Morgan Stanley

Plan Perspectives

Retirement Insights From Morgan Stanley

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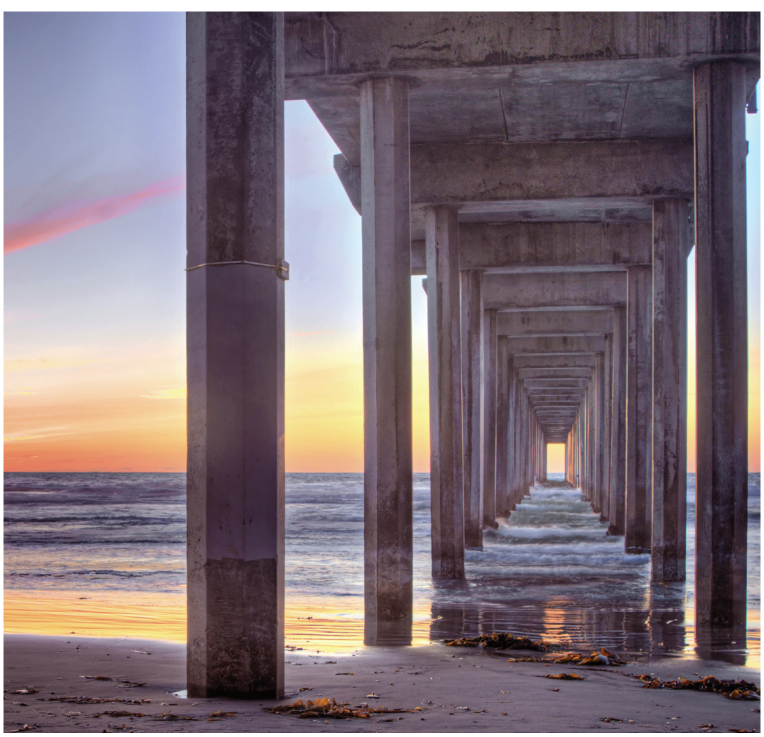
Are You Planning for Retirement by Default?

When you first joined your current employer, did you make a conscious decision to participate in the company 401(k)? Or were you automatically enrolled and given the option of not participating?



For many employees, automatic enrollment is now the case. A portion of their compensation is withheld every paycheck and contributed on their behalf to the 401(k) where it is placed in a default investment—typically a Target Date Fund. Often, the percentage of compensation contributed increases modestly each year, although the employee may reject this increase if he or she wishes.

Automatic enrollment has proven invaluable in helping many employees begin the long journey of planning for a comfortable retirement. The question is whether after years of employment, you are continuing to let your employer make your retirement planning decisions.

DECISION 1

Is Your Default Investment the Best Choice?

Target Date Funds (sometimes known as Lifecycle Funds) have become a popular default investment among 401(k) plans. As their name implies, they all have a specific retirement date for which they are aiming. XYZ Fund 2030, for example, offers an investment strategy designed specifically for people hoping to retire in 2030.

The farther away the target date, the more aggressively the fund's portfolio is managed. Over time, the allocation becomes increasingly conservative as the fund seeks to preserve what you've accumulated up to that point.

Like any 401(k) investment option, Target Date Funds charge fees that are extracted from returns. Check out the fees associated with your Target Date default investment option. Are they higher, lower or approximately the same as other options available to you? If they are higher, has the performance achieved by the fund warranted the additional cost?

▶ Balanced funds offer a similar portfolio structure as Target Date Funds in that they participate in both stocks and fixed income securities. The difference is that they don't allocate their assets more conservatively over time. However, they may charge lower fees than your default Target Date option and/or achieved superior performance. Another possibility for you to consider is participating in multiple funds, one or more of which invests in stocks and the others of which invest in fixed income securities. Again, a question to consider is whether these funds have shown the ability to offer comparable or better performance at lower cost.

DECISION 2

Can You Save More Than the Default Rate?

Automatic enrollment typically mandates a 2% or 3% contribution to the plan during the first year, with an additional percentage point added each subsequent year to a specified limit. Again, you do not have to accept these terms. However, will contributions of 2%, 3% or even 4% or 5% really get you to where you want to go?

Assuming you make $70,000 a year and earn a 5% annual return[1] on your 401(k) assets, look at what larger contributions can mean to you over time:

ANNUAL CONTRIBUTION	10 YEARS	20 YEARS
2%	$18,489	$48,607
4%	$36,979	$97,214
6%	$55,468	$145,820
8%	$73,958	$194,427
10%	$92,447	$243,034

DECISION 3

Are You Contributing Enough to Maximize an Employer Match?

One of the most common employer matching formulas is 50% of the first 6% of compensation you contribute to your 401(k) plan each year. In other words, if you're contributing less than 6%, you're leaving money on the table.

