employees of nonprofit or governmental organizations), are sponsored by employers and funded by employee contributions. The money you invest in these plans is tax-deferred, and many organizations match their employees' contributions up to a certain level (often 6 percent of salary).

"People who work at firms that offer defined-contribution plans such as the 401(k) should take full advantage of these programs," Cooper says. "They need to put in the maximum amount they are allowed, particularly if the employer contributes a matching amount. That's free money."

During the past 25 years, there has been an institutional change in the way people plan for retirement. We've shifted from being a nation in which workers depend on defined benefit pension plans funded by their companies to one in which workers are responsible for accumulating their own retirement savings. The transition toward defined contribution plans such as the 401(k) has prompted a corresponding shift in investment responsibilities — from pension plan trustees to employees.

But many workers eligible to participate in 401(k)s choose not to make contributions or participate only minimally. "Many people don't understand the concept of the 401(k) plan or they are too busy to stay on top of their investments," says Jon Dauphiné, director of economic security strategy for the American Association of Retired Persons (AARP).

To promote greater participation in retirement savings programs, Congress passed legislation last year that gives companies

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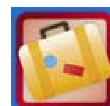
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the green light to automatically enroll all workers in 401(k) plans, unless they explicitly opt out. Known as the Automatic 401(k), the pension overhaul also enables employers to put employees' assets in default investment funds that are diversified and tailored to their age group. "The good thing about the Automatic 401(k) is that it makes sure that people will have enough to retire on, even if they don't have enough time to oversee their investments," Dauphiné says.

Given the discouraging predictions about the long-term solvency of our Social Security system, it's become increasingly important that workers take advantage of employer-sponsored retirement programs as well as contributing to private IRAs (individual retirement accounts) — both traditional and Roth.

"If Social Security is still there and you've been a savvy participant in your 401(k), then you're probably going to have enough money in your retirement years," notes Dauphiné. "However, there are a lot of people who have been participating in their 401(k), but they either have not put in enough or they are saving blindly. People need to sit down and track their investments. Even if you're in your 30s and 40s, you need to use an Internet calculator or consult with a financial advisor to ensure that you're on the right track to retire."

Within the 401(k) universe, participants often have a spectrum of investment funds to choose from. When selecting funds, it's important to determine the fee schedules of the various mutual funds and other investment vehicles, says Dauphiné, explaining, "High management fees can really eat into investment returns over time. In recent years, the AARP has been active in educating people on matters such as fund fees. We ask people if they know what kind of fees they are paying in their 401(k) plans and other investments. More than 80 percent don't know. Our advice is to do research and see what you're paying."

Kathy Keller, communications director of AARP's Ohio office, notes her agency has stepped up its efforts to provide a wide range of investment and retirement planning resources, including online retirement calculators and asset allocation models. For information, visit www.aarp.org/states/oh.

"Over time, we've seen a dramatic movement toward individuals having to rely on themselves to fund their retirement years," Dauphiné says. "This trend has made some people nervous about the financial security of U.S. families, but the reality is that it's happening. So individuals are going to have to educate themselves about investments and retirement planning. Whether they seek assistance from a financial consultant or use publications from AARP, the public library or other organizations, they should know that there is help available."

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ANNUITIES: CAVEAT EMPTOR

Useful investments for some, these retirement-planning tools aren't a one-size-fits-all option.

The financial services marketplace offers a broad choice of investment products. Throughout the spectrum of investments, few are marketed as aggressively as annuities, which are sold by life insurance companies and offer the benefits of tax-deferred growth and the option of a guaranteed stream of income to their owners.

In recent years, annuities have been heavily promoted as retirement-planning tools, especially to seniors. However, as annuity sales have grown, so has confusion among consumers. Much of this confusion is due, in part, to high-pressure sales tactics, says Chris Cooper, a Toledo-based financial planner.

"Annuities are being sold as the catch-all of all things retirement," he says. "It's not that annuities are a bad idea, but they are being sold to the wrong people in the wrong situations. A lot of annuities are being sold to seniors who don't even file a tax return and don't need a tax-deferred investment. In general, anyone who is in the 15 percent tax bracket or lower is better off in a taxable investment."

Along with surrender charges and penalties for early withdrawals, annuities (which include fixed, variable and equity-indexed) often have high management fees, which can significantly offset investment gains, explains Cooper.

So what's driving the annuity marketing push? "Annuity products pay a large sales commission, sometimes 6 to 8 percent, which can be twice the commission of a mutual fund," Cooper says. "The commission is so hefty that salespeople will come to your house to sell you an annuity."

While Cooper says that annuity products are useful investment tools for some people, it makes sense to research the products' fee structure before investing. He also recommends relying on fee-only financial consultants, which can help ensure that the professional is not pushing a particular product to receive a sales commission. "You want someone who will take an objective look at your portfolio and recommend investments that are appropriate for your specific situation," he adds. "Unfortunately, many consultants in the financial-services business are distributing products as if they were [one-size-fits-all commodities], like tires." — RS

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