access INSIGHTS
PLAN FOR A LIFE WELL LIVED
Spring 2021

Avoid These 6 Common Money Mistakes Made by People in Their 20s

(Here is an excerpt from a recent article in Barron's featuring Darren Zagarola on common mistakes young people make in planning for retirement.)

Retirement savers in their 20s can afford mistakes since even modest investments can grow into hefty sums given 40 years to compound. But avoiding some of the most common missteps young savers make can serve to enhance those savings, and returns, over the long term.

Darren Zagarola, with the financial planning firm Access Wealth, says today's graduates who are just joining the workforce and younger workers generally should watch out for six common financial mistakes as they take the first steps toward their retirement goals.

"It is important to start with good financial habits," Zagarola says. "Avoiding money mistakes in your 20s and becoming educated on wise investment strategies can make a huge difference as you enter your 30s and 40s, and even have an impact on how and when you choose to retire, as far away as that might seem."

- **Not creating a budget and savings plan:** Entry-level workers often don't believe they earn enough money to save, Zagarola says, but they typically are surprised when they track their monthly income and expenditures and learn to cut costs. Online tools such as Quicken, Mint, and NerdWallet can help them identify areas where they are spending too much and adjust their budgets accordingly, he says.

  Saving should be part of workers' monthly budgets, whether that means automatic contributions to an employer-sponsored retirement account, automatic transfers from their bank account to a brokerage account, or both, Zagarola says.

  "Make sure that when you're saving that money, it's a percentage of your pay so that when you get a pay raise, your savings gets a pay raise, as opposed to just putting in a specific dollar amount," Zagarola says. "Treat your savings like an expense. This is monthly cash outflow."

- **Not having an emergency fund:** Zagarola says workers should establish an emergency fund to get them through a setback such as losing their job or getting injured. Just as monthly savings should be treated as a recurring bill, he says, so too should contributions to an emergency fund, until workers have socked away about six months of income.

  While it's almost cliché to talk about the emergency fund, the pandemic has made apparent its utility. "The pandemic has reinforced the idea that you need to have three to six months of cash needs [on hand] because your job is not guaranteed in any industry in this country, and you need to be prepared," Zagarola says.

  When laid-off workers have no financial cushion, they may have to take the first job opportunity available, even if it's a bad one. "Having that reserve fund gives them flexibility in their decision-making process," he says.

- **Not contributing to retirement accounts:** Young workers sometimes decline to participate in employer-sponsored 401(k) or similar plans because they're afraid of market volatility or feel that they don't earn enough money to save consistently, Zagarola says. But this can be an especially costly mistake because investments made early in life compound tax-deferred over many years, typically producing healthy returns.

  Zagarola says workers should contribute as much as they can to their 401(k), but at least enough to fully take advantage of any matching contributions from employers. Workers who lack access to an employer-sponsored plan should consider opening an individual retirement account through a discount brokerage firm, he says. The key is to start early, save consistently and let that money grow over several decades.

  For younger employees, a Roth 401(k) may make sense because they will be paying taxes now, while they're in a lower tax bracket, instead of in retirement.

(Continued on Page 4)

Through comprehensive financial planning and investment management, Access Wealth helps clients plan for and achieve a life well lived.

120 Eagle Rock Avenue · Suite 230 · East Hanover, NJ 07936
www.access-wealth.com | www.access-wealth.com/blog
info@access-wealth.com
(973) 740-2400

Spring 2021

access INSIGHTS
PLAN FOR A LIFE WELL LIVED

How to Pay for Retirement

By Howard Hook, CFP®, CPA, CAP®

When planning retirement, one of the most crucial but often overlooked questions that individuals neglect to think about is "How to pay for retirement?" How will you generate cash in retirement when you are no longer earning the full-time salary you were accustomed to making?

There is no one-size-fits-all solution. There are several options to choose from, all of which have different advantages and disadvantages. Since the answer is different for everybody, it's important to understand the options (and consequences) to make the best decision for your future.

Here are six different sources that may provide you with cash in retirement to help you meet future cash needs:

1. Social Security Benefits

The most significant advantage to taking social security benefits first is that by doing so, you can delay taking distributions from other retirement sources, such as your IRA or 401(k) accounts. Delaying having to take distributions from retirement accounts allows those funds to continue to grow tax-deferred (or tax-free in the case of a Roth IRA). Additionally, you will pay less tax on social security income than you would on retirement distributions (other than a Roth IRA).

