

Standard 6: The student will explain and evaluate the importance of planning for retirement.

Planning for Your Retirement



Lesson Objectives

- ⇒ Identify and evaluate different retirement options.
- ⇒ Explain the different types of risk associated with long-term planning.
- ⇒ Apply the different types of risk to the various investment products, such as stocks, bonds, mutual funds, etc.

Lindzi and Lezli will attend retirement parties for their two grandmothers this month.

Grandma Eliza invested in her company 401(k). She also helped her four children attend college and encourages them to be successful in their careers. While she is not responsible for raising any of her grandchildren, she has established a college savings plan for each of them and contributes when she can.

Instead of putting money in her retirement account, Grandma Jessie spent her money on family: putting five children through college, helping three of them start businesses, and now is raising her two grand-daughters. Jessie also plans to rely on Social Security for her retirement income.

Which grandma made the best financial choices for her retirement?

Personal Financial Literacy Vocabulary

Annuity: A contract between an individual and an insurance company where the individual makes a series of payments that are invested by the company and repaid to the individual at a later date, generally during retirement.

Financial Risk: The chance that an individual, business or government will not be able to return money invested.

401(k): A retirement plan that allows employees in private companies to make contributions of pre-tax dollars to a company pool that is then invested in stocks, bonds, or money markets.

Fraud Risk: The chance that an investment has been misrepresented.

Individual Retirement Account: An account in which an individual may set aside earned income in a tax-deferred savings plan for his or her retirement.

Inflation Risk: The chance that the rate of inflation will exceed the rate of return on an investment.

Market Risk: The chance that the value of an investment will go down because of a change in supply and demand.

Social Security: A federal system of old-age, survivors', disability and hospital care (Medicare) insurance which requires employers to withhold (or transfer) wages from employees' paychecks and deposit that money in designated accounts.

Introduction



Many people spend much of their career looking forward to retirement. Even though the idea of retirement means many different things, most people would agree that financial security is an important part of their future goals. People save for retirement in many different ways. Some of the most common include Social Security, company retirement plans such as 401(k) plans, and annuities. Like anything else, each retirement savings plan has both benefits and risks. The biggest risk, however, is failing to plan.

Lesson

Saving for your retirement is hard to imagine when you are in school. You may already be saving money for other goals like a new computer game, a car, or maybe college. However, as an adult, the most important savings goal you will have is your retirement.

The oldest person alive in the United States today is 117 years old. Imagine this: if you retired at age 65 (the most common age for people to retire), then you have at least 52 years ahead of you! While you may not live until the age of 100, you will probably live many years past age 65.

What would you want your life to be like when you reach retirement? Have you heard your parents, grandparents or others talk about retirement? What are some of the ideas, plans, goals or statements they make about retiring? List your answers to these questions in the box below.

Your ideal retirement:

Your friend's or family's plans for retirement:

Whatever plans you have listed, you will need some kind of income to support you and your activities during those years. Otherwise, you may be living on very limited income with little or no money to pay for your basic needs. Following are several different types of retirement plans for you to consider.

Social Security

You may have heard people talk about the future of **Social Security**, the most common retirement benefit; it is provided by the federal government and supported with payroll taxes. The U.S. Social Security program is the largest government program in the world and the single



greatest expense in the federal budget. Today, the average monthly check from Social Security is only about \$1,000. While that may sound like a lot of money, it is basically the same as making \$6.25 for working a full-time job.

Relying only on Social Security for your retirement years will be very limiting. In fact, it may not be enough to pay for the things you want to buy or the way you want to live in your “golden” years. Because it is a government program, you have no control over your earnings and cannot predict what will happen to the program over the next 50 years.

Social Security benefits are based on the number of years you work and the income you earn. In general terms, you must work a minimum of ten years to receive Social Security benefits, but there are some exceptions. Almost every job in the United States requires employers to participate in the Social Security system, making it the most readily available retirement benefit.

Social Security was originally designed as “supplemental” income for people over the age of 65. In other words, it is supposed to be only one source of income when you retire. It is your responsibility to develop a savings and investment strategy to provide the funds needed to have a financially secure retirement and accomplish your personal goals for that phase of your life in addition to Social Security.

