

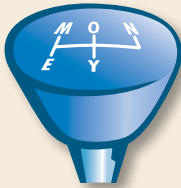
# INVESTING FOR RETIREMENT



- *Target Date Funds*



- *Rollover IRAs*



- *Asset Allocation*

- *Tax-Deferred Investing*



**VIRGINIA B. MORRIS AND KENNETH M. MORRIS**

# INVESTING FOR RETIREMENT

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# The Retirement Marathon

Investing for retirement is a long-term pursuit of financial security.

In 1900, retirement wasn't a hot topic. Employers didn't offer pensions, there was no Social Security, and the average life expectancy was 50.

More than a century later, everything's changed. More than 44 million people

collect retirement benefits, and that number is expected to reach 72 million by 2030. And people are living much longer: Current estimates suggest that a million or more people now in their 40s can expect to live to be 100 or more.



## READY, SET, GO

You can start investing for retirement when you earn income for the first time. That's when you can begin contributing to an individual retirement account (IRA). You can participate in retirement plans that your employers offer. If you work for yourself or own a small business, you can establish your own retirement plan. In fact, ideally, you'll take advantage of several of these ways to accumulate retirement savings during your working life. These dedicated assets, in combination with your taxable investment accounts, Social Security, and an employer pension if you have one, are the foundation of a financially secure future.



## In Your 20s: Getting Started

You can get a head start on building your financial future if you start early. The two opportunities you don't want to pass up:

- Contributing to a **tax-deferred** or **tax-free** Roth retirement plan
- Setting up one or more taxable **investment accounts**

While you may be paying off college debts or struggling to meet living expenses, the advantages of getting an early start on a long-term investment plan are too good to pass up.

Ideally, you should be investing up to 10% of your income. If you're in an employer sponsored retirement plan that deducts your pretax contribution from your salary, your taxable income will be reduced. If you contribute after-tax income to a Roth account, you'll eventually be eligible for tax-free withdrawals.

You may want to divide your taxable investments between a liquid emergency fund to cover unexpected expenses and an account with assets that have the potential to increase in value over time.

## In Your 30s & 40s: Hitting Your Stride

Even while you're juggling your income to pay for things that might seem more pressing, like buying a home, supporting a family, or anticipating your children's college expenses, you need to build your long-term investments.

One technique is to split the amount you invest between long- and short-term goals. Even if you put less into long-term plans than you'd like, at least these investments have the potential to grow, especially if you're building on a portfolio you started in your 20s. Generally speaking, long-term investments should focus on stocks, stock mutual funds or stock ETFs but short-term investments should be more liquid.

Keep in mind that investing for the long term is good for your current financial situation too:

- You save on taxes by participating in a tax-deferred savings plan
- You may qualify for a mortgage more easily if you have investment assets
- You can borrow from some retirement investments without incurring taxes and penalties

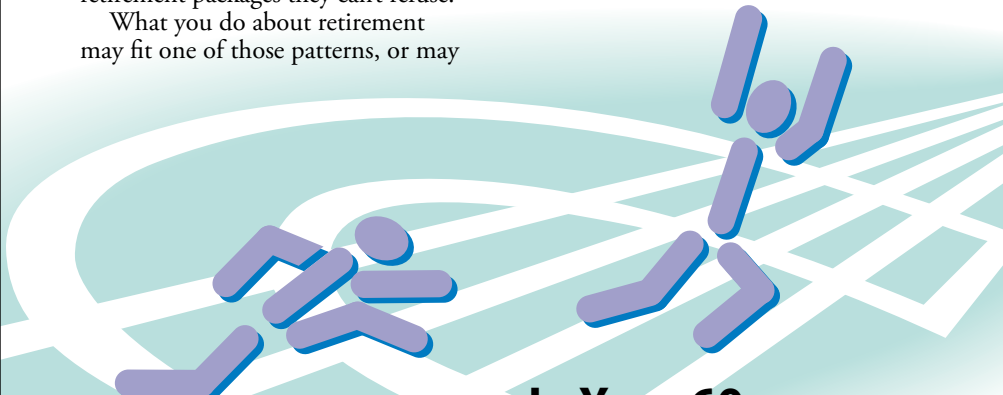
## WHAT THE FUTURE HOLDS

The truth is that retirement age is relative, not fixed. Some government workers retire after 20 years of service—sometimes as soon as their early 40s. Other people work productively through their 80s, thinking of retirement as something other people do. Many retire the first day they're eligible. Still others leave work unwillingly, taking early retirement packages they can't refuse.

What you do about retirement may fit one of those patterns, or may

be one you design for yourself. But whether retirement is a long way off, or sneaking up on you faster than you care to imagine, planning for the future has three main ingredients:

- Your financial security
- Adequate healthcare
- Benefits for your heirs



## In Your 40s & 50s: The Far Turn

You may be earning more than before, but you may be spending more too. College expenses can wreak havoc on long-term investment goals, as can expensive hobbies or moving to a bigger house.

On the other hand, if you've established good investing habits—like participating in a retirement savings plan and putting money into stocks, ETFs, and stock mutual funds—your long-term goals should be on track. You may also find that the demands on your current income eventually begin to decrease: The mortgage gets paid off, the children grow up, or you inherit assets from your parents.

That means you can begin to put more money into your long-term portfolio—through your employer's retirement savings plans or an IRA, through mutual fund or brokerage accounts, and through some income-producing investments such as CDs and bonds.

## ISSUES OF COST

What an investment costs you to buy and own has a major impact on the return—measured as change in value plus investment income. So you'll want to consider those factors as you build and manage your long-term portfolio.

## In Your 60s: The Home Stretch

When you start thinking seriously about retirement, you'll want to be sure you have enough income to live comfortably. If you have money coming in from a pension and investments, you'll have more flexibility to retire when you want.

Because many people can expect to live 20 or 30 years after they retire, you'll want to continue to invest even as you begin collecting on your retirement plans. One approach is to deposit earnings on certain investments into an account earmarked for new investments. Another is to time the maturity dates of bonds or other fixed income assets, like CDs, so that you have capital to reinvest if a good opportunity comes along.

Some of the financial decisions you'll be facing may be dictated by government rules about when and what you must withdraw from your retirement accounts. Others may be driven by your concerns about healthcare or your desire to leave money to your heirs. At the least, you'll have to consider:

- Shifting investments to produce more income with fewer risks, in case of a sudden downturn in the financial markets
- Rolling over retirement payouts to preserve their tax-deferred status
- Finding ways to reduce taxes and pay for those that are unavoidable



# Personal Investing Goals

Chances are, living the life you want after you retire will depend on your investment income.

When you invest, you use your **principal**, or money you already have, to produce additional income that will help you achieve a variety of financial goals that are important to you.

When one of your goals is providing for a secure long-term retirement, there's no fixed point when you need the money, as there is when you buy a house or pay college tuition. Rather, you need to plan for a continuous process that evolves through three distinct phases:

- **Building the value of your portfolio**
- **Producing income**
- **Preserving your principal**

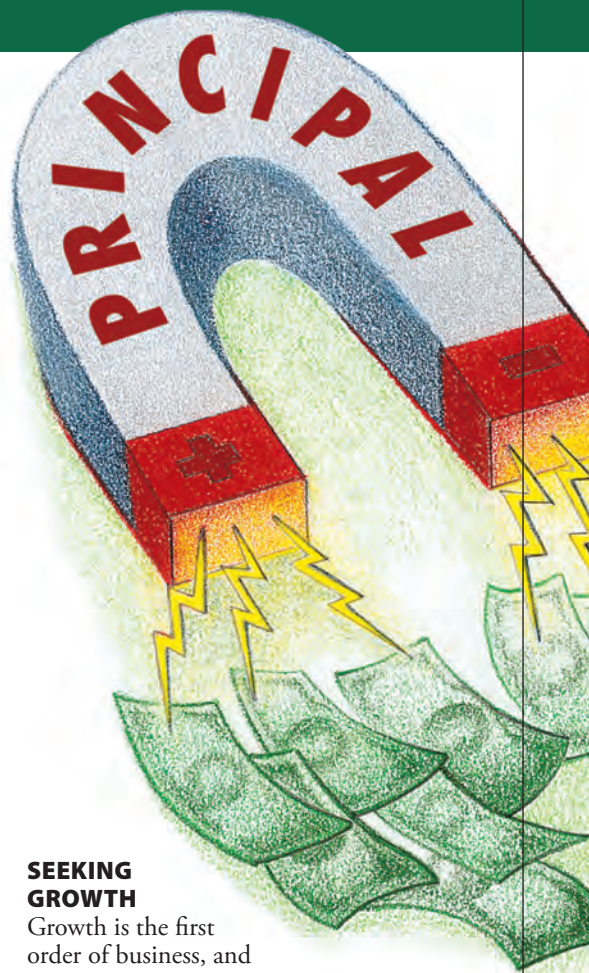
## A THREE-STAGE PLAN

The challenge is that each phase of meeting your goals requires a different mindset. Accumulating assets that will increase in value requires some risk-taking, including being prepared to ride out market downturns. Converting from growth to income production requires evaluating which investments to sell off and where to put the money for the most reliable return. Preserving principal for 20 or 30 years while it produces the income you need to live on may be the most difficult of all. It requires regularly adjusting what you spend as your investment return varies.

## SETTING A GOAL

One of the challenges of investing for retirement is trying to anticipate how much you need to accumulate. That's the case in part because you can't predict investment returns or future tax and inflation rates—which affect everyone—or more personal things like how long you'll live.

If you'd like more direction than "save as much as you can," you might use the rule of thumb that says you'll ideally have savings equal to 25 times the amount you'll need to withdraw from your accounts the first year you're retired to supplement the Social Security and pension income you expect to receive.



## SEEKING GROWTH

Growth is the first order of business, and investments may grow in many ways.

- You can **add to your principal** on a regular basis by contributing a percentage of your income to your investment account or contributing the maximum to an IRA.
- You can **reinvest** your investment earnings rather than spend them, either by using an official plan offered by a mutual fund or stock reinvestment program, or by putting all your interest and dividend payments into a special investment account.
- You can invest in **equity** products like stocks, ETFs, and stock funds, though growth isn't guaranteed, and they could also lose value in a weak or falling market.
- You can **allocate your assets** across asset classes to help reduce your exposure to recurring market and interest-rate risk.
- You can **diversify** your portfolio within asset classes to help reduce the risk of being too narrowly focused, though diversification doesn't guarantee a return or protect you against losses in a falling market.

## A WINNING STRATEGY

Random buying—a few stocks here, a bond there—rarely produces a strong enough return to provide the extra income you need in retirement. Jumping into what's hot works the same way, since usually by the time an investment is hyped, it has started to cool off. And you don't want to have paid a high price for an investment that ends up trading for less.

It's not that there's a single right way to make money with your investments. There are several approaches that you can adapt to suit your needs, your resources, and the risks you're willing to take.

The key is that to be a successful investor, you need a sense of what you want to accomplish, and a **strategy**, or plan, for getting there.

## A PLAN, NOT A STRAITJACKET

As an investor, you need to be flexible. The economy moves through different periods, affecting investment markets in various ways. In some periods, strong corporate profits mean that stocks tend to gain value, while in other periods they're likely to provide disappointing returns. Similar ups and downs affect bonds, mutual funds, real estate, and other investment categories. That means you may have to modify your portfolio from time to time to meet your goals.

You're likely to come up short, for example, if you keep lots of retirement money

## PLANNING INCOME

Income-producing investments are especially important after you retire. For example, the interest on a bond or the dividends from a stock may help cover day-to-day expenses or pay for the extras you enjoy. Since those payments are usually made quarterly or semi-annually, you can plan on them. You can also ladder some investments, like certificates of deposit (CDs) or intermediate-term bonds, to mature on a specific schedule, and replenish your cash reserve if you need the money.

There's risk, though. Interest rates may drop, dividends may be cut, and some expenses may rise. So you could end up with less income than you expect or need.



in **certificates of deposit (CDs)** and the interest they're paying is less than the rate of inflation. Just because CDs provide a handy place to keep your emergency funds and the money you're allocating to short-term goals like buying a new car, that doesn't mean they're necessarily a wise choice for the long term.

When you're investing for retirement, it may also make sense to shift your strategy as you get closer to actually leaving the workforce, moving from concentrating primarily on growth to a greater focus on producing income. You can take some risks in your 30s and 40s since you'll still have time to recover from market downturns. But a big loss in your 60s can be harder to overcome.

## DRAWING ON PRINCIPAL

While preserving principal and accumulating earnings are critical while you're investing for retirement, you can expect to use some of your principal as a source of income after you retire. Here, too, you need a plan for tapping your resources and a sense of which investments to liquidate and when to sell.

A maturing bond, for example, can become a source of current income. When it comes due, you can deposit the principal in a money market or savings account to draw on over the year, as you need cash. That might be smarter than selling off an investment that's generating growth and income, like a stock fund, or liquidating an asset when it has dropped in value if you expect it to rebound.

Remember, too, that once you reach 70½ you'll have to withdraw at least the required minimum each year from your tax-deferred employer plans and your traditional **individual retirement accounts (IRAs)**.

## PRESERVING PRINCIPAL

If you're planning to live on the income your investments provide, you have a vested interest in making sure it doesn't shrink in value or, worse yet, disappear. Curiously, the best preservation technique is often to continue to seek growth—slower, safer growth than you were looking for when you first began to build your portfolio, but growth nonetheless. Money earning minimal interest in a savings account doesn't keep its value. In fact, because of inflation, it shrinks. So keeping too much in cash is one of the biggest threats to your long-term financial security.