Let's say a 65-year-old married couple decides to live off their social security income. This would allow the couple's retirement accounts to continue to grow until age 72, at which time the IRS mandates they take required minimum distributions.

For some people, social security will not cover all their expenses. That's okay. Every dollar covered by social security reduces the amount that needs to come from other sources.

Conversely, social security benefits are reduced by taking them prematurely. Note that benefits increase 8 percent per year for every year you postpone collection beyond full retirement age.

Taking your social security benefits early may significantly affect your ability to keep pace with inflation, especially later in life. With life expectancy getting longer, this can create a more significant gap between your social security benefits and cash needs. As you get older, this shortfall will continue to grow, forcing you to tap other sources to provide you with sufficient cash in retirement. Social security benefits increase most years, but the formula used to determine the increase can be much different (lower) than the inflation you are experiencing.

Even if you decide to wait to collect benefits, it is wise to plan for the day when you will need to supplement your cash needs with something other than social security income.

2. Part-Time Work

Generating an income (even a modest one) may allow for the delay of distributions from retirement plans and brokerage accounts, giving those funds more time to grow. It can also allow you to accrue a larger social security income by delaying the collection of benefits. Continuing to work can also increase your benefits if you have not already maxed out on the number of working years social security looks at to determine your benefits.

Working part-time after retirement can also help smooth your transition into retirement. A phased retirement where you gradually stop working can help you deal with the emotional impact of entering the next phase of your life. For some people, the thought of working today and being fully retired tomorrow with nothing to do can be a bit daunting. Phased retirement allows you to take a test drive to see if you enjoy not working.

Conversely, working part-time may not allow you to do some of the things you had hoped to do once you retired. It's also important to remember that part-time work after retirement is likely a temporary solution. Over time, your appetite to keep working may wane, and at some point, you may be unable to work.

3. Pension Income

If you have a pension and have already reached your Full Retirement Age, deciding when to start taking the pension is quite simple. The starting date is usually outlined in the pension plan document and will begin upon separation of service for retirees who have reached a certain age, for example, age 65. But what happens if you retire before the retirement age outlined in the plan? You'll need to decide if you should start collecting your pension early to help pay for retirement or wait until you reach the documented age.

Taking an early pension:

- ***Allows for Investment Growth.*** This can delay the need to withdraw from other accounts. If you have a pension, social security, and a part-time job, you could earn as much, or even exceed, what you were making before retirement. If you are fortunate enough to be in this position, you may be able to allow your retirement accounts to grow for a long time before needing to withdraw from them. We've even seen clients have to withdraw IRA and 401(k) money they don't need, simply because they reached age 72, when minimum distributions become mandatory.
- ***Provides a Reliable, Easy-to-Access Income Stream.*** Pensions are usually paid once a month, on the same day each month. This steady income stream can be comforting if you have recently stopped working. Most pensioners have the monthly amount transferred directly into their bank accounts, making it even easier to access the needed funds.
- ***Provides for a Surviving Spouse.*** Choosing the appropriate beneficiary designation can allow the pension to be paid to your spouse after you die. This becomes critically important since the amount of social security income that the surviving spouse will receive will decrease.

When considering if you should collect your pension early, be aware of these disadvantages:

- ***Loss of Purchasing Power.*** Most pensions are not

Through comprehensive financial planning and investment management, Access Wealth helps clients plan for and achieve a life well lived.

120 Eagle Rock Avenue · Suite 230 · East Hanover, NJ 07936
www.access-wealth.com | www.access-wealth.com/blog
info@access-wealth.com
(973) 740-2400

access INSIGHTS
PLAN FOR A LIFE WELL LIVED

adjusted annually for inflation. With a planned retirement of 30 years, that is a significant loss of purchasing power.

- ***Taxes.*** Pension income gets taxed at ordinary income tax rates. Still, unlike part-time earnings, the government collects no FICA tax on pension income. Some states do not tax pension income or provide an exclusion for a portion of the benefit. New York and New Jersey do give some tax relief for pension income collected.

4. Distributions from Retirement Accounts

At some point, you will need to access your retirement accounts, which may include an IRA, 401(k), or 403(b) plan. Here are the advantages to taking distributions from a retirement account before taking social security income or pension withdrawals:

- ***Social Security Higher Lifetime Benefit.*** Taking withdrawals from your retirement accounts rather than social security can allow your social security income to grow (up until age 70). The nice thing about that is subsequent cost-of-living increases are based on the higher amount, providing you with more income to pay for retirement.

