T. Rowe Price's Core Retirement Planning Principles

Seventy-six million American baby boomers with unprecedented personal wealth are likely to retire over the next 20 years. But the extraordinary market turmoil of 2008 and 2009 has shaken the confidence of even experienced investors as they attempt to position their investment portfolios to generate withdrawals over a retirement that could last 30 years or longer.

For decades, T. Rowe Price has been helping investors develop effective strategies to save and invest for retirement. Drawing on this extensive experience, a group of senior financial planners and investment professionals recently developed the first comprehensive outline of the firm's basic approaches to retirement planning at all stages of life.

For those saving for, approaching, or already in retirement, these core principles can serve as a general road map to potentially achieve greater retirement security.

"Investors are understandably anxious about the investment decisions they're making under these volatile market conditions," says Christine Fahlund, a senior financial planner at T. Rowe Price.

"These core principles can help investors develop sound financial plans that could help them provide an adequate stream of income in retirement."

Understanding Risks

Even savvy investors with large nest eggs are vulnerable to multiple risks that could undermine their retirement security.

"Each of these risks could force you to withdraw more money in retirement than you expected, resulting in significant shortfalls and lifestyle changes if you're not prepared," Ms. Fahlund cautions.

So understanding and managing the following basic risks are vital to successful, long-term planning:

- **Inertia:** Many investors prefer to delegate complex financial decisions or avoid them entirely. Too often, this results in having no financial strategy or in following an inappropriate strategy, both of which can leave investors unprepared for retirement.
- **Financial Shortfall:** According to the American Society of Actuaries, more than half of married couples retiring today at age 65 will have one spouse live to age 90, and almost one in four will have a spouse reach age 95. Investors who don't plan for longevity—a retirement lasting 30 years or more—face the risk of running out of money prematurely.
- **Inflation:** Although inflation has averaged just 3% annually over the past 80 years, the purchasing power of $100 at this rate would be cut in half in just 23 years. And the inflation rate for some goods and services, such as medical care, has been rising faster than the average.
- **Volatility:** As recent events have clearly shown, stock market fluctuations can have a big impact on retirement portfolios. Investors retiring into a bear market, for example, could face long-term issues when it comes to sustaining retirement income. Just as they start taking withdrawals from their portfolio, those assets are losing value—resulting in a double hit to their savings.
- **Health:** Even average health care expenses can quickly deplete retirement savings without proper planning and insurance. According to the Employee Benefit Research Institute, a couple retiring today can expect to spend $295,000 on health care insurance premiums and out-of-pocket medical expenses. Investors preparing for retirement should consider purchasing "Medigap" insurance to protect against unexpected catastrophic medical expenses that may not be covered by Medicare. The purchase of long-term care

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insurance also should be investigated early in the planning process.

- **Taxes:** Massive monetary and fiscal stimulus efforts have resulted in huge budget deficits, adding to already large government debts. At some point, all levels of government may consider tax increases, leaving retirees with potentially higher tax obligations.
- **Behavior:** Saving at an inadequate rate or spending excessively in retirement both can have a big impact on the long-term sustainability of assets. Even a small increase in annual withdrawals in retirement could dramatically reduce the number of years that retirement assets ultimately last.

"It wasn't all that long ago that some pundits were arguing that Americans were saving too much for retirement," Ms. Fahlund says. "However, recent events have highlighted all too clearly the risks of saving too little and underscored the importance of a prudent, long-term savings and investment strategy."

Saving Guidelines

Unlike college planning, there are no student loans or scholarships available for retirement income. As a result, investors should put retirement saving ahead of shorter-term goals like a lavish vacation or a grandchild's education.

For younger investors, 30 or 40 years of compound growth potentially could make a big difference at retirement.

For older investors, a healthy savings base could provide a cushion for the unexpected—like health emergencies—and provide some measure of financial independence.

