

Navigating Financial Shoals in Academe: Questions and Answers



Saving for Retirement vs. Children's Education

Question: I am 38 years old. Since completing my Ph.D. in 1998, and since switching from teaching to administration, my salary has increased substantially. I am now contributing the maximum amount to TIAA-CREF for my retirement. My children are 8 and 6, and I am concerned about their college education. They excel in school and have the potential to go to a very good university. I would be disappointed if the only reason they chose to not go to a top college was my failure to save for them, and I would also be disappointed if I did not have sufficient resources when I retire. My wife does not work outside the home. My salary, at a private liberal-arts college, is the sole source of income for our family. How do I save for my retirement and for my children's tuition? Or how do I divide my savings dollars between my own retirement and the college education of my children?

Bill Losey: As a father of three young sons myself, I know what you're going through. You want to plan for a successful retirement but don't want to let the little ones down either. But before you save for college and retirement, you need to establish a firm financial foundation.

First, you should consider buying 20-year or 30-year term life insurance policies on your life and your spouse's life. The amount of insurance on your life should be more since you are the sole breadwinner. You will want to get a policy with a death benefit of at least \$500,000. At your age, assuming you are in good health, it will cost you less than \$500 per year. Because term-insurance rates have decreased, you may want to consider going for up to \$1-million in coverage now, which should cost around \$1,000 per year. That may sound like a lot, but if you passed away, that pool of money could generate \$40,000 to \$60,000 a year in income for your wife. The goal with insurance is to replace your income if you die.

Although your wife does not work outside the home, she is working. If she were to die, it would cost you a small fortune to hire someone to handle the household the way she does. Assuming she cooks, cleans, runs errands, coordinates deliveries and repairs, grocery shops, plans parties and events, and cares for the kids, your wife should have a policy on her life for at least \$500,000. That pool of money could generate \$20,000 to \$30,000 per year in income for you. You can hire a local agent for insurance, contact TIAA-CREF, or visit <http://www.insure.com> to shop for the lowest possible rates.

Second, since you have two children, I highly recommend that you complete some basic estate-planning tools such as wills, health-care proxies, and a power of attorney. Depending on where you live, an estate-planning lawyer should probably be able to draw these documents up for you for \$500 to \$1,000. Make sure you hire a lawyer who specializes in estate planning. Additionally, make sure you name guardians and contingent guardians for your children in the event that both you and your wife should pass away before your children are considered adults. If you do not have a will or choose guardians, the court decides who gets the kids.

Third, I would suggest you begin accumulating three to six months' worth of living expenses in a

savings account. For example, if it costs you \$4,000 per month to run your household, you should have between \$12,000 to \$24,000 set aside for those unforeseen emergencies that can arise. In this age of perpetual layoffs and downsizing, that is a necessity.

Assuming you now have your financial foundation in place, my next suggestion is to continue making the maximum contribution to your retirement plan. Because you have more than 20 years until retirement, all those years of tax-deferred growth and compounding will work to your advantage. It is not uncommon for me to see people who have amassed \$500,000 to \$1-million over a career. In addition, you lower your taxable income every year by deferring this money. Remember, you cannot borrow to finance your retirement.

In my opinion, saving for college should be the last priority. That is because you always have the ability to borrow up to 100 percent of the cost of college. You probably also have the ability to borrow against your retirement plan. Until your children get within 18 months of college, you will have no definitive idea what college the children will go to, how much it will actually cost you out of pocket, what sort of grants they may receive, and what type of government-loan programs will be available.

After fully funding your retirement, and if your financial foundation is firmly in place, you can use any extra money each month on a college savings account, such as a 529 plan. A 529 plan is an education savings plan operated by a state or educational institution designed to help families allocate funds for future college expenses. As long as the plan satisfies a few basic requirements, the federal tax law provides special tax treatment of the accounts. Visit <http://www.savingforcollege.com> or <http://www.collegesavings.org> for specific information on 529 plans.

