Help yourself to the new retirement

It's easier to save and to get advice on where to put your money. By Mary Beth Franklin

ONCE UPON A TIME, SPENDING AN ENTIRE CAREER with one company virtually guaranteed you a pension for life. Today, workers are more likely to hold a variety of jobs throughout their lifetimes and shoulder more responsibility for their own retirement. Thanks to last year's landmark pension-reform law, saving for your retirement will be easier than ever and your employer will continue to play a major part in helping you prepare for the future. But now your boss's role is likely to be one of a guiding partner offering advice and matching contributions to your 401(k) rather than a lifelong source of pension checks.

Last year's Pension Protection Act encourages employers to institute three simple procedures to put workers on a path to a more secure retirement. First, companies can automatically enroll employees in a 401(k) plan rather than waiting for them to sign up. Second, they can automatically increase their workers' contributions each year. And third, if participants don't select their own investments, employers can deposit their retirement-plan contributions into an appropriate stock market based investment rather than a more conservative option.

The new law represents the biggest shift in 401(k) plans since they were created more than 25 years ago, and its significance can't be overstated. "By simplifying the process, tools such as automatic investing, automatic enrollment and deferral, and step-up contribution programs can help Americans overcome their savings paralysis and lead to financial security," says Daniel Houston, executive vice-president of the Principal Financial Group, a leading provider of 401(k) plans. Today, 401(k) plans are the primary retirement-savings program for 47 million Americans, more than twice the number of people covered by traditional pension plans.

A BOOST FOR SAVINGS

AUTOMATIC-ENROLLMENT FEATURES WILL primarily benefit younger workers. But mid-career and older workers also have something to cheer about. The law permanently extends higher contribution levels for 401(k)s and IRAs, as well as "catch-up" contributions for workers 50 and older.

This year, all workers can contribute up to $15,500 to 401(k)s and similar workplace-based retirement plans, up $500 from 2006. Workers 50 and older can kick in an extra

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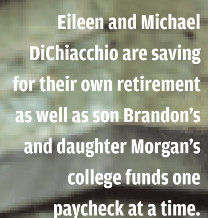

Eileen and Michael DiChiacchio are saving for their own retirement as well as son Brandon's and daughter Morgan's college funds one paycheck at a time.

50
percent

HOW MUCH YOUR BUYING POWER WILL BE CUT AFTER 25 YEARS, WITH RELATIVELY MODEST 3% ANNUAL INFLATION

$5,000 in catch-up contributions, for a total of $20,500 in 2007. In addition, you can stash up to $4,000 in a Roth or traditional IRA, plus an extra $1,000 if you're 50 or older.

The higher contribution limits can have a major impact on retirement savings. Consider a worker, now 40 years old, who started making 401(k) contributions in 2002, when the higher limits took effect. Using the maximum tax-deferred contribution levels, including catch-up contributions, our worker could accumulate more than $1.1 million by age 65, according to the Investment Company Institute. If those higher limits and catch-up contributions had been allowed to expire in 2010, the account balance would be just $888,000.

Leading 401(k) providers recommend that workers aim to save at least 15% of their gross income (including employer contributions) in order for their investments to replace at least half of their current salary, adjusted for inflation, in retirement. Under current law, Social Security benefits would replace another 25% to 40% of pre-retirement earnings, depending on your income. (Replacement rates are higher for lower-earning workers.)

Aim to replace about 85% of your pre-retirement income to maintain the same standard of living in retirement. If your mortgage is paid off by the time you retire and you no longer need to sock away money for retirement, you may be able to live comfortably on less. But if you plan to buy a second home, expect to travel or engage in expensive hobbies, or don't have access to employer-provided health coverage, you might spend even more than you did when you were working full-time.

SIMPLE INVESTING

NOT ONLY DO THE NEW RULES LET YOU PUT MORE money aside for retirement, but they also let you get advice on what to do with it if, like many workers, you lack the time, interest or expertise to make those decisions on your own. Employers are now encouraged (but not required) to provide employees with investment advice. Financial advisers hired by your employer can recommend specific investments within your 401(k) menu as long as their fees aren't affected by which investments you choose. They can also make recommendations based on computer models that take into account your age and risk tolerance.