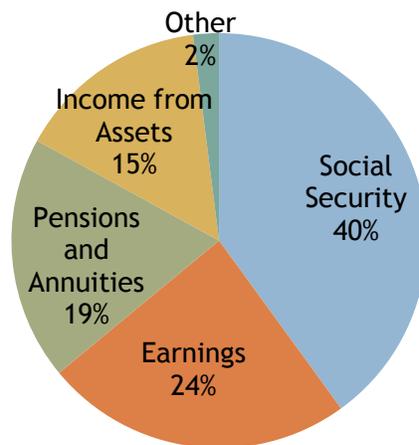
Company Retirement Plans

Company retirement plans are part of the benefits provided by many employers, and they vary greatly from company to company. In some cases, the employer pays into a retirement fund for you. Sometimes, you are required to pay into the retirement fund; and sometimes you and your employer both pay into the fund. It depends on the plan and depends on the employer. Before accepting a job, it is always good to ask about the retirement benefits.

One of the most common types of company retirement plans is a **401(k)**. This type of retirement plan has two basic features: (1) It allows you and/or your employer to put money into an investment account each month; and (2) Taxes are not paid on the amount invested until you withdraw your money from the account. The amount you receive when you retire is based on how much money is in the account. Most 401(k) plans require you to make choices about how to invest your money because your employer is not allowed to do it for you. Many young employees, like you, fail to see the benefit of participating in a company retirement plan. However, that can be an expensive choice, especially if your company matches the money you put into the account. Why not spend a little of your money to get the money from your employer? Otherwise, you are missing out on an important part of your company benefits.

An **annuity** is a different kind of retirement account. Annuities are based on a contract where you pay in a specific amount each month and receive a guaranteed amount each month when you retire. While annuities are a good option to consider, they tend to generate less overall earnings than a 401(k). However, their benefits are guaranteed, and 401(k) plans have no guarantees.

Individual Retirement Accounts, commonly called IRAs, provide another option for retirement planning. You may want to consider an IRA if your company does not offer a retirement plan, but you may also choose to set up an IRA as a supplement to other retirement accounts. Most IRAs are invested in mutual funds which tend to have



Sources of Income for Americans Age 65 and Older

Source: Employee Benefit Research Institute, December 2007

lower risk than other investment options. Before opening an IRA, you should find out exactly how your money will be invested and understand any potential fees for managing the account.

Today, there are two basic kinds of IRAs:

- A **traditional IRA** allows you to contribute money to your account, deduct the contribution from your personal income taxes, and then pay those taxes when you pull the money out of your account. Money paid into a traditional IRA is available after you turn 59 1/2 years old. You may also be able to withdraw funds from your account for special purposes or emergencies; otherwise, you will pay costly penalty fees for using your money. Those penalties are in place as an incentive to keep your money invested for retirement purposes instead of using it like a savings account.
- A **Roth IRA** is a little different. With a Roth, you pay personal income taxes on your earnings before placing it in your IRA account. Because you pay the taxes upfront, you will not pay any taxes when you withdraw the money at a future date. Roth IRAs also have fewer restrictions for taking the money out before retirement.

You may want to get professional advice from a financial planner or other financial consultant before opening an IRA account to determine which type is most beneficial for you.

Summary

While most retirement accounts allow you to access your money before retiring, you have a high opportunity cost when making that decision. Remember, the purpose is to save for retirement. If you use the money now, you will not have it when you need it later on. The money you need now should be in your savings account—not your retirement account. In the box below, summarize the different kinds of retirement savings options available.

| My Summary of Retirement Plans |
|---------------------------------------|
| Social Security |
| |
| 401(k) |
| |
| Annuity |
| |
| Traditional IRA |
| |
| Roth IRA |
| |

Different Types of Investment Risk

The reason for establishing a retirement account in your younger years is to let it grow throughout your life. Remember the Rule of 72! You want your investment to earn a high rate of return so you have more money when you retire. Because you are not planning to use the money in your retirement account for several years, a lot can happen between the time you start participating in a retirement plan and the time you start receiving payments from it.

Investing in a retirement account has both potential costs and potential benefits. For example, a cost is you cannot spend the money now, and a benefit is having more money in the future. Another cost is the risk associated with investing. Risk is the potential of losing some or all of your money. However, you still have risk if you do not invest. What if Social Security is not available when you retire and you planned on having it?



If you understand the different kinds of risk, you can take steps to manage those risks and protect your investment.