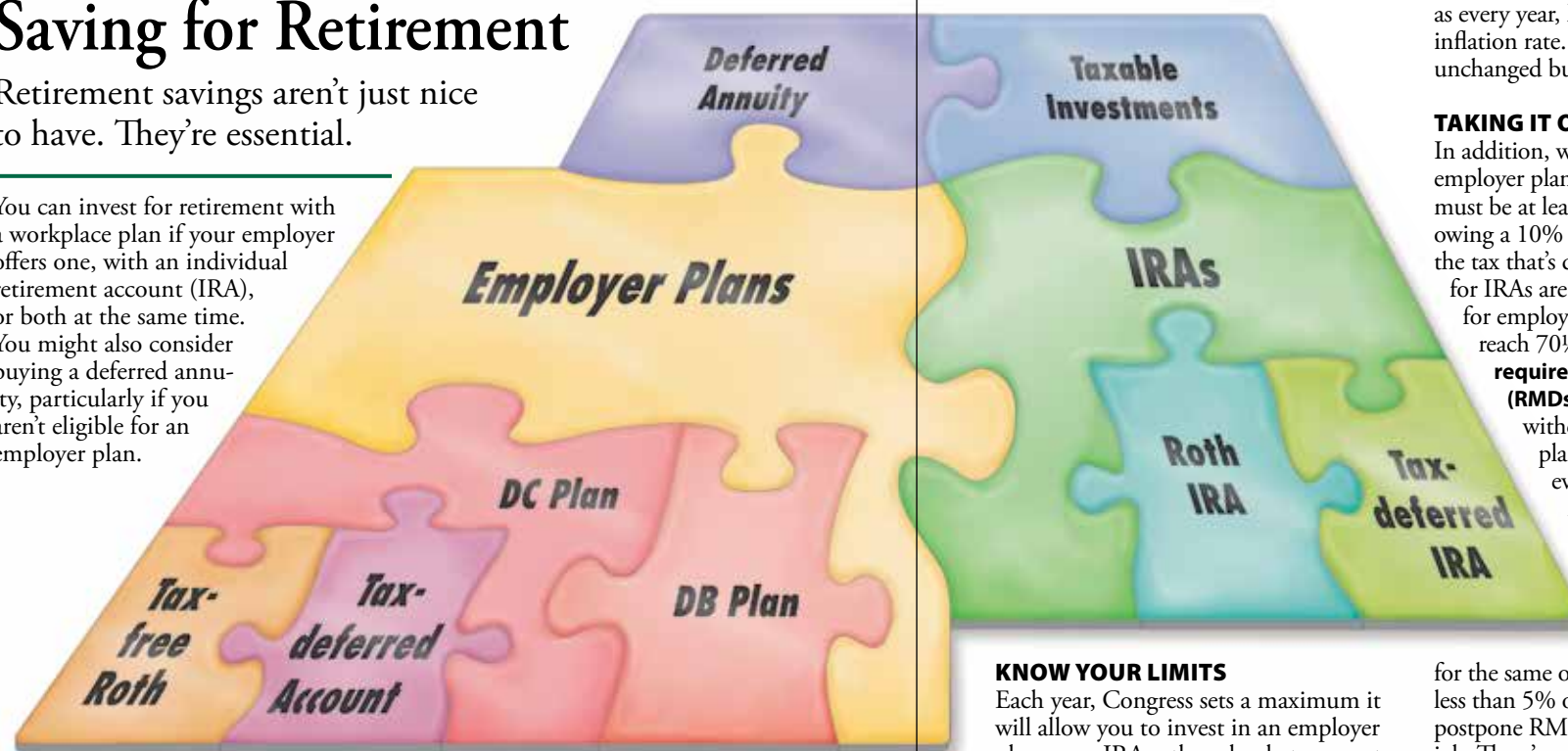




# Saving for Retirement

Retirement savings aren't just nice to have. They're essential.

You can invest for retirement with a workplace plan if your employer offers one, with an individual retirement account (IRA), or both at the same time. You might also consider buying a deferred annuity, particularly if you aren't eligible for an employer plan.



All these retirement-specific accounts are similar in one way: Earnings you accumulate are tax deferred and automatically reinvested, so your account can compound more quickly than if you were withdrawing to pay annual income taxes or other expenses. Contributions may also be tax deferred.

## DEFINING THE PLAN

When you invest for retirement by deferring income to a plan your employer offers, you're participating in a **defined contribution (DC) plan**. The earnings you accumulate and the value of your account when you're ready to begin taking money out are determined by how much you—and your employer if your contributions are matched—contribute, the return on your investments, and the number of years you participate. There are no guarantees about how much it will be.

Participation in the plan may be voluntary, so you must enroll. But employers are increasingly enrolling everyone who is eligible automatically, with the condition that you can drop out if you wish.

In contrast, a **defined benefit (DB) plan** is funded entirely by your employer with money that's separate from your salary. A DB plan pays a benefit, determined by the plan's formula, when you

retire. That income, called a pension, generally depends on how old you are when you begin to collect, the number of years you worked, and what you were earning. All employees are enrolled, and it's the employer's responsibility to meet its obligation to pay. However, these plans are increasingly rare.

## PUTTING IT OFF

If you contribute pretax income to a tax-deferred employer plan, you reduce your salary and what you owe in income tax for the year. The tradeoff is that when you begin taking money out, you'll owe tax on what you withdraw at the same rate you're paying on your ordinary income.

Employers who offer a tax-deferred plan may have the option of also offering a Roth version of the plan. If you choose this alternative, you contribute after-tax income but are eligible to take tax-free withdrawals, provided your account has been open at least five years when you retire and you're 59½ or older. Some employers allow you to split your contribution between a traditional account and a Roth account.

IRAs also have a tax-free version, called a Roth IRA. The big difference is that there are income caps that may limit your eligibility to contribute to a Roth IRA. There are no such limits with the Roth alternative in an employer's plan.

as every year, linked to increases in the inflation rate. In some years they are unchanged but have never been reduced.

## TAKING IT OUT

In addition, when you invest in either an employer plan or an IRA, you usually must be at least 59½ to withdraw without owing a 10% tax penalty in addition to the tax that's due—though the rules for IRAs are a little more flexible than for employer plans. And once you reach 70½, you must begin taking **required minimum distributions (RMDs)**—the official name for withdrawals—from all employer plans and tax-deferred IRAs, even if you don't need the income. The withdrawal rate is fixed, based on your age.

There is an RMD exception with employer plans. If you're still working for the same organization and you own less than 5% of the company, you can postpone RMDs until after you leave the job. There's nothing comparable for IRAs.

## GETTING BACK TO BASICS

In addition, you can invest for retirement in a taxable investment portfolio that gives you more flexibility than retirement plans, plus some tax benefits. Rules that apply to qualified plans and IRAs—like contribution limits and required withdrawals—don't apply to taxable accounts. This means you have more control over how much you invest and what you do with your account assets.

## KNOW YOUR LIMITS

Each year, Congress sets a maximum it will allow you to invest in an employer plan or an IRA—though what you put in one doesn't affect what you can put in the other. If you split your contribution among IRAs or between traditional and Roth employer accounts, the total you can contribute is the same as if you were using one IRA or employer account.

If you're 50 or older, you're also entitled to make an annual **catch up contribution** to either type of plan even if you've always contributed the maximum amount.

Basic and catch-up contributions, which are higher for employer plans than for IRAs, may be adjusted as frequently

## CHANGING JOBS

If you're part of a DC plan and you change jobs, the contributions you've made to the plan plus the earnings they've generated belong to you. So do any employer contributions and their earnings if you've been on the job long enough to be entitled to them, or **vested**. That's a major attraction of these plans.

It's your responsibility to decide what to do with these portable assets:

- You always have the option to roll the balance over into an IRA.
- You may be able to leave your account with your former employer.



- You may be able to roll the account value into your new employer's plan if the plan accepts rollovers.


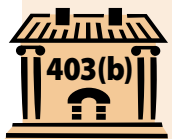

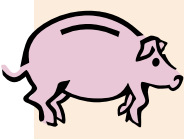


It's smart to discuss the alternatives with your financial adviser, as there are pros and cons with each approach. Among the things to consider are the fees you'll pay and the flexibility you'll have in making contributions and taking withdrawals.

Even if you're short of cash, the biggest mistake you can make is taking a cash distribution and spending the money. You'll pay taxes and a 10% penalty, plus miss out on potential future earnings.

# Defined Contribution Plans

Retirement plans share some characteristics, but each has unique features.

The defined contribution (DC) plan you participate in depends on where you work. Employers can offer the plan or plans that are available for their category of sponsor. Among those you might be eligible for are:

Type	Offered	Features
 <b>401(k)</b>	At public and private companies and nonprofit organizations	<ul style="list-style-type: none"> <li>• Annual contribution limits and vesting rules</li> <li>• Balances portable when leaving job</li> <li>• Transfers into plan may be possible</li> <li>• Tax-free Roth option may be available in addition to tax-deductible plan</li> </ul>
 <b>403(b)</b>	At nonprofit organizations	<ul style="list-style-type: none"> <li>• Annual contribution limits and vesting rules</li> <li>• Balances portable when leaving job</li> <li>• Transfers into plan may be possible</li> <li>• Expanded opportunities to make catch-up contributions</li> <li>• Tax-free Roth option may be available in addition to tax-deductible plan</li> </ul>
 <b>457 Plan</b>	For state and municipal workers	<ul style="list-style-type: none"> <li>• Annual contribution limits and vesting rules</li> <li>• Balances portable when leaving job</li> <li>• Transfers into plan may be possible</li> <li>• Expanded opportunities to make catch-up contributions</li> </ul>
 <b>Thrift savings plan (TSP)</b>	For federal employees and at some public and private companies	<ul style="list-style-type: none"> <li>• Annual contribution limits and vesting rules</li> <li>• Balances portable when leaving job</li> <li>• Transfers into plan may be possible</li> <li>• Tax-free Roth option available in addition to tax-deductible plan</li> </ul>
 <b>SIMPLE IRA or 401(k)</b>	At public and private companies with no more than 100 employees	<ul style="list-style-type: none"> <li>• Matches are mandatory</li> <li>• Simple IRAs have lower contribution limits than other plans</li> <li>• Balances portable when leaving job</li> </ul>
 <b>Profit sharing or money purchase plan</b>	At public and private companies, including those with no more than one or two employees	<ul style="list-style-type: none"> <li>• Contribution limits higher than with most other plans</li> <li>• Money purchase but not profit sharing plans require annual contributions</li> <li>• Assets can be rolled over to an IRA</li> </ul>

### AUTOMATIC ENROLLMENT

Employers who sponsor defined contribution plans have the right to automatically enroll you in their plan. With **automatic enrollment**, your employer decides the percentage of your salary that you contribute—often 3% with a built-in annual increase—as well as the type of investment you initially make: a target date fund, a balanced fund, or a managed account. If you don't want to participate in the plan, you can refuse in writing. If you do participate, you have the right to change the default investment and the percentage you contribute.



The most common defined contribution plans—401(k)s, 403(b)s, 457s, and thrift saving plans (TSPs)—share a number of important fea-

tures, such as annual contribution limits and vesting rules. They're also similar enough so that if you change jobs, and your new plan accepts rollovers, you can transfer the balance from your previous plan to the new plan. This **portability** is particularly attractive if you change jobs a number of times in your career.

At the same time, each type of plan has unique features. For example 403(b)s and 457s offer expanded opportunities to make catch-up contributions. Similarly, 401(k)s, 403(b)s, TSPs, and 457s, may offer tax-free Roth versions of their traditional tax-deferred plans. Your employer will provide an official document that explains how your plan works and what your rights are. It may be dense, but it's important reading.

### ESSENTIAL DETAILS

When you participate in most employer plans, you can determine how much to invest, usually as a percentage of your earnings that will equal no more than the federal cap. In 2016, that's \$18,000 plus another \$6,000 if you're 50 or older. You can always contribute less.

As an added benefit, many employers who offer retirement savings plans match a portion of the contributions you make, either as a percentage of what you contribute up to a cap or, in the case of a corporate employer, on a profit-sharing basis. Matches are mandatory in SIMPLE plans and for federal employees, not allowed in 457s, and voluntary in 401(k)s and 403(b)s. Employers offering these plans might choose to match 50% of your contribution up to 5% or 6% of your salary.

### IT'S YOUR JOB

With a retirement savings plan, you're usually responsible for choosing the investments for your plan account from a menu your employer offers. The size of the menu varies by type of plan and, in some cases, by the plan provider your employer chooses. The federal government's TSP has six choices—five index mutual funds and a lifecycle fund, also known as a target date fund—while on average a 401(k) offers 18 mutual funds, investment contracts, or other products.

The idea is to select several alternatives, each of which puts your money to work in a different way or a single alternative, such as a balanced fund, a target date fund, or a managed account, all of which provide that variety. Then each time you defer income to your account—typically from every paycheck—your contribution is divided on a percentage basis among the investments you've chosen.

Because you're selecting investments, you have some control over the amount of risk you're taking and your potential return over time. But it also means you are responsible for the outcome, measured by your account value. That can be affected by changes in the economy and market performance as well as by the choices you make.

### A VESTED INTEREST

When you're **vested**, you have the right to the assets in your plan account if you leave your employer for any reason before you are eligible to retire. Any amounts you contribute and any earnings they produce vest immediately because it's money you've earned and deferred to the plan.

In contrast, you are vested in your employer's matching contributions and earnings on those contributions by working long enough to satisfy the vesting period that applies. If you leave sooner, even if you're let go, you may forfeit all or some of that money.

The timing isn't arbitrary. Your employer chooses one of the vesting schedules established for DC plans—either immediate vesting, fully vested after three years, or vested at 20% a year with full vesting after six years. If you're thinking about changing jobs, you may want to time your departure to correspond with becoming vested, especially if there's a substantial sum at stake.



### TOP HAT PLANS

Some companies offer Supplemental Executive Retirement Plans (SERPs) as a way to recruit and retain employees. SERPs—sometimes referred to as **top hat plans**—are non-qualified plans. Contribution limits that apply to DC plans don't apply, so such a plan can be a major retirement asset. But these deferred compensation plans are backed only by the employer's promise to pay rather than by money that's invested in your name.



# IRAs: What They Are

IRAs are easy to set up—but not always easy to understand.

**IRAs, or individual retirement accounts,** are tax-deferred, personal retirement plans. You can contribute every year you have earned income whether or not you participate in an employer's retirement plan. There are two types: the traditional IRAs, to which contributions may be deductible or nondeductible, and the Roth IRA.