Let's repeat: financial foundation first, retirement second, college savings third. If you make that your priority list, you'll have no reason to be disappointed.

Contributing to a 403(b) vs. Buying Stocks

Question: I already contribute to my university's 403(b) pension plan. Is it generally better to contribute the maximum to my university's retirement plan and IRA accounts, which are taxed as ordinary income when I retire, or invest in funds in reasonably safe stocks that will be taxed at the capital-gains tax rate?

Bill Losey: In my opinion, it generally makes better sense to contribute the maximum amount every year—in 2004, \$13,000—into your 403(b) plan. Every dollar you save today is a pre-tax dollar. By saving the maximum, you lower your taxable income every year, starting today. That could save you up to 40 cents in taxes on every dollar you save, depending on your tax bracket.

In addition to tax benefits today, you also have the advantage of letting your investments grow tax-deferred until withdrawn. That compounding of assets makes your money grow faster because you are not taxed on the gains until you withdraw them. In essence, you are getting interest on your interest many times over.

Recent tax-law changes have lowered the capital-gains-tax rate on short-term and long-term gains to 5 percent and 10 percent respectively, from 10 percent and 20 percent. Who knows for sure what the tax rates will be when you retire and begin withdrawing your money?

Ultimately, the answer to your question will depend on your goals, age, time frame, and the size of your portfolio. Find a competent certified financial planner or certified public accountant who can review your situation and provide some recommendations.

'Catching Up' at Age 35

Question: I am 35 years old, and I might have my first real job this fall. I have not saved for retirement at all. What would be a good strategy for "catching up"?

Bill Losey: It is typical for someone your age not to have done any saving for retirement. So don't be overly concerned. You are not alone.

Whether you are twenty-something, thirty-something, or forty-something, there are only three things you can control to help achieve financial security. They are: how much you earn, how much you spend, and how much you save. Notice that these are all behavioral characteristics. There is no mention of stock returns, interest rates, and the economy here.

First, realize that your ability to earn an income is your greatest asset. Earn as much as you can. To earn the big bucks, you'll want to continue to educate yourself. Earn advanced degrees. Earn multiple degrees. Look for promotions. Network with people you know and don't know. Seek out new opportunities and volunteer assignments to increase your visibility on and around your campus. Don't get stuck in a dead-end job. You want to be an appreciating asset, not a depreciating one. These strategies should keep your income rising.

Second, live below your means. Decrease your spending. This is a real tough one for most people to master. I know this from personal experience. Rather than focus on making my money work for me, I had to work to pay off purchases I couldn't afford on my current income. In this day of "I want it now," we often buy things we don't need. Track your expenses in a software package such as Quicken or Microsoft Money. Watch where the money goes. You'll be amazed, and your expenditures will become conscious decisions. When I started monitoring my cash flow, it started flowing more to my retirement account than the credit-card companies. It also became fun, because I could see my investments increase every month. Your self-worth will rise with your net worth.

Third, if you have the financial ability, contribute the maximum to your 403(b) plan. If you have additional resources to save, consider starting a Roth IRA as well. If you cannot max out your contribution, save whatever you can even if it is only a dollar a day. The key is to get started. You need to change your behavior. When you change your behavior, you'll change your life. Save as much as you can. And save often, because time is on your side.

Learn to control what you can control. That is the toughest part of achieving financial independence, because it means you are responsible for your future.

Navigating Financial Shoals in Academe: Questions and Answers cont.

Saving More Spending Less

Question: I am 47 years old and have been saving for retirement in an employer-match program since I was in my late 20s, except for the 4 years I was working on my Ph.D. on a full-time basis. After substantial losses in the market in recent years have accumulated about \$100,000 in TIAA-CREF, most of which is in stocks (equity index and growth), with the balance in real estate and an annuity. How much principal should one accumulate for retirement to ensure an income equivalent to \$55,000 to \$60,000 per year in today's dollars? With \$100,000 in my accounts now, how much do I need to invest each year to ensure I can meet that financial goal and retire at 65?

