



July 1, 2004

RETIREMENT PLANNING

How Getting Sick, or Staying Well, Can Upset a Solid Retirement Plan

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Misguided assumptions can leave well-to-do retirees in shaky territory. See five assumptions to watch for: getting sick, living long, return rates, spending expectations and inflation. Read our main article about retiring on \$1 million, join a discussion with readers and financial planners and vote in our poll on how much you expect to have amassed at retirement.

Health Care

Assumption: My health-care costs will be manageable.

With health-care costs rising 14% a year on average, experts say an increasing number of retirees are unprepared for their medical bills. In a sobering reality check, Paul Fronstin and Dallas Salisbury of the Employee Benefits Research Institute outline in an upcoming study how much an average 65-year-old retiring in 2004 needs to have on hand to cover health-care costs, assuming he or she lives until 80 (another shaky assumption in its own right, see below) and has Medicare and employer-based coverage.



Today, we look at five assumptions people make about retirement that might very well fail to pan out -- to the detriment of even well-to-do retirees. We also invite you to **participate in a discussion** with a panel of financial-planning experts. Plus, see several steps well-off investors entering retirement should **take with their portfolios** to help make them last.

Vote: How much do you expect to have saved, in today's dollars, when you retire, not counting the equity in your home?


To cover premiums (assuming a 7% average annual increase), retirees need about \$72,000 in savings, the study says. Add out-of-pocket expenses, and that figure increases to \$105,000, meaning retirees need to budget around \$7,000 a year to cover the cost. That's nearly 18% of the \$40,000 financial advisers say that retired millionaires should expect to tap annually from their investments.

Often, retirees go into their golden years wearing rose-colored glasses when it comes to planning for health care. But Medicare -- and its new prescription-drug benefit -- won't

fully pay the bills. While hospital coverage under Medicare is premium-free with a yearly deductible, coverage for doctors visits and lab tests, among other items, is only covered at 80% after a \$100 deductible. Besides that, there's a monthly premium. This year the premium rose to \$66.60 -- a 13.5% percent increase over 2003.

The Medicare drug benefit isn't a huge financial relief either. Starting in 2006, the drug benefit will help

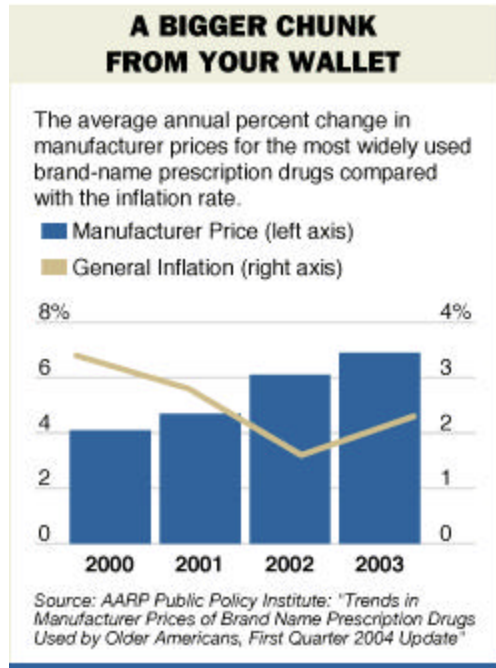
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cover many more retirees who need drugs, but there will be monthly premiums, a \$250 deductible and out-of-pocket spending limits up to \$3,600. Further, drug costs are increasing faster than the rate of inflation, meaning seniors will shoulder more of the cost burden each year.

A May AARP study showed that prices for brand-name prescription drugs most frequently used by seniors increased 27.6% from 2000 to 2003, compared to a general-inflation rate of 10.4%. The bottom line? Retirees need supplemental health insurance to bridge the gaps.



Current or former employers help pick up the slack for about 34% of people 65 and older, according to research by the Kaiser Family Foundation, and Medigap -- a set of standardized insurance policies sold by private companies-- covered another 23%. But employers are increasingly unloading their burden. Large firms of 200 or more workers offering retiree coverage have fallen to about 38% in 2003 from nearly 66% in 1988, Kaiser reports. Moreover, about 86% of large private-sector employers plan to increase contributions to premiums by retirees over the next three years, Kaiser reported survey earlier this year.