To make things even simpler, more companies offer employees one-stop investment options such as target-retirement funds, which essentially combine advice and investing in one product that operates on autopilot. All you do is choose a fund whose name includes the year you expect to retire, or one close to it. The fund does the rest: It distributes assets among stocks, bonds and cash (including international holdings), and adjusts the mix to make it more conservative (with more bonds

» TAX-FREE INCOME

Why we love the Roth IRA

The Roth IRA is the best all-around retirement plan there is. You can contribute up to $4,000 to a Roth IRA in 2007, or $5,000 if you are 50 or older by the end of the year. But not everyone is eligible. To contribute to a Roth IRA this year, your income can't exceed $114,000 if you are single or $166,000 on a joint return.

Why is the Roth such a great deal? Let us count the ways:

■ **You can stockpile** savings that will be tax-free when you start making withdrawals in retirement.

■ **You can withdraw** your *contributions* at any time without paying taxes or a penalty. That's because you don't get an up-front tax deduction for your contribution as you do with a traditional IRA.

■ **You get generous** escape hatches that let you withdraw your *earnings* to pay for major expenses, such as a first home or college (which is why a Roth IRA is a great way for parents of young children to juggle saving for college and retirement). After your account has been open for at least five years, you can withdraw $10,000 in earnings tax- and penalty-free to buy a first home. And you can withdraw earnings penalty-free to pay for college expenses.

■ **You get estate-planning advantages,** too. Unlike traditional IRAs, Roths don't require distributions. And your heirs can inherit a Roth IRA tax-free.

Now that Roth 401(k) plans have been made permanent, more employers are likely to offer them. As with the Roth IRA, you get no tax break up front, but all of your withdrawals in retirement will be tax-free. Roth 401(k)s share the same contribution limits as traditional 401(k) plans—$15,500 in 2007 plus an additional $5,000 for workers 50 and older. And there are no income restrictions, so if you earn too much to contribute to a Roth IRA, you can still contribute to a Roth 401(k).

Now that Hank and Amy Neumayer have prepaid college tuition for their daughters Laura and Diane, they can focus on their early retirement.

and fewer stocks) as you near retirement. No need to rebalance periodically that, too, is taken care of (for more on target-retirement funds, see the box on page 60).

The concept is catching on in a big way. In just five years, the number of target funds has grown from 33 to more than 200. Assets in these funds total nearly $135 billion, up from $10 billion. And recent changes in pension law virtually guarantee that target funds will soon be ubiquitous, serving as the default option in many corporate retirement plans. “By the end of the decade, we think that target funds will account for 60% to 70% of retirement-plan assets,” says Pamela Hess, director of retirement research at Hewitt Associates.

HIRE A MANAGER

ALTHOUGH TARGET-DATE RETIREMENT FUNDS are increasingly popular, they’re not the best choice for everyone. If your situation is complicated because you own a large block of company stock, for example, or you want to coordinate your 401(k) strategy with outside investments or your spouse’s retirement savings you may have a convenient alternative: a managed account. Instead of giving you a menu of funds in your 401(k), your plan provides a professional adviser to select and monitor your retirement investments.

Hank Neumayer took full advantage of that option when it was offered to him by Ford Motor Co., where he has worked for 22 years. Neumayer, 44, is thankful that he is covered by his company’s pension plan, and he hopes that his job and his benefits will last for another eight years, when he’ll qualify for early retirement. But he’s not counting on it. So he’s saving aggressively just in case Ford freezes its pension plan and his anticipated benefits don’t materialize. “I know that what I’ve got so far is safe,” says Neumayer, a field auditor for dealerships. “But it’s only about half of the $5,000-a-month pension I’d get if I were to retire in my early fifties.”

To make up for any potential shortfall in retirement income, Neumayer, who lives in Louisville, Ky., makes the most of his 401(k) plan. But he doesn’t go it alone. Thanks to a special discount arrangement that Ford employees and retirees have with Mainstay Capital Management, in Grand Blanc, Mich., Neumayer pays about 0.3% for professional investment management less than half the retail price. On his balance of more than $500,000, that costs about $1,600 a year.

