PRIVATE CAPITAL MANAGEMENT

PCM Insight: Saving for Retirement

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"Often when you are at the end of something, you're at the beginning of something else." **- Fred Rogers**

Over the previous century, little has changed regarding retirement planning. The basic formula remains the same: work, save, then retire. While the fundamental approach may be the same today, the difficulties today's workers confront and the resources at their disposal are significantly different. Before discussing the tools available to help overcome challenges, let's examine some of the difficulties.

SAVINGS CHALLENGES

Challenge #1: Bond Yields: Compared to 40 years ago, bond yields are significantly lower now. We are reminded of retirees clipping bond coupons in the 80s at a double-digit annual rate. Even with the recent increase in interest rates, the difference from then is still substantial. Many retirees today cannot afford to leave their investments in a conservative bond portfolio for the duration of retirement because the rate of inflation in recent years has been equal to or higher than the average bond yield.

Challenge #2: Life Expectancy: Thanks to modern medical advances, people are living longer than in previous generations, with women, on average, having a longer life expectancy than men. While this is excellent news, retirees now need their money to last longer. When making retirement plans, longevity risk should be carefully considered.

Challenge #3: Lack of Pensions: Years ago, the traditional retirement plan was to work for the same company for as long as possible and then collect a pension. Most retirees were able to maintain a good standard of living with only a pension and Social Security. In recent years, pension plans have grown to be more of a liability than corporations intended. The introduction of the 401(k) plan led many companies to move away from pensions, putting the responsibility on employees to manage their own retirement funds. Although some employers make matching contributions, employees bear the market risk, as well as the savings risk. Finding a business that offers a defined benefit pension plan today would be unusual.

To achieve a successful retirement despite these challenges, it is important to leverage the tools available today!

SAVINGS TOOLS

Employer plans: Most employers offer defined contribution plans such as the 401(k) and 403(b). These tax-deferred savings vehicles are seamlessly integrated into the payroll structure, making it easy on the employee to contribute from their salary. Taxes are deferred until withdrawal during retirement. The maximum contribution amount allowed for 2023 is $22,500 with a catch-up contribution of $7,500 allowed in the year you turn 50. Starting in 2025, there is an additional catch up of ~$3,000 (inflation adjusted) for ages 60 – 63. Many employers also offer a Roth 401(k) option to their employees. The Roth 401(k) allows for current taxation of the contributions with the benefit of tax-free growth and no required distributions in the future. Typically, as a company benefit or retention tool, the employer offers to match the employee's contribution to a limit.

Self Employed 401(k): A Solo K is an option for sole proprietor or married individuals operating a business together to have access to a retirement plan without the reporting and paperwork requirements of traditional 401(k) plans. These plans have the same contribution limits, and tax preferences as larger employer 401(k) plans. They allow for both employer and employee contributions providing a potential savings opportunity of $66,000 for 2023, with an additional $7,500 allowed for employees starting at age 50.

SEP IRA: If you are self-employed, the SEP IRA is another option. With this plan, the business will make the contribution on behalf of the employee and will receive the tax deduction. The money grows tax deferred and will be taxed to the employee at withdrawal. The SEP IRA boasts higher contribution limits than the Traditional IRA – this year's limit is the lesser of 25% of compensation or $66,000 (no catch-up contribution is allowed). Employees can also be enrolled in the SEP, however, the contribution still comes from the business and the percentage of contribution must be the same as the owners.

Traditional IRA: This vehicle allows for tax deferred growth. Your contributions could be tax deductible based on your income and whether you are covered by an employer sponsored plan. You will have more investment choices than an employer sponsored plan since you are responsible for the management of the account. The 2023 contribution limit is $6,500 with an additional $1,000 allowed from age 50.

Roth IRA: The Roth IRA provides tax-free growth and tax-free distributions in retirement. The Roth IRA follows the same contribution rules as the Traditional IRA with some differences. Roth contributions are allowed in addition to participating in an employer sponsored plan. With a Roth there are income phase outs for direct contributions, though there may be options for Roth conversions. One significant benefit of Roth accounts is that there is never a required minimum distribution, making this an ideal asset for legacy and tax planning. The tax-free component is what makes this vehicle extremely appealing to many investors.

Taxable Investment Account: Despite its counterintuitive name, a taxable account refers to an account where the money that is deposited to it has already been taxed. Because of this there are no contribution limits imposed. These accounts are generally invested in a variety of market assets with the goal of receiving a return on the investment. Long-term capital gains realized from these investments are taxed at a lower, more preferential rate than the income tax rates. These accounts offer an opportunity to diversify the tax treatment of overall retirement savings.

A good financial plan will help determine not only the amount of savings needed to meet your goal for financial independence, but also the best combination of savings vehicles, and investment strategies to maximize retirement, tax, and legacy efficiency. Lastly, no one has a monopoly on all good ideas – which is why we encourage you to hire a professional. Investors who seek out professional guidance are more likely to feel optimistic about their long-term goals and their ability to retire successfully. A Financial Advisor will help you create a retirement plan that encompasses your family's short- and long-term goals as well as leveraging the appropriate tools to achieve them.