These five steps will help you toward a safe, secure, and fun retirement

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Retirement planning is a multistep process that evolves over time. To have a comfortable, secure—and fun—retirement, you need to build the financial cushion that will fund it all. The fun part is why it makes sense to pay attention to the serious and perhaps boring part: planning how you'll get there.

Planning for retirement starts with thinking about your retirement goals and how long you have to meet them. Then you need to look at the types of retirement accounts that can help you raise the money to fund your future. As you save that money, you have to invest it to enable it to grow. The surprise last part is taxes: If you've received tax deductions over the years for the money you've contributed to your retirement accounts, a significant tax bill awaits when you start withdrawing those savings. There are ways to minimize the retirement tax hit while you save for the future—and to continue the process when that day arrives and you actually do retire.

We'll get into all of these issues here. But first, start by learning the five steps everyone should take, no matter what their age, to build a solid retirement plan.

KEY TAKEAWAYS

- Retirement planning should include determining time horizons, estimating expenses, calculating required after-tax returns, assessing risk tolerance, and doing estate planning.
- Start planning for retirement as soon as you can to take advantage of the power of compounding.
- Younger investors can take more risk with their investments, while investors closer to retirement should be more conservative.
- Retirement plans evolve through the years, which means portfolios should be rebalanced and estate plans updated as needed.

1. Understand Your Time Horizon

Your current age and expected retirement age create the initial groundwork of an effective retirement strategy. The longer the time between today and retirement, the higher the level of risk your portfolio can withstand. If you're young and have 30-plus years until retirement, you should have the majority of your assets in riskier investments, such as stocks. Though there will be volatility, stocks have historically outperformed other securities, such as bonds, over long time periods. The main word here is "long," meaning at least more than 10 years.

Additionally, you need returns that outpace inflation so you can maintain your purchasing power during retirement. "Inflation is like an acorn. It starts out small, but given enough time, can turn into a mighty oak tree. We've all heard—and want—compound growth on our money. Well, inflation is like 'compound anti-growth,' as it erodes the value of your money. A seemingly small inflation rate of 3% will erode the value of your savings by 50% over approximately 24 years. Doesn't seem like much each year, but given enough time, it has a huge impact," says Chris Hammond, a Savannah, Tenn., financial advisor and founder of RetirementPlanningMadeEasy.com.

You might not think saving a few bucks here and there in your 20s means much, but the power of compounding will make it worth much more by the time you need it.

In general, the older you are, the more your portfolio should be focused on income and the preservation of capital. This means a higher allocation in securities, such as bonds, that won't give you the returns of stocks but will be less volatile and provide income you can use to live on. You will also have less concern about inflation. A 64-year-old who is planning on retiring next year does not have the same issues about a rise in the cost of living as a much younger professional who has just entered the workforce.

You should break up your retirement plan into multiple components. Let's say a parent wants to retire in two years, pay for a child's education at age 18, and move to Florida. From the perspective of forming a retirement plan, the investment strategy would be broken up into three periods: two years until retirement (contributions are still made into the plan), saving and paying for college, and living in Florida (regular withdrawals to cover living expenses). A multi-stage retirement plan must integrate various time horizons, along with the corresponding liquidity needs, to determine the optimal allocation strategy. You should also be rebalancing your portfolio over time as your time horizon changes.

2. Determine Retirement Spending Needs

Having realistic expectations about post-retirement spending habits will help you define the required size of a retirement portfolio. Most people believe that after retirement, their annual spending will amount to only 70% to 80% of what they spent previously. Such an assumption is often proved to be unrealistic, especially if the mortgage has not been paid off or if unforeseen medical expenses occur. Retirees also sometimes spend their first years splurging on travel or other bucket-list goals.

“In order for retirees to have enough savings for retirement, I believe that the ratio should be closer to 100%,” says David G. Niggel, CFP, ChFC, AIF, founder, president, and CEO of Key Wealth Partners, LLC, in Litiz, Pa. “The cost of living is increasing every year—especially health care expenses. People are living longer and want to thrive in retirement. Retirees need more income for a longer time, so they will need to save and invest accordingly.”

As, by definition, retirees are no longer at work for eight or more hours a day, they have more time to travel, go sightseeing, shop, and engage in other expensive activities. Accurate retirement spending goals help in the planning process as more spending in the future requires additional savings today. “One of the factors—if not the largest—in the longevity of your retirement portfolio is your withdrawal rate. Having an accurate estimate of what your expenses will be in retirement is so important because it will affect how much you withdraw each year and how you invest your account. If you understate your expenses, you easily outlive your portfolio, or if you overstate your expenses, you can risk not living the type of lifestyle you want in retirement,” says Kevin Michels, CFP, EA, financial planner, and president of Medicus Wealth Planning in Draper, Utah. Your longevity also needs to be considered when planning for retirement, so you don’t outlast your savings. The average life span of individuals is increasing.

Actuarial life tables are available to estimate the longevity rates of individuals and couples (this is referred to as longevity risk).

