COOPERATIVE EXTENSION SERVICE

VIRGINIA POLYTECHNIC INSTITUTE AND STATE UNIVERSITY

Blacksburg, Virginia 24061

MID-LIFE PLANNING FOR RETIREMENT

Letter 2

V.P.I. & S.U. LIBRARY

AUG 7 1978

BLACKSBURG, VIRGINIA

Dear Pre-retirees:

In letter one we discussed pensions and social security as the sources of retirement income. The effects of retirement on employee benefits were also discussed.

Income for retirement can also come from sources such as annuities, savings accounts, certificates of deposits, U.S. Savings Bonds, Government bonds, municipal bonds, common stock or preferred stock. Each of these has its own advantages and disadvantages as a method for investing retirement funds. Wiser decisions can be made when we have some knowledge of each of these. Only when we understand the nature of each can we know whether each one will find a need in our own savings and investment program.

Savings and investments need to be part of a total picture of our finances. The amount of money we need in our personal situation in life and the effects the economy has on us at any particular time are all part of the general picture.

One guide used frequently, as to the amount of money, is that "60-75 percent of pre-retirement income is needed to maintain the same standard of living after retirement as before retirement."

Of course, there are many, many factors that affect our personal situation. Two of the biggest financial ones are the change in income and expenditure patterns during the last few years before retirement. For the average family income from employment continues to increase up to about age 60 and then begins to drop. For most families, children become financially independent several years before parents retire. This allows a period where income may continue to rise at the same time that family expenditures may decrease. Of course, your particular family's situation may not fit this "average." Whether it does or not you can't afford to wait until a few years before retirement to start saving for retirement.

MHM: 147

The Virginia Cooperative Extension Service by law and purpose is dedicated to serve all people on an equal and nondiscriminatory basis.
An Equal Opportunity/Affirmative Action Employer

An Educational Service of the Virginia Polytechnic Institute and State University, Virginia's Land-Grant University, with U. S. Department of Agriculture and Local Governments Cooperating

The economic situation changes rapidly and the effect it has on individuals varies greatly. Probably the best way to protect ourselves against inflation is through certain investments. Hopefully, this series is reaching you early enough that you can balance your savings and investments between those that give some hedge against inflation and those that give a fixed rate of return.

What Types of Savings and Investments Fit Into Your Plans?

Defining your goals is imperative. How much? What is the amount of capital that you will try to accumulate? Maybe this is not the usual way to approach a savings goal but it has its advantages. How much capital will you need for a good retirement income? How will you reach this goal? The first step may be as simple as "having ten dollars deducted from your pay check for credit union shares." It's important to set your goal and list the steps to take to reach that goal.

Time is of essence and a most rewarding resource in reaching your goal. Time is money. The earlier you begin to save, the less you will need to save, or the more interest you will accumulate on less savings from your present income. Time and the compounding of interest is a forcible factor.

There are several ways to look at time in relation to money:
--$50 invested at 6 percent, compounded annually will become $100 in 12 years. You can compute the approximate number of years it will take your savings to double by dividing the annual interest rate into 72. 72 divided by 6 percent = 12 years. If you have a higher rate of interest such as 7.5 percent on a certificate of deposit, or if interest is compounded daily or quarterly the original amount will double much sooner.

--$10 invested today at 6% will be $32.07 in 20 years (1977). If you wait 10 years to invest the $10, you will have only $17.90 in 1997.

--Yet another way to compare is by age.

At age 40, $5 invested at 6% = $17.90 at age 60

At age 50, $10 invested at 6% = $17.90 at age 60

. . .For one more thought: at age 40 a person invests $10 each month at 5% a year compounded quarterly, at age 55 you can start drawing out the same amount each month and still have $2,955 in the account at the end of 15 years of withdrawals! Substitute $100 per month in the plan and at age 75 you will still have $29,553.74 in the account. Saving $50 a month and putting it into an investment paying 7.5% would get you to the same goal.

These plans do not take income tax into account, so you may need to consider alternatives to delay paying taxes until after age 65.