- All **traditional IRAs** are **tax deferred**, which means you owe no tax on your earnings until you withdraw
- **Roth IRAs** are also tax deferred, so you owe no tax on your earnings as they accumulate. Withdrawals will be **tax free** if you follow the rules

## WEIGHING THE CHOICE

If you have a choice of which IRA to open, you'll want to weigh the pros and cons:

	ROTH	TRADITIONAL IRA	
		Nondeductible	Deductible
<b>PROS</b>	<ul style="list-style-type: none"> <li>• Tax-free income at withdrawal</li> <li>• No required withdrawals</li> </ul>	<ul style="list-style-type: none"> <li>• Tax-deferred earnings</li> <li>• No tax due on contributions at withdrawal</li> </ul>	<ul style="list-style-type: none"> <li>• Immediate tax savings on tax-deductible contributions</li> <li>• Tax-deferred earnings</li> </ul>
<b>CONS</b>	<ul style="list-style-type: none"> <li>• AGI limits</li> <li>• Not deductible</li> <li>• Requirements to qualify for tax-free withdrawal</li> </ul>	<ul style="list-style-type: none"> <li>• Not deductible</li> <li>• Tax due at regular rates at withdrawal</li> <li>• Required withdrawals beginning at 70½</li> </ul>	<ul style="list-style-type: none"> <li>• Tax due at regular rates at withdrawal</li> <li>• Required withdrawals beginning at 70½</li> </ul>

## DO YOU QUALIFY FOR A ROTH IRA?

	You qualify for a Roth	Partial Roth	You don't qualify for a Roth
<b>SINGLE</b> Adjusted Gross Income	\$118,000		\$133,000
<b>MARRIED</b> Adjusted Gross Income	\$186,000		\$196,000

### A SWEET DEAL

The only requirement for opening an IRA is having earned income—money you make for work you do. Your total annual contribution is limited to the annual cap. That's \$5,500 in 2017, whether you choose a traditional IRA or a Roth. If you're 50 or over, you can also make an additional annual catch-up contribution of \$1,000.

Any amount you earn qualifies, and

you can contribute as much as you want, up to the cap. But you can't contribute more than you earn.

### SPOUSAL ACCOUNTS

If your husband or wife doesn't work, but you do, you can put up to the annual limit into a separate spousal IRA in addition to your own contribution. The advantage for the nonworking spouse is being able to build an individual retirement fund.

### WHICH IRA FOR YOU?

In addition to having earned income, you must qualify to deduct your contributions to a traditional IRA or contribute to a Roth IRA. The rules are different in each case.

If you're single, you qualify for a fully deductible IRA contribution when you file your federal income tax return if you were not covered by an employer sponsored retirement plan during that year. If you were covered by a plan, you may be able to deduct some or all of your contribution based on your modified adjusted gross income (MAGI).

If you're married and file jointly, either of you can deduct your own contribution if you are not covered by a retirement plan at work. But if either of you is covered by a plan, the other's right to a deduction

filing separate returns usually aren't eligible either to deduct contributions or contribute to a Roth.

While you can't deduct your contribution to a Roth IRA, taxes on earnings in your account are deferred as they accumulate, and you make tax-free withdrawals if you qualify. In most cases, that means you are at least 59½ and have had your account open at least five years before you withdraw.

### IT'S YOUR ACCOUNT

It's easy to open an IRA. All you do is fill out a relatively simple application

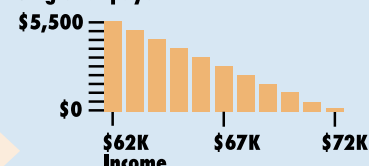
provided by the mutual fund company, bank, brokerage firm, insurance company, or other financial institution you choose to be **custodian** of your account.

Because IRAs are self-directed, meaning that you decide how to invest the money, you're responsible for following the rules that govern the accounts. Basically, that means putting in only the amount you're entitled to each year. You must also report your contribution to a traditional IRA to the IRS, on Form 1040 or 1040A if it's deductible and on Form 8606 if it's not.

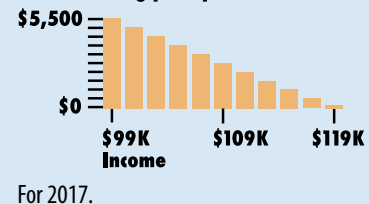
You can invest your IRA money any way that is available through your custodian including individual securities, funds, and bank products. The things you can't buy are fine art, gems, non-US coins, and collectibles. And you can sell investments in your IRA account without paying tax on your gains until you withdraw from your account, but there may be transaction costs.

### Deductions are gradually phased out if you are covered by a retirement plan

#### Single taxpayer



#### Married filing jointly



For 2017.

is reduced gradually if your joint MAGI is over \$186,000 and eliminated if it's over \$196,000 in 2017. If you're both covered, the limits are \$99,000 and \$119,000 in 2017.

Eligibility for a Roth IRA is based on your filing status and MAGI, with higher income limits for married couples filing a joint return than for single filers. If you qualify to make a partial contribution to a Roth, you can put the balance in a traditional IRA. Married couples



### WHEN TO CONTRIBUTE

You have until the day taxes are due—usually April 15—to open an IRA and make the contribution for the previous tax year.

You can contribute to your IRA in a lump sum or spread the deposit out over the year. You may put in the whole amount the first day you can,

January 1 of the tax year you're making the contribution for, to give your money the longest time to grow. If you're like most people, you're more apt to make the deposit on the last possible day. The most practical solution may be making contributions on a regular schedule.

## IRAs: Weighing the Merits

The more you know about your IRA, the more there is to love.

The tax-deferred advantage of an IRA is that your investment can compound faster than it would in an account from which you withdrew earnings to pay taxes, as this hypothetical example shows.



### START CONTRIBUTING AT AGE 22

If you begin contributing \$5,000 a year to your IRA as soon as you start earning income, your investment will continue to compound until you are ready to withdraw. Even after you start taking money out, anything left in the account will continue to accumulate earnings.

### AT AGE 42

If your average annual return in the IRA is 6%, your account will be worth \$194,964 after 20 years. If your average return is higher or lower, the value will reflect that.



Compounding earnings are the key to tax-deferred growth.

### CONTINUE TO CONTRIBUTE UNTIL AGE 70

When you reach 70, your account could be worth \$1,359,792. This amount, compounding at an average annual rate of 6%, would allow you to take required minimum distributions for your projected life expectancy without running out of money.\*



\*This result is not based on the performance of any specific investment.

### TAXING ISSUES

**Traditional IRAs** and **Roth IRAs** both give you the advantage of **tax-deferred** growth. What's different is what happens when you take money out of your account any time after you reach 59½.

With a traditional account, what you withdraw is considered regular income, and you owe income tax on the earnings at your current rate. If you've deducted your contributions, you owe tax on that part of your withdrawal as well. As a result, the amount you have available to spend is reduced by whatever tax you owe.

Withdrawals from a Roth account are completely **tax free** if your account has been open at least five years. That's a big difference that gets bigger as your tax rate goes higher. For example, if you were single, had a marginal tax rate of 25%, and withdrew \$40,000 from an IRA, you would have about \$4,600 more in your pocket if the money came out of a Roth account.

### ADDED APPEAL

If you're eligible to contribute, Roth IRAs offer other advantages. Unlike a traditional IRA, you can continue to contribute for as long as you have earned income—even if you're 90.

Perhaps more important, you're not required to begin withdrawals at age 70½ as you are with a traditional IRA. That means you can manage your finances to suit yourself, or use your

account to build the estate you'll leave to your heirs. There may be tax consequences with that approach, though, so you should discuss your plans with your tax or financial adviser.

If there's a drawback to Roth IRAs, it's that the contribution is never deductible. But for most people long-term, tax-free income may have more advantages than a deduction now.

### THE PENALTY QUESTION

To get the tax breaks that come with an IRA, you agree that you won't have access to the money until you reach 59½. It's the government's way of encouraging you to save for retirement. In fact, you have to pay a 10% early withdrawal penalty on top of the tax due when you take money out ahead of schedule.

But the law is also flexible. If you need money you've put into an IRA to pay specific expenses, buy your first home, or pay your children's college tuition, you can withdraw from your account without owing the 10% penalty that usually applies to early withdrawals.

If the money is coming out of a traditional IRA, you'll owe whatever tax is due, just as you would if you withdrew after 59½. With a Roth, you'll owe tax at your regular rates for earnings you withdraw but no tax on contributions you withdraw. And, you can take up to \$10,000 tax free from Roth IRA earn-

ings if you're buying a first home for yourself, your child, or your grandchild.

You can also withdraw contributions you make to a Roth IRA at any time without penalty. The advantage is having that money available for college or other expenses. The risk is reducing what you've saved for retirement.

### IRA COSTS

Setting up an IRA usually requires just an opening deposit and sometimes a administrative fee, usually less than

\$50. The costs of owning the account depend primarily on the investments you make and the custodian you select. If you choose a brokerage firm or mutual fund company, you may pay a commission or transaction costs when you buy or sell investments, annual asset-based fees on mutual funds in the account, and perhaps an annual maintenance fee. It pays to know what these costs will be before selecting the custodian, as they do affect your return.

### STRATEGIC PLANNING

When you're ready to start taking money out of your IRAs, you need a strategy to meet the legal requirements while realizing the best return you can. After you turn 70½, you must withdraw at least the required minimum, and you may take more if you need money for living expenses. But you don't want to withdraw too fast so your accounts can continue to grow, helping to ensure you'll have a source of income for as many years as you need it.

If you have more than one IRA, one issue is deciding which one or ones to draw on first. One advantage IRAs have over employer accounts is that you calculate the total you must take out from each account, but you may take the entire withdrawal from any one account or any combination of the accounts. With multiple 401(k)s, on the other hand, you must take the required withdrawal from each account separately.

### FINDING THE CASH

Since wise investment strategy suggests you should diversify your retirement accounts by investing in several asset classes, you probably won't have the exact withdrawal amount waiting for you in a savings account.

You could sell stocks or bonds, but what if the market is down or they're strong performers you'd really like to hold on to? One option may be to open a money market account with your custodian to collect dividends, interest payments, and capital gains you realize as part of managing your portfolio. The amount you accumulate that way probably won't equal your RMD, but could give you a head start.

If you prefer you can take the RMD as a lump sum any time before the end of the year. Or you might arrange regular monthly distributions with your plan custodian. The only thing you don't want to do is miss the RMD. There's a major penalty if you do.



# Using a Rollover IRA

There's no trick to moving retirement assets.

If you're leaving your job and don't know what to do about your 401(k), you may want to choose a rollover IRA. It's an alternative that's always available if you want to keep your assets and any future earnings tax deferred. A rollover IRA also offers you the most flexibility in choosing investments. And it gives you the most control over withdrawals when you're ready to start using the money.

To start the rollover process, you generally fill out an application provided by the financial institution to which you plan to transfer your money. You'll get a new account number, which you'll need to complete the rollover request form provided by your old plan administrator.

When you turn in the form, the administrator liquidates your assets and transfers the cash value to your rollover IRA, either electronically or by check.

Rollover IRAs have some unique qualities. You can move any amount into your account, provided you're moving it from an employer sponsored retirement plan or another IRA. You're not limited to the annual ceiling on traditional and Roth IRA contributions.

You may be able to move rollover IRA assets into a new employer's plan if the plan accepts rollovers. While some plans may accept any IRA assets, it's smart to keep your employer plan rollover in its own account to avoid any possible roadblocks.

Rolling over keeps your earnings tax deferred



## CONVERTING TO A ROTH IRA

In addition to rolling the assets in a traditional employer plan into a traditional IRA or the assets in a Roth 401(k) or Roth 403(b) into a Roth IRA, you can also convert a traditional employer plan to a Roth IRA. You owe income tax at your regular rate on any tax-deferred contributions and all plan earnings that you move. But—and it's a significant but—when you're at least 59½ and your rollover Roth IRA has been open at least five years, you can take tax-free withdrawals.

What's more, Roth IRAs do not require mandatory distributions as all employer plans including Roths and traditional IRAs do. And you can continue to contribute to a Roth IRA as long as you have earned income, even if you're 90, if your modified adjusted gross income is less than the ceiling for contributing.

The good news, though, is that there are no income limits on converting to a Roth IRA. So it's the only way that people who earn too much to make Roth contributions have access to tax-free retirement income. Before you convert, though, it's smart to consult your tax and legal advisers to evaluate the impact on your own situation.

## IRA CUSTODIANS

The financial institution where you open your rollover IRA is the custodian of your account. As custodian, the institution is responsible for making the investments you authorize, keeping track of the paperwork, and reporting investment performance and account balances.

But because most IRAs are self-directed, the custodian doesn't make investment decisions on your behalf. Nor does it have fiduciary responsibility for the choice of investments you make. That means if you decide to put all your money into a risky investment, your IRA custodian isn't responsible for advising against it. The same is true if you keep all your money in a low-interest savings account.

Your custodian may charge an annual fee for handling your account—often as little as \$10 a year, and rarely more than \$50. And if your account balance reaches a certain amount, which the custodian sets, the annual fee may be dropped.

## IRA TO IRA

You can roll an existing IRA from one custodian to another or convert a traditional IRA to a Roth IRA, as you can with an employer plan. You might want to simplify your recordkeeping by having just one custodian. You might want more investment options or more flexible beneficiary provisions. There's considerable variation among IRAs, and it makes sense to find the arrangement that works best for you.

A rollover IRA gives you flexibility, a range of investment choices, and control

## PLAY BY THE RULES

You've got lots of leeway with a rollover IRA, but there are still some rules you have to follow.

Most IRA custodians require you to set up a new account for the rollover rather than adding the money to an existing IRA account to which you make annual contributions.

If you're moving assets from an employer plan, you can roll over your pretax contributions, your employer's matching contributions, and any earnings in your 401(k) or other qualified retirement account. But, if you've made any aftertax contributions to a traditional plan, you'll have to take that amount as a cash distribution. You can't roll it over.

If you roll over an employer plan indirectly, which means you take a cash distribution and deposit it in an IRA within 60 days, your employer must withhold 20% of the total you ask to move. You must make up that amount from another source to maintain the tax-deferred status of that part of the rollover. Any amount you don't deposit is considered a taxable withdrawal. There's no withholding on a direct rollover, which usually makes it the preferable alternative.

## ALL TOGETHER NOW

If you change jobs several times in your career, rolling over or converting assets from your employer plans into a single IRA can create a substantial account. You'll have more flexibility in timing withdrawals than you would if your assets remained in an employer plan. You're also less likely to forget about the money, as you might with assets you leave with a long-ago former employer. It may also be an advantage to have a more complete picture of where you stand financially.



