



Free Dow Jones Sites

[News](#)
[Technology](#)
[Markets](#)
[Your Money](#)
[Opinion](#)
[At Leisure](#)
[Home Page](#)
[Take A Tour](#)
[Subscribe](#)
[In Today's Paper](#)
[Portfolio](#)
[Setup Center](#)
[Discussions](#)
[Site Map](#)
[Help](#)
[Contact Us](#)



THE JOURNAL REPORT: YOUR MONEY MATTERS

March 27, 2006

Dow Jones WebReprint Service®

What If...?

When planning for retirement, so much depends on what you assume. Here's how to make those assumptions smarter.

By **KAJA WHITEHOUSE**

It's all in the assumptions.

So it goes with retirement planning, which depends to a great extent on what you assume will happen in the future—with the economy, with your health, with your investments, with your spending.

If those assumptions are too optimistic, instead of enjoying the good life, you could find yourself canceling travel plans or having to sell your house to make ends meet.

If they are too pessimistic, you could wind up working longer than you really wanted—or had—to.

You can increase your chances of getting it right if you ask the right questions and tweak your forecasts accordingly. How much will you spend? How long will you need that money? How will costs rise over that time? What will your tax bill look like?

Retirement-planning worksheets and calculators require users to plug in assumptions. A lot of people just guess wildly. While guessing is part of the game, there's smart guessing and dumb guessing.

Here's a look at seven key factors in retirement planning—inflation, taxes, spending, health care, longevity, assets and investing—and what you need to know about them to make the best assumptions possible.

INFLATION

The rate of increase in the cost of living is a vital factor to consider when planning your retirement readiness. Deciding what rate to assume, however, can be tough.

The most commonly used number for financial planning purposes is 3%, but that's just an estimate based on historical norms. Actual rates of inflation can vary widely. In recent years, a 3% rate of inflation has made sense. In the '70s and '80s, however, inflation soared to double-digit levels, hitting nearly 14% in 1980.

While you can't predict how the economy will affect costs during your retirement, you can try to make your estimate more accurate by tailoring it as closely as possible to your specific needs.

Inflation rates are really just a compilation of costs derived from the consumer price index, or CPI, which is based on a basket of goods and services bought by typical urban consumers. Some of the costs in that basket will have a greater impact on you than others.

One way to get an idea of how inflation might affect you is through a Web page of the Bureau of Labor Statistics. The site, at data.bls.gov/PDQ/outside.jsp?survey=cu, lets you see how specific costs have risen over time. The site can be hard to use, however. To get your inflation rate, first select the goods and services that interest you. Then, under "more formatting options," you want to click "12 month percentage change."

If you need help with the site, contact the Bureau of Labor Statistics office of public affairs at 202-691-5902.

Where you live will also have an impact on your personal inflation rate. The Bureau of Labor Statistics Web site allows you to adjust for location, but it doesn't have comprehensive information for all the locations listed.

To get a better sense for how location can affect your costs, play with the cost of living calculator at www.inflationdata.com. It will show how much you need to maintain your lifestyle in different cities across the country.

Also consider whether some of your retirement income will come with inflation protection. Social Security benefits, for example, have built in cost-of-living increases. Some employer-sponsored pension plans come with cost of living increases, but that's increasingly rare.

Fixed-income investments may appeal to conservative individuals, but they run the risk of failing to keep up with inflation. In recent years, most short-term fixed-income investments have lagged behind the general increase in costs. One alternative is bonds that protect against rising inflation, Treasury Inflation-Protected Securities, or TIPS.

Stocks are generally assumed to be the best investment for fighting inflation because they do a better job than bonds of keeping up with the rising cost of goods and services. Just be sure to factor inflation into your return assumptions so you don't overestimate how much you will earn on your stock investments.

Cloudy Crystal Ball

Played out over decades, small changes in assumptions can make a huge difference in how you'd fare financially in retirement.

■ Here are three scenarios for where someone age 40 would end up at 65, based on differences in just one variable,

"If you're expecting a 7% rate of return on an investment today and inflation is 4%, your real return is just 3%," says William Arnone, a retirement expert with the consulting and accounting firm of Ernst & Young in New York.

TAXES

Taxes, too, automatically reduce income. Imagine you are expecting \$50,000 in pension income if you retire at age 65. If your combined state and federal taxes lop 20% off your income, you'll have \$10,000 a year less to live on.

Yet some retirement-planning calculators don't even consider the impact of taxes, or they don't allow you to adjust for the fact that taxes will differ depending on what your investments are and where you plan to live during your retirement. When using these calculators, you want to add the cost of taxes to your spending or income needs.

As you make your calculation, assume for now that you should be able to pay 15% long-term capital gains rates on your taxable stock investments, but you will pay federal ordinary-income taxes on withdrawals from pensions and traditional 401(k) and IRA accounts.