Still the news isn't all bad, says the EBRI's Mr. Fronstin, who is director of the health research and education program. Employers are shifting costs by encouraging employees to use generic drugs and mail-order companies to save money. There are also signs that insurers are at the top of their "premium cycle" where they increase costs to gain market

share.

"There's some thought that we're at the top of that cycle now and over the next few years we'll see that ... they're going to be able to lower premiums almost down to where the cost trend is," Mr. Fronstin says. (See related article.)

-- Elizabeth Weinstein

Longevity

Assumption: My spouse and I won't outlive our retirement plan.

When is a long life a curse?

For retirees who didn't bargain on taking breakfast out on their Florida veranda into their late 80s or 90s, an extra-long life can be an unkind financial burden.

Financial planners and actuaries usually recommend that people save for retirement assuming they'll live until around 80, noting there's a 50% chance of living longer than that. The most recent life-expectancy tables from the Centers for Disease Control provide more specific estimates. In 2001, the average 65-year-old male could expect to live another 16.4 years, an increase of almost four years since around

1950. Females could expect to live another 19.4 years, also an increase of about four years in the same time period.

On top of those rosier prospects, Census figures show that more people are living to a really ripe old age. In 2000, there were 50,454 centenarians living in the U.S., a 35% increase over 1990.



Still, while life expectancy has been climbing steadily, many people don't plan for it. Some make faulty assumptions about who pays for long-term care, thinking Medicare or regular health insurance pays for services such as nursing homes (they don't). Medicare generally doesn't pay for long-term care, though it will cover skilled nursing care and home health-aide services on a limited basis for certain people who qualify, according to the program's Web site.

About four million people had private long-term care insurance in 2000, and most of those purchasers were affluent, elderly people often interested in protecting their estates in the event of a long nursing-home stay or a health crisis, according to a survey by the Kaiser Family Foundation.

Retirees who haven't saved -- or saved enough -- for the possibility of needing long-term care can face harsh realities when the hard numbers roll in, says Gerry Smolka, a senior policy adviser at the AARP Public Policy Institute. "Unless you qualify for Medicaid, these costs are ones you need to have saved for or insured against," she warns.

The average annual premium for a 65-year-old with 5% compounded inflation protection cost \$2,346 in 2002, according the latest data from America's Health Insurance Plans, a Washington, D.C.-based health-insurance association. For a 79-year-old, the cost more than tripled.

The national average rate for an individual in an assisted-living facility was \$2,379 a month in 2003, an increase of 10.2% from 2002, according to a 2003 MetLife survey. (In assisted-living facilities, older adults receive some assistance to support a relatively independent lifestyle.) A separate MetLife 2003 survey reported that the average rate for a private room in a nursing home was \$181.24 per day, an 8% increase over 2002. And the rate for a home-health aide was \$18.12 per hour, a 2.9% increase over the same period.

Financial advisers say people planning for retirement can keep the cost of long-term care down by saving, thinking ahead and getting creative. For starters, since long-term insurance premiums are based on a buyer's age at the time of purchase, younger buyers can lock in much lower rates than someone who waits. Stuart Ritter, a certified financial planner with T. Rowe Price in Baltimore, advises that pre-retirees shop around for long-term care insurance in their early 50s and make a decision about it one way or the other by their early 60s. Another option is replacing one kind of insurance with another, he says.

"Around your early 50s and early 60s is the time your need for life insurance significantly decreases ... but your need for long-term care insurance goes up," Mr. Ritter says. "So you can take the same dollars and just allocate it towards a different need."

Those who avoid the long-term care topic can find their egg shattered altogether, says Jodi Anatole, vice president of long-term care at MetLife. "There are people who are in denial thinking it won't happen to them, and what really raises their awareness is hearing situations of people who have run out of money and haven't been able to be in a facility of their choice because they didn't have a way to pay for it."

