RETIREMENT PLAN MAKEOVER

These six steps can help you enhance your returns, nip-and-tuck your taxes and retire with that young-enough-to-enjoy-it look.

Subtle changes to your retirement plan today can make a difference of millions of dollars of wealth by the time you retire. Yet many investors put these changes off. Some want to wait to see what the stock market is going to do this month or this year. But wise planning doesn't rely on timing. Others believe that only investors with six-or seven-digit retirement accounts need to think about things like asset allocation, but a 40 year-old with $20,000 in savings today already controls hundreds of thousands of dollars in potential retirement wealth.

New investment choices, including exchange-traded funds and specialized annuities, make it easier than ever to revamp an underperforming retirement plan and begin building more wealth for tomorrow. Here are six simple tools and strategies to help you get started today.

1. PRIORITIZE YOUR SAVINGS OPTIONS.

Saving for retirement is all about tax advantages–getting as much money as possible into tax-deferred accounts, as soon as possible. Doing so creates a triple compounding effect. You earn a return on your money and a return on that return, plus a third de facto return on money that would have normally gone to pay taxes.

There are dozens of tax-advantaged investments available. Most employees' first choice for retirement savings is an employer-sponsored 401k plan, and rightly so. The benefits of such plans are hard to beat. Contributions are made with pre-tax dollars, which reduces the participant's taxable income. Often, employers provide matching funds for a portion of these contributions.

But contributions to 401k plans in 2005 are limited to $14,000. The limit for traditional and Roth IRA accounts is a scant $4,000. Self-employed savers have more options, including SEP, Keogh and Solo 401k plans. Limits for these are more generous, but all of them top out at $42,000 in 2005. For many those limits will be sufficient. But what about high-income investors who are looking to contribute more, or those with lump sums in taxable accounts who are looking to jump-start their tax-deferred savings?

Annuities have no contribution caps; they offer an unlimited ability to get money growing tax-deferred. There are two basic types. Deferred annuities are designed to help people accumulate money for retirement. Immediate annuities allow those entering retirement to turn a lump sum of savings into a guaranteed stream of lifetime income.

"There's a wide gamut of potential annuity customers, from people in their 40s and 50s who use them to save, to people in their 60s and early 70s who use them to guarantee income in retirement," says John Meyer, senior vice president of New York Life's individual annuity department. "Fewer employers these days offer defined benefit plans. Immediate annuities provide a way for investors to create their own pension plan."

Meyer points out that annuities today offer new features that add convenience, liquidity and new planning possibilities. For example, New York Life's LifeStages income annuities can provide a guaranteed stream of payments for the life of the purchaser and a loved one, and leave a tax-free death benefit for an heir. And new withdrawal options allow holders of the annuity to access cash in case of

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emergency. They can take an advance of six months' worth of payments, or cash in 30% of the remaining value of payments on the fifth, 10th and 15th anniversary of the first annuity payment.

Each of the retirement savings options mentioned thus far requires an additional decision about how the money will be invested. Participants in 401k or self-employment retirement plans as well as IRA holders must choose between stocks, bonds, mutual funds, exchange-traded funds, money market funds and more. Annuity holders have essentially the same choice; they must decide between fixed annuities, which provide set returns, and variable annuities, in which funds are invested in a variety of mutual funds.

Which of these options is best? That decision requires a look at the basics of investment risk.

2. MINIMIZE THREE TYPES OF INVESTMENT RISK.

Stocks are riskier than bonds, right? It depends on which type of investment risk you're talking about. Let's look at three types: inflationary, market and issue-specific.

Inflationary risk is perhaps the most overlooked type, and the most important one for long-term retirement savers. It's the risk that your savings fail to keep up with the reduction in purchasing power brought about by inflation. An annual inflation rate of 5%, for example, will cut the purchasing power of your money in half in 14 years.

Fail to earn more than that on your money, and you're basically guaranteeing a loss, perhaps not in principal, but in purchasing power, which is what really matters. The rate of inflation changes constantly. Currently it's between 3% and 4% per year. Three-year Treasury bonds and CDs currently pay about the same. Most money market accounts pay around 2%.

Over the past 10 years the Standard & Poor's 500 index—it tracks the shares of America's 500 largest companies—has posted an average total return of more than 11% per year. That's why stocks are considered one of the best ways to reduce inflationary risk over long time periods. For 20-year holders, the S&P 500 index has never returned less than the rate of inflation.

But of course, stocks don't provide the same return each year. The S&P 500 index, for example, returned 10.9% in 2004 and 28.7% in 2003 but lost 22.1% in 2002. That illustrates market risk—the risk that the overall stock market declines in value, dragging your stocks down with it. Market risk is one of the primary reasons why some investors shy away from stocks. But long-term investors may face less market risk than they think.

Consider again the S&P 500. Between 1926 and 2004 the index posted negative yearly returns 29% of the time. But look at rolling five-year period and the percentage that saw negative returns drops to 12%. For 10-year periods, it's just 3%.

Whether, and how much, an investor should invest in stocks depends on the amount of time they have before they'll spend the money. For those planning for a retirement that's decades off, the risk of not investing in stocks may well exceed the risk of doing so. But what about choosing the right stocks?