Roth 401(k)s and Roth IRAs are free of taxes on withdrawals. Social Security, meanwhile, is taxed only at certain income levels. You may be subject to a tax on between 50% and 85% of your Social Security benefit if your income (as defined by the Social Security Administration) exceeds a certain level.

For more information, you can go to the Social Security Administration's Web site, www.ssa.gov.

Each state, on the other hand, takes a different approach to taxing retirement income. Currently, nine states—including Alaska, Florida, Nevada, South Dakota and Texas—have no personal income tax for anyone. As such, they can be great for retirees who want to reduce their costs.

Other states offer reduced income taxes on retirement income. In Illinois, for example, income from qualified retirement plans and IRAs isn't taxed, according to John Logan, senior state-tax analyst with tax-information provider CCH Inc., Riverwoods, Ill. In Hawaii, income from employer contributions to pensions and profit-sharing plans is tax-free. In New York, taxpayers over age 59½ can exempt \$20,000 of their pension income from taxes annually. And some states, like California and Maryland, exclude all Social Security benefits from state income taxes, says Mr. Logan.

Once you get a good sense of your tax picture in retirement, try toying with how it might change if you move to another state. You might find that a move to Florida, for example, could allow you to retire sooner than you anticipated.

Just be careful about retaining two residences in retirement. If both states can claim you as a resident, your retirement income might still be subject to state income taxes.

SPENDING

To estimate your spending in retirement, it's best to get a handle on what you're spending now. This means creating a budget. It can be easily done with expense-tracking software like Intuit Inc.'s Quicken or Microsoft Corp.'s Money.

A free tool for tabulating retirement expenses, taking taxes into account, can be found at financialcalculators.com, owned by Financial Calculators Inc. in Riverton, Utah.

Your spending will change once you reach retirement, so you need to adjust accordingly. Work-related expenses, such as dry cleaning, transportation, lunches and work clothes, will decline or disappear. Certain fixed expenses, like the mortgage, life-insurance premiums and contributions to retirement savings accounts, might also disappear. Other expenses could increase, such as travel costs and medical care.

Consider costs that are unique to you. Might you need to care for an elderly parent during your retirement, or contribute to a child's college tuition? Some people may want a bigger home in their retirement, or a new car. Tailoring the computation to your specific spending needs is an important part of the planning process.

According to a new study using data from the Bureau of Labor Statistics, many people may overestimate the amount of money they will spend in retirement. The study found that retirees' total spending, after an initial drop from pre-retirement levels, doesn't rise with inflation—it generally remains steady. That's because even though inflation pushes prices higher, the elderly tend to consume less as they age.

The study's author, Ty Bernicke, of Bernicke & Associates in Eau Claire, Wis., found that health-care spending increased, but this rise was offset by a decline in other spending. It's a trend that spans all income brackets, not just retirees who need to count their pennies, says Mr. Bernicke.

The prospect of a spending level that remains constant is at odds with the scenarios depicted by many financial planners, who tend to assume that spending increases with inflation from the first year of retirement on.

HEALTH CARE

In Mr. Bernicke's research, the cost of health care was the wild card. Two individuals' experiences and health can be wildly different, and with health-care costs rising faster than the rate of inflation, it's important to consider how potentially high medical costs might affect your retirement plan.

First, there's the cost of insurance. If you retire before age 65, you'll need health insurance until you're eligible for Medicare. Once you're eligible for Medicare, at 65, you'll also need insurance to cover the gaps in coverage, known as Medigap insurance. It can be expensive, even for people who have employer-sponsored retiree health care, because of the fast deterioration of these plans.

When Ed Beltram of Woodland Park, Colo., took early retirement from Lucent

Technologies Inc. in 2001 at the age of 56, he was paying premiums of \$42 a month for dental and medical care for both himself and his wife.

Just five years later, those monthly premiums have jumped to \$690, not including dental coverage. The reason: Mr. Beltram's employer—which promised a cap on employee contributions when he retired—stopped covering dependents in 2004.

"We really had a curveball thrown to us," says Mr. Beltram, who is the spokesman for the Lucent Retirees Organization, an organization created in 2003 by the company's retirees.

Lucent's director of corporate media relations, Mary Ward, responds that the soaring cost of health care "is something everyone in this country has had to deal with. The fact is, Lucent simply could not afford to continue covering virtually the entire cost of health care for 114,000 retirees and their dependents and remain competitive."

Despite the cuts, Ms. Ward says, Lucent still provides better benefits to its retirees than most U.S. companies.