Bill Losey: In order to answer your questions, I need to make some assumptions. Let's assume inflation averages 3 percent annually throughout your lifetime. Let's also assume you are able to earn a 7 percent average annual return on a diversified portfolio of \$15,000 in Social Security at age 65. With that as a backdrop, \$60,000 in today's dollars becomes the equivalent of \$102,000 at the age of 65. Your \$100,000 will have grown to approximately \$338,000 by age 65. According to calculation I performed, you will need to accumulate approximately \$1.5 million to give you the highest probability of ensuring retirement at age 65. In order to make this goal a reality, total annual contributions from you and your employer should be \$30,000.

Realize that there are no certainties except death, taxes, and uncertainty. We have no idea what inflation will be, what return you will achieve and what the world will be like in 20 yrs. There are three things you can do every day to put yourself in the best position. Earn more. Save More. Spend Less. These are the only things we can control.

Deciding on a Level of Retirement Income

Question: My wife and I are both full professors in our 50s. One of our goals has been to put our three daughters through college without loans, and we have adequate resources saved and invested to achieve that goal. We will also have our home mortgage paid off in the next three years. My question concerns what will be an adequate retirement income. By most of the current charts and advice columns, we are supposed to have a retirement income approximately equal to our current annual salary in order to

maintain an equivalent lifestyle. However, with retirement, we will no longer have to save for our children's education, pay the mortgage, or save further for our retirement. Given those decreases in expenses, do we still have to work toward a retirement income equal to our present income?

Bill Losey: First, congratulations on being able to send your three daughters to college without loans. That is a huge accomplishment. You must have been extremely disciplined.

The current charts and advice columns I've seen typically say that you'll need 70 percent of your pre-retirement income to maintain the lifestyle you enjoy today. For example, if your pre-retirement income is \$100,000, those sources suggest that you'll need only \$70,000. In my opinion, that is a huge fallacy.

Over the past 10 years, I've counseled hundreds of people, and I have yet to meet a retired professor who was disciplined and actually spent what he or she budgeted for. In short, virtually all people underestimate how much money they'll actually spend in retirement.

With that in mind, I would suggest you plan on 100 percent or even 110 percent of your current income for retirement, because of your own longevity, increased medical costs, and unforeseen expenses. Although you will no longer have a mortgage payment, you will still



have expenses for upkeep on your home and other assets. Cars break down, roofs leak, and furnaces die. Although you will no longer have to save for college for your daughters, there may be expenses for weddings, graduate school, and those expensive, yet-to-be-born grandchildren.

Retirees have much more free time than full-time professors. They typically spend at levels equaling their pre-retirement income or even slightly higher. Unless you are 100 percent certain that you can live on less, and unless you are a disciplined spender (and you may be), I would suggest you continue working toward a retirement income equal to your present income.

I would also consult with a financial planner or investment adviser who can help crunch some numbers and assist you with this decision. Your financial future shouldn't be left to generic charts

and advice columns. Remember, it's your money and your life. Make smart decisions.

Assessing Virtues of Retirement Plans

Question: Given that faculty members and administrators, particularly the latter, change universities more often than ever before, the choice of retirement plans becomes more critical. Based on my understanding, the choice between a defined-contribution plan and a defined-benefit plan becomes more and more important, and that choice may

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change throughout one's career. For example, I believe a defined-benefit plan may be advantageous later in one's career, and a defined-contribution better earlier. Is my thinking valid?

Bill Losey: Let me start by explaining the key differences between a defined-benefit plan and a defined-contribution plan.