-- Elizabeth Weinstein

Where Number Crunching Can Go Wrong

The Market

Assumption: "I'll get the return on my investments that I expect."

Few can predict how stocks are going to do short term. But for the long term, history is supposed to offer guidance: From 1926 to 2003, stocks have done well, averaging 10.4% annually, according to Chicago market tracker Ibbotson Associates. Thus, the investment industry maintains investors should "buy and hold."

That advice is supposed to be the most apt for the well off, who purportedly have the most cushion to protect them.

But what if stocks fail to live up to their double-digit reputation? Market watchers from Wall Street Journal writers Jonathan Clements and Jesse Eisinger to investors like Warren Buffett have questioned stocks' staying power.

In terms of valuations, stocks today are arguably expensive, leaving less room for growth than during the 90s bull market. Some also worry that moves by the Federal Reserve, like today's to increase interest rates could damp investors' enthusiasm for volatile investments like stocks, made riskier by the uncertain geopolitical climate. Inflation could also begin creeping up to erode potential stock gains, some say. As for bonds, commentators suggest banking only on yield -- about 5% from 10-year Treasuries.

But if the doubters have you anxious, it doesn't mean you should abandon stocks. Financial planners say stay in stocks, but ratchet down your expectations.

Stuart Ritter, a certified financial planner with T. Rowe Price, recommends retirees "hold no less than 30% to 40% of their portfolio in equities... to keep up with inflation and what's potentially a 30-year retirement horizon." He says those who are early into retirement can be a bit more aggressive with stocks, if they can handle the risk and if their withdrawal rate -- the amount of cash they withdraw from their investments to live on each year -- is low enough. While every situation is different, someone with \$1 million in retirement should generally aim for a 4% withdrawal rate, or \$40,000, a year, advisers say.

"If you're conservative [with your withdrawals] in the beginning of your retirement, you can benefit later on," says Patrick Burke, principal in asset management at the Vanguard Group. "It may not work the other way around."

Advisers also caution against relying on annual averages over time when figuring your retirement returns. "Don't throw darts at the wall expecting an average rate of return," says Cynthia Egan, executive vice-president of retirement-income services at Fidelity Investments. Instead, she says, you should "look at the probabilities of your portfolio lasting you throughout your retirement given a particular withdrawal rate."

You can get a sense of such probabilities using a calculator that runs what's known as Monte Carlo simulations that take into account how different market scenarios can affect your retirement income. Fidelity provides this kind of calculator to clients in the retirement-planning section of their Web site. T. Rowe Price has a free retirement calculator that uses Monte Carlo simulation.

Aside from having a realistic assessment of your returns during retirement, there are other ways you can soften the impact of tepid future market gains. Depending on your situation, you can delay tapping Social Security. Also, try to minimize your investing expenses, which can take a big chunk out of your potential returns, Mr. Burke says.

-- Dexter Webb

Spending

Assumption: My expenses in retirement will be lower.

For retirees, it seems the more you earned before you retired, the more you'll spend after.

At least that's the conclusion of a study, released in April, by the Center for Risk Management and Insurance Research at Georgia State University.

While earners bringing home \$90,000 a year lived on 78% of that sum in retirement (including income from Social Security), people who earned \$150,000 spent 85%, and those who earned \$250,000 spent 88%, according to the study. And these figures are on the rise from several years ago. In 1997, people earning \$90,000 went through only 71% of their pre-retirement income; in 2001, 76%.

"They say you need 70% of your income," says Bob Belucci in Deerfield, Ill., 62, who retired from a sales position with Xerox in December with \$1.2 million in assets beyond he and his wife's home. "But I think you need about what you made before you retired."

Scott Kahan, a financial planner who deals with clients worth \$1 million or more, says a plan to live on 100% of your pre-retirement income is the safest approach. "People do spend more than they thought they would, and people who have more, spend more."

