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Making the most of your money — Step 5 — Surviving your retirement

by Hugh F. Doherty, DDS, CFP

The signs are everywhere. Doctors are letting their pension plan statements pile up unopened, afraid of the bad news inside. They anxiously watch their investments sink, taking 40 percent of their retirement savings down with it. Once-confident do-it-yourself investors, they are flocking to financial planners. No doubt about it: The bear market's claws have shredded dreams of an earlier and richer retirement for millions of Americans.

You don't have to be a "dot-bomb" ex-millionaire to feel the pain. These ordinary folks, tempted by the bull market's easy gains, began upping their bets on aggressive stocks and have lost 25, 30, even 35 percent of their wealth. Average investors — long criticized by financial pros as overly cautious — saw their balance drop in 2000 for the first time in their pension plan's history.

The time is now for doctors who are retirement savers to figure out how to get back on track. This article has excerpts from my Retirement Guide for Dentists to help you make the choices the bear market demands. [To obtain a copy, call (800) 544-9653.] You must learn how to manage your pension plan monies alongside taxable accounts in order to keep more of your earnings away from Uncle Sam. Near-retirees should learn when to start planning a strategy for tapping their nest egg and how to anticipate the rise in health-care costs.

For 30- and 40-year-olds still decades away from a life of leisure, this bear market may turn out to be little more than a speed bump. But doctors who thought they were close to hitting the exit ramp may find themselves making tough decisions, which could include postponing retirement.

That's what Jim and Mary Lou, clients from Chicago, Ill., are wrestling with. Jim, a 59-year-old dentist, really got bombed in the market when the bull market lifted his moderately aggressive retirement portfolio of more than $1 million. So, they have set their sights on semiretirement at age 62 as an achievable goal. Since the market peak, Jim's investments are down 30 percent. Even with plans to trade his house for a condo and downsize their collection of Asian and African art, Jim figures he will now be working full-time until he turns 65. My advice to them is not to flee from stocks.

Almost everyone is looking for more advice. Financial planners and money managers are enjoying a surge in business. I am seeing a lot more people coming in with their tails between their legs. All of my would-be-retiree clients who sought advice still have the majority of their assets in equities. Most doctors want to leave practice at a particular time. Sticking with their planned retirement age is the top priority for most of these doctors.

Take heart
So what should you do as you contemplate your shrunken account balances? My advice is to hang in there! You are in this for the long term and will always need growth. Right now, many investors are paying the price for stubbornly refusing to diversify out of technology and large-cap stocks during the Bull Run. But look at the bright side. The aggressive ones have lost earnings, not principal, and they are still ahead. Even with the nasty downturn, the Standard & Poor's 500 stock index has rewarded investors with 15 percent average annual returns for the past decade.

The people hit hardest are the older baby boomers, whose aggressive investments and

$1 million balances in the late 1990s lulled them into thinking about taking mid-50s retirement. But if you expect to work for another decade or more, you can probably meet your goals with minor adjustments, provided you aren't counting on stocks to rise 20 percent per year forever.

Have faith; take stock

I know you are shell-shocked. The first order of business is to take a deep breath, sit down, and open those statements. Many investors like you are reluctant to sell their beaten-down tech stocks because they believe they will be coming back. You also feel like that is "locking in the losses." Let's face it: Some of those stocks will never be back. Dumping losers to build a more balanced portfolio is repositioning and moving forward.

Stay invested

This is painful news for those feeling battered by the market: The only asset that gives you a fighting chance to make up your losses is stocks. You have to stay in and have the patience to let the market work in your favor, but that doesn't mean staying within the S&P 500 universe of large-cap, tech-heavy United States shares. Diversifying by company size, across industries, and around the world can reduce your risks. Bonds and money-market assets can smooth your returns by providing steady income. But even early retirees still need to keep 60 percent or more of their funds in stocks to produce the income they'll need for the next 25, 30, or 35 years. You know why. For your money to outlive you, you need to invest for growth for the rest of your life.