Indeed, few retirees in the U.S. even have access to an employer-sponsored health plan. In 2002, 13% of private-sector employers offered health benefits to retirees who were eligible for Medicare—down from 20% in 1997, according to the Employee Benefit Research Institute, a Washington, D.C., nonprofit. For early retirees, 13% offered benefits in 2002, down from 22% five years earlier.

Long-term nursing care can be another wild card. The national average cost of a private room in a nursing home was \$70,080 a year in 2004, or \$192 a day, according to data from New York insurer MetLife Inc. The most expensive state was Alaska, where nursing care averaged \$204,765 a year. Meanwhile, the national average stay in a nursing home for current residents was 2.4 years, making the average cost \$168,192.

It's an easy cost to overlook, since not all retirees will need nursing care in old age. But the financial implications of disregarding this risk can be devastating.

One solution is long-term care insurance, which is especially appealing to middle-income retirees. Those wealthy enough to pay for their own health care can generally bypass this insurance, as can low-income retirees, who qualify for Medicaid coverage of long-term care costs.

LONGEVITY

How long you expect to live is another important factor. Payments from Social Security and defined-benefit pension plans should last as long as you do, but your 401(k) and other personal savings will need to be doled out carefully.

Say you're a 65-year-old woman who's about to retire. At that age, you can expect to live roughly 20 more years on average. But if you start tapping your nest egg at a rate that will deplete it in 20 years, you may be underestimating how long you'll

need income. You could easily live years beyond the average, without any assets of your own to provide income in the later years.

So, what life expectancy should you use as you begin to draw on your savings? Stuart Ritter, a certified financial planner with T. Rowe Price Group Inc., Baltimore, recommends that people always plan to live until at least age 95. The reason: Of four 65-year-old couples, one person will live to age 95, he says.

Indeed, 41% of women age 65 will live to 90, 19% will make it to age 95, and 5% will celebrate their centennial, according to Ron Gebhardtsbauer, a senior pension fellow with the American Academy of Actuaries, a professional organization in Washington, D.C. Twenty-eight percent of 65-year-old men will make it to age 90, 11% to age 95 and 2% to 100, says Mr. Gebhardtsbauer, who based the data on a pool of pensioners.

You can also assess your personal life expectancy with online calculators based on factors such as diet, exercise, family health history and personal support network. Some good calculators that can be found on the Web include the BBC's bbc.co.uk/health/interactive_area/calculators_lifeexpectancy1.shtml, and MSN Money's moneycentral.msn.com/investor/calcs/n_expect/main.asp. Another neat one is provided by some professors from the Wharton School of the University of Pennsylvania, at gosset.wharton.upenn.edu/mortality/perl/CalcForm.html.

One simple way to protect against spending your money too fast is to assume a 4% annual withdrawal rate, according to research by T. Rowe Price.

ASSETS and INVESTING

Know what assets will be available to you.

While Social Security, for example, is expected to remain largely unchanged for people currently nearing retirement age, concerns about the program's long-term solvency may make it a good idea for younger people to consider what their retirement would look like without this benefit, or with a scaled-back payment.

Also, if you have an employer-sponsored pension, plan on receiving only what you have earned thus far—not what you might expect based on your age and wages when you retire, says Alicia Munnell, director of Boston College's Center for Retirement Research. Employers are increasingly freezing pension plans, essentially stopping workers from receiving additional benefits.

You also shouldn't count on your primary residence as a retirement asset, says Ms. Munnell. If you sell your home to raise money for retirement, you still have to buy a new home or pay rent, she says.

Other experts warn that you should be very careful about rate-of-return projections when assessing returns on your personal savings. While average stock market returns can be 10% or more a year, those averages are based on a much longer time frame than you will have in retirement.

For a shorter time frame, you should be more conservative, says Ron DeStefano, a consulting actuary with Aon Consulting, an arm of Aon Corp., which is based in Baltimore. Mr. DeStefano often suggests that retirees assume an annual pretax rate of 6% on their investments.

"With equity these days, you're not sure what's going to happen," Mr. DeStefano says.

—Ms. Whitehouse is a reporter for Dow Jones Newswires in Jersey City, N.J.



TOTAL MERRILL®

Talk to your Merrill Lynch Financial Advisor about retirement planning strategies.

Merrill Lynch and its representatives do not provide tax, accounting or legal advice. Any tax statements contained herein were not intended or written to be used, and cannot be used for the purpose of avoiding U.S. federal, state or local tax penalties. Please consult your own independent advisor as to any tax, accounting or legal statements made herein.

2006-0319A

[Return To Top](#)

**Sale of this WebReprint Service® Article Does Not Constitute Or Imply Any Endorsement
Or Sponsorship Of Any Product, Service, Company Or Organization.**

REPRODUCTIONS REQUIRE FURTHER PERMISSION

© 2006 Dow Jones & Company, Inc. All Rights Reserved

www.djreprints.com