Well-to-do retirees have little trouble spending what they've saved, says Ron DeStefano, senior vice president

Lifestyles of the Wealthy and Retired

Of the more than 1.7 million households headed by folks who are between ages 62 and 72 and have \$1 million or more in assets beyond their home, the goals for household savings and investments include:

Providing for retirement	93.0%
Buying a home	4.4
Buying a vehicle (car, pickup, van, boat, RV)	20.2
Providing for future medical needs	60.1
Providing for "rainy day" emergencies	62.6
Taking a vacation or traveling	54.7

at Chicago-based Aon Consulting, which helps run the study. "They're buying new cars, remodeling their houses, and taking up expensive hobbies," he says. "The very wealthy have more options to modify their lifestyle, but by and by, they don't."

Making a major purchase (appliance, stereo, etc.)	13.1
Giving to charity	20.3
Providing for heirs, children, or grandchildren	65.3

Source: SRI Consulting Business Intelligence, 2002-2003 MacroMonitor

What to do? For starters, make sure you're realistic about your spending expectations as you formulate a retirement plan. Consider not only your own needs but whether you're going to want to help your kids -- and their kids. Indeed, providing for heirs is the number-one goal of wealthy retirees beyond providing for themselves (see chart).

If spending becomes a real problem, rethink your ways. Asks Mr. Kahan: Is luxury now worth instability as you get older? "It sometimes comes down to a trade-off of your current lifestyle versus the future."

-- Megan Ballinger

Inflation

Assumption: Inflation will stay below 3%.

In recent years, inflation, the rate that prices rise for goods and services as measured by the Consumer Price Index, has been tame, to say the least. In 2003, the CPI rose just 1.9%, for example, and averaged just a little more than 2.4% over the past decade, compared with 4% over the past fifty years, according to the Labor Department.

Now, however, thanks to a glut of economic stimulus and exceedingly low interest rates, the economy's growth rates are finally on the rise -- bringing prices along with them. In May, the consumer price index rose 3.1% from a year earlier. The Federal Reserve is set to start raising interest rates at the end of June to help cool any risk of inflation.

The bottom line for investors? If inflation comes back to its 4% average over the next 20 years, the stuff you can buy for \$10,000 today will cost you nearly \$22,000 in 20 years. Imagine your money going half as far as it does today and you see why inflation is worth thinking about.

A sharp rise in inflation can be a particular blow for retirees because costs for the

A COSTLIER TRIP TO THE MARKET

Your simple shopping list today may cost you 27% more than it did 10 years ago. Price comparison of actual item costs, 2004 and 1994.

Shopping List	2004 Actual Cost	1994 Actual Cost
2 lbs. ground chuck, 100% beef	\$5.04	\$3.73
1 loaf white bread	0.96	0.77
4 lbs. fresh whole chicken	4.16	3.60
1 doz. fresh Grade A eggs	1.37	0.80
2 lbs. bananas	0.98	0.94
1 can orange juice, frozen concentrate	1.82	1.60
1 lb. red apples	1.07	0.81
3 lbs. tomatoes	4.53	2.85
2 lb. 100% ground roast coffee	5.66	5.08
1 head of iceberg lettuce	0.71	0.54
Total	\$26.30	\$20.72

Note: Data as of May 31 each year.

some of the services they use most have been rising quicker than prices overall. The cost of medical care, for example, is up more than 47% over the past decade through the end of April. That's more than double the CPI's growth rate over the same period.

Source: Department of Labor

To guard against the pernicious effects of inflation, consider investing in Treasury Inflation-Protected Securities. TIPS are bonds backed by the federal government whose prices adjust twice each year to keep up with the CPI. Due to a sharp rise in demand, the still-small TIPS market is set to expand with a broader range of maturities, and the number TIPS-focused mutual funds on the market is on the rise too. These offerings can be a good fit for a portion of your short-term investments because they combine muted risk with inflation-protection, an attractive formula for retirees.

Also: If you use an online calculator, or an adviser, find out what inflation expectation they're using. Make sure it's conservative enough for your comfort level.

-- *Ian McDonald*

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We also invite you to **participate in a discussion** with a panel of financial-planning experts. Plus, see several steps well-off investors entering retirement should **take with their portfolios** to help make them last.

Thoughts on our retirement package? **Write to** Alexandra Kaptik at alexandra.kaptik@wsj.com.

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