A defined-benefit plan, also called a pension plan, is a retirement-planning vehicle that, upon retirement, will pay an individual a specific benefit for a certain period of time. The size of the monthly benefit you receive upon retirement will be based on many factors, including your final average salary, usually during the last three to five years that you work; your age; and your years of service within the retirement system. With a defined-benefit plan, the employer bears the investment risk, and contributions to the plan may be made by the employee, the employer, or both.

A defined-benefit plan may be advantageous for someone who does not have the discipline to invest regularly on his or her own, or who plans on remaining with one employer (or in one retirement system) for decades, or who doesn't want control over his or her retirement income.

A defined-contribution plan, such as a 401(k) or 403(b), is a retirement-planning vehicle in which an employee elects to defer some amount of his or her salary into the plan. A 403(b) is offered by nonprofit organizations, like colleges and universities. A 401(k) is offered by a for-profit business.

There are several advantages to a defined-contribution plan: Contributions lower your annual taxable income because they are made on a pretax basis; larger contributions can be made to your account; earnings are tax-deferred until withdrawn; and some plans allow loans. An individual can contribute \$13,000 to such a plan in 2004, while employees with more than 15 years of service and

who are over age 50 may contribute up to \$19,000. With a defined-contribution plan, the employee bears the investment risk, and contributions to the plan may be made by the employee, the employer, or both. This type of plan may be advantageous for someone who has the discipline to invest regularly and who wants control over his or her investment choices and retirement options.

In my opinion, the stage of an employee's career is less important than other factors in deciding which plan is best. The common thread between both types of plans is time. With a defined-benefit plan, you need years of consistent service and a high final average salary to reap the rewards. With a defined-contribution plan, if you save diligently over your career, it is not uncommon to accumulate \$500,000, \$750,000, or \$1-million or more in your retirement-plan account.

Depending upon the state you work in and the college you work for, you will typically have a choice between defined-contribution and defined-benefit plans. Check with your human-resources department. It is not uncommon for me to work with a client who has both types of plans from years of service in different states. Realize that, because of budget constraints and liability issues, defined-benefit plans are becoming increasingly rare and most people will have no option other than a defined-contribution plan.

Getting a Decent Return While Minimizing Risk

Question: As most of us in academe save for retirement, we recognize that "risk" is a part of any investment portfolio. Many of us are still smarting from the market's downturn in 2000 but recognize that there are few options that offer really low risk. How does one create a portfolio that offers a decent return but minimizes risk? High-yield investments have much great colatality, but the annuities are not keeping pace with increased costs of living. What's a wise ratio for something at mid-career.

Bill Losey: Great question! When you realize that whether or not you achieve your financial goals will depend, in large part, on how well you position your assets, you'd have to say that asset allocation is one of the most important decisions an investor can make.

According to Ibbotson Associates, a financial-research company, asset allocation accounts for nearly 92 percent of the overall portfolio performance, with stock selection accounting for only 4 percent and market timing accounting for less than 2 percent. That clearly shows that how you allocate assets may actually be more important than the individual investments you choose. The ultimate financial goal, of course, is a secure retirement. How soon you retire, how long the money will last can be greatly affected by your decisions on asset allocation. Since I don't have any information about your income, age, savings habits, or goals, my advice is to seek out a financial planner or other professional who can help you in this area.

Weighing Merits of Annuities

Question: Faculty members and administrators whose investments are with TIAA-CREF are often unsure about the merits of annuitizing their accruals at retirement as opposed to other options. What advice can you offer?

Bill Losey: Navigating through the maze of annuities, investment options, and IRA rollovers available is quite confusing, and most faculty members and administrators we've come into contact with find this process overwhelming. Let me try to break it down for you.

When you annuitize your accruals, that becomes a contractual agreement whereby you exchange your retirement-plan accumulations with an insurance company for an income stream that lasts for as long as you live. In essence, you are giving complete control of your assets to the insurance company for a promise that they will pay you a certain amount of money for a certain period of time.

