

KEYSTONE FINANCIAL PLANNING ELECTRONIC NEWSLETTER

June 30, 2004

Unrealistic expectations threaten your retirement

Don't fall into the trap that has grabbed a lot of your fellow workers: they have unrealistic expectations about investment returns and retirement assets and face disappointment in their golden years. A recent survey by Merrill Lynch uncovered some not so surprising mistakes workers are making in their retirement planning. Two of the top concerns of the 1,100 survey participants were "managing retirement assets" and "retirement planning." But many were not financially or mentally prepared for the challenges they face, the survey found.

First, the median value of retirement savings among respondents was just \$51,000. Many retirement planners would caution a retiree who had that amount of money and who invested it in a diversified manner to spend no more than about \$2,500 per year from it.

Second, a shocking one-quarter of participants said they expected investment returns of 25% or more per year, while the median expected return among those surveyed was 10%. Those expecting 25% per year are dreaming: there has never been an extended period when the investment markets offered a return that high. Although the annualized return of the Standard & Poor's 500 Index is 10.4% since 1926, there have also been plenty of 30-year periods (equivalent to a long retirement) with annualized returns of less than 9% and some as low as 7.8%.

Finally, those surveyed expected to withdraw an average of 21% per year from their savings. At that rate, a diversified portfolio might last only four or five years at best. Many retirement experts caution retirees to take no more than 4% to 5% from their portfolios each year. That withdrawal rate is expected to keep up with inflation in all types of markets.

Inflation-protected U.S. bonds are set to take off

As interest rates are poised to rise from their current record lows, bond owners are worried about being stuck with their current fixed yields. But not every bond owner is worried: the growing number who have purchased Treasury inflation-indexed securities are confident they will stay ahead of higher rates and higher inflation.

The U.S. Treasury in 1997 began offering the bonds, widely known as TIPS (for Treasury inflation protected securities). The Treasury's timing was off: inflation and fears of inflation were tame throughout the late 1990s and until early this year. Now, with many predicting a pick-up in inflation due to the worldwide economic recovery and soaring energy prices, TIPS are set to take off, says a new study by the Federal Reserve Bank of New York.

TIPS offer a fixed interest rate, which has ranged from 1.5% to 2.5%, with a kicker: if inflation increases, the principal value of the bond is also increased. This not only increases the value of the principal at maturity, it increases the regular interest payments because there is a larger amount of principal against which to apply the interest rate.

TIPS offered outsize returns to investors during their early years both because market interest rates fell, pushing up the values of existing bonds, and because investor reluctance to buy TIPS, coupled with a less liquid market for trading, led them to be auctioned off with fixed rates that were higher than the Treasury expected. Indeed, the Federal Reserve Bank economists estimate that TIPS have cost the government \$3 billion in extra interest payments compared to the issuance of its standard fixed rate bonds.

Expansion of the TIPS market has made it easier for investors to buy and sell them. Several mutual funds specializing in TIPS run by Pimco and Vanguard have attracted billions of dollars, and new funds are being formed by competitors. Mutual funds offer the easiest access for individual investors. They also solve a unique problem to TIPS: the inflationary increase in principal amount is treated as a taxable gain each year, but it is not paid until the bond matures. This has led some critics to argue against using TIPS in taxable accounts, because they force owners to pay taxes on money they haven't received. Mutual funds must pay out almost all of their capital gains each year in dividends, so they do provide the gain to investors who must pay taxes on them.

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