When it comes to saving, there are a few basic considerations:

- **Savings rate:** In an effort to maintain their preretirement standard of living in retirement, investors should save 15% to 20% of their annual incomes beginning at age 25. Savings may include defined contribution plan deferrals, employer contributions to such plans, and personal savings and investments outside of employer-sponsored retirement plans. The earlier savings begin, the easier it should be to meet retirement goals.
- **Tax-deferred investing:** Pretax dollars invested in employer-sponsored retirement plans or individual retirement accounts (IRAs) offer investors the potential to earn tax-deferred dividends, interest, and capital gains on investments. In addition, Roth IRAs and Roth subaccounts in 401(k) plans are funded with after-tax dollars but have the advantage in most cases of distributing tax-free income in retirement. Many retirement plan participants age 50 and older are eligible to make catch-up contributions to their 401(k) plans—as much as $5,000 beyond the statutory limit ($16,500 in 2009) or the plan's annual deferral limit.
- **Cash reserves:** Because emergencies can happen at any time, investors at every stage of life should create a separate cash reserve account sufficient to pay at least three to six months' worth of living expenses. Investing this money in relatively low-risk money market or other stable investments can help maintain the principal. Keeping it in a separate account minimizes the temptation to tap the funds for nonemergency expenses.

Income and Expenses

What will the good life cost in retirement?

A careful inventory of potential retirement income sources and expected expenses is essential for effective planning, as follows:

- **Income needs:** Some expenses, such as retirement savings, mortgage payments, and payroll taxes, may diminish or disappear during retirement, allowing retirees to enjoy a similar standard of living on a smaller gross income than what was required before retirement. We suggest that retirees plan on replacing 75% of their preretirement income during retirement.
- **Income sources:** Social Security may replace about 20% of preretirement income (based on

current maximum Social Security benefits at full retirement age) and another 5% may come from part-time work or pension benefits. This leaves about 50% to be replaced by personal savings, which can include defined contribution plan accounts; savings accounts; and such taxable investments as stocks, bonds, and mutual funds.
- **Future expenses:** Consider the costs of essential goods and services, such as food, clothing, housing, health care, and debt service. Next, account for lifestyle or discretionary expenses like travel, entertainment, and hobbies. If expenses exceed income, make some adjustments, looking first to trim discretionary expenses before moving on to the more difficult task of reducing essential expenses.

Closing the Gap

All too often, investors near or at retirement find that their expected income is likely to fall short of their expenses. While there's no magic solution to this problem, there are several ways to help close the gap. A few of the simpler strategies to consider:

- **Delay Social Security:** For each year of delay from age 62 to 70, Social Security benefits increase 7% to 8% with additional annual increases to adjust for inflation.
- **Work longer:** Additional years of savings and the potential for compounded returns on investments reduces the total number of years during which retirees will need to draw income in retirement.
- **Supplement income:** A part-time job can make a big difference. Earning $20,000 a year in the first five years of retirement, for example, is the equivalent of having saved $100,000 more.
- **Reduce withdrawals:** If possible, investors retiring into a bear market should consider holding constant their withdrawals from retirement savings for a few years or even cut back on their withdrawals, at least temporarily.
- **Cut expenses:** Retirees should consider cutting back on discretionary expenses like travel and entertainment. If that's still not enough, downsizing a home and relocating to a lower-cost region may be options.

Asset Allocation

Diversifying a retirement portfolio among stocks, bonds, and short-term investments can help mitigate the effects of short-term market volatility, while offering the long-term growth potential necessary to sustain income throughout retirement. Broad diversification within asset classes can further help reduce the overall effect of negative performance from one stock or sector.

Here are some of the key considerations for appropriate asset allocation and diversification:

- **Time and volatility:** A suitable asset allocation strategy depends both on the time available before the assets will be needed and the number of years that the assets will be relied upon for withdrawals in retirement. In general, a 25-year-old investor with 40 years before retirement can likely afford to take greater market risk in his or her portfolio, counting on the longer time period to smooth out the short-term volatility. Older investors nearing or in retirement should consider a larger allocation to bonds and short-term investments in order to better safeguard their savings.
- **Balance risks:** While the long-term growth potential of equities can help reduce the chance of running out of money prematurely, bonds and short-term investments can help to insulate retirement portfolios from excessive short-term market volatility. However, apart from cash reserves intended to address unexpected contingencies, our research shows that too large of an allocation to cash can significantly reduce the chances that assets will last throughout retirement.
- **Maintain equities:** Only equities have historically provided the growth potential necessary to generate income, preserve purchasing power, and provide a cushion for unexpected expenses during a retirement that could last at least to age 95. Younger investors can benefit from the superior long-term growth potential offered by stocks over time. Although older investors may be more attracted to less-volatile bonds and stable value investments, their lack of long-term growth potential relative to stocks could reduce the size of the financial "cushion" available to meet unexpected future expenses.
- **Dynamic allocation:** Over time, investors must adjust their allocations to stocks, bonds, and other investments to reflect reduced ability to absorb volatility risk, while at the same time maintaining sufficient growth to provide protection against shortfall risk. For example, investors might consider a glide path approach in