Neumayer has been so pleased with the performance of his 401(k) investments, which have consistently outperformed Standard &

50 percent

CHANCE THAT AT LEAST ONE MEMBER OF A HEALTHY 65-YEAR-OLD COUPLE WILL LIVE TO 92, REQUIRING RETIREMENT SAVINGS TO LAST ABOUT 30 YEARS

MARK CORNELISON

50 percent

HOW MUCH OF YOUR INVESTMENTS YOU NEED TO KEEP IN STOCKS AFTER YOU RETIRE TO STAY AHEAD OF INFLATION

Poor's 500-stock index, that he and his wife, Amy, turned over all of their other investments to Mainstay CEO David Kudla. "Employees can't control what happens to their pensions, but they can control how much they save and how it is invested," says Kudla. "If the assets are managed well, they could more than make up for any pension shortfall."

Last year, the Employee Benefit Research Institute found that if the pension of a 50-year-old worker earning $70,000 a year is frozen and replaced with a 401(k) plan, the employee would need to accumulate nearly $300,000 to purchase an annuity that would fill the gap created by the pension freeze.

RETIREMENT VERSUS COLLEGE

LIKE MANY WORKERS IN THEIR THIRTIES AND forties, the Neumayers face the challenge of saving for their children's education at the same time they are investing for retirement. They recently finished paying for two prepaid-tuition contracts for their daughters, Laura, 11, and Diane, 9. The contracts, which cost about $60,000 each, will cover four years of tuition, room and board at any private university in Kentucky. The girls can use the money at any college in the country, but there may be a funding gap if they go to school out of state. "We're finished paying for college and well on the road to retirement," says Neumayer, noting that he and his wife, who works for an insurance company, have accumulated about $1 million in retirement savings.

Most people aren't so fortunate or disciplined. And saving for competing long-term goals requires a careful balancing act. "Keep in mind the effects of the trade-offs you make," advises Christine Fahlund, chief financial planner for T. Rowe Price.

To illustrate, Fahlund uses the example of a couple with a combined annual income of $100,000 who invest 6% each year for 36 years 18 years prior to their child starting college and 18 years from the start of college until the couple retires. The example assumes the couple's income grows 3% a year, their investments earn an average 8% annually, and their savings are invested in either a tax-deferred 401(k) plan or a 529 college-savings plan, from which distributions are tax-free if used for qualified educational expenses.

If our hypothetical couple invest solely for their own retirement over the full 36-year period, their retirement nest egg would be worth nearly $1.7 million assuming their 401(k) plans offer no matching contributions or more than $2.5 million with a 50% match. "Given the potential boost provided by a company match, investors should certainly factor that in when choosing a saving strategy," says Fahlund.

If the couple decided to focus on college first, investing the same amount each year in a 529 plan for the first 18 years and then shifting all their savings to retirement, they could accumulate $253,000 by the time the child starts school. Although this strategy produces the most for college, it potentially reduces their retirement savings by 70% compared with saving only for retirement. "Unless an investor has numerous other ways to pay for retirement, he or she probably shouldn't consider this option," Fahlund warns.

Most families are likely to choose a dual approach, splitting their annual investments between college and retirement and later shifting solely to retirement. In that case, our hypothetical couple would accumulate more than twice as much for retirement $1.6 million versus $759,000 (assuming a 401(k) match) compared with focusing on college first. But the college fund would be worth $126,000 about 50% less.

That's okay, says Fahlund. "Although it's admirable to want what's best for your children, don't fall into the trap of becoming so obsessed

» ALL-IN-ONE PORTFOLIO

Best of the target-date retirement funds

Target funds adjust their holdings to become more conservative as they approach their maturity date. Our favorite such funds keep a good portion of your investment in stocks, even as you get close to retirement.

FUND	SYMBOL	1-YEAR RETURN*	PERCENTAGE OF FUND IN: STOCKS	BONDS	CASH	FOREIGN ASSETS†
T. Rowe Price Retirement 2015	TRRGX	13.7%	70%	25%	4%	21%
Vanguard Target Retirement 2015	VTXVX	12.6	63	36	1	13
T. Rowe Price Retirement 2025	TRRHX	15.2	83	13	4	22
Vanguard Target Retirement 2025	VTTVX	14.5	79	21	1	16
T. Rowe Price Retirement 2035	TRRJX	16.0	89	7	4	23
Vanguard Target Retirement 2035	VTTHX	15.5	89	10	1	18
T. Rowe Price Retirement 2045	TRRKX	16.0	88	8	4	23
Vanguard Target Retirement 2045	VTIVX	15.4	89	10	1	18

*To August 24. †May include both stocks and bonds. SOURCE: Morningstar Inc.

with paying for college that you neglect your own retirement," she says. You can always tap other funding sources for college, ranging from loans and scholarships to summer jobs. "But if you don't have sufficient assets or a pension," says Fahlund, "there are limited options other than Social Security and continued employment to fund your retirement."