## Deferred Annuities

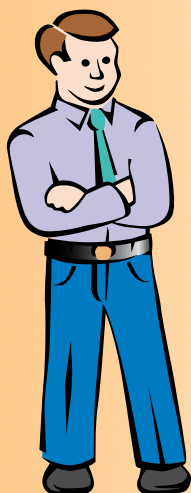
Annuities are designed to provide regular retirement income.

A deferred annuity is a contract you sign with an insurance company. You pay premiums, either as a lump sum or over a period of years, building an account balance that can be converted to income or paid as a lump sum. You can use money

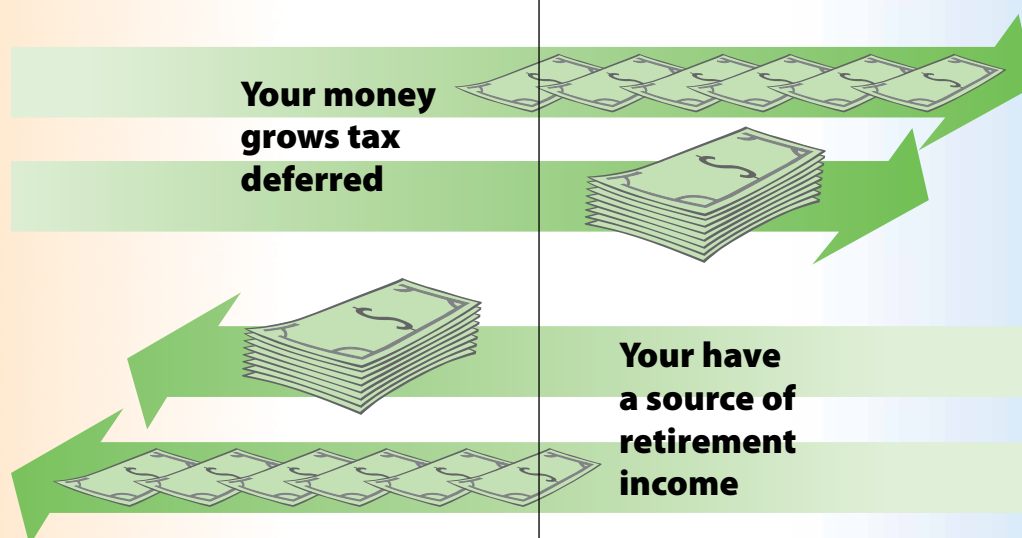
from any source to pay your premiums. It doesn't have to be earned, as it does with an IRA. The contract describes the benefits the annuity provides and the fees and other expenses that apply, which vary by type of annuity and issuer.

With a deferred annuity, you save now to have income later.

### THE INVESTOR



“I agree to invest a set amount in the annuity, either in a lump sum or over a period of years.”



### THE INSURANCE COMPANY

“We agree to pay a benefit based on the plan's earnings, beginning at an agreed retirement date.”



### COLLECTING ON YOUR ANNUITY

After the **accumulation** phase, when your annuity investment grows, there comes a point when you start collecting—and paying the taxes you've deferred.

If you're receiving regular payments, you owe tax on the earnings portion of each payout. If you take a lump sum, though, you owe all the tax that's due up front. Tax is figured at your regular income tax rate.

It's also possible to begin receiving regular income before you turn 59½, taking up to 10% of the total value of your account each year. You owe tax on the earnings portion only and no penalty.

If you **annuitize**, your account balance

is converted to a stream of income that lasts as long as you live, or you and a joint annuitant live. The amount depends on the balance and your age or your joint ages at the time of conversion. Alternately, you can choose regular payments of a particular amount or for a particular term. What you receive, or for how long, depends on your balance. There's no guarantee of lifetime income. You may also be able to choose a lump sum payout, but a fee may apply.

You can take income without tax penalty any time after 59½, or you can wait. There's no federal law requiring withdrawals, though some states and certain policies require them, often by the time you turn 90.

### FIXED OR VARIABLE

If you buy a deferred annuity, you'll have to choose between a fixed or a variable contract. A **fixed annuity** is the more conservative choice. It promises a set rate of return, though the rate can be—and usually is—reset regularly. In some cases, the initial rate, or the one you're quoted when you buy your annuity, may be higher than the rate that you earn later.

If the rate drops, the earnings that have been projected for your contract based on the promotional rate will decline. While most fixed annuities have a **floor**,

or guarantee of a minimum rate, it can be as low as current bank savings rates.

Unlike a fixed annuity, a **variable annuity** lets you choose how your money is invested. You select among a number of alternatives, called subaccounts or annuity funds, which typically include a variety of equity and fixed-income choices. Your return isn't guaranteed as it is with a fixed annuity. Rather it depends primarily on the investment performance of the funds you choose and the fees you pay. Your return is likely to vary, up and down, over time, and there may or may not be a floor.

Another difference between fixed and variable annuities is that with a fixed annuity the guarantee of future income is based entirely on the issuing company's ability to pay. With variable annuities, that's just one factor. But either way, researching annuity company ratings before you buy is crucial.

Annuities that aren't part of a qualified employer plan are described as non-qualified. Two major differences are that you can add more money each year and are not required to withdraw from a nonqualified annuity at 70½.

### DEFERRED ANNUITIES—THE PROS AND CONS

Deferred annuities, both fixed and variable, can provide important retirement benefits. Despite their advantages, however, deferred annuities also have some drawbacks.

#### ADVANTAGES

- Tax-deferred growth
- No limit on the amount you can contribute to a non-qualified annuity each year
- A wide choice of contracts to suit your investing style and goals
- Promise of lifetime income if contract is annuitized

A side benefit of receiving income from an annuity contract is that the part that's return of principal isn't taxed because you've used after-tax income to pay your premiums. Just the income from earnings that have accumulated is taxed, at your regular rate. The same applies to income from traditional IRAs when you're not eligible to deduct your contributions.

#### DRAWBACKS

- Surrender fees and penalties if you withdraw early, or in some cases, if you take a lump sum withdrawal
- Minimized tax advantages for high-income taxpayers because earnings are taxed as regular income, not capital gains
- Potentially large annual fees, which reduce investment growth, a particular problem with variable annuities
- Lack of liquidity, especially in fixed annuities, though they may grow at a rate similar to cash-equivalent investments, including US Treasuries



# Taxable Investing

You can diversify your retirement investing by using taxable as well as tax-deferred accounts.

When you think about investing for retirement, you probably focus on your employer sponsored retirement plans, individual retirement accounts (IRA), and maybe an annuity. It's these sources, as well as Social Security and perhaps a pension, which you expect to provide the income you'll need for a comfortable retirement. But in concentrating on these retirement-specific accounts, you may lose sight of the advantages of investing for retirement with a taxable account.



By investing strategically, you can benefit from a number of tax-saving opportunities, including lower tax rates on most dividends, stock fund distributions, and long-term capital gains.

Not all taxable investment income receives special treatment, though. Interest on corporate and Treasury bonds, certificates of deposit (CDs), and bank accounts is taxed at your regular rate, as are income distributions from bond mutual funds and real estate investment trusts (REITs).

One way to replicate one of the chief benefits of tax-deferred investing in a taxable account is to reinvest any dividends or capital gains in your investment account and pay any taxes that are due from your checking account. The reinvested earnings help to build your account value, boosting the base on which new earnings can accumulate.

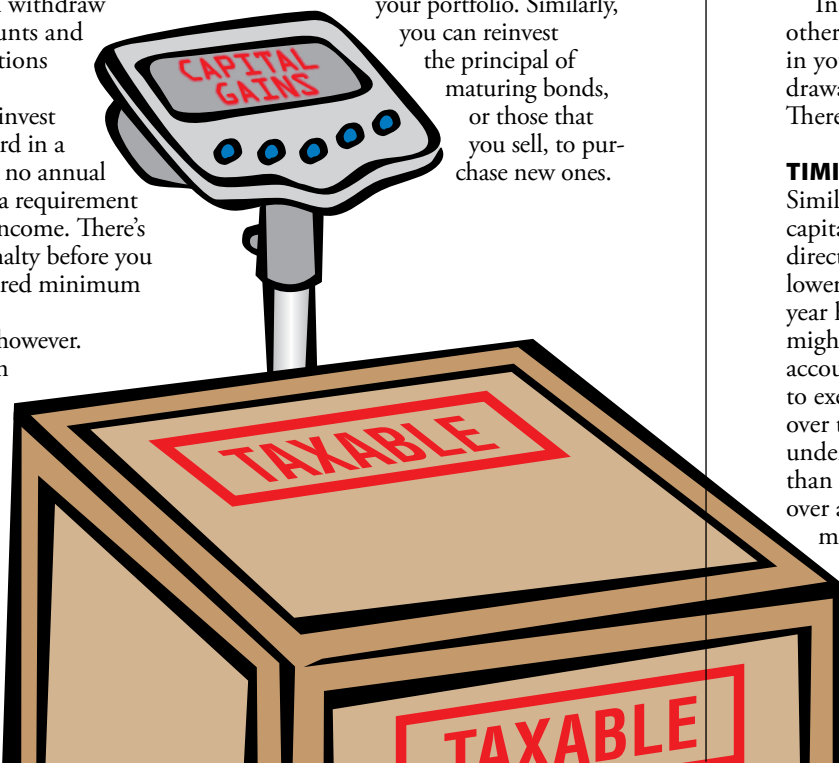
You can work with your financial adviser to decide whether you want to reinvest the earnings in additional shares of the same stocks, ETFs, and mutual funds or add different investments to your portfolio. Similarly, you can reinvest the principal of maturing bonds, or those that you sell, to purchase new ones.

## TAX-DEFERRED vs. TAXABLE

The great appeal of tax-deferred investing is that it lowers your tax bill now and allows your account value to compound more quickly than it would if you were withdrawing annually to pay taxes on earnings. The trade-off is that you lose a certain amount of flexibility. There are limits on the amount you can contribute, when you can (or must) withdraw, and sometimes on your choice of investments. In addition, you pay tax at your regular rate on all earnings you withdraw from tax-deferred accounts and on any pretax contributions or those you deducted.

In contrast, you can invest as much as you can afford in a taxable account. There's no annual contribution limit, nor a requirement that you invest earned income. There's no early withdrawal penalty before you turn 59½, and no required minimum distributions after 70½.

There is a downside, however. You owe income taxes on any earnings on your taxable assets in the year they're paid, and you owe capital gains taxes on any increase in the value of assets that you sell at a profit. Those taxes reduce the value of your portfolio, but perhaps not as much as you might think.



## TAX-EFFICIENT INVESTMENTS

If you use taxable accounts to build increased retirement security, your investing strategy may be somewhat different from your approach to tax-deferred retirement investing. The reason is simple: the tax factor.

For example, in choosing actively managed mutual funds for your taxable portfolio, you may want to look for highly rated funds that are tax efficient. This means, among other things, that the **turnover rate**, which is the frequency with which underlying assets are bought and sold, and short-term capital gains, which are taxed at your regular rate, are kept to a minimum.

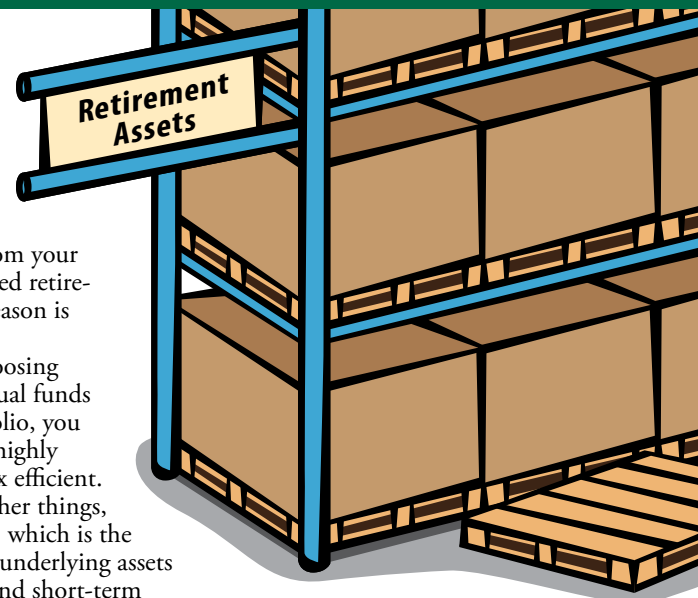
Or, you might decide to use passively managed index funds or index-linked ETFs. The portfolios of these funds change only when the components of the underlying index change, which is sometimes as infrequently as once a year.

If your risk tolerance allows it, you may also seek tax efficiency by investing a portion of your stock allocation in small- and mid-capitalization stocks that typically pay no dividends but may have a greater potential than large-company stocks to increase in value over the long term. And if you do eventually sell these investments at a profit, that's the only time you'll owe tax.

In a tax-deferred account, on the other hand, tax efficiency is not a factor in your choice of funds since all withdrawals will be taxed at the same rate. There you want to emphasize return.

## TIMING CAPITAL GAINS

Similarly, you can ensure that any capital gain on a security you own directly will qualify to be taxed at the lower long-term rate if you wait until a year has passed before you sell. Or you might choose to invest in managed accounts, which allow you to exert more control over the sale of the underlying investments than you would have over a similarly invested mutual fund.

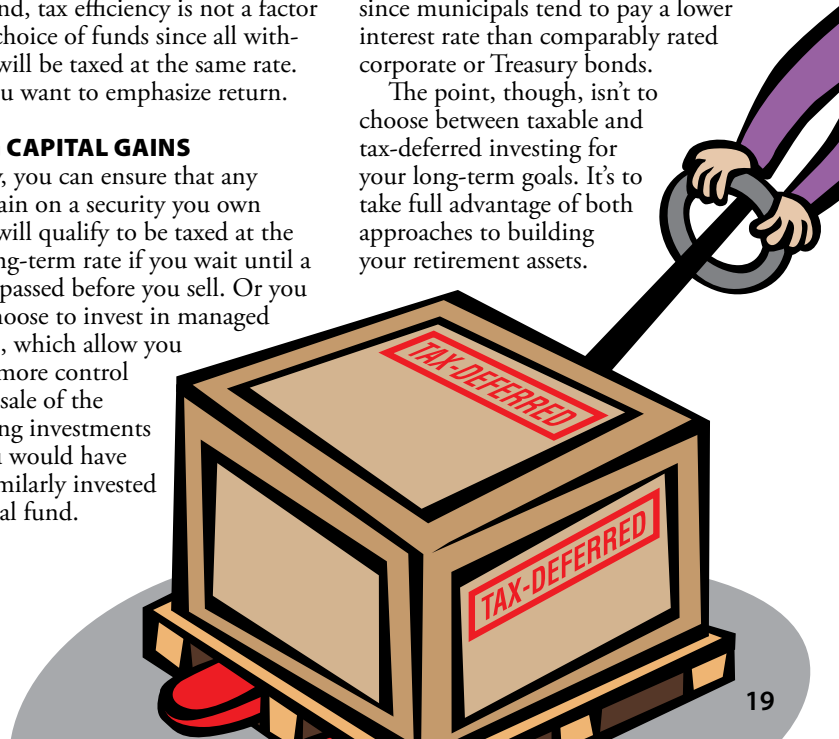


## TAX-EXEMPT INVESTMENTS

Keeping tax consequences in mind, you might invest the fixed-income portion of your taxable portfolio either in municipal bonds issued by the state where you live or in a single-state bond fund that invests in those bonds. In most cases, the interest income is completely tax-exempt. However, if you sell the investment before maturity, any long-term capital gain is taxed at the same rate as other long-term gains.