- ***Greater Tax-Efficiency.*** Retirement plan withdrawals are not as tax-efficient as social security withdrawals, but they are more tax-efficient than part-time earnings. Retirement plan withdrawals from a Traditional IRA or 401(k) are taxed at ordinary income tax rates. Withdrawals from a Roth IRA or Roth 401(k) generally are tax-free, which can be a good way to generate cash in retirement while your Social Security income accrues.

- ***Lower Tax Bracket.*** There may be a gap between when you retire and when you will be required to take money from your retirement accounts. During those years, you may find yourself in a low tax bracket. Taking withdrawals from a 401(k) or IRA and paying tax at a low rate, one that may be lower than the one you will pay once you are required to take funds from the account, can be a good strategy.

However, if you are in a high tax bracket, taking money from your retirement accounts can result in higher taxes. In addition, your Medicare Part B premiums may go up because premiums are higher for people whose income exceeds a certain threshold. Every dollar lost to taxes or Medicare Part B premiums is one less dollar you have for living expenses. This makes taking withdrawals from retirement accounts a complicated decision that is not suitable for everyone.

There also is a risk of outliving your retirement accounts. Taking out too much at an early age can put you behind the eight ball, especially when coupled with poor investment returns. Since the amount you are withdrawing is not fixed by someone else, it is up to you to ensure you are not taking out too much. You can withdraw the same amount each month, but you need to be disciplined and stick with the plan, even if you think you need more money that month.

5. Bank Accounts

Withdrawing cash needs from a savings account has a place in a retiree's toolbox for the following reasons:

- ***Easy to Access.*** Bank account funds are among the easiest to access. If left in your checking account (which is not advisable), there is nothing to do until the account needs to be replenished. If kept in a savings or money market account, you can link them to your checking account and pay bills. Connecting the accounts can also act as overdraft protection for your checking account. Any time there are insufficient funds in the checking account to cover a check, the amount is automatically swept from the savings account to the checking account.

- ***Tax-Efficiency.*** Taking your cash needs from a checking or savings account is as tax-efficient as it gets since no income tax is incurred when you withdraw funds from a bank account. If you need $50,000 for the year, you withdraw $50,000 from the savings account, and no tax is due.

- ***The Principle is Protected.*** The account principal does not fluctuate based on how the markets are doing. The value only increases or decreases if you deposit or withdraw money. Any interest earned will increase the account value as well.

There are some disadvantages to relying too heavily on funds from a savings account for your cash needs. For example:

- ***Account Value Erosion.*** The amount they can go up is minimal. When they do go up a lot, it is because inflation has gone up even more. Unfortunately, this is not a good long-term strategy for people faced with a 30-year retirement. The concept of having to accept principle fluctuation is a tough one for retirees to handle. Declines in account values due to the stock market are considered detrimental to maintaining one's lifestyle. However, being invested in the market is the only way to outpace inflation.

- ***Lack of Emergency Funds.*** The other disadvantage to using too much of your savings is that you may not have enough funds in the savings account to pay for what is needed if an emergency arises. Care should be taken not to reduce the balance in the account so much that you put yourself at risk in a crisis.

We recommend keeping three years of your cash needs in cash and cash equivalents. Rather than keeping funds in a checking or savings account, we suggest using Certificates of Deposit (CDs) or Short-Term Bond Funds, which provide a higher return than cash in the bank.

6. Brokerage Accounts

The final source of funds to pay for retirement is a brokerage account. You may want to consider using a brokerage account to help pay for retirement before accessing other income sources for the following reasons:

- ***More tax-efficient than IRA and 401(k) withdrawals.*** This is because only the portion of the brokerage account's distribution representing the gain (amount over what you initially invested) is subject to tax. The amount of tax depends on how long you held the investment you sold to make the distribution. If held for one year or less, then the gain is taxed at short-term capital gains rates, which are the same as ordinary income tax rates. If the investment was held for more than one year, the gain is taxed at long-term capital gains rates, which will always be

(Continued on Page 4)

Through comprehensive financial planning and investment management, Access Wealth helps clients plan for and achieve a life well lived.

120 Eagle Rock Avenue · Suite 230 · East Hanover, NJ 07936
www.access-wealth.com | www.access-wealth.com/blog
info@access-wealth.com
(973) 740-2400

Mistakes

Continued from Page 1

- **Avoiding the stock market:** "Once you have an emergency fund established and have started contributing to a retirement plan, it is time to consider an investment portfolio," Zagarola says. Yet, having witnessed the financial crisis of 2008 and the Covid-19 pandemic, many young workers may be skeptical of the market, so they either invest too conservatively or don't invest at all.