GO FOR A ROTH

MICHAEL AND EILEEN DI CHIACCHIO ARE TAKING a dual approach to saving for their future. Michael, 38, a project manager for a real-estate investment company, contributes 6% to his company 401(k) plan, more than enough to capture the matching contribution. In the 25% federal tax bracket, every $1,000 invested in his 401(k) cuts his tax bill by $250. Then he fully funds a Roth IRA for himself and another for Eileen, also 38, who teaches at a public school. Although there is no upfront tax deduction for Roth contributions, all withdrawals are tax-free in retirement.

Roth IRAs and their latest iteration, Roth 401(k)s, make a lot of sense for younger workers who will benefit from decades of tax-free growth. They are also flexible savings vehicles for families balancing retirement and college needs. Contributions can be withdrawn tax- and penalty-free at any time, and even earnings can be withdrawn penalty-free to pay college expenses (see the box on page 58 for other reasons Roth IRAs are a great investment).

The DiChiacchios, who live in Springfield, Pa., are also nibbling away at tomorrow's college costs for their children, one paycheck at a time. They started saving for college eight years ago when their son, Brandon, was born, sending $50 a month to 529 accounts for him and his sister, Morgan, now 10. Since then they have increased their monthly contribution to $300, split evenly between the two accounts. "I'm not sure it will be enough, but at least it's a start," says Michael.

ROLL IT OVER

SAVING FOR RETIREMENT IS CRITICAL, BUT MANY people falter when they change jobs and decide to cash out their 401(k) accounts. That can be a costly mistake. Not only will you have to pay federal and state income taxes on your distribution, you will also be nicked with a 10% early-withdrawal penalty if you are younger than 55. Plus, you'll sacrifice years of compounded tax-deferred growth.

For example, say you have $10,000 in your 401(k) and you decide to cash out when you change jobs. If your combined federal and state tax rate is 30%, you'll lose $3,000 off the top, plus another 10% in early-withdrawal penalties, leaving you with just $6,000. Had you allowed that money to grow untouched for 20 years, earning an average 8% annual return, it would be worth nearly $50,000.

When you switch jobs or retire, you have three options for your retirement savings. If you have a balance of $5,000 or more, you can leave it with your former employer. Or, regardless of the amount, you can roll it over into an IRA or into your new employer's plan, if it accepts rollovers.

In general, an IRA offers you more investment options than most employers' 401(k)s, so a rollover is usually wise. But if your 401(k) includes company stock, don't move it without evaluating all your options. There are special rules for something called net unrealized appreciation that can offer significant tax savings if you own company stock inside your 401(k). ■

»FINANCIAL CHECKUP

Online tools help you assess your progress

Four new Web tools give you a quick look at where you stand on the road to retirement.

With Fidelity's myPlan Snapshot (www.fidelity.com), all you do is provide five facts: your age, salary, monthly savings, the amount you've saved so far and your investment style (conservative or aggressive). You'll see how large a nest egg you can accumulate given your current strategy, or you can adjust the variables to see how much more you could stockpile. Fidelity's more detailed myPlan Retirement Quick Check takes about 30 minutes to complete.

Want to know how you stack up against your peers? Try Nationwide's RetirAbility Check (www.nationwide.com; click on "get ready for retirement"). The tool grades your progress thus far with an "R-score" and gives advice on how to improve your score.

The Pudding Index (www.puddingindex.com), as in "the proof is in the pudding," creates a benchmark by comparing your current savings with those of someone of similar age and salary level, and then projects how much retirement income you could replace from your savings at age 65.

Test your Retirement IQ with ThriveQ (www.thriveQ.com), an online tool from Thrivent Financial to help you clarify your vision of what retirement means to you.