Contact your plan administrator to find out if an employee match is applicable, and if so, what your plan's employee matching formula is. Then take full advantage of it by contributing at least the required amount.

DECISION 4

Are You Taking Too Much or Not Enough Risk?

Target Date Funds adopt a more conservative position as time progresses, but what if you realize that if you don't take more risk, you're not going to achieve your retirement goals? Conversely, what if you're simply not comfortable with the level of risk assumed by your Target Date Fund?

Just because you're hoping to retire in 20 years, you don't have to participate in a 20-year Target Date Fund. A 10-year fund would offer a more conservative approach, while a 30-year fund would invest more aggressively. Or you can simply forego Target Date Funds in favor of other investment options available to you and create a more customized strategy. ■

Damage Control for Your Retirement Plan

Retirement is only a few years away…or at least you thought it was. After identifying what your expenses in retirement will be (as detailed in our article on page 4), you've realized that you will not have enough income to maintain your lifestyle once you stop working. What, if anything, can you do at this late date?

There are several possible solutions. Like a business facing difficult conditions, you either have to increase revenue or decrease expenses (or both). Here are a few ideas to consider:

1. ACCELERATE YOUR SAVINGS

How much are you contributing to your 401(k)? Enough to qualify for your employer match? That's great, but you can contribute as much as $18,000 a year in 2017, plus an additional $6,000, if you're 50 years of age or older. Imagine you contributed $24,000 to your 401(k) over the next five years and earned an annual return of 5%.[1] You would accumulate an additional $139,246 for your retirement. In addition, you would reduce your income tax liability since 401(k) contributions are deducted from your paycheck with no withholding. If you're in the 25% tax bracket, for example, an annual contribution of $24,000 will save you $6,000 a year.

2. PLUG UP THE LEAKS IN YOUR 401(K) PORTFOLIO

You may not be able to predict which investment options offered by your 401(k) will produce the highest returns, but you can determine which are draining your savings through excessive fees and expenses. Given the scenario above in which you invest $24,000 a year for five years and earn an annual return of 5%, a management fee of only 1% can decrease your $139,246 return to $135,191, a $4,055 reduction.

Review your 401(k) investment options for fees and expenses as well as performance. If the expense ratio quoted by any of these investment options is greater than 1%, make certain the performance it has achieved warrants the cost. If you are interested in investments that reflect the overall market, exchange-traded funds or index funds may or have been known to extract fees of well under 1%.

1. Hypothetical illustration. Not representative of any specific investment.

3. POSTPONE APPLYING FOR SOCIAL SECURITY BENEFITS

It may seem counterintuitive to avoid applying for Social Security benefits as soon as you're eligible at age 62. However, your payments will be approximately 30% lower than they would be if you waited until what the Social Security Administration deems Full Retirement Age (see chart). In addition, taking benefits before Full Retirement Age comes with another big drawback. If you decide to work during that time, your benefit is reduced by $1 for every $2 you earn above a specific threshold ($16,920 in 2017).

Consider waiting until Full Retirement Age or older before you apply. In fact, by waiting until age 70, you can receive a benefit that is 24-32% higher than what you would have received at Full Retirement Age.

YEAR OF BIRTH	FULL RETIREMENT AGE
1943-1954	66
1955	66 and 2 months
1956	66 and 4 months
1957	66 and 6 months
1958	66 and 8 months
1959	66 and 10 months
1960 and later	67

4. DOWNSIZE AND RELOCATE

Retirees don't just move to Florida because of the weather. If you're fortunate enough to own a home that has appreciated in value, consider whether you really need all that room and would benefit more from pocketing a substantial gain by selling it. In addition to boosting the value of your retirement nest egg, you might reduce property taxes and maintenance costs by moving elsewhere. And, if you live in an expensive area of the U.S.—New York or San Francisco, for example—you might reduce expenses further by relocating to a more affordable state with no state income tax and an overall lower cost of living.

5. PAY OFF YOUR MORTGAGE

Why would you spend money to pay off your mortgage when you're already short of retirement funds? Because your monthly mortgage payment may well be your biggest expense and eliminating it might make a difference in your ability to afford a comfortable retirement. The key word here, however, is "might." Consult with your Financial Advisor to determine whether reduced monthly costs are worth the outlay of funds required to own your home outright.

6. KEEP WORKING

Yes, we know this isn't what you had in mind, but the longer you work, the more you'll accumulate in your 401(k) and the less likely you'll have to withdraw savings for day-to-day expenses. Even a part-time job can make a major difference in your finances, especially if you contribute to your 401(k) or other retirement plan. ■

What You Should Know Before Borrowing From Your 401(k)

Unforeseen expenses for which you don't have ready cash can happen at any time. Should you borrow from friends or family, apply for a loan at your local bank or maybe look to your 401(k) for assistance?

