

Chapter 1

FORGET KANSAS, GET TO KNOW OZ

WE'RE NOT IN KANSAS ANYMORE

It's one of the greatest moments in one of the greatest movies of all time, *The Wizard of Oz*. Dorothy Gale, played by Judy Garland, has just been transported along with her little terrier, Toto, from the Kansas farm where she lives with her auntie Em and uncle Henry to a mysterious place called Oz. The flat, monotone Kansas prairie has been replaced by a bizarre landscape bursting with color and lush with exotic flowers and plants. Bedazzled, Dorothy looks around, trying to gain her bearings in this unfamiliar terrain. And then she utters those famous words to her little dog: "Toto, I have a feeling we're not in Kansas anymore."

When it comes to describing the situation most of us face today when planning for retirement, I can hardly think of a better line: We're not in Kansas anymore. The old, familiar landscape we once took for granted, the cozy, secure world where you could count on the combination of government largesse and an employer-funded pension to provide you with a comfy retirement, has given way to a totally new environment, one as alien to the world we knew before as Oz is to Kansas.

Granted, in this new retirement world we don't have to deal with such nasty creatures as the Wicked Witch of the West or her army of freaky flying monkeys, as Dorothy, the Tin Man, the

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Scarecrow, and the Cowardly Lion did. But the twenty-first-century retirement-planning landscape is nonetheless teeming with daunting challenges of a different breed. We must learn how to get the most out of financial instruments that retirees a generation ago never had to concern themselves with, an alphanumeric soup of 401(k)s, 403(b)s, 457 plans, IRAs, Keoghs, SEPs, and so on. (IRAs, Keoghs, and SEPs, oh my!) And then there are the myriad rules concerning IRA rollovers, early withdrawal penalties, borrowing regulations, and RMDs (required minimum distributions). On top of all this, we've got to invest our retirement savings and thus learn to navigate the often treacherous waters of the financial markets, where sudden setbacks can sometimes undo years of diligent saving. In short, just as Dorothy had to familiarize herself with the strange ways of Oz in order to find her way back home, so too must we develop retirement-planning strategies that offer the best chance of success given the new realities we face.

In this chapter I'll bring you up to speed on the new retirement landscape, including a number of distinctly positive developments stemming from recent changes in the tax laws that can increase our chances of achieving a comfortable retirement. Only by coming to grips with the various changes that have transformed the world of retirement planning and understanding how those changes affect you can you sensibly plan for your own retirement.

Changes in the Financial Aspects of Retirement

Social Security Ain't What It Used to Be

Traditionally, retirement-planning experts have told us to think of our income sources during retirement as a three-legged stool, the first leg being Social Security, the second company-funded pensions, and the third personal savings. In fact, however, this stool would have been pretty lopsided because for most people the role of that first leg, Social Security, was much, much bigger than the other two.

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But today's and future generations of retirees aren't going to get anything remotely approaching the kind of windfall Social Security recipients received in years past. For one thing, there aren't enough workers paying into the system to provide benefits comparable to those past generations received. You don't have to be a financial whiz to figure out that fewer people putting money into the system and more drawing it out spells trouble. And that, according to the Social Security Administration's own projections, is exactly what lies ahead.

Given the uncertain outlook for this program, some financial planners suggest that people filling out retirement-planning worksheets put a big fat zero on the line where you enter your expected Social Security benefit. I think that's a little extreme. Even if the Social Security trustees' projections are accurate and the trust fund runs dry in 2042 or so, it's not as if the Social Security system will go bankrupt then, as is often suggested in the press. Payroll and income taxes will continue to flow into the system as before. Those taxes just won't be enough to pay full benefits, but they would be able to pay between 65 and 73 percent of currently scheduled benefits over the subsequent thirty-five years.

It's anyone's guess how this will be resolved. At some point in the future the Social Security system could include some version of individual accounts that would allow us to put a portion of our Social Security taxes into stock and bond mutual fund accounts instead of having the money invested solely in U.S. Treasury bonds, as is now the case. That might help some of us earn a higher rate of return on the money we put into the plan and possibly boost what we collect in benefits down the road. Or Congress might try to shore up the existing system by raising payroll taxes or tinkering in other ways. Or maybe we'll see a combination of both approaches. Whatever is done, however, I would expect that future Social Security benefits will be smaller than they've been in the past. If you are relying primarily on Social Security to carry you through retirement, you are (a) counting on a very short retirement, (b) counting on a very grim retirement, (c) fooling yourself, or (d) all of the above. Suffice

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it to say that planning to make Social Security the cornerstone of your retirement isn't really planning at all.