In contrast, it's generally smart to avoid buying municipal bonds in a tax-deferred retirement plan because all withdrawals are taxed, including any portion that might have been tax-exempt in a taxable account. Municipal bonds may not be the best choice for a tax-free Roth retirement account either, since municipals tend to pay a lower interest rate than comparably rated corporate or Treasury bonds.

The point, though, isn't to choose between taxable and tax-deferred investing for your long-term goals. It's to take full advantage of both approaches to building your retirement assets.



# Choosing Securities

The path to a diversified portfolio requires choosing a variety of investments for your retirement accounts.

The challenge you face in saving for retirement is choosing investments for each of the accounts in your overall portfolio while always thinking of the accounts as segments of a combined whole. In some cases, including most employer plans, you choose from a fixed menu of alternatives. With IRAs and taxable accounts, you have a broader choice. Either way, the more you know about the choices you might make, the more confidently you can decide.

**MUTUAL FUNDS**

- Provide diversification
- May not be focused
- May not be fully invested

**INDEX FUNDS AND ETFs**

- Seek to replicate index results
- Transparency
- May be more tax efficient
- Poor performance in down market

**INDIVIDUAL SECURITIES**

- Investments must be balanced
- Need a varied, representative sample
- Can be costly to diversify
- Performance must be monitored

**MANAGED ACCOUNTS**

- Professional management
- Advantage of multiple managers



## INFINITE VARIETY

Your diversified portfolio is likely to be one-of-a-kind because the unique combination of factors that define your goals, timeframe, and risk tolerance won't be exactly the same as any other investor's.

## MAKING A FUND CHOICE

One reason you may select actively managed mutual funds, which are common in employer plan menus, is that professional managers choose the funds' investments. They also determine when to sell holdings to cash in on capital gains or prevent potential losses—decisions based on the research from a team of investment analysts. Another appeal is that mutual funds pool assets from many investors, so they are typically able to diversify broadly, providing greater protection against certain kinds of risk.

If you are using funds, it's important to look for those that invest differently from each other. You can check each fund's prospectus for its most recent list of holdings and for a statement of its investment objective. If you own several funds invested in large-company stock, you're probably much less diversified than you want to be.

Similarly, you'll want to choose funds that invest in a way that's consistent with their stated objectives and style. For example, if you own a long-term bond fund whose manager decides to sell bonds and hold cash because he or she believes interest rates are going to rise, that move will affect the way the fund behaves.

Any **style drift**, or shift away from the investments you expect the fund to make, may provide short-term gains. But your portfolio will not behave as you expect over the long term.

## THE INDEX ALTERNATIVE

One reason index funds and index-based ETFs may attract your attention is that they're designed to replicate—not beat—the results of the indexes they track. That means there is no issue of these funds making other investments—including those in a different asset class—to improve their return. As a result, they have little style drift.

In addition, index and index-based funds are **transparent**. That means you know at all times what the fund owns: the securities in the index. Further, turnover tends to be limited to transactions that reflect changes in the index itself. That keeps buying and selling within the funds to a minimum, reducing your short-term capital gains and making the funds more tax efficient than many managed funds.

Of course, index funds and ETFs have their shortcomings—including their performance in a falling market and the extent to which weighting impacts their returns. But very few managed funds outperform index funds year in and year out, and they cost more to own.

## ISSUES OF COST

Since cost has an impact on your return, you'll want to compare the expense of buying and holding various investments. As a rule, no-load mutual funds with low annual expenses, ETFs that you buy for a modest or no commission and hold for an extended period, and individual securities you buy and hold in the same way are generally the least expensive.

## ONE BY ONE

You may prefer to choose individual securities within some asset classes, or use both individual securities and funds. For example, you might create an equity portfolio of large-company stocks combined with small-company and mid-sized company mutual funds or ETFs. Or you may put together a bond portfolio of intermediate-term Treasury notes and long-term municipal bonds combined with short-term corporate bond funds.

One challenge with an equity portfolio is creating a rich enough mix of industry, **market capitalization**, or size, and **style**—that is, growth or value—so you hold some securities that are providing strong returns at any given time. To create a broad mix in a fixed-income portfolio, you'll want to consider **term**, **issuer**, and **credit quality**, since the highest-rated bonds tend to pay the lowest rates.

Once you've built a portfolio of individual securities, you're also responsible for deciding if and when to sell certain ones. Failing to shed investments that are unlikely to provide consistent future returns can be a drag on performance.

Despite the added work that may be involved, you may find this approach more rewarding personally and financially than a more hands-off investment style.

## MANAGED ACCOUNTS

You can also invest in specific asset classes through **managed accounts**. To have access to the services of a professional investment manager, you work with your financial adviser or broker to select account managers who specialize in the asset classes you want to include in your portfolio.

For example, you might select a manager for US equities, another for non-US equities, and a third for long-term debt. There are also multi-manager accounts, which allow you to spread a certain amount of money across several asset classes. Or, you might prefer a portfolio that combines managed accounts with individual securities and various funds.

## CHANGING VIEWS

In the past, influential economists have suggested that between 10 and 30 individual securities were adequate for an individual investor who wanted to manage investment risk. For example, Burton Malkiel, in *A Random Walk Down Wall Street*, concluded that if you owned a well-diversified portfolio of 20 equally weighted stocks, you had as much risk reduction as you were going to achieve.

More recently, others have suggested a higher number is more appropriate, based in part on the difficulty of choosing specific securities and in part because the increased volatility of the markets as a whole makes it more difficult to anticipate returns.



# Target Date Funds

If you've got your eye on a retirement date, a target fund may fit the bill.

When you invest for retirement, you can select a portfolio of individual securities, mutual funds, and ETFs or choose a **target date fund**. Its objective is to build and then preserve assets, so that investors in the fund can look forward to a more financially secure retirement.

To meet its goal, a target date fund assembles and regularly realigns a portfolio of individual mutual funds to:

- Help manage investment risk without significantly reducing return during the fund's growth phase
- Try to provide continued, if sometimes modest, growth during the fund's income-producing or asset-preservation phase

## FINDING A FUND

While target date funds currently make up only a small percentage of all mutual funds, they're increasingly available in 401(k) and similar retirement plans, as an investment choice in individual retirement accounts (IRAs), and as an investment alternative in regular taxable accounts.

The financial institutions that offer target date funds never sponsor just one, but offer several funds with different end points to meet the needs of people at different stages in their lives. These end points are usually spaced in five-year or ten-year intervals—2020, 2025, 2030, 2035, and so on, for example.

In selecting a target date fund, you typically choose a fund whose date is closest to the date you plan to retire. For most people, that's often at some point in their 60s, since 65 remains the traditional, though not necessarily the average, retirement age.



## TAKING CAREFUL AIM

One approach to investing in a target date fund, whether it's offered through your employer's retirement plan or you purchase it independently, is to concentrate your retirement assets in that account rather than using it as one account among many. Because the fund is already diversified, and the manager adjusts the way it is allocated to suit the approximate number of years until you retire, you don't have to be responsible for diversifying and reallocating a portfolio on your own.

In another approach, you might use a target date fund for a portion of your retirement portfolio while putting the rest into other investments. If you're comfortable taking more risk than may be typical for someone your age—perhaps because your spouse has an employer pension or you have received an inheritance—you might invest a portion of your IRA in a target fund and the rest in more aggressive funds. Or, you may want to put a larger percentage into conservative investments from the start.

## THE INNER WORKINGS

The **time horizon** of a target date fund largely determines the investments the fund owns. Over time, the balance between risk and return is adjusted, either as part of a gradual, planned reallocation or in response to a combination of changing market conditions and the passage of time, depending on the philosophy of the fund.

Reallocation generally decreases the fund's assets invested in equity funds, while over time increasing the assets invested in bond funds. The pace and style of these changes are known as the fund's

**glide path** and determine the allocation at the target date.

This approach is based upon the principle that a portfolio of equities, even if well diversified, tends to be more volatile than a portfolio of bond funds, thereby exposing you to greater risk. Of course, bond returns aren't guaranteed either, since bond funds are subject to credit and interest-rate risk.

Like other funds, most target date funds hold a percentage of fund assets in cash. While cash returns tend to be lower than those of equities or bonds, and may be a drag on fund results, having money on hand gives the fund managers the flexibility to make new investments without necessarily having to sell off other assets in the portfolio. The fund may also elect to keep cash on hand to buy back shares of the fund that investors wish to sell. That reserve prevents having to sell off assets to repurchase shares, potentially throwing off the current allocation.

## LOOKING UNDER THE HOOD

When a target date fund is a **fund of funds (FOF)**, as most are, its underlying investments may be proprietary mutual funds offered by the investment

company sponsoring the FOF, funds offered by other investment companies, or a mix of affiliated and nonaffiliated funds. Some FOFs also invest in exchange traded funds (ETFs), which share similarities with both index funds and individual equities. And some FOFs use derivative products, such as equity or index options or certain futures contracts, to hedge against risk or to leverage the fund's assets.

The **prospectus** provides an overview of each fund and must be detailed enough to cover the information the Securities and Exchange Commission (SEC) requires. It's an essential read if you're considering a fund.

In addition, US Department of Labor rules require that employers who offer target date funds in a retirement savings plan provide a detailed explanation of each fund's risks and potential return. It must cover the fund's primary investment strategy, performance history, the risks it poses, and its fees and other expenses. In addition, you must be told what allocation the fund plans for its target date, whether that allocation will continue to change, when it will reach its most conservative point, and when the fund expects investors to start withdrawing.

You'll want to consider these factors as you decide whether to invest in a FOF, and you'll want to continue to monitor the fund's progress in helping you reach your goals.



# Investment Risk

There's no such thing as a totally safe investment, but you can choose the level of risk you're comfortable with.

When you invest, you always take a certain amount of risk. The most dramatic consequence is the possibility you could lose some or all of your principal. But you also have to consider the more probable risk that you won't accumulate as much as you need to meet your retirement needs.

The two are interrelated. If you focus on reducing the risk of loss, you usually reduce your potential return and long-term financial security. If you can tolerate some fluctuation in your accounts' values, the most productive approach is often a middle ground, so that you include some investments with little risk to principal, a few with considerable risk, and the majority in assets that pose some risk but may also provide a strong return.

The bottom line is that you have to find the balance between too much and too little risk that fits your goals and your time horizon.

## ESTIMATING RISK

There's no way to predict how investments will perform in the future or the risks that may limit their return. But by looking at the way that an investment or category of investment has performed in the past, you can get a sense of the level of return it's reasonable to expect.

For example, if the annual return on large-company stocks has averaged around 10% since 1926, it's unrealistic to assume that future returns will average 20% or more, despite the fact that they have been that high or higher in individual years. It's also true that they've been significantly lower—negative—in about one-third of the years.

## KEEPING YOUR EYES CLOSED

One of the worst mistakes you can make as an investor is to ignore or underestimate the risks you're taking, or to assume nothing bad is going to happen. The only thing that's more risky is failing to invest because you're afraid you could lose money. Although you're likely to suffer some loss of portfolio value in a market downturn, in the next upturn you're positioned not only to regain lost ground but potentially to accumulate additional account value provided you stay invested.

## THE INVESTMENT PYRAMID

Risk is the result of **volatility**—how much and how quickly the value of an investment changes—and **uncertainty**.

### HIGHER RISK

**Derivative products, such as futures contracts or some options, speculative equity investments, low-rated bonds, and certain commodities generally expose you to higher than average risk most of the time. In some cases, you could lose more than your initial investment.**

### MODERATE RISK

**Some investments pose greater risk at some times than at others. Stocks, equity mutual funds, and ETFs, as a group, may provide strong returns in some but not all periods. Individual stocks can expose you to major gains or losses, based on a number of predictable and unpredictable factors. The same is true of bonds and real estate.**

### LIMITED RISK

**Investing in the stocks and bonds of the largest and most stable issuers and the funds that invest in them poses more limited risk of major losses, but losses can and do occur in some periods. Even some investments considered essentially free of default risk, such as Treasury issues, can expose you to market risk.**

### LOWER RISK

**The investments that pose the least risk of loss are insured bank products and short-term government issues. However, they typically expose you over the long term to inflation risk, which can be especially severe when interest rates are low.**

## VOLATILITY

Volatility refers to sudden and potentially dramatic changes in an investment's value. The more volatile an investment is, the greater the opportunity for a big profit within a short period. But there's also a greater potential for a major loss if the price drops and you sell for less than you paid to buy.

Some investments are inherently volatile, including derivatives whose value depends on the value of an underlying commodity, such as oil or wheat, and stock of new companies whose fortunes may change quickly based on an internal success or failure. Others may be volatile only when

the investment markets in which they trade are in turmoil. Still others are rarely if ever volatile. For example, the market prices of high-rated bonds typically change slowly and within a limited range.

One measure of a stock's volatility is its **beta**, which links its price movement to the average change in a control group of stocks. The less risk you prefer, the more likely you'll be to choose stocks with a beta lower than 1. Or, if you're seeking greater risk and greater potential return, you'll choose stocks with a beta higher than 1.