Some 401(k) plans offer loan provisions. You can generally borrow up to 50% of your vested balance and take up to five years to pay back your loan (loans for home purchases may offer even more lenient terms). The rate you pay may be less than personal loan rates at the bank—1%-2% above Prime Rate in many cases. You don't have to wait for approval. And best of all, you pay yourself back, not a creditor.

NOW FOR THE BAD NEWS

By borrowing from your 401(k), you are slowing the momentum of your retirement savings. To compensate, you will have to make larger contributions to your plan in the future, but if you're looking to your 401(k) as a source of cash, is it really realistic that you'll be able to do that? In addition, borrowing from your 401(k) can trigger other negative consequences:

- If you leave your employer or lose your job, you will have to repay your loan within a specified time frame, typically 60 days. Failure to do so will result in the IRS treating your loan as if it were a withdrawal, so you'll not only have to pay taxes on the balance, but a 10% penalty, if you're under the age of 59½.
- 401(k) contributions are made with pretax dollars but loan repayments are not. Your loan repayments are deducted from your paycheck and made on an after-tax basis. That means you'll eventually pay taxes on them twice—once when you receive them from your employer and again when you withdraw them from your 401(k) at retirement. If you're in the 25% tax bracket, you will have lost 50% of your loan repayments to the IRS.
- Your plan may charge loan origination and maintenance expenses.

EXPLORE OTHER ALTERNATIVES

Your 401(k) is designed to help you plan for retirement, a time in your life when you're going to need a considerable sum to meet day-to-day expenses for perhaps 20-30 years or more. Do not borrow from it to fund a vacation or discretionary purchase. You might also want to consult with a Financial Advisor about other options such as home equity or other collateralized loans. Finally, you might think about stopping contributions to your 401(k) for a while and using the funds to meet pressing expenses. Even that tactic is preferable to borrowing from your retirement to finance current obligations. ■

Setting a Realistic Retirement Goal

How much will you really need to maintain your current lifestyle in retirement? An overall nest egg of $X? A certain percentage of your current income?

There are a number of rules of thumb to help people figure out how much they'll require (70% of your current income, for example), but these rules simply don't apply to everyone. The best way to determine how much you will need is to go through the process of:

- Determining how much you're currently spending
- Estimating whether these costs will increase or decrease during retirement and by how much
- Identifying the sources of income that will be available to you
- Matching income sources with projected expenses to determine whether you have a goal or a surplus

Admittedly, this is a tedious process that few people want to complete. Below, we've identified expenses you might not have thought about. When considering these expenses, think about whether they are essential, important or discretionary.

Housing and Related Expenses

- Rent/Mortgage Payments
- Condominium Association Fees
- Homeowner Insurance
- Cable/Internet
- Heat/AC/Electric
- Phones – Both Home and Cell
- Water
- Sewer/Trash Collection
- Property Tax
- Maintenance (lawn, snow removal, etc.)
- Other

Transportation Expenses

- Car Payments/Lease
- Auto Insurance
- Tolls
- Parking
- Maintenance
- Public Transportation
- Other

Personal Expenses

- Groceries
- Dining Out (include takeout)
- Clothes
- Life Insurance
- Medical Insurance
- Dental Insurance
- Out-of-Pocket Medical Expenses
- Out-of-Pocket Prescription Expenses
- In-Home Care Services
- Vacation
- Entertainment in Addition to Dining (concerts, movies, etc.)
- Dues
- Education
- Loan Payments Other Than Car
- Charitable Deductions
- Gifts to Family Members
- Federal Income Tax
- State Income Tax
- Other

Now that you've taken inventory of your expenses, identify the income sources that will help you meet them from the list below:

- Earned Income From a New Job
- Pension Payments
- Social Security
- Interest and Dividends
- Deferred Compensation or Other Nonqualified Plan Distributions
- Withdrawals From 401(k)
- Withdrawals From IRAs
- Withdrawals From Personal Savings
- Payments From Annuities
- Other Sources (inheritance, rental income, etc.)

For withdrawals from your 401(k), IRA and/or savings, start with 4% annually, but, again, that's a rule of thumb that might not necessarily apply to you. If you can meet expenses with smaller annual withdrawals, by all means do so.

HOW DID YOU DO?

Does your projected income match your expenses? If you have a surplus, congratulations. If you have a gap, now is the time to take measures that might help you fill it. See our article on "Damage Control for Your Retirement Plan" on page 2 and consult with a Financial Advisor to develop strategies for reducing gaps or perhaps increasing your surplus. ■

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