Corporate Pension Plans Are Going the Way of the Hula Hoop

Remember hula hoops? They were all the rage back in the early 1950s among hip-swiveling young baby boomers. But within a few years, sales of these plastic novelty items fell from the millions to perhaps a few thousand a year, and today the few remaining hula hoops are little more than nostalgic relics of a more innocent era.

Well, the trajectory has been similar, though not nearly as short-lived, for defined-benefit pensions. These are the types of pensions most of us think of (or used to think of) when we hear the term *pension*—that is, one in which the company puts money into an investment fund and, regardless of the performance of the investments, promises to pay you a monthly check for life based on how many years you worked at the company and the size of your salary. Often, after putting in twenty-five or more years at a company, retirees could walk away with pension benefits that guaranteed them upward of half of their salary.

As these types of pension plans were nearing their peak in the late twentieth century, the seeds for their demise were being sewn. For one thing, companies began to realize that with this type of pension they could be on the hook for much bigger liabilities than they'd expected. After all, with more and more people living well into their nineties or even hitting the century mark, companies could end up making monthly payments for thirty or forty years, if not longer, to retirees who stubbornly refused to die. Many companies began to decide they were better off shutting down their defined-benefit plans or at least not starting any new ones. As a result, the number of company-funded pensions fell from 114,000 in 1985 to about 31,000 today, a drop of more than 70 percent.

The old pension arrangement where the company funded the plan and you were guaranteed a monthly check for life is rapidly becoming a vestige of a near-obsolete system. If you are

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lucky enough to work for a company that still provides such a plan, that's great. But that's not the case for most of us, which means that for the majority of Americans that second leg of the retirement stool has gotten a lot shorter.

More than Ever Before, the Onus Is on Us to Save and Invest for Our Own Retirement

With the first two legs of that three-legged retirement stool contributing less to our retirement security than in the past, we now have to rely more than ever before on that third leg: personal savings.

Fortunately, even as traditional defined-benefit pension plans have been disappearing, most of us have had access to a growing array of other types of retirement savings plans. At the top of the list are defined-contribution plans such as 401(k)s, which allow you to contribute a percentage of your salary before taxes into a variety of investments, typically mutual funds. In many cases, employers will match a portion of what you put into the plan. These are called defined-contribution plans because in accordance with federal pension law the plan stipulates, or defines, how much you can contribute to the plan. No guarantees are made about the benefits the plan will pay, however. Which makes these plans the mirror image in a sense of the defined-benefit plans discussed above, where it was the benefit payment that was defined, while the employers' contribution could change depending on the performance of the plan's investment assets.

401(k)s and other types of plans require us to take on a much bigger role than ever before in planning for retirement in two specific and crucial ways.

First, you've got to take the initiative to put your money into these plans. If you contribute only a small percentage of your salary to your 401(k) plan, then you will have only a little bit of money at work for your retirement. If you don't contribute any of your salary, then the plan is absolutely no help to you at all.

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Even in the cases where the employer is willing to kick in some contributions to the plan, those contributions are matching contributions.

Those who are willing to stash away money in these plans, however, got a big break in a piece of legislation known as the Economic Growth and Tax Relief Reconciliation Act of 2001, or more simply the 2001 tax bill. In addition to phasing in cuts in marginal income tax rates, this bill dramatically increased the amount of pretax dollars we can stash away in virtually the entire panoply of retirement savings plans not only this year but stretching out into the future. Those higher contribution allowances, plus other modifications that make it easier to keep tabs on your retirement savings when you switch jobs, have made everything from 401(k)s and 403(b)s to SEPs, Keoghs, and traditional IRAs even more effective retirement savings tools than they were before.

People who are willing to save and invest for their own retirement also got some help from an even more recent change in the tax laws—namely, the Jobs and Growth Tax Relief Reconciliation Act of 2003. This tax bill provided a number of goodies. For one thing, it accelerated across-the-board income tax cuts that had already been enacted in the 2001 tax bill but were not scheduled to kick in until 2006 or later. Result: As of 2003, the top income tax rate immediately dropped from 38.6 percent to 35 percent. But the bill also lowered the tax rate on capital gains—dropping the maximum from 20 percent to 15 percent for gains realized after May 6, 2003—and lowered the tax on most dividends by making the tax rate on dividends the equivalent of that on capital gains. This created a huge cut for many investors, lowering the maximum rate on most dividends from 38.6 percent to 15 percent in 2003. Of course, many lower-income investors will pay lower rates on capital gains and dividends than the newly reduced maximums I've mentioned here.