Be realistic

The past 18 months have given most people the notion that stocks will rise 20 percent every year, but economists have worse news. It is their assumption that future investors may not reap even the average returns of the postwar period. From 1946 through 1997, stocks paid off, with dividends and capital gains, at a compound average annual rate of 7.5 percent after inflation. Part of that gain came from the fact that stock prices grew two-and-a-half times as fast as corporate earnings, pushing the market's average price-to-earnings ratio from 10 to more than 25. "Investors grew more optimistic about how growth could translate into stock prices," said Roger Ibbotson, Yale University professor of finance and chairman of Ibbotson Associates, a Chicago data and consulting firm. "We are not going to see a repeat of that." Ibbotson predicts that stocks will return only 6.25 percent per year in coming decades; other economists are even more pessimistic.

Such a drop in returns could sharply boost the amount you need to save. Test your asset-allocation mix with a variety of predicted returns at online services such as www.financialengines.com. Jim, our dentist-client, may have to push back his retirement three to five years, which illustrates how difficult it can be to reach your financial goals.

The new tax bill

Uncle Sam is boosting tax breaks for retirement savers. The new tax-cut bill will eventually allow you to contribute as much as $15,000 per year (up from $10,500) in pretax dollars into your 401(k) or similar account. Annual contribution limits to IRAs, which can be pretax or after-tax depending on your pension coverage, are rising to $5,000 (up from $2,000).

For empty-nesters, the tax bill provides two big breaks. People over age 50 will be allowed to contribute an additional $5,000 in pretax dollars to 401(k) plans or similar accounts. An employee can stash up to 100 percent of his or her pay into a 401(k) — via pre- and after-tax contributions and employer matches — to a maximum of $40,000. The old limit of the lesser of $30,000 or 25 percent of pay held back the savings of wives who returned to the work force to help build a retirement nest egg.

Don't be afraid to get help

Investing isn't as easy as it might have seemed during the late 1990s. Look back at your experience and ask yourself: Do I have the insights to pick winning investments in a tougher market, a cool head to stick with a plan, and self-discipline to rebalance my portfolio at least once a year? Chances are the answer is "no." If so, your money could be better off in a professional's hands. At the very least, get an adviser to provide an independent analysis of your asset mix.

The bull run of the 1990s rewarded all investors, savvy or naïve. We are unlikely to see a repeat of that in our lifetime. It will be up to you to do thorough planning and smart investing for a secure retirement. Now, more than ever, your retirement plan is worth the attention you give it. Get a coach. Even the greatest golfer in the world, Tiger Woods, still has a coach.

What doesn't belong in your pension plan
Suppose you have a Standard & Poor's 500 stock index fund and a corporate bond fund. Does it matter which one you put into your tax-deferred retirement account and which one goes into your taxable brokerage account? You bet it does! Where you place your assets can make a significant difference in enabling you to increase your retirement wealth.

I have written about asset allocation, the process of diversifying to achieve the highest return for your risk tolerance. But it's just as important to think about asset location. Your goal is to maximize after-tax returns by reserving the limited space in your tax-deferred accounts for items that generate the largest tax bills.

Asset location, or placement, is a concern for those who save more than the current annual contribution limits of their retirement accounts. Generally, those who save less should put everything (except tax-exempt municipal bonds) into tax-deferred accounts. They offer advantages that are hard to beat, such as tax deductions and perhaps an employer match on contributions. Your money also grows more rapidly than it otherwise would when you are forced to pay taxes every time you sell a winner or pocket dividends and interest.

Investment guidelines
While asset location is an inexact science, there are some general rules. If you want to trade, you can do so inside a tax-deferred account to avoid paying capital-gains taxes every time you sell a winner. And never put municipal bonds in your retirement plan. If you do, you will pay income taxes on their tax-free incomes as you withdraw the money.

The asset-placement plan that's right for you depends on what's in your portfolio, your time horizon, and your estate-tax planning goals. For investors who meet their fixed-income needs with municipal bonds, for example, the decision is easy: Put equities in the 401(k). If you're not in a high enough tax bracket for munis to make sense, give taxable bonds first take on your tax-deferred plans.

