3 steps to start building your own retirement plan

Alexander Webb Nov 3, 2021, 4:28 PM

The choices you make when retirement planning are some of the most important financial decisions you'll ever make. MoMo Productions/Getty

Planning your retirement as early as possible is key to ensuring you're financially secure when you're no longer working.

When planning for retirement, many experts recommend transitioning your portfolio away from stocks and into bonds as you age.

How you save for retirement has important tax implications for you and your family.

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We all dream of a stress-free retirement as a way to enjoy our golden years. But getting there takes a lot of careful planning. And it's important to start early. When you plan for retirement, you're setting income goals and determining the course of action needed to achieve them. That means choosing long-term investment vehicles such as 401(k) accounts, IRAs, or annuities. The sooner you begin funding them, the more money you're likely to have when it comes time to retire.

Following are the basic steps to take when doing your retirement planning.

Step 1: Calculate how much you'll need for retirement

Perhaps the biggest question in retirement planning is: How much do I need to save?" While every situation is different, Fidelity estimates that retirees will need

10 times their salary in savings to retire in order to maintain the same lifestyle while still working.

By age	Salary amount you should have saved
30	1x your starting salary
35	2x your starting salary
40	3x your starting salary
45	4x your starting salary
50	6x your starting salary
55	7x your starting salary
60	8x your starting salary
67	10x your starting salary

The IRS estimates that most retirees should save enough to receive 80% of their yearly salary during retirement. Of course, everyone's situation is different. Two key factors will determine how much you need: when you want to retire and how you want to live in retirement.

For example, if you want to travel more during retirement than you did during your working years, Fidelity recommends you may want 12 times your annual salary saved. If you plan on living more modestly, you may only need eight times. Here's a helpful tool from Fidelity that allows you to compute what your likely retirement needs are.

Whatever you do, it's best to start saving as early as you can. Compound interest means that a dollar saved when you are younger can be as valuable as saving several dollars later in life.

Step 2: Choose a retirement plan

There are various retirement vehicles to choose from, which is a big decision that can affect how you save for retirement. From 401(k) plans to Roth IRAs, the options can be hard to parse.

Steps to take when choosing a retirement plan:

- Experts generally recommend you first max out any retirement plan with employer-matching funds. Failing to do so is like leaving free money on the table.

- Next, you want to consider the tax implications. A Roth plan makes sense if you think you'll have a higher tax rate in the future. If you think your taxes will be lower in the future, you may want to defer taxes on your retirement savings by using a traditional IRA, 401(k), 403(b). Keep reading to learn more about Roth plans.

- Whatever plan you choose should generally have a diversified basket of equities and bonds. Most experts recommend your portfolio get more conservative as you age.

- Whatever plan you choose, it's important to start saving as soon as you can, and fund as much as you can afford.

Here are the different types of types of retirement accounts to consider:

Employer-sponsored plans

Employer-sponsored plans are retirement plans created under terms set by your employer. While the details of specific plans will vary, the two most common plan types are 401(k) and 403(b).

Two types of employer-sponsored plans are:

- 401(k)s: This is a retirement plan that's commonly offered by many employers. They allow employees to allocate a portion of their pay directly into the account, with employers matching contributions up to a certain percentage. 401(k)s are usually tax-deferred, meaning contributions are not taxed, but withdrawals are.

- 403(b)s: This is a type of retirement plan for workers in government, nonprofits, or religious organizations. Most plans offer investments in mutual funds or annuities. They are usually tax-deferred, meaning you pay taxes only when you withdraw your money.

Since these plans are sponsored by your employer, details such as which assets are available will vary. Both 401(k)s and 403(b)s are funded with after-tax money, allowing you to make tax free withdrawals in retirement. The 2021 contribution limit for both 401(k) and 403(b) plans is $26,000 if you're 50 or older and $19,500 for everyone else.

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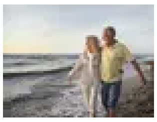

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Many employers offer matching contributions for these two plans, meaning they'll match any contribution you make up to a certain amount. For example, if you make $50,000 at an employer offering a 2% match, they'll contribute $1,000 to your plan, but only if you do so too. Unless you have a Roth plan, you will pay taxes on your investment, but only when you withdraw the funds.

IRAs

An IRA, short for individual retirement arrangement, is a type of retirement account that's set up by an individual, not their employer. IRAs offer a variety of investment choices, from mutual funds to bonds. Below are several different types of IRAs:

- Roth IRAs: This type of IRA is funded with after-tax money, allowing for tax-free distributions in retirement. If you expect to have a higher tax rate in the future, or want your heirs to inherit money tax-free, you may want to consider a Roth IRA.

- Traditional IRAs: This type of IRA is the opposite of a Roth IRA in that it's funded with pre-tax money. This allows you to defer payment of income taxes on the money you save until you take distributions when you retire. This is a good way to reduce your taxable income now, while saving for retirement. If you expect your tax rate to be lower in the future, a Traditional IRA may be best for you.

- SIMPLE IRAs: A SIMPLE IRA is an employer-sponsored IRA for employees of small businesses. It functions similarly to a 401(k) with details varying by employer.