I'll be the first to admit that both the 2001 and the 2003 tax bills contain a number of squirrely provisions that undermine their effectiveness and make planning more difficult. The

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lower tax rates on capital gains and dividends in the 2003 bill tax cuts, for example, revert back to their earlier higher rates in 2009, while the lower income tax rates initiated by the 2001 bill and accelerated by the 2003 bill revert to their older higher levels after 2010—unless Congress votes to keep the lower rates. But even if the relief is only temporary, lower income tax rates still mean less money going into the government's coffers, which leaves more money available to you for retirement saving. Similarly, the less of your investment gains you have to share with the government, the faster your money can compound and the larger a retirement nest egg you can grow with the same amount of savings. And for those of us who like to believe that reason and sound judgment will ultimately win out (and feel that we need every edge we can get when it comes to retirement planning), there's always the chance that Congress will make these tax cuts permanent.

In light of these changes, you'll want to reevaluate your investing strategy to make sure you're getting the maximum possible benefit of the new rules both in terms of the types of investments you buy and which ones you hold in tax-advantaged versus regular taxable accounts. We'll get into that in the investment discussions in Chapter 6. It's important to keep in mind, however, that *no* revisions of the tax laws will change this basic fact: The extent to which you can create a sizable nest egg for retirement these days increasingly depends on how much of your salary you are willing to save today.

Second, you've got to assume responsibility for investing whatever you save. In the old company-funded defined-contribution plans, you didn't have to concern yourself with how the money was invested. The company hired one or more professional investment advisers to deal with questions such as how much of the plan's money should be invested in bonds and how much in stocks, as well as what kinds of each.

But in the world of defined-contribution plans and IRAs, *you are the investment manager*. You've got to decide how much of your money should be in bonds or bond funds, and what

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kind. You've got to figure out how much to put in stocks or stock funds, and what kind. Which brings us to the final financial change . . .

The Stock Market Isn't as Sure a Thing as It Seemed During the Go-Go '90s

Back during the late great bull market of the 1990s, investing seemed so easy, so simple, so lucrative. All you had to do was put your money in a few high-flying tech stocks—AOL, Cisco, you name it—or pick one of the dozens of top-performing growth-stock mutual funds, and bingo! Your money doubled or even tripled in a matter of a few years. One unfortunate result of that period of what appeared to be easy money is that we got the impression that we could rely on annual returns of 15, 20, even 25 percent or more a year. We came to believe that we could actually earn such high returns without risk. All gain, no pain! And this attitude in turn gave us the erroneous sense that saving isn't the key to achieving a secure retirement, smart investing is. After all, if you can earn high returns on your money, you don't have to save as much to accumulate a sizable nest egg.

Let's say, for example, you're forty years old and want to accumulate \$500,000 by age sixty-five. Well, if you could count on annual returns of, say, 15 percent year after year, then putting away just \$180 a month would get you to your goal. (For simplicity's sake, I'm ignoring taxes here.) But what if it turns out that 15 percent is unrealistic and that you really shouldn't be counting on more than, say, an 8 percent return on a regular basis? Then to have a shot at accumulating \$500,000 by the time you hit sixty-five, you would have to put away more like \$550 a month—or *three times as much*.

Neither I nor anyone else knows for sure what returns the financial markets will deliver in the years ahead. But I think it's become pretty clear now that the blimpish returns of the late '90s were an anomaly, little more than a crazy outgrowth of the whole dot-com, New Era, irrational-exuberance phase the country went through. It would be flat-out irresponsible to base one's retirement planning on those kinds of returns. I think

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most people are resigned to that reality. But what I don't think has necessarily sunk in is the fact that *lower returns mean we've got to save more money to reach the same retirement goals.*

So, financially, we've got two attitude adjustments to make. First, we've got to become a lot more realistic about how much money we've got to put away on a regular basis in 401(k)s, IRAs, and other accounts if we want to attain a reasonably secure retirement. In other words, the stock market isn't going to save us from our poor saving habits. And assuming we make that adjustment, we've then got to get the investing part right, which in and of itself requires a delicate balancing act. After all, if you invest too timidly and plow all your money into "safe" investments such as bank CDs and money market funds, your retirement stash might not grow large enough to fund the living style you aspire to for your golden years. Invest too aggressively and you may find yourself in the position many retirement investors found themselves in after the stock market collapsed in early 2000, with the value of their retirement savings cut by 20, 30, even 50 percent or more and faced with having to rethink their retirement plans or even postpone them indefinitely.