Following are four specific kinds of risk to be aware of when investing your money.

| | |
|-----------------------|---|
| Market Risk | Market risk is the potential that your investment will be worth less tomorrow than it is today because prices or values have dropped. For example, most people buy a house expecting the value to appreciate (the future sales price increases). While that tends to happen most of the time, sometimes it does not. The same problem can happen with investments. That is one reason buying a car is not a good investment. The value of a car decreases as you put more miles on it. Of course, if you keep it long enough, it might become a “classic” and increase in value again – but that is a big risk! |
| Financial Risk | A financial risk is the potential that the business you invest in goes bankrupt or fails to make a profit. While a private business may lose money and go broke, it cannot happen to the federal government. That explains why some people prefer buying government securities instead of corporate bonds or stocks, even though the rate of return is lower. This kind of risk is also called a business risk. |
| Inflation Risk | Inflation risk says the price you pay for goods and services rise faster than the rate of return on your investment. For example, if inflation is 5%, then you would want to earn more than 5% on your investment. Otherwise, you are not keeping up with the inflation rate. If you continually earn less than the inflation rate, you are losing purchasing power with your investment and your money is worth less. |
| Fraud Risk | Fraud risk is the potential that someone either deceives or tricks you into investing in something where you get nothing in return. While fraud is illegal, there are plenty of people willing to make promises, take your money, and run. Anyone can write a fancy brochure or create a Web site with false information. The best way to protect yourself from investment fraud is to invest with highly regarded, reputable companies. |

So, why do people invest when there are so many risks? Because the potential to make money is greater than the risk of losing it when you make good investment choices. The rule of risk is rather simple: you have the potential to earn more when the risk is high, and the potential to earn less when the risk is low.

That does not mean you should always invest in something just because it is either high or low risk. It means that you should always make informed choices when investing, and knowing the risk level of your investment is part of the process. While it is impossible to eliminate all risks when investing, knowing how to diversify the types of investments in your retirement account will help protect your financial future. By diversifying, you are investing in different financial products.

Use the box below to summarize the four kinds of risk, in your own words.

| My Summary of the Different Kinds of Risk | |
|--|--|
| Market Risk | |
| Financial Risk | |
| Inflation Risk | |
| Fraud Risk | |



**COMPLETE: Risky Business –
Activity 6.1.1**

Have your teacher review your answers before continuing with this lesson.

List three things you have learned from this lesson:

- 1.
- 2.
- 3.

Conclusion

You are responsible for deciding how to invest your money. While employers may offer retirement plans, they generally leave the investment options up to you. Remember, it is your money and your future—so you want to make the best choices possible. Saving for retirement is long-term investing. Even though it seems like forever until you will need the money, you can increase your earnings by starting early in your career. Establishing a diversified retirement plan, avoiding investments that seem “too good to be true,” and understanding your potential risk are three keys to building your financial independence later in life.

Linzi and Lezli should be proud of both grandmas. Reaching retirement is an important milestone in anyone's life.

However, they made very different life choices that will impact their financial security during their retirement years.

While Grandma Jessie can be commended for investing in her family, she will have very limited income and may not be able to achieve her goals for retirement. Social Security provides a set income, which some people find insufficient to cover their expenses on a monthly basis.

Grandma Eliza, however, sufficiently planned for her retirement and should be able to live a more financially independent life.

Name: _____ Class Period: _____

Planning Your Retirement

Review Lesson 6.1

Answer the following questions and give the completed lesson to your teacher to review.

1. The risk that a company might not have enough money to stay in business is called
 - a. market price risk.
 - b. financial risk.
 - c. currency risk.
 - d. inflation risk.

2. A company sponsored plan where you determine how to invest your money is called
 - a. an annuity.
 - b. an IRA.
 - c. a pension plan.
 - d. a 401(k) plan.

3. Which of the following is a characteristic of a Roth IRA?
 - a. Once money is deposited into a Roth IRA, it cannot be taken out until retirement.
 - b. Money is deposited into a Roth by your employer.
 - c. Money invested into a Roth is “before-tax” dollars.
 - d. Money invested into a Roth is “after-tax” dollars.

4. The rule of risk basically says: The greater the potential for risk in an investment, the
 - a. more you are guaranteed to earn.
 - b. greater the potential to earn more.
 - c. less you are guaranteed to earn.
 - d. less the potential to earn more.

Name: _____ Class Period: _____

Risky Business – Activity 6.1.1

Read the following situations and determine which kind(s) of risk is involved.

1. You invest in real estate hoping that prices will increase so you can sell the property for a profit.

_____ risk

Explain your answer: _____

2. Your neighbor invites you to participate in a new plan where you are guaranteed to make a 25% rate of return on each \$1,000 invested. You make your money when you get others to invest in the plan, too.

_____ risk

Explain your answer: _____

3. You put all of your money in a savings account at an insured bank because you are afraid of losing it in the stock market.

_____ risk

Explain your answer: _____

4. Your friend's grandfather does not believe in banks. He lived in the Great Depression when banks failed and people lost money.

_____ risk

Explain your answer: _____

5. Your friend is planning to open a business and asks you to invest in it with him.

_____ risk

Explain your answer: _____