Generally, bonds benefit more from tax deferral than stocks do, because more of their earnings come from interest, which is taxed at higher rates than capital gains. That's because a much higher percentage of their annual earnings — 100 percent for bonds held to maturity — comes from interest, which is taxed at ordinary income-tax rates. In contrast, income (in the form of dividends) and realized capital gains make up only a small percentage of an S&P 500 fund's annual return. By sheltering bond income in tax-deferred accounts, you avoid losing a large chunk of it to the IRS. The benefit over a lifetime is huge.

Indeed, investors in the highest bracket who plow their contribution into a bond fund today and sell in 20 years will have more dollars than they would have by holding the bond fund outside a retirement plan. The same investment in an S&P 500 fund, once liquidated, is worth less inside a plan than outside.

Individual stocks you plan to hold for the long run should get low priority for space in your pension or IRA. After all, they generate little in the way of taxes until you sell. And why pay income-tax rates on your profits — as you would when tapping a tax-deferred account — when you can opt for lower capital-gains tax rates? (The exception is stocks with high dividends, which belong in tax-deferred accounts.) Another downside to placing stocks in an IRA is that if you sell a loser, you can't claim the loss on your tax return.

Of course, many investors want an all-equity mutual-fund portfolio. In that case, put actively managed funds — those run by stock-pickers who trade often — into a tax-deferred plan. That way, you shelter the taxable distributions that result from their trades. Candidates for taxable accounts are index funds, which sell stocks only when their benchmarks change, and tax-efficient funds, which aim to minimize tax bills.

Your time horizon
The decision of what to put where is less clear-cut when you own a mix of actively managed equity funds and taxable bonds. Here, your time horizon is key. If you have equity funds that invest in growth stocks, put them in your pension or IRA if you plan to hold them at least 15 years. As long as your equity fund outpaces your bond fund by an average of five percentage points per year, the compounding of the higher pretax return on the stock fund will result in greater earnings than sheltering the bond fund. Since value funds often produce more taxable distributions than growth funds do, they should perform better in a deferred account over shorter periods.

If your asset placement isn't what it should be, go ahead and restructure. But before selling winners in taxable accounts, harvest losses to reduce your tax bill. You can always adjust your tax-deferred accounts, because gains on sales aren't taxed in them. Individual stocks generally belong in taxable accounts.

A longer view
Asset-location rules can reverse if you throw estate planning into the mix. For example, if you plan to leave your IRA to grandchildren, your time horizon expands to cover their expected lifetimes. As a result, an S&P 500 fund might be a better choice for your pension than even a bond fund. Although the index fund produces smaller taxable distributions, it earns more than the 10 percent per year, on average, vs. 6 percent for the bond fund. With those smaller sums growing at a faster clip, an index fund will eventually come out ahead of a bond fund.

Note: Once you put something in a tax-deferred account, your heirs won't get a step up in basis. This tax break, available in a taxable account, erases the capital gains your investment earns during your life, at least as far as Uncle Sam is concerned. The break is normally worth more with stocks than bonds, which earn more of their returns in interest than capital gains. Look at the numbers to make sure you still come out ahead.

Designing an optimal asset-placement strategy can be wearisome, but the payoff can be lower taxes with more money on which to retire.

Health-care costs
Do you think health insurance won't be a problem after you retire? Even companies in corporate America are cutting down on health insurance, and some are making retirees pick up more of the premiums. Medicare kicks in at age 65. Before then, a retiree without coverage is at the mercy of private insurers. Rates for older applicants can be three to six times what a 24-year-old would pay ... and more if there are health problems.

Later on, Medicare covers only about half of seniors' health-care bills. Medigap provides supplemental coverage, but it's costly. Standardized rates for Medigap policies range from less than $50 per month to almost $300, and the benefits are generally less than great.

Health insurance
What can you do? I encourage you to review and ask your insurance agent questions about your coverage annually. When planning your retirement, factor in the possibility of health-insurance costs. One of the best insurance agents I have worked with is Chris Callen. He is available at (800) 288-6578 to address your concerns.