So, the financial changes I've outlined above clearly constitute more than a subtle new twist in the ways we plan for retirement. We're talking about radical change that requires an entirely new mind-set in the way we plan for retirement in the future, as well as new strategies.

Lifestyle Changes in Retirement

At the same time financial changes have been altering the face of retirement planning, so too has the very way we think about retirement undergone a dramatic shift. And to make realistic financial decisions about the future, you've got to take these lifestyle or demographic changes into account as well.

We Are Living Longer than Ever Before

Today a sixty-five-year-old man in decent health can expect to live another twenty years or so, or until age eighty-five, and in

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many cases much longer. In fact, a sixty-five-year-old man today has about a 13 percent chance of making it to age ninety-five and a 4 percent chance of living to one hundred. And women can expect to live even longer on average than men.

All of which means that unlike in even the relatively recent past, when retirees might have spent ten or fifteen years in retirement before checking out, today it's not uncommon for someone to spend twenty, thirty, or even forty years in retirement. In other words, many people may spend as much time in retirement as they did in their careers. If you'd like to get an estimate of your life expectancy that factors in such variables as your family medical history and lifestyle, check out the Longevity Game in the Calculators section of the Northwestern Mutual website at www.northwesternmutual.com. (If your sense of humor runs to the macabre, you might want to check out the Death Clock—www.deathclock.com—which purports to predict the *exact day* of your demise, based on one of four scenarios you choose: optimistic, normal, pessimistic, or sadistic.)

We're Far More Active During Retirement than Previous Generations

Far from being a time to disengage from life, today's and future generations of retirees will likely see this as a new stage of life: a time for exploration; an opportunity for continued personal growth; a chance to try new sports, hobbies, and activities, to spend time with family, and to set and achieve new goals. In short, today's retirees are not going gently into geezerhood. They may play golf, bingo, and shuffleboard, but you're also likely to find them making pottery, teaching reading to disadvantaged kids, running charities, writing books, registering voters, running for public office, shooting hoops, playing baseball, surfing—both the Net and the Banzai Pipeline at Ehukai Beach Park in Oahu—and returning to college.

The Paychecks No Longer Stop at Retirement

In the mid-'80s through the early '90s, labor economists began to notice two unusual developments. First, the labor force par-

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participation rates for people sixty-five and older, which had been steadily declining since World War II, began slowly climbing upward again, rising from 11.8 percent in 1990 to 12.8 percent in 2000, while the Bureau of Labor Statistics projects it will hit almost 15 percent by 2010. What's more, the lines between work and retirement were no longer so distinct. Instead of going one day from work to no work, people began making a gradual transition from the workaday world into retirement, often taking on transitional positions or "bridge jobs" that essentially allowed people to ease their way from their careers into retirement.

But the shift in how people view the relationship between retirement and work has been even more profound. People no longer see the two concepts as mutually exclusive. Although it may seem like an oxymoron, you can work yet still be retired. Indeed, *rehire* may be a better term than *retire* to describe what many people plan to do after calling it a career. When the Gallup Organization polled one thousand nonretired Americans in 2002, more than 80 percent said they planned to work in retirement.

The Retirement Squeeze

Longer life spans and changes in the way we live after leaving our careers make retirement a much more stimulating, challenging, and enjoyable time for us, almost like a shot at a final adventurous journey. But living a longer and more active life than past retirees also means that we're likely to need more money to fund this phase of our lives than previous generations of retirees required.

The style we can afford to live in during retirement comes down to how much we save and how well we invest before we retire. It's really that straightforward. We'll get some help from the government and some help from our employer. But in the final analysis, our actions will determine how comfortable or how grim a retirement we will have.

There are many who haven't faced up to this new reality.

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Consider the following findings from recent surveys of American workers:

- Less than two-thirds of workers have tried to calculate how much they must save and accumulate for a comfortable retirement.
- Nearly half of workers have saved less than \$50,000 for retirement, and 15 percent have not saved a single cent.
- More than 50 percent of preretirees underestimate their life expectancy.
- Some 40 percent of Americans are counting on the lottery, sweepstakes, getting married, or an inheritance to fund their retirement.

Some people look at statistics such as these and predict that many Americans are headed for a retirement disaster, a version of retirement where the years are more grim than golden. And I'm sure that for many people—especially anyone whose idea of retirement planning is playing the lottery—that will be the case.