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which 90% of assets is invested in equities for those at least 25 years from retirement, 55% at retirement, and 20% 30 years after retirement. This strategy is designed to offer growth potential, support withdrawals over a 30-year retirement, and provide age-appropriate exposure to market risk before and during retirement.

- **Rebalance regularly:** Periodic rebalancing—on an annual basis, for example—can help keep an investment strategy on track to provide long-term growth and sustainable income. If equities decrease in value, for example, investors can bring their portfolios back to their target allocations by reducing their allocation to bonds and purchasing stocks or by simply investing any new contributions in stocks until the overall portfolio regains its target allocation. Savvy investors also can combine the withdrawal process with the rebalancing process by withdrawing from an overweighted asset class to bring the allocation back in line.

Life Stages

Lifestyle choices, family obligations, and medical needs are as unique as the people who face them—and can change over years or overnight.

"Every investor should know and understand the basic retirement planning strategies, but at the same time no two investors are alike," Ms. Fahlund says. "Therefore, retirees should adopt strategies that are flexible enough to meet their individual needs and circumstances."

Among these strategies:

- **Early career:** For younger workers, budgeting, saving, and investing for retirement are probably not top priorities. However, those who start a savings plan early enough may have decades of compounded growth before retirement, resulting in significantly greater assets at retirement than those who start saving later in their careers.

  "Bear markets provide real opportunities for younger investors," Ms. Fahlund says. "Depressed pricing means they can accumulate more shares of equities that could grow and benefit them greatly in retirement."
- **Mid-career:** This is typically when workers start to reap the benefits of job experience and seniority through increased salary and benefits. Although income may well be higher, expenses also are likely to have increased due to larger families or increased child care expenses, for example. But even with these competing expenses, it's vital to continue putting money aside for retirement while there is still sufficient time to benefit from tax-deferred growth and compounding.
- **Late career:** These are usually the peak earning years. Just as important, expenses may be lower than in the mid- or early careers: Children may be grown and starting their own careers, while mortgages are either paid off or getting close to it. Some of the extra money can be put aside for retirement by increasing savings rates and taking advantage of catch-up contributions in retirement plan accounts.
- **In retirement:** After years of working, saving, and investing, retirement is finally a reality. It's time to withdraw from savings to generate a reliable income stream that has a solid chance of lasting throughout retirement. In the first year of retirement, retirees should typically plan on withdrawing 4%

of their investment portfolios—and increase that amount each year thereafter to keep up with inflation. Both investments and withdrawals should be reviewed annually.

Another key aspect of ensuring that savings last throughout retirement is determining which accounts to draw from first. Retirees should generally tap taxable accounts first, followed by tax-deferred accounts, and then tax-free accounts.

Every retiree is sure to face some relatively predictable expenses, such as food, housing, insurance, utilities, and taxes. To the degree that Social Security or pension benefits do not provide enough income to cover these nondiscretionary expenses, investors could consider an annuity or other insurance product designed to provide guaranteed income that escalates or is adjusted for inflation annually throughout retirement. At the same time, it is important to maintain a well-diversified investment portfolio to take advantage of growth opportunities.

For many investors, these core principles are only a beginning from which they may want to develop more detailed plans.

"If you're not prepared with a good financial strategy," Ms. Fahlund says, "your lifestyle in retirement could be lower than what you'd dreamed it would be. By adopting these core principles, investors can go a long way toward building prudent financial plans."

For more information about retirement planning, including how to order the T. Rowe Price Retirement Readiness Guide and Retirement Savings Guide, please go to ***troweprice.com/retirement****.*