Before we get too far along with the investment of our savings, let's raise some flags to be examined. Let's understand some truisms. The ideal investment is nonexistent. If it did exist, it would have four characteristics: First it would be completely safe from loss; second, it would be liquid, that is, readily convertible into cash; third, it would return a high rate of interest or dividends; fourth, its return would keep pace with inflation. No type of investment has all these characteristics. In general, those that provide the greatest safety and liquidity of the investment, the smaller the rate of return.

Each source of savings should be selected because of the role it plays in your over-all plan. What is the purpose and how will it help you to balance your savings between those that provide a fixed return and those that will provide some protection against inflation.

Sources for Investments

Regular passbook

A passbook savings account is easy to establish and convenient to use. It is a method for storing money to be used for short term goals or emergencies. The passbook savings account is a good place to store money that will be needed to pay taxes, insurance, small emergencies or until enough funds are accumulated to invest in other types of investments. Savings in such an account are insured up to $40,000. This type of savings is not a hedge against inflation. There are other sources that are as safe and yet pay a higher rate of interest.

Savings Certificate

A savings certificate available at banks and savings and loans is an investment-type means of saving. The minimum cost of a savings certificate is $100. It is an appropriate investment if one plans to use the money 1 to 6 years after the purchase of the initial certificate. Interest rates range from 5½ to 7 3/4 percent. The longer the investment period and the larger the investment, the greater the rate of interest. If the certificate is cashed before the maturity date there is a penalty. The rate of interest drops back to passbook rate and one quarter's interest is forfeited. However, this should not be a disadvantage. You can borrow up to face value for 1 or 2 percent more than the rate of interest the certificate pays. For example: On a $5000 certificate paying 7½ percent, you can borrow $2000 at 8½ or 9½ on the unpaid balance of the loan. That's a good credit deal! And you can be better off in the long run as you are still earning money on savings and obtaining a low interest rate loan.

Funds are insured up to $40,000 for each account. Two people can have $120,000 of insured certificates by using individual names for each $40,000 and both names for $40,000 worth of certificates.

Some financial institutions pay passbook savings rates on the interest earned on certificates and others pay the same rate on the interest accumulated as the interest on the certificate. Again, it pays to shop around.

The real disadvantage of certificates is they do not hedge against inflation and there is no income tax advantage.

Credit union shares

Credit Unions have the advantage of pay roll deduction for savings and loan payments. This is the easiest way to save. Credit Unions are good places to keep money to be used for taxes, insurance, vacation, Christmas, or to accumulate funds for other investments, but offer no protection against inflation. Funds in Credit Unions usually are covered by insurance against loss, up to $40,000 for each account.

U.S. Savings Bonds

U.S. Savings Bonds can often be bought through pay roll deductions. An $18.75 bond will mature to a $25 bond in 5 years and 10 months. Each is bought at 75 percent of its face value. A $100 bond is purchased for $75. If these are held to maturity the rate of return is 5½ percent. If they are cashed within a year of purchase, the rate drops to 4 percent. No state or local tax is assessed against the interest on U.S. Savings Bonds. Federal income tax must be paid, but it can be delayed by exchanging Series E for Series H type. The tax then becomes due when the Series H Bond matures. This can be particularly advantageous if one were to reach 65 or to retire at a lower income before the Series H Bonds mature. U.S. Savings Bonds do not give any protection against inflation.

What Are Your Goals - Again?

Beyond the simple types of savings listed above and annuities, (discussed later), the sources for investments become more complicated. However they are not difficult to understand if you will take time to learn about each one. Remember, time required for learning is as valuable as money. Too, the more complicated ones give more protection against inflation.

As you begin to accumulate for retirement you need to time your investments for growth of capital income or a combination. Persons in their 40's should be looking at growth type investments. Growth occurs when the capital increases, as has been true of more real estate, common stock (growth stocks), and your own business. Income producing investments are bonds, some common stocks, and certificates of deposits.

As retirement approaches, some funds in growth investments can be switched to income producing investments. All of these decisions need to be made in light of the rate of inflation at the time of retirement.

As the economy changes, the rates of return on specific types of investments change also. So once you have made a decision, it needs to be re-evaluated periodically. The rates of interest on certificates of deposit have changed recently. Government bonds are not bringing as high rate of interest as a year ago. So, keep abreast of what is happening to your investments. Don't marry them for better or worse; be willing to switch when economic situations change.