## THE RISK OF HIGH YIELDS

One cardinal rule for successful investing is to know what you're doing. When the economy is down, and interest earnings decline, you might be tempted to seek an investment that produces the same high returns to which you've grown accustomed. The risk is buying lower-quality investments (which pay more to attract buyers), or investments you don't know anything about. It's a good idea to be skeptical of any investment described as risk free or that promises a dramatically higher yield than better-

known products. Even if it's legitimate, it's likely to have strings attached.

### HIGHEST GAINS OR LOSSES

You can win big, but lose bigger, with risky investments.

### LOWEST GAINS OR LOSSES

\$10,000 in a savings account at rates below inflation will be safe but will lose value over time.

## EMPLOYER STOCK

If you work for a publicly traded company, one of your retirement plan choices may be buying its stock. Or your employer may make its matching contributions in stock. There may be good reasons to choose the stock, including the fact that it gives you an opportunity to share in the success you're contributing to.

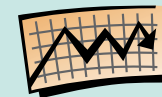
But there are risks in tying your financial security too tightly to a single source. At the worst, you could lose your job and your 401(k) could take a big hit. A useful guideline is to keep your holding to less than 20% of your account value.

## OTHER KINDS OF RISK

**Beyond the risks of the investments themselves—for example, a new company that fails or an established company that suffers severe losses—there are other risks you can't predict or control but must be prepared for:**

### MARKET RISK

depends on the state of the economy as a whole. If the stock market tumbles, your stock investment will probably decline in value even if the companies whose stock you own are making money.



### CURRENCY FLUCTUATION

is increasingly a factor in investment risk, as more people put money into international markets. If the dollar rises in value, for example, the value of overseas investments declines—and vice versa.



### INFLATION RISK

affects the value of fixed-rate investments like bonds and CDs. If you buy when interest rates are low, the value of your investments declines as inflation and interest rates rise because the old interest rate isn't adjusted to keep pace.



### POLITICAL TURMOIL

is a risk because the economies of different nations are closely intertwined. Threats to the oil supply, for example, have disrupted the economy before and could again.





# Asset Allocation

Asset allocation is a strategy for building and managing your investment portfolio.

An **asset class** is a group of investments that shares specific characteristics that differentiate it from other groups of investments. Among the primary distinctions are that each asset class puts your money to work in a different way than the others and exposes you to different types of investment risk.

**Asset allocation** means dividing your investment portfolio among asset classes—primarily stocks, bonds, and cash equivalents, but potentially tangible property including real estate and precious metals, and derivatives, including options and futures contracts. Stocks—also called equities—include stock mutual funds and exchange traded funds (ETFs) that track stock indexes. Bonds include bond mutual funds and ETFs that track bond indexes. Cash equivalents include certificates of deposit (CDs), US Treasury bills, and money market mutual funds.

Generally you allocate on a percentage basis, assigning part of your investment principal to each asset class you're using. For example, you might invest 60% in one class, 20% in a second, and 20% in a third. Or you might allocate one-third of the total to each of three classes.

## LOOKING FOR RESULTS

Your allocation typically has a major impact on your investment **return**. That's because no single asset class consistently produces the best return every year, based on a number of factors including what's happening in the investment markets and in the economy at large. And a class that has been strong one year may be weak the next.

If you were invested primarily in the class that was outperforming the others in a particular year, your increased portfolio value would reflect those gains. But if in the following year or two that class underperformed, your portfolio value would be dragged down by the losses. The challenge is that while this up-and-down pattern repeats regularly, the timing is not predictable.

Remember, too, that while asset allocation can help you manage risk, it doesn't guarantee a profit or prevent a loss in a falling market.

## MANAGING RISK

Although each asset class is made up of many different securities, certain recurring market conditions affect an entire asset class in a relatively predictable way. For example, if interest rates

## ALLOCATION

An asset allocation model is a blueprint for spreading your investment capital among different asset classes. The most suitable model varies, based



### AGGRESSIVE

An **aggressive** allocation, which may be appropriate for young people or those with a steady source of fixed income, tends to emphasize equities, with as much as 80% to 90% of the portfolio being invested in stock, stock mutual funds, and stock ETFs.

## HOW ALLOCATION WORKS

Once you have chosen an appropriate allocation—say that you decide to put 60% of your assets into stock, 30% into bonds, and 10% into cash—the next step is to put it into practice. For example, you might have \$1,000 to invest. You'd use \$600 to buy shares of a stock fund, put \$300 in a bond fund, and place the remaining \$100 in a savings account. The next time you have \$1,000 to invest, you do the same thing. And, if you rolled over \$10,000 from a 401(k) to an individual retirement account (IRA), \$6,000 would go into stock funds, \$3,000 into bond funds and other fixed-income alternatives, and \$1,000 into cash equivalents, such as US Treasury bills (T-bills) or a short-term bond fund.

are low and corporate earnings are strong, stocks as a group have tended to produce robust returns while bond returns were likely to be more anemic. This is known as **systemic risk**.

By creating a portfolio of asset classes that respond differently to particular market and economic conditions—not all of which are likely to occur at the same time—you have a better chance of weathering some major losses without significantly reducing your potential for long-term growth. That's because gains in

one asset class can not only offset losses in another, but, if they're strong enough, can also provide a positive return for the year.

Asset classes that produce their strongest returns in different economic climates are described as having a low or negative **correlation**. In other words, they don't respond the same way to a particular stimulus. For example, stocks and cash equivalents tend to have a very low correlation. When the interest rate on T-bills is high, stock returns tend to be limited or even negative.

## MODELS

on an investor's age, economic situation, and tolerance for investment risk, plus expectations about how the market is likely to perform.

Comparing different ways to allocate may help you determine the model that might be best for you.



### MODERATE

A **moderate** allocation might assign between 50% and 70% of the total to equities, depending on your age, your financial goals, and your other financial resources, with the balance going to fixed income and some cash.



### CONSERVATIVE

A **conservative** allocation, which may be appropriate for older people wanting to preserve capital and collect regular income, might assign 40% of the total to equities, with the rest divided between bonds and cash, depending on the economy and an investor's personal financial situation.

## A TIME TO REALLOCATE

Over time, you may want to modify your portfolio allocation in response to a number of different situations.

As you get closer to retirement, you may want to shift some of your assets out of potentially volatile growth investments, such as stock or stock funds, into income-producing investments that have tended to be more stable in value.

You may want to reallocate your portfolio in response to major life events that have an impact on your financial situation, such as getting married or divorced, having children, or changing jobs.

## ALLOCATION CHOICES

**Stock** has historically provided the strongest return by doing well in some years, even though results have been flat or lost ground in others.

**Bonds** have produced strong returns in some years and weaker returns in others, though the highs and lows tend to be less extreme than with stock.

**Cash equivalents** usually provide the smallest, but most consistent, returns.

**Real estate** tends to increase in value over time, sometimes dramatically. It can lose value, too, and real estate is illiquid, which means it may be hard to sell easily at the price you want.

# Diversification

Diversifying means buying a number of investments within an asset class.

No matter how good a recipe is, it doesn't guarantee high-quality results. You also need superior ingredients. In investment terms, this means building your portfolio by selecting a diversified group of securities for each asset class you invest in and ensuring that each security meets your criteria for investing.

For example, if US equities is one of your asset classes, you might choose a number of **individual stocks**. Or you might diversify by choosing a variety of **mutual funds** or **exchange traded funds (ETFs)** investing in US equities.

**Diversification** within each asset class is essential because it allows you to offset, or dilute, security-specific risks.

## FINER DISTINCTIONS

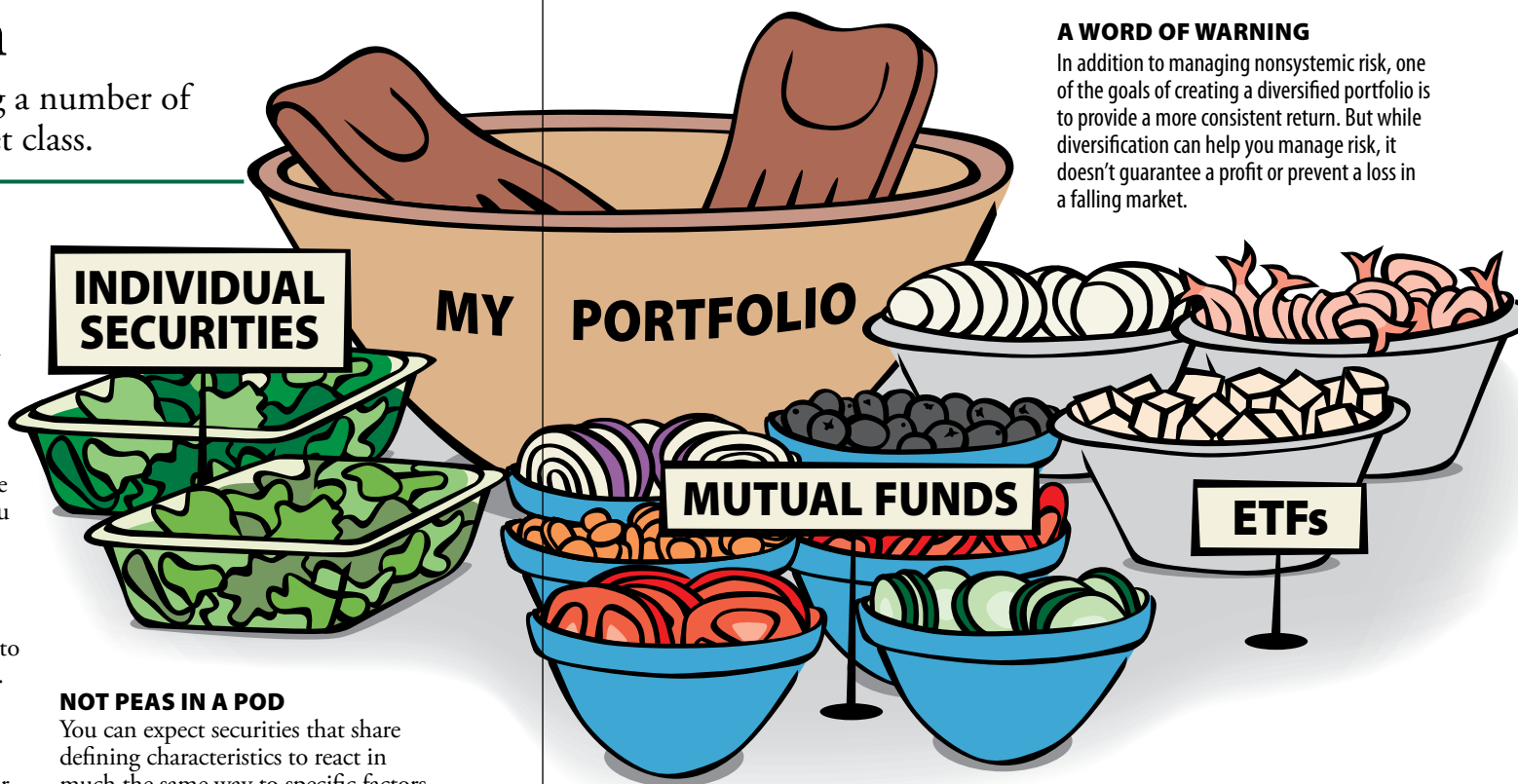
Most asset classes are defined in fairly sweeping terms, such as US equities or long-term US debt. There are more than 4,500 listed common stocks that belong to the first category, several thousand that aren't listed, and more than 500 ETFs and 4,500 mutual funds that invest in stocks. Long-term US debt includes several million corporate, federal government, and municipal issues.

**Subclasses**, or smaller categories, within the broad classes typically behave differently from each other even though they share the essential defining features of the class to which they belong.

For example, companies issuing equities can be divided by **market capitalization** into large, mid, small, and micro subclasses. Differences in capitalization generally indicate differences in growth potential, share-price volatility, and the likelihood that the issuing company will survive an economic downturn.

Other ways to distinguish equity subclasses are by industry, sector, and valuation—that is, whether they're overpriced or underpriced based on a criterion such as average price/earnings ratio (P/E) for their peers, as well as domestic and international issues.

On the fixed-income side, differentiators include taxable and tax-free status, interest rate, term, callability, and rating.



## NOT PEAS IN A POD

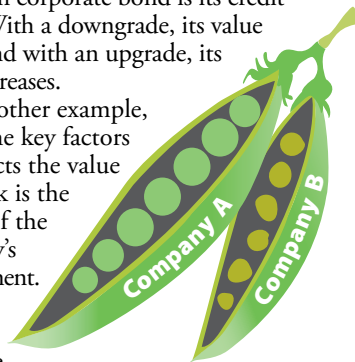
You can expect securities that share defining characteristics to react in much the same way to specific factors or situations. For example, one of the major determinants of the value of any long-term corporate bond is its credit rating. With a downgrade, its value drops, and with an upgrade, its value increases.

As another example, one of the key factors that affects the value of a stock is the quality of the company's management. Some companies have exceptional management and, as a result, tend to outperform their peers. Other companies have inferior management and tend to falter even though they may be producing comparable products or providing similar services.

These are examples of a **security-specific risk**, or, in the language of asset allocation, **nonsystemic risk**.

## LIMITING YOUR EXPOSURE

The possibility of a downgrade in a long-term corporate bond's rating that dramatically reduces a bond's return represents a significant source of risk. Compounding the problem, it's hard to predict when the credit quality of a particular bond will change. While this risk



## A WORD OF WARNING

In addition to managing nonsystemic risk, one of the goals of creating a diversified portfolio is to provide a more consistent return. But while diversification can help you manage risk, it doesn't guarantee a profit or prevent a loss in a falling market.

is significant with any single bond, you can reduce your overall risk by buying an assortment of similar bonds.

If, for instance, instead of owning one bond you own a diversified portfolio of bonds, then the credit quality of some of the bonds may be upgraded while the credit quality of others is downgraded. Over time, the upgrades and downgrades may equalize so that, overall, the impact of credit changes on your portfolio's return is reduced. In other words, a certain amount of credit risk can be diversified away.

As an investor, it's often hard to know which companies are well-managed and which are poorly managed—except in hindsight. However, in a diversified portfolio of stocks, the effects of superior and inferior management tend to balance out. Therefore the impact of management quality is another nonsystemic risk that you can reduce or even eliminate through diversification.

But adding investments randomly is unlikely to achieve the diversification you seek. The quality and range of investments and the care with which

they're selected is more important than how many you own.

