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When Your Paycheck Stops

Ready to retire? Better make sure you can afford it. Here's how to make the most of what you've stashed in your piggy bank.

By Jane Bryant Quinn
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April 18, 2006 issue - One day, you'll look at your money and say, "That's all there is." No paycheck, no raises—only the income you generate from the work and savings you achieved in the past. Oof. What now? That's a scary question for boomers hitting the milestones of 60 and 55. For years, you've focused on earning, spending and (more recently) saving for the future. Now the future is heaving into view. You will retire—in fact, some of your friends are free already. Many went cheerfully; others were pushed. Some intend to work until 80, maybe including you. But you've entered the years when plans can go awry. Ready or not, everyone has to figure out how to make his or her savings last until 95. Wow.

There's no way of nailing the future down. But good preretirement planning can hold your anxiety down. Here's a start:

Figure Out What You Can Spend
Early retirement may turn into a pipe dream, once you calculate how much income you'll need for the rest of your life. "Some folks are realistic about their spending," says planner Lauren Klein of Newport Beach, Calif., but others—especially younger, executive-level retirees, have a harder time. "They want to front-load their retirement and spend early," she says. "For them, loss of status is a greater fear than outliving their money." (As if there's status in going broke.)

Smart preretirement planning begins with a budget—one that takes a first pass at separating future wants from needs. Will you still keep two cars? Should you drop your life insurance? Can you get out of debt before your paycheck stops? Living is cheaper without work expenses. On the other hand, medical costs will rise. Planner Susan Elser of Indianapolis tells her clients to figure on spending $3,000 a year, per person, for insurance premiums, deductibles, co-pays and drugs, when they go on Medicare.

On the income side, you'll be getting Social Security (watch the mail; three months before every birthday, the government sends you a notice, showing the current size of the benefit you can expect). Companies are shrinking their private pension plans, but full benefits are being paid in the public sector.

If you plan to draw an income from savings invested in stocks and bonds, the prudent annual limit is lower than you think. Planners advise that you spend no more than 4 percent of the total in the year you retire. On a $150,000 nest egg, that's just

$6,000. In each subsequent year, increase your withdrawal by no more than the inflation rate. If you start with a 5 percent draw, you risk running out of money.

This comes as a shock to preretirees who'd planned to tap their savings for more. But that's what planning is all about. If you can't get by on the wise 4 percent withdrawal rate, you should have a serious talk with yourself and your spouse about your priorities, trade-offs and aspirations, says Paul Winter of Five Seasons Financial Planning in Holladay, Utah. Are you willing to work longer, slash expenses, work part time or move to a cheaper part of the country? The sooner you decide, the better your chance of right-sizing your retirement.

For Alice Sidwell, 64, early retirement didn't seem to be realistic. She worked for United Airlines as a flight attendant, but despite years of saving, her pension and 401(k) would not have been enough. "I could have lived," she says, "but couldn't have made extra purchases."

An inheritance saved her. In 1999 she sat down with planner Mark Brown, of Brown & Tedstrom in Denver, who looked at her spending and assets and told her that she could afford to retire. He also reorganized her money. Previously, it was run by a stockbroker who constantly bought and sold stocks (including risky penny stocks). Brown switched her investments into a diversified mix of stock and bond mutual funds. Her withdrawal rate is just 3 percent, so she's living well below her means.

Living the Dream

- How six baby boomers are making the most of their savings

Photo Illustration by Joe Zeff for Newsweek

Redo Your Investment Plan
When you're getting close to retirement, reconsider your investments. Bury any impulse to try to pick winning stocks—most of us aren't any good at it. Switch to mutual funds instead. (OK, keep a "mad money" fund—but if you lose it, take that as a sign.)

If you've piled up company stock in your 401(k), divest it now—not only the stock you bought yourself, but anything you received as a company match. Diversify into mutual funds no matter how good you think your company is.

Selling her company stock was one of the choices that helped Maria Bellon, 59, retire. A career BellSouth employee, she signed up 30 years ago to invest her 401(k) in stock and never looked back. She had a great run—but by 2000, BellSouth made up more than 80 percent of her retirement fund. Her planner, Mario Yngerto of Genesis Wealth Management in Plano, Texas, encouraged her to diversify. She scooted at $40 a share—not long before the stock bubble burst and the price plunged to less than $20. Bellon says she felt disloyal when she moved the money out, but is relieved she did. At retirement, she rolled her 401(k) and most of her lump-sum pension into an IRA invested in index mutual funds, which Yngerto tends.

When investing retirement assets, planners almost unanimously endorse what's called a total-return approach. That means taking all your financial assets—your 401(k) plus any taxable savings—and spreading them over a well-diversified group of mutual funds. The usual building blocks include large and small U.S. stocks, international and emerging-market stocks, and a mix of short- and long-term bonds. You calculate the safe 4 percent withdrawal rate and spend that much (or less) from your account each year. You're not specifically investing for income. You're investing for gain and taking the cash you need from the total pot.

For some retirees, that goes against the grain. They worry about dipping into their principal and seek safer programs focused on bonds and other income investments. As the years go by, however, and inflation rises, income investing won't keep up. You'll run out of cash unless you also invest for growth. At 55, most planners tell clients: 60 percent stocks, 40 percent bonds. At 65, they lean toward 50-50 stocks and bonds.

But don't go by age alone, says investment adviser Stuart Zimmerman of Buckingham Asset Management in St. Louis. A 50-50 mix might be right for a 65-year-old who needs the assets to live on. But if you have more than you need, you're managing some of the money for the next generation. That calls for a more aggressive 60-40 mix of stocks to bonds.

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To Roll or Not?