Municipal Bonds

Municipal bonds are sold by local or state governments, through brokers, to raise money. The interest on these bonds is not taxable. However, unless the investor in such bonds falls within the 30% or greater income tax bracket, the tax exemption is essentially of little or no advantage. The tax bracket is figured on the highest rate you pay, not on the percentage of your income.

Bonds are issued with maturity dates that may be for 10 to 30 years. The owner collects the face value at maturity. The interest is paid on an annual basis. Bonds can be bought at a discount, thereby increasing the yield. A $1000 bond bought at $900, with an interest rate of 7 percent, will yield 7.7 percent. While the bond can be bought below or above face value, raising or lowering the effective interest rate, it does not provide a hedge against inflation.

Common stock

Stock represents a share of the ownership where bonds represent a loan to the government or a company. The interest on loans (bonds) must be paid to the holders before profits are paid to the stock holders (owners) of the company. There is a very distinct difference between owning bonds and stock, but unless you have money to burn, literally, you will buy stock in companies with solid records. Thereby your money is comparably safe.

Remember there is no perfect investment tool and those that provide growth potential also carry a degree of risk. Yet, there are 100's of good companies from which to choose. Many have 100 years of unbroken records of paying dividends. There is an element of risk, but you won't lose all your money.

You will stand a better chance to gain than to lose if you:

1. Keep a fund in liquid assets for emergencies. Do not put "life" money into stocks.

2. Establish guidelines. Most books on investments will be useful in helping you to select your own guidelines.

3. Establish your investment plan. What is your goal? Perhaps you will need $200 a month, $2,400 a year. An investment of $40,000 at 6 percent, $50,000 at 5 percent, or $30,000 at 7½ gives you a target.

How much income? How much growth do I need to build into my plan?

4. Know what you're buying. Don't take someone's word-dig out the facts. There is no lack of information about quality stocks in the security manuals at stockbrokers' offices, public libraries and many banks.

5. Be patient and invest gradually. Invest in the stockmarket, don't speculate. Investing a certain amount each month or quarter buys some shares at low periods and some at high periods. This gives you the advantage of averaging the cost, called "dollar averaging."

6. Diversify your stocks. Don't put all your eggs in one basket, or even one industry. One experienced counselor told his clients, "Never, no matter hos much you like an investment, put more than 5 percent of your total assets into it. If it does well, your stake will build up significantly over the years. But if it goes sour, you won't be hurt too much."

7. Buy for the long pull--years not weeks. Over a reasonably long time span, the ups and downs of market prices tend to even out.

8. Buy stocks in those companies whose earnings are growing faster than the economy. This gives you protection against inflation.

Your age has a great deal to do with the type of stock you should consider. The younger you are, the more years you have to build a plan and the better able you are to take some risks. The risks allow you to improve your chances for greater appreciation of the funds you set aside.

For those 40-50 age range most of your investment funds should probably be in common stocks, particularly those that emphasize growth rather than income.

For those 50-60, keep heavily committed to common stock, but begin to shift from strictly growth to those that have a bit more emphasis on safety.

While the cost to purchase is not the most important decision, it does enter in. Some companies have a plan whereby the dividends are automatically reinvested. Additional shares can be purchased through the company, and neither plan requires a fee for purchasing the additional stock.

Investing money in the stock market can be done through individual stock broker or through financial institutions, known as mutual funds. These use your money to buy stocks in many companies. Mutual funds are known as load and no-load. The load companies have a sales charge, most often this is 8½ percent of the funds you invest. No-load companies charge a management fee of about ½ percent per year of the value of your investment.

Mutual funds are organized for different objectives. Some concentrate on growth, some on income, and some are a balance between growth and income.

There are several hundred mutual funds and the one or ones (you still need to diversify) you put your money into, should be as carefully chosen as if you were selecting individual stocks.

Carefully selected growth stocks provide a hedge against inflation. Over a short period of two or three years and a rapidly rising rate of inflation this did not prove true. Over a longer period of 10 to 12 - 15 years, common stocks have usually given protection against the erosion of capital through inflation.

Preferred Stock

The holders of preferred stock would receive higher priority than the holders of common stock, should a company issuing common stock be forced to reduce dividends. The buying principles for common stock also apply to purchasing preferred stock.

Miscellaneous

There are other investment sources that you may wish to consider and to investigate through further reading.