## DIVERSIFYING WITH FUNDS

A well-diversified portfolio is likely to contain securities from various subclasses—though not necessarily from all of them—within each of its asset classes.

For example, short-term bonds, which mature in less than a year, tend to be less vulnerable to inflation risk than bonds with 30-year terms. They're also much less likely to expose you to credit risk since the issuer's ability to pay will not be subject to as many changing factors. But in most environments they pay lower rates.

One approach to consider is concentrating your investment assets in mutual funds and ETFs. Because each fund is diversified in its own right, you don't have the responsibility of choosing individual investments or concerns about owning enough different securities in any category. And because you can choose among a broad range of funds, each of which invests to meet a particular objective, you can create a diversified portfolio of diversified funds.

But as part of your selection process, you'll want to evaluate the fees and other costs of owning the funds you're considering. The higher the annual expenses, the lower the return you realize.





# Portfolio Planning

You don't have to reinvent the wheel to plan your asset allocation. It's already been done.

Allocating and diversifying your portfolio isn't a one-time decision. It's the ongoing process of seeking the strongest possible return that's consistent with your investment goals, timeframe, and risk tolerance. An appropriate allocation when you're in your 30s may no longer be the best choice in your mid-50s. In most cases, you're the one who must make the adjustments.

## CASH IN THE BANK

A cash investment is a way to have money available for emergencies and for new investment opportunities. While keeping the bulk of your money in a regular savings account has serious limitations as a long-term investment strategy, the logic behind a cash reserve makes a lot of sense. If all your assets are invested in stocks and long-term bonds, and you need to **liquidate**, or turn them to cash quickly, you may take a loss if the market is down. That doesn't happen if they're already in cash.

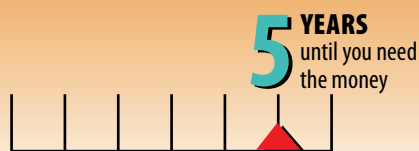
## TAKING STOCK

In an asset allocation model, stocks represent growth. While some stocks pay dividends that provide a regular income, stocks are essential to long-term invest-

## STASHING THE CASH

Option	Characteristics
Bank money market account	<ul style="list-style-type: none"> <li>Instant access</li> <li>Better interest rates than savings account</li> <li>May reduce cost of checking account</li> <li>Check-writing privileges</li> <li>FDIC-insured</li> </ul>
Money market mutual fund	<ul style="list-style-type: none"> <li>Easy access</li> <li>Interest may be higher than bank money market account</li> <li>Check-writing privileges</li> <li>Not FDIC-insured, may lose value</li> </ul>
CDs	<ul style="list-style-type: none"> <li>Money available (with early withdrawal penalty possible)</li> <li>Interest rate slightly higher than money market accounts</li> <li>Due dates can be staggered for convenience</li> <li>Bank CDs FDIC-insured</li> </ul>
US Treasury bills	<ul style="list-style-type: none"> <li>Easy to purchase</li> <li>Little inflation risk</li> <li>Can be sold any time, though at a potential loss</li> <li>Extremely safe</li> </ul>

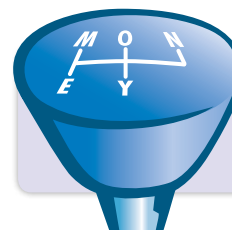
## LOOKING AHEAD\*



ment planning because historically they have increased in value. While it's always possible to lose a lot of money in the stock market in any one period, stocks in general—though not every individual stock—have characteristically rebounded from past losses to provide long-term gains.

You may have as much as 80% of your total portfolio in stocks (or stock funds) while you're in your 20s and 30s. That means every time you invest \$1,000, \$800 of it would go into stocks, mutual funds, or ETFs. However, as you get older, say in your 50s and 60s, the percentage of stocks in your portfolio is usually scaled back. Generally the greater the risk a particular stock carries, the more suitable it is for younger investors or those with substantial assets elsewhere.

\*These hypothetical allocations are intended only as illustrations and do not predict the return of any specific portfolio.



## SHIFTING GEARS FOR SHIFTING GOALS

As retirement gets closer, you might want to shift from seeking growth toward providing income.

## STOCKS

**80%**  
Stocks have the potential to grow in value over time and may pay regular dividends.

**60%**  
You may gradually reduce your allocation somewhat to reduce portfolio volatility.

**40%**  
Stock always has a role to play in your investment portfolio.

## BONDS

**15%**  
Bond issuers pay interest, usually on a regular schedule, and promise to repay principal at maturity.

**30%**  
You may gradually increase your bond holdings as you reduce your stock holdings.

**40%**  
Bonds tend to be less volatile than stock and provide a larger annual yield.

## CASH

**5%**  
Cash in insured accounts preserves principal and provides regular if typically modest income.

**10%**  
You may start taking profits on stock and adding to your cash reserve.

**20%**  
You may want to have two or three years worth of income available in cash.

## THE BOND'S THE THING

Bonds have traditionally been seen as income-producing investments. If that's your goal, you buy a bond, hold it to maturity and receive a regular interest payment every six months or year. Then you get the principal back when the bond matures. As an added plus, bonds issued by the US government have limited credit risk so there's unlikely to be a **default**, or failure to pay what's due. That's one reason these bonds appeal to investors—often those nearing retirement—who are looking for steady income and don't want to risk losing their principal.

On the other hand, like other bond investments, they are subject to **market risk**. This means if demand is down, perhaps because newer bonds are paying a higher rate of interest or because people are selling bonds to invest in the stock market, your bonds may be selling for less than par value. If you bought at issue and sell before maturity, you could lose some of your principal.

Whatever your age, you'll probably want to consider investing in bonds—or bond mutual funds or ETFs—because they can help reduce the overall volatility of your portfolio. For example, you might buy some mix of government,

corporate, and municipal bonds of different maturities and with different ratings.

The advantage of bond funds or bond ETFs over individual corporate or municipal bonds is that it's easier to achieve greater diversification at lower cost.

However, with a fund, there's not a fixed interest rate, since the fund owns bonds with varying rates, and there's no maturity date, as it owns funds with different terms. In addition, there's no promise to return your principal, though it's possible that you may be able to sell your shares at a higher price than you paid to buy them.

## OTHER FIXED INCOME

Pass-through securities are another type of fixed-income investment. They are created by bundling together a group of loans, such as mortgages or student loan debt, a process known as securitization. Among the best known are the mortgage-backed securities called GNMA's, or Ginnie Maes, which are insured by the Government National Mortgage Association. As borrowers repay the principal and interest on the underlying loans, those payments are passed along to investors. Most individuals invest in Ginnie Maes by buying a GNMA fund.

# Tracking Performance

Knowing where you are now helps get you to where you want to be.

Accumulating the assets that will help provide a secure retirement requires regular attention. This means monitoring each of your accounts and the investments they contain on a regular basis to determine whether they're adding value or acting as a drag. It means knowing what you can reasonably expect from specific investments, which will vary by asset class. And it means being prepared to modify the choices you've made if they aren't meeting your expectations.

At the same time, you have to be realistic. If investment markets are struggling to stay positive, as they periodically are, you're not likely to improve performance by replacing your current holdings with new ones. Nor is selling off everything and putting the proceeds into a savings account likely to get you where you want to be.

## ENTER THE BENCHMARK

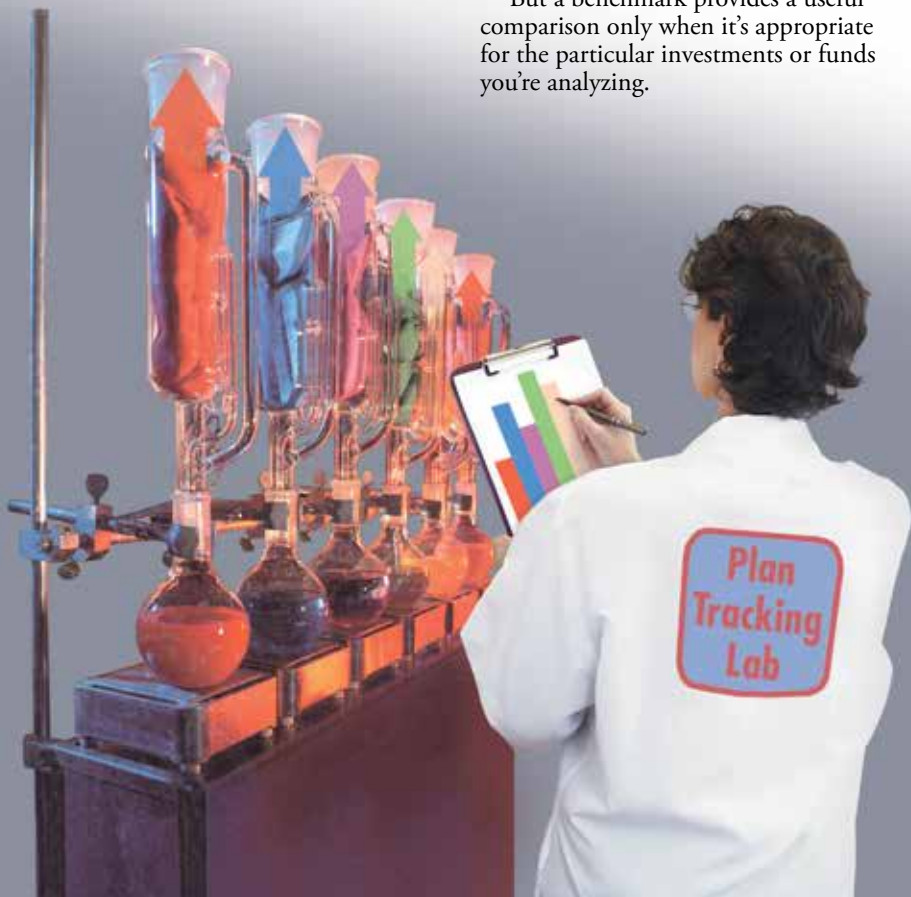
One of the things you'll want to know as you evaluate performance is how well

your investments are doing in comparison to other investments with similar characteristics and return potential. That's where benchmarks come in.

A benchmark is usually an index or average that reflects the changing value of a particular financial market or market sector. It serves as a standard against which to compare the performance of an investment that belongs to that market or sector.

For example, the Standard & Poor's 500 Index (S&P 500), which tracks the performance of 500 of the largest and most widely held US stocks, is the benchmark against which the performance of large-company US stocks, and the mutual funds and ETFs that invest in them, is measured. Other benchmarks track small-company stocks, long-term government bonds, and nearly every other category you can think of in the United States and markets around the world. There are also a variety of mutual fund indexes to track different types of funds.

But a benchmark provides a useful comparison only when it's appropriate for the particular investments or funds you're analyzing.



## WHAT YOU'RE LOOKING FOR

The key to performance testing is **return on investment (ROI)**, or what you get back in relation to the amount you invest, called your investment principal.

**Total return** is the amount an investment increases or decreases in value plus any dividends or interest you collect. **Percent return**, which is the most accurate way to compare return on different investments, is total return divided by the principal. **Annual percent return** allows you to make comparisons on a yearly basis, and is calculated by dividing percent return by the number of years you've owned the investment.

If you're comparing returns as a way to decide which investments to keep and which to consider replacing, remember to make comparisons of similar investments. This is essential because the return on specific asset classes and subclasses is driven by different factors. For example, most small-company stocks don't pay dividends, though many large-company stocks do. Likewise, the market values of short-term bonds usually don't change much if at all during their terms. Long-term bond prices, on the other hand, may change substantially as interest rates change.

You'll also want to look at performance over a period of time rather than just at the last few months or even the last year, as the way an investment performs changes as the economy cycles up and down. The only exception may be if the issuer is suddenly in serious financial trouble from which it seems unlikely to emerge and you want to avoid deeper losses.

## COST ISSUES

Among the key factors that influence retirement plan performance is what you pay in fees to buy and hold specific investments and in some cases to participate in the plan. If you buy and sell frequently, your costs will be higher.

If you choose individual securities for your IRA, your costs are limited to the commissions you pay on transactions, which vary by brokerage firm, and an annual asset-based fee if you use an investment adviser to help you create your portfolio.

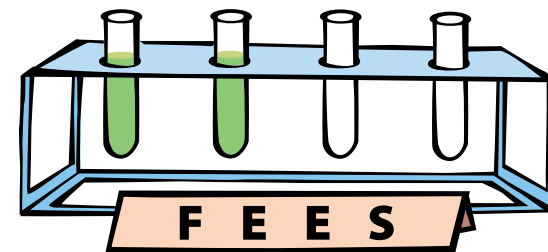
If you use primarily mutual funds in your IRA, there may be no charge to buy if you open your account with

## FEE INFORMATION

You can find more information about plan fees from the US Department of Labor at [www.dol.gov](http://www.dol.gov), from the Securities and Exchange Commission at [www.sec.gov](http://www.sec.gov), and from FINRA, at [www.finra.org](http://www.finra.org).

a fund sponsor that sells directly to clients. But all mutual funds have an **expense ratio**. It's the percentage of your account value that's subtracted before return is reported to pay the costs of running the fund, investing assets, and providing shareholder services. Each fund's prospectus provides details of its expense ratio and other charges that may apply, which vary from fund to fund.

With an employer plan, annual asset-based fees apply. They vary based on the investments that are available and by the size of the plan. There may also be administrative fees for participating, though some employers cover these costs.



## WORDS OF CAUTION

As you analyze an investment's return remember that the gains or losses it has provided—known as past performance—don't predict future results. The fate of some one-time stars of the stock market provides ample verification.

However, one of the core principles of asset allocation is that an investment's return tends to move in a statistically predictable way above and below its **mean**, or average value. This variation, called standard deviation, allows you to anticipate the probable range of future returns over a full economic cycle.



# Rebalancing Acts

Keeping your portfolios balanced may mean moving investments around from time to time.

Many people are careful to allocate their assets when they start to invest but fail to make adjustments over the years. That's almost never a good idea.

Two situations may require that you rethink your initial allocation or make some changes to get back on track:

**1** As you get closer to retirement, you may want to readjust your allocation strategy to add more stability and emphasize income-producing investments.

**2** If market performance increases or decreases the value of one asset class so that your actual portfolio allocation is significantly different from the allocation you selected, you may want to realign your holdings to get them back in balance.