Issue-specific risk is the risk that the particular stock or bond you buy produces a lousy return. Picking individual stocks and bonds requires experience and know-how. For lay investors, the easiest way to reduce issue-specific risk when buying stocks is to buy into a broad basket of individual investments by purchasing a mutual fund or exchange-traded fund.

Investors who are uncomfortable doing that on their own—studies show many are—should use a financial advisor, says Maria Umbach, vice president of marketing at Prudential. "The right financial advisor can help an investor understand the risks and potential rewards of different asset classes, including stocks," says Umbrach. "They can help investors manage their expectations as they save for retirement." More on choosing the right advisor in a moment.

3. USE ETFS AS RETIREMENT PLANS.

Saving for retirement, remember, is about getting as much money as possible into tax-deferred accounts. But the next best thing may be exchange-traded funds, or ETFs. A relatively new investment, ETFs combine the best characteristics of mutual funds and stocks, are tax-efficient and often carry ultra-low internal expenses.

Like index mutual funds, ETFs are baskets of stocks that track stock indexes. There are ETFs that mimic domestic and foreign indexes, stock and bond indexes, sector indexes and more. Like stocks, ETFs trade constantly throughout the day. (They can also be bought on margin and sold short.)

ETF taxes are scant. When mutual funds produce capital gains, they're usually obligated to pay them out to investors. If the funds are held in a taxable account, investors will have to pay taxes on those distributions. ETFs generally pay gains distributions only when changes are made to their underlying indexes. That means that investors will for the most part pay taxes only on dividend distributions.

The S&P 500 index, recall, returned more than 11% annually over the past 10 years. But less than 2% of that return was in the form of dividends. So ETF shares miss out on the bulk of taxes until they're sold. They're also cheap. Domestic stock ETFs offered by Vanguard, for example, carry expense ratios (expenses as a percentage of assets) of just 0.15%, vs. 0.20% for their comparable index mutual funds.

4. THERE'S A TIME TO BUY, AND A TIME TO BUY MORE.

The old Wall Street axiom, "buy low, sell high," does most investors little good. It's like saying "get rich, not poor." Investors know they should buy low. The question is, how?

For most investors, there is exactly one way to ensure that they buy shares of a stock, mutual fund, ETF or annuity at a lower-than-average price. It's called dollar cost averaging, and it couldn't be easier. All that's required is for an investor to make regular, periodic contributions to their investments in steady dollar amounts.

Consider four months' worth of regular $500 contributions into a mutual fund. In the first month the share price is $10, so their contribution buys 50 shares. In the next month the price increases to $12, so they buy 41.7 shares. In the third month, the price falls to $8, so they buy 62.5 shares. Finally, the price returns to $10, and the investor buys another 50 shares.

What was the average share price during the four-month period? Average the four values and you get a share price of $10. How much did the investor pay? Divide the total dollar amount spent ($2,000) by the number of shares bought (204.2). You get $9.79 per share. The investor bought at a lower-than-average price without even trying, because he or she bought more shares at the lower price than at the higher one.

Implementing the strategy in your own portfolio is easy. Employer-sponsored plans do it automatically, since steady dollar amounts are deducted from each of your paychecks and invested. Most mutual funds and brokers allow you to make automated, regular contributions, which can be deducted from your bank account.

"Our periodic investment program is particularly popular with retirement investors," says Kevin Finn, senior vice president of core brokerage product development at T. D. Waterhouse. The program allows investors to deduct as little as $100 per month from their bank accounts to add to a mutual fund. "It lets you ride out market fluctuations and stay disciplined," says Finn.

5. ROLLOVER, AND FETCH TOP RETURNS.

When 401k participants (and, in most cases, participants in 457 and 403b plans, which are retirement plans most often offered to government workers and teachers, respectively) leave their employers, they have the option of transferring their plan assets into an IRA. It's called a rollover, and it's usually a good idea, provided you make sure the money is indeed treated as a tax-free rollover, and not as a taxable distribution. Employer plans offer a choice of perhaps a few dozen mutual funds, while IRAs offer near-limitless investment choices.

"IRA rollover accounts provide access to mutual funds, stocks, bonds, ETFs–a full range of investment products," says T.D. Waterhouse's Finn. "They give you full discretion over how your retirement funds are invested."

Annuities are another choice for rollover funds. New York Life's Meyer says annuities are helpful for meeting required minimum distribution rules that, for traditional and rollover IRAs, kick in at age 70 1/2. "An IRA immediate annuity provides lifetime income, plus it satisfies the minimum distribution requirement because payments are based on the investor's life expectancy."

The vast number of investment choices available inside an IRA can help investors to enhance their returns or reduce their risk. But for many investors, the responsibility of managing a large rollover account is daunting. Selecting from a handful of 401k mutual funds, after all, can be complicated enough. Choosing between tens of thousands of mutual funds, stocks and bonds will, for some, require professional help.

6. KNOW WHEN TO GET HELP.

A good financial advisor can help you save for retirement and make the right investment choices, and also show you how to pay for things like a child's education or a home renovation.

Financial advisors should be knowledgeable, and have access to a broad range of investments and research. But the key to choosing a good advisor, says Prudential's Umbach, is to find one who listens.

"Look for someone who wants to understand your risk tolerance, and who responds to your needs instead of pushing a cookie-cutter investment," says Umbach. "It has to be a needs-based approach. The right advisor will ask plenty of questions."

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