There are also mutual funds that invest only in bonds, mortgages, or real estate.

Home ownership

Home ownership is usually selected as a specific place to live and not as an investment. However, it is an investment of a large sum of money and in recent decades has proven the greatest hedge against inflation that the average family has. The equity build up in home ownership certainly should be given its rightful attention in developing a savings and investment program.

Annuities-Income for Life

One source of supplementary income can be an annuity. An annuity provides a guaranteed income which you cannot outlive.

There are different kinds of annuities available. An annuity can be either a "fixed" or a "variable" annuity. The fixed annuity will be paid to the policy owner in specific amounts of dollars. This type does not provide a hedge against inflation, but does give a guaranteed number of dollars per month, or quarter. In the variable annuity the funds paid in are invested in securities such as common stock and the amount of payment received varies with the return on the securities. This feature provides a hedge against inflation. The payments received from the annuity are in a fixed number of units, but not dollars.

A variety of options are available. One option provides monthly income for life of the annuitant. Another option gives a lower monthly income, but guarantees the income to heirs. This is the survivor life-time right. Another, the installment refund annuity, provides income for one person until death, and if the amount put into the annuity has not been used up, the balance is paid to a beneficiary. Of course, the last two options increase the cost of the annuity. This cost shows up as cost to buy the annuity or as smaller payments during the pay out period.

Annuities are sold by financial institutions such as banks, stock brokers, and life insurance companies.

Annuities can be purchased in several ways. You can buy an annuity with a lump sum at any given time, or by making regular payments.

The annuity bought with a lump sum payment can be paid for with the cash value from a life insurance policy or from savings. Annuities may also be purchased on the installment plan beginning 10-20 years before retirement.

Summary:

An income of 60-75 percent of pre-retirement income is needed to maintain the same standard of living after retirement as before. Savings and investments can be resources to add to pension or social security payments. Families need some funds in passbook savings, credit unions, certificates of deposit where money can be obtained quickly in case of an emergency. Funds to be used further in the future can be placed in bonds, stocks, or other types of investments. Savings should also be balanced between those that give a fixed rate of return and those that give some protection against inflation.

An investment in an annuity is a guarantee that you won't outlive your income. There is a choice between a fixed annuity with certainty of amount of dollar, or a variable annuity that varies with returns from the funds invested.

<u>For Further reading</u>

Changing Times, The Kiplinger Magazine, 16 Mistakes Investors Make, Aug. 1976.

Changing Times, The Kiplinger Magazine, Where Should You Invest Your Money Now? May, 1977

Changing Times, The Kiplinger Magazine, Ways to Cut the Risk When You Invest, September 1977

Planning Your Financial Future, U.S. News and World Reports Books, 2300 N Street, N.W., Washington, D.C. 20037, 1972.

1. Planning Your Financial Future, 1972

2. Investments, Insurance, Wills 1972

3. Stocks, Bonds and Mutual Funds, 1972 are all U.S. News and World Report Books, 2300 N Street, N.W., Washington, D.C. 10027

Highly Recommended:

<u>Guide to Your Investments</u>, Dun & Bradstreet, Hardy, C. Colburn, Thomas Y. Crowell Company, New York.

Your library has many good books on investing. Your bank and stock brokers have current information that is useful and are glad for you to come to their office just to read these materials.

Prepared by:

Hilda Dailey, Extension Specialist,
Home Management

Distributed by:

____
Extension Agent

The reference books were listed only for the purpose of information and the VPI & SU extension service does not recommend any one of the reference books to the exclusion of others which might be available.

Issued in furtherance of Cooperative Extension work, Acts of May 8 and June 30, 1914, in cooperation with the U.S. Department of Agriculture. W. R. Van Dresser, Dean, Extension Division, Cooperati-e Extension Service, Virginia Polytechnic Institute and State University, Blacksburg, Virginia 24061

COOPERATIVE EXTENSION SERVICE
U.S. DEPARTMENT OF AGRICULTURE
Virginia Polytechnic Institute
and State University
Blacksburg, Virginia 24061

POSTAGE & FEES PAID
United States Department of
Agriculture
AGR 101
(Third Class)
Bulk Rate

OFFICIAL BUSINESS
PENALTY FOR PRIVATE USE $300