But it doesn't have to be that way. Once you understand the new ground rules for retirement, you can create a plan that makes the most of whatever financial resources you have and the retirement-planning tools that are available to you. We will get into the nuts and bolts of that plan in the following chapters. But to get you off to a good start on your retirement-planning journey, I want to suggest that you take a few cues from Dorothy's traveling companions in *The Wizard of Oz*: the Tin Man, the Scarecrow, and the Cowardly Lion.

Start with Your Heart

The Tin Man, as you'll recall, accompanied Dorothy on the trip to Oz because he wanted to ask the Wizard for a heart. He wanted not just to live life but to experience it with emotion and passion.

So what does this have to do with your retirement planning? Well, I think you'll improve your chances of creating a plan and following through with it if you incorporate some pas-

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sion and emotion into your vision of retirement. In all likelihood you will be spending the last twenty or more years of your life in retirement, so you ought to give plenty of thought ahead of time to how you would like to spend those years. What is likely to challenge you, to excite you, to keep you interested and engaged in life?

Finances aside, it's also critical to think ahead about your retirement lifestyle because you are likely to feel more happy and fulfilled after leaving work if you are making a transition into a life that you have planned and looked forward to. A variety of studies show that retirees who have actively planned for the kind of life they will lead after their careers have a greater sense of control over their lives and tend to enjoy life more than people who simply face retirement without having thought or planned ahead.

So take a few days or weeks to think about how you would like to spend your retirement. And then over the years before you retire, do what you can to make sure those plans are realistic.

Rely on Your Brain

Your heart can help you decide on the kind of life you want to live in retirement, but you're going to have to rely on the old mental processor to put together a plan that will get you what the heart desires. In short, you're going to have to put some thought into such issues as how much you should be saving, how you should be allocating your assets between stocks and bonds, and what stocks, bonds, or mutual funds you should be buying with your retirement savings.

That said, I know that many people are a bit intimidated by things financial. They're worried that they'll make lousy investment decisions or otherwise screw things up and put their retirement savings in jeopardy. But you don't have to be a financial whiz to make reasonable financial decisions for your retirement. Remember in *The Wizard of Oz* how the Scarecrow lamented that his life would be so much better if he only had a brain? Despite that plea, it was the Scarecrow who invariably

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came up with the best ideas whenever Dorothy and her friends needed to get out of a jam. He actually had the brains all along.

Well, in my experience the same thing is true for most of us when it comes to creating a retirement plan and investing our retirement savings. You don't have to be an Einstein. If you are a reasonably intelligent person capable of making reasonable decisions, you should have no trouble creating and executing a retirement plan. Which is to say that anyone who's successfully managed to do things such as raise a family, hold down a job, and have normal social relationships with other human beings probably has more than enough innate skills for retirement planning. In fact, I'd say the bigger danger comes when people become convinced that they know so much that they've got this investing thing licked. That's when overconfidence rears its head and you find people making lousy planning and investing decisions, as many did by pouring too much of their retirement savings into risky tech and dot-com stocks during the '90s. If you're willing to put a little thought and effort into learning the fundamentals of retirement planning and mastering the basics of investing—and you're willing to set your emotions aside long enough to make your financial decisions in a sober, clear-headed way—you have more than enough brain power to create a successful retirement plan.

Show Some Courage

Here, I don't mean courage in the sense of bravery, which is what the Cowardly Lion was seeking (unnecessarily, as it turns out) in *The Wizard of Oz*. I'm referring to discipline, willpower, and having the courage of your convictions to set a plan and follow it through.

Now, that may sound simple. But in many ways this is the hardest part of retirement planning, something that can't be taught but that each of us must somehow pick up on our own. I'm talking about having the discipline to forgo some treats or indulgences in the present so that you will be able to save for the future. I'm talking about having the willpower to continue your plan to put the maximum percentage of your salary into

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your company's retirement savings plan when you would rather use the money to buy a new car. I'm talking about keeping your hands off your 401(k) when the balance has grown big enough so that you think maybe it wouldn't hurt to take a few thousand bucks out to pay for a nice, no doubt well-deserved vacation to Europe. And I'm talking about having the willpower when you leave a job to roll over your savings plan balance into an IRA account or into your new employer's plan, rather than simply taking a lump-sum payment and blowing the money, or at least that part of the money that's left after paying taxes and a 10 percent penalty to Uncle Sam.

Okay, so now that we've got the lay of the new retirement landscape and we understand the new rules of the retirement-planning game, let's move on to what you need to know so you can create a plan.