- SEP IRAs: A SEP IRA is a retirement plan that employers can establish on behalf of their employees. It can also be used by business owners or self-employed people as a personal retirement plan.

"I'm a big fan of Roth IRAs and employer-sponsored Roth retirement accounts" says Loretta Vitt Dubova, Attorney at Vitt Law Offices, PLC, who specializes in areas of estate planning, estate administration, and elder law. When someone cashes out the plan after inheriting it, "in many cases, a child or non-spouse beneficiary of a Roth retirement plan will not pay income tax," Dubova adds. This is in contrast to a traditional, non-Roth IRA where beneficiaries must pay income tax on distributions, she explains.

Annuities

An annuity is an insurance product that provides a steady stream of money during retirement. You make a prepium payment or series of payments and choose whether you'd like payments in a lump sum or over time. Annuities income and investment gains grow tax free, too. Lifetime annuities are a good option for those worried about outliving their retirement savings.

Quick Tip: Experts generally recommend a Roth 401(k), Roth 403(b), or Roth IRA plan if you expect to have a higher tax rate in the future, while a traditional retirement plan may make more sense if you think your future tax rate will be lower.

Step 3: Select your retirement investments and start contributing

Once you've selected your retirement vehicle, it's time to start thinking of what to invest your contributions in. Retirement accounts allow you to invest in a wide variety of assets, such as stocks, bonds, and mutual funds. But what should you invest in?

Financial advisors usually suggest a diversified portfolio, which might include index funds that track major sectors or indices, such as the S&P 500. In general, diversification among assets is important, with most investors typically increasing the allocation of bonds, which are generally less risky than stocks as they get older.

"The standard way of thinking is that asset allocation needs to get more conservative over time," says Javier Estrada, professor of finance at IESE Business School, who has done academic research on retirement planning strategies. However, "asset allocations need to be personalized depending on the individual's goals, portfolio holding period, and risk tolerance," he says.

If adjusting your asset allocation mix over time sounds too complicated, you can invest in a target-date fund that does it for you. You simply choose the date of your retirement, and the fund will automatically rebalance your portfolio as time passes, making it more conservative over time. Estrada calls target-date funds "a good option for people with little knowledge of how to save for retirement" but notes that sophisticated investors, or those with a good adviser, may want the flexibility of doing their own reallocations.

Regardless of the strategy you take, it's important to maximize your contributions each year that you can. It's especially crucial to take advantage of any employer

match programs, because they are essentially a free way to magnify your investing impact.

Quick Tip: Target-date funds automatically rebalance your retirement portfolio toward safer investments over time. This makes them a simple "set-and-forget" option for many people.

During retirement: Withdraw funds at a sustainable rate

No matter how much you save, if you spend too quickly you could spend your final years in trouble. And if you spend too slowly, you might not be able to enjoy the money you've saved.

One common metric is the 4% rule. You spend 4% of your retirement savings in your first year, then only increase that figure with inflation. For example, if you have $1 million saved for retirement, in the first year you'd withdraw $40,000. If the inflation rate is 2%, then next year you'd withdraw $40,800, and so on.

An influential study by finance professors at Trinity University found this worked over every 30-year period from 1926 to 1994, for portfolios in their sample that had at least 25% bonds. Updated versions have also found similar results. While the bond-heavy portfolios are less likely to run out of money if stocks crash, they also grow more slowly than equity-heavy portfolios do in good times.

That's one reason why many think that a 75/25 mix is far too conservative. Estrada researched this topic, finding a 90/10 allocation remarkably successful for most investors. For investors seeking to "maximize the size of the retirement portfolio, there may be better strategies to follow" than simply adjusting more and more towards bonds as retirement approaches, he says.

Step 3: Select your retirement investments and start contributing

The Bucket Strategy is another way to plan for retirement withdrawals. It involves withdrawing the money you'll need in the next few years into low-risk buckets withdrawing the money you'll need in the next few years into low-risk buckets. This is designed to avoid you selling too many assets after a market crash.

Although it has many adherents, Professor Estrada found it underperforms static withdrawal strategies on all four metrics he tested. Instead, he recommends periodically rebalancing your retirement portfolio. "Bucketing may be behaviorally comforting but financially suboptimal" said Prof. Estrada, adding "everything that bucketing achieves can be achieved by periodically rebalancing a portfolio, which also leads to additional benefits."

Beyond asset-allocation strategies, it's important to understand the rules of your retirement plans. For example, most withdrawals from a 401(k) before age *59 ½* incur a 10% penalty.

The financial takeaway

The choices you make when retirement planning are some of the most important financial decisions you'll ever make because they will ultimately have a huge influence on your quality of life when you get older. It starts with thinking about how you want to live when you're older and then charting a path to get there, whether it's through an employer-sponsored 401(k), an IRA, or a range of other investment options.

No matter what plan you choose, it's important to make the most of tax deferrals, employer matches, and other ways to make the most of your retirement funds. And remember to adjust your portfolio over time, moving out of riskier assets in favor of a more conservative allocation as you get older.

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