Premiums vary widely depending on age, health, and residence. A 55-year-old woman in good health might pay $250 per month for a standard preferred-provider organization (PPO), in which you can usually see specified doctors but also can go out of the network at a higher cost. A 63-year-old male smoker could face premiums of $600. A retiree with diabetes, arthritis, or heart disease might find it difficult to get coverage at all. In some states, health-maintenance organizations (HMOs) — which pay more of the bills but require patients to see in-network doctors — have open-enrollment periods during which they take any applicant, although not necessarily at an affordable price.

Attention shoppers
Shopping for the best rates can be problematic. Many insurers demand a month's premium in advance before they will give a firm price and commitment to cover. If you have health problems, ask an agent to suggest insurers likely to accept you. One rejection increases the likelihood that others will do the same, since insurance companies share such information.

Trimming coverage is one way to lower premiums. An indemnity plan that lets you choose your own doctor costs 10 to 25 percent more than a PPO. Increasing the deductible from $500 to $1,000 can shave off 10 percent.

Long-term-care insurance
You probably don't need long-term-care insurance if you have less than $250,000 or more than $1.5 million in assets. Those with less than $250,000 might find it difficult to make the payments and would soon qualify for Medicaid if confined to a nursing home. Those with more than $1.5 million can bear the cost themselves.

A year in a skilled nursing home costs about $50,000 on average nationally, though it can be more than double that in high-cost areas. The typical stay is less than two years. About 40 percent of those age 65 and older will need long-term care at some point. In-home or adult day care and assisted-living facilities cost 50 to 80 percent as much.

One way to save is to buy while you are young. A healthy 45-year-old might pay $690 a year for the same policy that costs a 65-year-old $1,600. If you decide to buy, be sure to pick a top-rated company (CNA, Unum, etc.) — one that will be around when you need it. I recommend insurance companies that are rated A or better by such firms as A.M. Best or Standard & Poor's. Choose a company with at least $500 million in assets, 50 years in business, and five years in long-term care. If you are 50 years old or older, obtain a long-term-care policy that will help preserve your accumulated retirement wealth in the event that the unexpected happens.

Everyone contemplating retirement needs to face up to the possibility of hefty health-insurance costs. Perhaps sailing around the world will have to wait. Until next month ...

The material for this article is an excerpt from Dr. Hugh F. Doherty's forthcoming book, Making the Most of Your Money, and is printed with Dr. Doherty's permission. For more information on this article, he can be reached at hugh@hughdoherty.com.

Words to the Wise About Surviving Your Retirement

- You must learn how to manage your pension plan monies alongside taxable accounts in order to keep more of your earnings away from Uncle Sam.
- You are in this for the long term and will always need growth.
- You must dump losers to build a more balanced portfolio, which is repositioning and moving forward.
- For your money to outlive you, you need to invest for growth for the rest of your life.
- Economists predict that stocks will return only 6.25 percent a year; others are even more pessimistic.
- Take advantage of Uncle Sam's new tax bill, which is boosting tax breaks for retirement savers.
- Get a professional coach to help you pick winning investments in a tougher market, help you stick with a retirement game plan, and develop the self-discipline to rebalance your portfolio at least once a year.
- Where you place your assets can make a significant difference in enabling you to increase your retirement wealth.
- Never put municipal bonds in your retirement plan, or you will pay income taxes on their tax-free incomes as you withdraw the money.
- The asset-placement plan that's right for you depends on what's in your portfolio, your time horizon, and your estate-tax planning goals.
- Bonds benefit more from tax-deferral pension plans than stocks do, because more of their earnings come from interest, which is taxed at higher rates than capital gains.
- Designing an optimal asset-placement strategy can be wearisome, but the payoff can be lower taxes with more money on which to retire.
- When planning your retirement, you must factor in the possibility of high health-insurance costs.
- If you are 50 years old or older, obtain a long-term-care policy that will help you preserve your accumulated retirement wealth in the event that the unexpected happens.

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