## KEEPING YOUR BALANCE

Different assets grow at different rates. Over time, the ones that grow more quickly will make up a greater percentage of your portfolio than you originally planned. To maintain the portfolio's asset allocation mix, you may decide to transfer money from asset classes that have grown faster—such as long-term corporate bond mutual funds or small-cap stock funds—into those that have grown more slowly, such as blue-chip stock funds or capital preservation funds. If you don't reallocate, you may find yourself with a portfolio that has more risk or less potential for a long-term return than you originally intended.

## GETTING IT DONE

You can rebalance your portfolio in different ways. They all work, but you may be more comfortable with one approach than another.

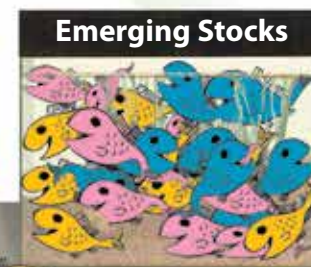
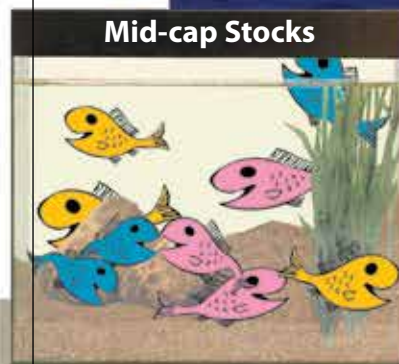
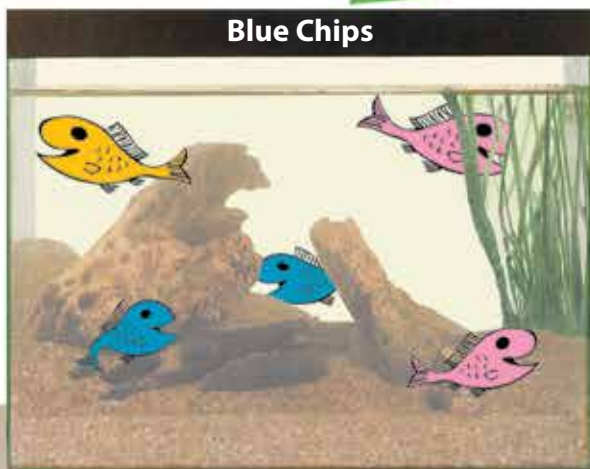
For example, you can sell off a portion of the asset class that has increased most in value and reinvest those profits in the lagging asset class or classes.

You can change the way your future contributions are allocated, putting more money into the lagging asset class until things are back in balance.

You can also add new investments in the lagging asset class to your portfolio and funnel your contributions to those investments.

If you're reallocating to emphasize income over growth, you can gradually sell off some of your stock holdings, moving the money into fixed income. At the same time, you can direct a larger percentage of your continuing contributions into those more conservative choices.

It's better not to let your portfolio get too far out of balance.



## A REBALANCING TIMETABLE

Some investment professionals suggest rebalancing your allocation once a year as part of an annual reassessment of your financial plan. But there's no official timetable, and the further in the future your retirement is, the less important frequent rebalancing is likely to be.

Rather than rebalancing mechanically, you might decide to sell off holdings in your portfolio's strongest asset class only when that class exceeds a specific percentage—say 10% or 15%—over your target allocation. That way, you avoid what seems like the backward logic of selling an investment that is doing well in order to put your money into something that seems less likely to help you meet your long-term needs.

With a **target date fund**, the fund provider is responsible for rebalancing and reallocation. The premise of these funds is that they gradually modify the asset mix from an emphasis on growth to an increasing emphasis on producing income. A **balanced fund** manager also readjusts its allocation to maintain the mix of equity and bonds described in the prospectus.

## THE HIDDEN COST OF SHIFTING

If you have online access to your portfolio or you have a 401(k) plan brokerage account, you may be able to shift your asset class allocation and the individual investments within each class as often as you wish.

When your portfolio value is up, you can lock in profits without having to plan for the immediate tax consequences. When it's down, you can move into something safer.

But remember that this kind of constant shifting makes retirement planners shiver. Most trading comes with a price tag, in terms of sales charges and sometimes back-end loads, exchange fees, or exit fees. The more often you trade, the more you pay. So there's a real risk that you may be spending more to make changes than you earn from making them. An even more serious consequence is that switching out of equities when the equity market drops means you're locking in a loss.

On the other hand, some of the investments in your account may be living up to your expectations, while others are not. Is that the time to make a change? If a mutual fund produces returns below the average for its category for two years, it may be time to sell your shares and put the money into another alternative within your plan.

## WAIT IT OUT

If watching the stock ticker take a nose-dive makes you worry that your retirement accounts are losing value too, or if an account has dropped enough in value to make you uncomfortable, what should you do? Often, the answer is sit tight.

In reality, there's always the potential that equity markets will drop and your account will lose some of its value. That's why a broadly allocated portfolio and a gradual shift toward a more conservative mix as you get closer to retirement are essential. While that doesn't ensure your account won't lose value, it should help cushion the blow.

# GLOSSARY

**Asset allocation** is a strategy for managing certain types of investment risk by investing specific percentages of your investment principal in different asset classes, including stocks, bonds, and cash. However, asset allocation does not guarantee a profit or protect you against losses in a falling market.

**Benchmark** is a standard against which investment performance or other variables are measured. A market index or average whose gains and losses reflect the changing direction of the market segment it tracks may serve as a benchmark for individual securities or mutual funds.

**Compounding** occurs when your investment earnings are added to your principal, forming a larger base on which future earnings may accumulate. As your investment base grows larger, it has the potential to compound faster.

**Debt securities**, also called notes and bonds, are investments that involve lending money to an issuer, such as a corporation or government, in exchange for interest payments for the use of your money and the promise that your principal will be returned at the end of a specific term.

**Diversification** is an investment strategy for managing certain types of investment risk that involves buying a number of different securities, mutual funds, or exchange traded funds (ETFs) in different categories or subclasses within a single asset class. However, diversification does not guarantee a profit or protect you against losses in a falling market.

**Equity** is ownership, and equity investments give you ownership shares. In the case of stock, for example, you own shares of the corporation that issues the stock.

**Financial plan** is a list of the things you would like to be able to afford in the future, your timetable for achieving those goals, an estimate of what they will cost, and a strategy for investing that's designed to help you achieve them.

**Index** is a list of securities that share a relevant characteristic, such as asset classification, market capitalization, or investment objective, and whose collective performance is taken as a sign of how that segment of the market is faring.

**Market capitalization**, or market cap, is one way to measure the size of a company and is often used to anticipate its potential for investment return and the types of risk it may pose to investors.

Market cap is calculated by multiplying the current price of a share of the company's stock by the number of outstanding shares.

**Portfolio** is the group or collection of investments that you own. Each time you purchase a new investment, you expand your portfolio, ideally making it more diversified.

**Principal** is the amount you invest. When your investment account is insured, as bank accounts are, your principal is guaranteed. If the account is not insured, you could lose some or even all of that money.

**Return** is the profit you make on an investment, usually expressed as a percentage of your investment cost. It includes any increase or decrease in the value of the investment plus any earnings you receive from the investment.

**Risk** is the possibility that you could lose money or buying power by making particular investments or that you might not realize the level of return you had hoped for or expected from your investments.

**Rollover IRA** is an IRA that holds assets you have moved from an employer's retirement plan or another IRA. The advantages of a rollover IRA are that you maintain the tax-deferred status of your savings but are likely to have more control over how your assets are invested and how you manage required withdrawals if they apply.

**Taxable** means you owe income or capital gains tax on investment income or the profit from the sale of an investment for the tax year in which the income is paid or the profit realized.

**Tax deferred** means you postpone paying income tax on earnings and in some cases on contributions to an investment account. You pay tax on your withdrawals at your regular tax rate unless the account is a Roth IRA, 401(k), 403(b), or 457. Those withdrawals are tax free if you are at least 59½ and your account has been open at least five years.

**Tax exempt** or tax free mean that no income tax is due. In most cases, the terms apply to earnings from specific investments, such as municipal bonds, or investment accounts, such as a Roth IRA.

**Yield** is the income you receive annually from an investment, expressed as a percentage of the price you paid to buy it.

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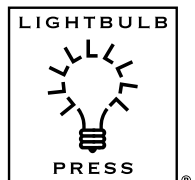
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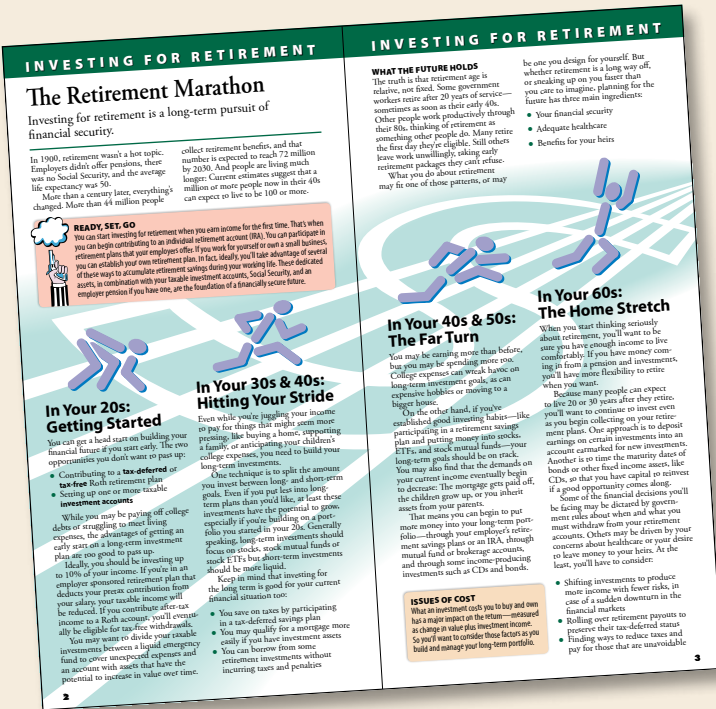
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# INVESTING FOR RETIREMENT

explains how decisions you make during your working life can help ensure you'll have a more financially secure retirement. The guide discusses personal investing goals, explores ways to use asset allocation and diversification to offset investment risk, and explains the role of both taxable and tax-deferred investments in your portfolio. Equally important, the guide looks at the many different sources that may provide retirement income—since putting together an income stream is one of the greatest challenges facing people who are nearing or already in retirement.



## The Retirement Marathon

Investing for retirement is a long-term pursuit of financial security.

In 1990, retirement wasn't a hot topic. Employers didn't offer pensions, there was no Social Security, and the average life expectancy was 50. More than a century later, everything's changed. More than 44 million people collect retirement benefits, and that number is expected to reach 72 million by 2030. And people are living much longer. Current estimates suggest that 4 million or more people now in their 40s can expect to live to be 100 or more.

**READY, SET, GO**  
You can start investing for retirement when you earn income for the first time. That's when you can begin contributing to an individual retirement account (IRA). You can participate in retirement plans that your employer offers. If you want to opt out or own a small business, retirement plans that you establish yourself are another option. In fact, identify your tax advantages of several of these ways to accumulate retirement savings during your working life. Your dedicated efforts to accumulate retirement savings, during your working life, have a significant impact on your wealth in retirement. In addition, your investments, Social Security, and an employer pension if you have one, are the foundation of a financially secure future.

**In Your 20s: Getting Started**  
You can get a head start on building your financial future if you start early. The two opportunities you should watch for are:

- Contributing to a tax-deferred or tax-free Roth retirement plan
- Setting up one or more taxable investment accounts

While you may be paying off college debts or struggling to meet living expenses, the advantage of getting an early start on a long-term investment plan can't be overstated. If you're an employer-sponsored retirement plan that deducts your pre-tax contribution from your salary, your taxable income will be reduced. If you contribute after-tax income to a Roth account, you'll eventually be eligible for tax-free withdrawals. You may want to divide your taxable investments between a liquid emergency fund to cover unexpected expenses and an account with assets that have the potential to increase in value over time.

## INVESTING FOR RETIREMENT

**WHAT THE FUTURE HOLDS**  
The truth is that retirement age is relative, not fixed. Some government workers retire after 20 years of service—sometimes as soon as their early 40s. Other people work productively through their 50s, thinking of retirement as the first day they're eligible. Still others have work unwillingly taking early retirement packages they can't refuse. What you do about retirement, or may fit one of those patterns, or may be one you design for yourself. But whichever retirement is a long way off, or sneaking up on you faster than you care to realize, planning for the future has three main ingredients:

- Your financial security
- Adequate healthcare
- Benefits for your heirs



## In Your 40s & 50s: The Far Turn

You may be earning more than before, but you may be spending more, too. College expenses can wreak havoc on long-term investment goals, as can expensive hobbies or moving to a bigger house. On the other hand, if you've established good investing habits—like participating in a retirement savings plan and putting money into stocks, ETFs, and stock mutual funds—your long-term goals should be on track. You may also find that the demands on your current income eventually begin to increase: The mortgage gets paid off, the children grow up, or you inherit assets from your parents.

That means you can begin to put more money into your long-term investments—through your employer's retirement savings plan or an IRA, through mutual funds or brokerage accounts, and through some income-producing investments such as CDs and bonds.

**ISSUES OF COST**  
What an investment costs you to buy and own has a major impact on the return—retained as a change in value plus investment income. So you'll want to consider these factors as you build and manage your long-term portfolio.

## In Your 60s: The Home Stretch

When you start thinking seriously about retirement, you'll want to be sure you have enough income to live comfortably. If you have money committed in from a pension and investment, you'll have more flexibility to retire when you want.

Because many people can expect to live 20 or 30 years after they retire, you'll want to continue to invest even as you begin collecting on your retirement plan. One approach is to deposit earnings on certain investments into an account earmarked for new investments. Another is to time the maturity dates of CDs, so that you have capital on retirement if a good opportunity comes along.

Some of the financial decisions you'll be facing may be dictated by government rules about when and what you must withdraw from your retirement accounts. Others may be driven by your concern about healthcare or your desire to leave money to your heirs. As the years go by, you'll have to consider:

- Shifting investments to produce more income with fewer risks, in case of a sudden downturn in the financial markets
- Rolling over retirement payments to preserve their tax-deferred status
- Finding ways to reduce taxes and pay for those that are unavoidable

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