At retirement, should you leave your 401(k) in your company plan or roll it into an

Individual Retirement Account? In big-company plans with low-cost choices and good sources of advice, retirees could leave the money there, says Cindy McGhee of A&F Financial Advisors in Charleston, W. Va. If you die, your spouse can treat the plan as his or her own. But if your kids will inherit, it's smarter to take all the money and switch to an IRA. IRAs let them stretch the payouts over their lifetimes, giving them years of tax-deferred growth.

Here's an important tax-saving tip for employees with major capital gains in their company stock. Empty your 401(k), but instead of rolling the stock portion into an IRA, put it into a regular brokerage account. In an IRA, you'll wind up paying income taxes on the capital gain. By taking it out of the plan, you'll owe income taxes only on the original cost. The appreciation will be taxed at the low 15 percent rate on capital gains, says IRA expert Ed Slott, author of "Parlay Your IRA Into a Family Fortune." "I shudder when I hear ads saying, 'Call to roll over your 401(k)'," he says. "Those rollover jocks never ask about company stock, and you wind up paying extra tax."

You can also roll your money into tax-deferred annuities. That's a controversial choice, but not for Dan Breeding, 57, and his wife, Susan, 53. He took early retirement last year, mainly because his firm had been downsizing and he worried about his job. They're pretty new parents, with two adopted children from Kazakhstan, now 4 and 5. They moved from Indianapolis to Lone Jack, Mo., where it costs about 10 percent less to live.

Breeding is well organized and likes guarantees. His planner, Amy Rose Herrick of Topeka, Kans., rolled his savings into six different tax-deferred annuities. These annuities amount to mutual funds in an insurance wrapper. If you die at a time when your funds are worth less than you paid, your beneficiary will get your original investment back. You may also get a minimum-performance guarantee. In return, you pay much higher total fees than you would for straight mutual funds—in Breeding's case, about 1.65 percent a year (to cover expenses and commissions), plus the cost of the funds, so future investment performance won't be so hot. Also, there may be penalties for cashing out too soon.

Most of the planners NEWSWEEK spoke with say they avoid annuities—especially costly bonus annuities. Breeding has three of them. They yield a little more upfront—but, the Securities and Exchange Commission warns, you may pay for that "bonus" in the form of higher fees or surrender costs or longer required holding periods. Herrick says the value of the bonus exceeds its cost after six to eight years. Still, it's an expensive choice.

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Tap Your House for Cash

You can't count the value of your house as a retirement asset unless you're prepared to tap the cash. You might buy something smaller or move to a cheaper part of the country. Or like Neil and Nancy Collins, both 60, of Melrose, Mass., you might decide to rent. The Collinses aren't retiring yet (he's a financial planner, she's a teacher). But they're preparing for the change by selling their house, harvesting the equity and buying a condo in Estero, Fla. In Melrose, they'll move to an apartment. Renting "gives us tremendous flexibility," Neil says—"financial, geographic and lifestyle."

They're right to watch their costs. Planner Ron Rhoades of Joseph Capital Management in Hernando, Fla., sees too many retirees buying dream houses they can't afford. He says that for every extra $100,000 you spend on a home, you'll be out $7,000 in expenses and lost investment revenue.

But for everyone eager to move, there's someone who can't bear the thought. Take Elene Wilburn, 70, of Twinsburg, Ohio, who lives on her public-school pension and Social Security. "I love my house," she says. "I like planting flowers in the yard and don't want to move." Her solution? A reverse mortgage that put a pile of cash in her pocket. It sounded so good, she thought at first it was a scam.

With a reverse mortgage, you get a loan equaling 50 percent or more of the value of your home. But you never make any monthly payments. Instead, the loan gradually builds up—compounding interest costs and fees. You can stay put for as long as you want. The debt doesn't fall due until the house is sold, when you move or die.

Wilburn learned all the details at a sales meeting held by American Reverse Mortgage, and decided to sign up. She borrowed $286,000 on a loan insured by the Federal Housing Administration—some in a lump sum, the rest in a credit line for future use. She'll take a Caribbean cruise—"something I've always wanted to do"—and set up college funds for her grandchildren.

The drawback to reverse mortgages is their cost. You're charged a variable interest rate—now at 6.3 percent (and rising). The mortgage broker or lender can charge up to 2 percent—that's $5,000 on a $250,000 loan. There are also closing costs, servicing costs and insurance fees. All told, the expenses could reach $25,000 or more, says Ken Scholen, AARP's reverse-mortgage expert. The more your home is worth and the younger you are, the more the loan costs. Ideally, he says, you should consider this mortgage later in life. For a good, free booklet explaining the ins and outs, call AARP at 800-209-8085 and ask for Home Made Money, or read it on the Web at aarp.org/revmort.

Cover the Cost of Care
"Don't risk a lot for a little." That's what financial planner Charles Buck, 58, of Woodbury, Minn., tells the students who take his retirement-planning class at the state university's Mankato campus. Taking his own advice, he and his wife, Dianne, 53, bought a joint long-term-care insurance policy. They've both seen dementia in their extended families, and don't want to impoverish each other if one of them becomes ill.

These policies aren't for people with modest incomes (you can't afford them) or the superrich. They're for people in between, says planner Dean Harmon of The Woodlands, Texas, who recommends them to clients with assets ranging from $500,000 to $4 million. Shop when you're 55 to 65. Generally, you shouldn't pay more than 7 percent of your future retirement income (not your working income), says planner Robert Pagliarini of Allied Consulting Group in Los Angeles. You might balk even at that expense—but it sure brings peace of mind.

Most of all, you need to save—and yes, "panic saving" works. Hurl money into a retirement account. It's never too late.

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