  Zagarola says young adults who saw stock prices plunge 40% to 50% during the two most recent recessions may have been scarred by those experiences, but need to remember that time is on their side. Equities came roaring back in both instances, so the stock market remains "the best place long-term" for young workers to put their savings, he says.

- **Not managing debt and maintaining a good credit rating:** Consumers with bad credit pay higher interest rates when they purchase a car or home, and those additional dollars can't be saved for retirement or emergencies. Zagarola says young workers should establish a good credit history by charging all or most of their expenses and immediately paying them off.

  "It is important to understand that if you are only making minimum payments on credit card debt, the interest you are paying on the outstanding balance could be significant over time, even doubling the amount you have to pay," he says.

  To learn about your credit rating, request a free credit report from AnnualCreditReport.com, he says. You are entitled to a free copy of your credit report every 12 months from TransUnion, Experian, and Equifax, so he recommends requesting a report from a different credit-reporting agency every four months. Workers should review each report carefully to ensure everything is correct, he says.

  Having a budget helps workers avoid missing payments on student loans, auto loans, mortgages, and credit cards, which will preserve their credit rating, he says. For workers with credit card debt, Zagarola recommends looking for a credit card offering 0% interest on balance transfers, allowing them to pay down their debt much more quickly.

- **Not having insurance:** Young workers on a tight budget sometimes try to save money by going without insurance or by purchasing substandard insurance products at discounted rates, including health, auto, renter's, and homeowner's. By doing so, they become more vulnerable to financial setbacks that threaten to consume their retirement savings, Zagarola says.

"People look at things based on the premium. They don't look at things based on the coverage," he says. "You need to make sure that you're properly insured for what you have. You're working hard to build your assets; you should work equally hard to protect them."

Retirement

Continued from Page 3

lower than your ordinary income tax rate. Therefore, the same investment purchased in a brokerage account and a retirement account (such as an IRA) will result in a different amount of tax owed upon withdrawal. For example: Bob, age 65, buys 100 shares of XYZ mutual fund in his brokerage account and his IRA account, investing $12,000 into each account. Three years later, XYZ mutual fund is worth $15,000 in each account. He realizes he could use the $15,000 to pay his property tax bill for the year. What is the most tax-efficient way for Bob to withdraw the money?

If Bob sells XYZ mutual fund in the IRA and withdraws the $15,000, he will pay ordinary income tax on the entire amount. If he is in the 30% ordinary income tax bracket, he will pay $4,500 of income tax and be left with $10,500. If he sells XYZ mutual fund in his brokerage account and withdraws the $15,000, he will pay long-term capital gains tax of $450 ($3,000 gain at 15 percent), leaving him with $14,550. Clearly, he should sell XYZ mutual fund in the brokerage account to pay less tax.

- ***Brokerage accounts are likely to earn more than bank accounts.*** Investments in brokerage accounts can be made into many different types of investments. This can include cash, stocks, bonds, and mutual funds. The latter three are likely to make more money than money stored in a bank account.
- ***Accessing brokerage accounts before Social Security allows for social security benefits to accrue longer.*** Using the brokerage account for your cash needs can allow your social security benefits to continue to accrue and allow your retirement accounts to continue to grow tax-deferred, which also is a big plus for using a brokerage account.
- ***Using cash from brokerage accounts gives retirement accounts more time to grow.***

The most significant disadvantage may be that when making changes to a brokerage account by selling an investment, there likely will be tax owed, even if you do not withdraw the money for your needs. Using the same example as above, let's say that Bob decides he no longer wants to invest in XYZ mutual fund and has found a better mutual fund instead. If he sells XYZ mutual fund for $15,000 in his IRA account and buys ABC mutual fund, he will not pay any income tax on that transaction because he did not withdraw any funds from the IRA. If he does the same thing in the brokerage account, he will pay income tax, in this case, $450 for the privilege of switching investments. So, rather than investing $15,000 into ABC mutual fund, he can only invest $14,550 because he will need to set aside $450 to pay the tax on the gain on the sale.

There are many ways to access cash in retirement to pay for expenses. The six methods described here are not mutually exclusive and can be (and usually are) combined. What is right for you may not be suitable for someone else. Figuring out what works best is not easy, but understanding your options and the advantages and disadvantages of each one can help you reach the best decision for you and your family.

120 Eagle Rock Avenue · Suite 230 · East Hanover, NJ 07936
www.access-wealth.com | www.access-wealth.com/blog
info@access-wealth.com
(973) 740-2400