The amount of your annuity payments will depend on the size of your accumulation, the annuity-income option

you select, and your age at retirement. A single-life annuity provides the largest income; however, it is only paid out to you. Distributions will not continue to your beneficiary after you die under the single-life option. For example, if you die the day after you sign the paperwork, the insurance company has no contractual obligation to pay out anything. Your family and heirs lose everything. However, a joint annuity will pay you a lifetime income, and should your spouse outlive you, he or she will continue to receive an income over his or her lifetime or for a designated period.

As an adviser to many in academe, I have concerns about the ability of my clients' investment portfolios to generate ever-increasing streams of income that will keep pace with inflation. It's important to remember that today's dollar won't be worth as much in the years ahead. Nowadays, inflation is in the low single digits. However, even at a very low inflation rate of 3 percent, a person would need to double his or her income in 20 years just to maintain today's standard of living. If you retired at 55 with

\$50,000 in income, you would need \$100,000 at age 75. While annuity payments are guaranteed, you may lose some purchasing power over time. By contrast, while payments made from investment portfolios may vary from year to year, they historically have grown.

Since people are living longer, it is important to maintain a diversified portfolio that will grow as you age in order for you to maintain or even enhance your standard of living. True annuitization does not allow the opportunity for your assets and income stream to grow, while investing in a portfolio of stocks and bonds does. Maintaining a diversified portfolio allows you to maintain control of your assets and acts as a potential hedge against inflation. It may be a better option to take a periodic withdrawal from your portfolio, which can be increased or decreased depending on market conditions and your needs, rather than annuitizing and locking in your payments. That, coupled with a guaranteed income stream from Social Security, may be just the ticket to reach a point of financial independence.

Monthly Payments vs. Lump Sums

Question: What do most people take at retirement: the monthly pension or the lump-sum distribution offered by their retirement plans? What are the issues to consider when deciding which option is best?

Bill Losey: This is a variation on the previous question about the value of annuities. I have found that the more discerning and knowledgeable a person, the less often he or she chooses the monthly pension option. Realize that when you choose this option, you have given complete control of your assets to an insurance company. In return, the company promises to pay you an income for your life (or that of your spouse), or for a certain period, such as 10 or 20 years. Generally, the interest rate earned on your assets will be no more than 6 percent, with a minimum base guarantee of 2.5 percent.

It has been my experience that peo-

ple choose this option because they like the guaranteed income. They fail, however, to understand that their decision is irrevocable, while the cost of goods and services increases each year with inflation. In short, with a monthly pension there is typically no annual increase in your benefit check to keep pace with inflation.

People who take the lump-sum-distribution rollover option with an IRA generally desire to retain control over their assets and maintain flexibility over their distribution options.

Given the dramatic decline in the stock market in recent years, coupled with interest rates at 50-year lows, people should explore all of their options before deciding. Some retirees have opted to annuitize a portion of their portfolio to generate at least some guaranteed income. Others have annuitized their entire account. Many others have taken the lump-sum-distribution rollover option and have the flexibility to increase or decrease the amount of income they withdraw.

Remember, it's not an all-or-nothing proposition. At the end of the day, it doesn't matter what option others select. It matters what option you feel comfortable with and what option is most appropriate to help you accomplish your needs and goals.

Looking Ahead to Health Care

Question: Health-care solutions seem to change on a daily basis. After retiring, I will not receive medical benefits from my employer. Assuming that I'll be in reasonably good health, what percentage of my retirement savings should I plan for medical expenditures? I'm 32 and have been saving through TIAA-CREF for six years.

Bill Losey: You are to be commended for thinking about this issue at the ripe old age of 32. Unfortunately, we live in an uncertain world. Since we have no idea what the long-term future of health care looks like, and since you probably have at least 25 years before retiring, I honestly can't answer that question. However, if you were retiring today, I would recommend earmarking 10 to 15 percent of your retirement savings toward medical and dental insurance, prescriptions, Medicare, long-term-care insurance, and vision expenses.