Additionally, you might need more money than you think if you want to purchase a home or fund your children’s education post-retirement. Those outlays have to be factored into the overall retirement plan. Remember to update your plan once a year to make sure you are keeping on track with your savings. “Retirement-planning accuracy can be improved by specifying and estimating early retirement activities, accounting for unexpected expenses in middle retirement, and forecasting what-if late-retirement medical costs,” explains Alex Whitehouse, AIF, CRPC, CWS, president and CEO, Whitehouse Wealth Management, in Vancouver, Wash.

3. Calculate After-Tax Rate of Investment Returns

Once the expected time horizons and spending requirements are determined, the after-tax real rate of return must be calculated to assess the feasibility of the portfolio producing the needed income. A required rate of return in excess of 10% (before taxes) is normally an unrealistic expectation, even for long-term investing. As you age, this return threshold goes down, as low-risk retirement portfolios are largely composed of low-yielding fixed-income securities.

If, for example, an individual has a retirement portfolio worth $400,000 and income needs of $50,000, assuming no taxes and the preservation of the portfolio balance, they are relying on an excessive 12.5% return to get by. A primary advantage of planning for retirement at an early age is that the portfolio can be grown to safeguard a realistic rate of return. Using a gross retirement investment account of $1 million, the expected return would be a much more reasonable 5%.

Depending on the type of retirement account you hold, investment returns are typically taxed. Therefore, the actual rate of return must be calculated on an after-tax basis. However, determining your tax status when you begin to withdraw funds is a crucial component of the retirement-planning process.

4. Assess Risk Tolerance vs. Investment Goals

Whether it's you or a professional money manager who is in charge of the investment decisions, a proper portfolio allocation that balances the concerns of risk aversion and return objectives is arguably the most important step in retirement planning. How much risk are you willing to take to meet your objectives? Should some income be set aside in risk-free Treasury bonds for required expenditures?

You need to make sure that you are comfortable with the risks being taken in your portfolio and know what is necessary and what is a luxury. This is something that should be seriously talked about not only with your financial advisor but also with your family members. "Don't be a 'micro-manager' who reacts to daily market noise," advises Craig L. Israelsen, Ph.D., designer of 7Twelve Portfolio in Springville, Utah. "'Helicopter' investors tend to over-manage their portfolios. When the various mutual funds in your portfolio have a bad year, add more money to them. It's kind of like parenting: The child that needs your love the most often deserves it the least. Portfolios are similar. The mutual fund you are unhappy with this year may be next year's best performer—so don't bail out on it."

“Markets will go through long cycles of up and down and, if you are investing money you won’t need to touch for 40 years, you can afford to see your portfolio value rise and fall with those cycles,” says John R. Frye, CFA, chief investment officer and co-founder, Crane Asset Management, LLC, in Beverly Hills, Calif. “When the market declines, buy—don’t sell. Refuse to give in to panic. If shirts went on sale, 20% off, you’d want to buy, right? Why not stocks if they went on sale 20% off?”

5. Stay on Top of Estate Planning

Estate planning is another key step in a well-rounded retirement plan, and each aspect requires the expertise of different professionals, such as lawyers and accountants, in that specific field. Life insurance is also an important part of an estate plan and the retirement-planning process. Having both a proper estate plan and life insurance coverage ensures that your assets are distributed in a manner of your choosing and that your loved ones will not experience financial hardship following your death. A carefully outlined plan also aids in avoiding an expensive and often lengthy probate process.

Tax planning is another crucial part of the estate-planning process. If an individual wishes to leave assets to family members or a charity, the tax implications of either gifting the benefits or passing them through the estate process must be compared.

A common retirement-plan investment approach is based on producing returns that meet yearly inflation-adjusted living expenses while preserving the value of the portfolio. The portfolio is then transferred to the beneficiaries of the deceased. You should consult a tax advisor to determine the correct plan for the individual.

“Estate planning will vary over an investor’s lifetime. Early on, matters such as powers of attorney and wills are necessary. Once you start a family, a trust may be something that becomes an important component of your financial plan. Later on in life, how you would like your money disbursed will be of the utmost importance in terms of cost and taxes,” says Mark T. Hebner, founder and president, Index Fund Advisors, Inc., in Irvine, Calif., and author of “Index Funds: The 12-Step Recovery Program for Active Investors.” “Working with a fee-only estate planning attorney can assist in preparing and maintaining this aspect of your overall financial plan.”

The Bottom Line

The burden of retirement planning is falling on individuals now more than ever. Few employees can count on an employer-provided defined-benefit pension,

especially in the private sector. The switch to defined-contribution plans, such as 401(k)s, also means that managing the investments becomes your responsibility, not your employer's.

One of the most challenging aspects of creating a comprehensive retirement plan is striking a balance between realistic return expectations and a desired standard of living. The best solution is to focus on creating a flexible portfolio that can be updated regularly to reflect changing market conditions and retirement objectives.

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