Preparing to Retire

Key steps to take as you approach retirement
Why Plain Talk?

At The Vanguard Group—a leading proponent of investor education in the mutual fund industry—we believe that knowledge is one of the keys to investment success. To that end, we have developed our Plain Talk Library, a series of candid, concise, and easy-to-understand publications on a wide variety of investment topics.

To request a free copy of any of these brochures, call us at 1-800-662-7447 on business days from 8 a.m. to 10 p.m. and on Saturdays from 9 a.m. to 4 p.m., Eastern time. You can also read or order them online at www.vanguard.com.

We hope you find the information in the Plain Talk Library helpful as you chart your investment course with us.

- Mutual Fund Basics
- The Vanguard Investment Planner
- Women and Investing
- Financing College
- Preparing to Retire
- Investing During Retirement
- Estate Planning Basics
- How to Select a Financial Adviser
- Measuring Mutual Fund Performance
- Bear Markets
- Bond Fund Investing
- Index Investing
- International Investing
- Taxes and Mutual Funds
- Dollar-Cost Averaging
- Why Vanguard?
Preparing To Retire

For more and more Americans, retirement is no longer just about leisure. Many retirees take new jobs after giving up their careers, and even more devote themselves to volunteer work. A large majority see retirement as “a time to begin a new chapter in life by being active and involved, starting new activities, and setting new goals.”*

As you approach retirement, no doubt you have your own ambitions for a fulfilling retirement. Fortunately, a number of positive factors have combined to make a comfortable retirement possible for most Americans: better health care, longer life expectancies, and a variety of financial support systems for retirees, including Social Security, Medicare, and various retirement plans. Those factors make a secure retirement possible, but they do not guarantee it. To ensure that you have the retirement you want, plan your retirement finances now—before you leave the workforce.

This brochure will outline three steps you need to take as you prepare to retire within the next five years:

- Creating a realistic retirement budget.
- Evaluating your retirement income sources.
- Managing your assets as you approach retirement.

In addition, you will need to consider a number of related issues, such as when you should start taking Social Security, what you should do with assets in retirement plans, whether you will need to replace some benefits provided by your employer, and whether you should go back to work. To help you plan, this booklet includes four worksheets that you can use to evaluate your financial needs and resources during retirement.

Given the complexity of many retirement issues, a brochure can serve only as a solid introduction to the topic. Even people who decide to seek advice from a financial planning firm will find that having a basic knowledge of retirement issues will serve them well.

Contents

The Importance of Planning ................................................................. 1
Some expenses that shouldn’t be overlooked

Step 1— Creating a Realistic Budget .................................................... 3
The impact of longer life expectancies
The long-term dangers of inflation
Health insurance for retirees
Long-term care insurance
Life insurance
Tax considerations

Step 2— Evaluating Your Income Sources .......................................... 8
Working during retirement
Understanding Social Security benefits
Starting your Social Security benefits
Understanding a defined-benefit pension
“Pension maximization” plans
Adding it all up

Step 3— Managing Your Assets as You Near Retirement .................. 15
Using your investments during retirement
Your financial fitness for retirement
Retiring with surplus income
Make your investments last
The importance of inflation and investment returns
Investments to offset inflation

Allocating Your Assets ...................................................................... 24
Investor Questionnaire
Choosing an asset allocation
Monitoring your asset allocation
Which investments should you spend first?

Some Concluding Thoughts ............................................................... 32
Five years to go
One year to go
Planning pays off

A Vanguard Invitation ....................................................................... 34

A Listing of Vanguard® Funds ............................................................. 36
THE IMPORTANCE OF PLANNING

Some people decide to retire on the spur of the moment, without carefully reviewing their financial situation or considering the future implications for their finances. Within a few years, many of them find that they can’t afford the retirement they wanted. To avoid that situation, you need to plan now, before you retire. Begin by carefully evaluating what financial resources you have now and what resources you might need in the future—especially after factoring in inflation.

One often-heard rule of thumb suggests that people will need 70% to 80% of their current income after they retire. Such a guideline may have been useful for thinking about a retirement in the distant future, but it’s not adequate for someone who hopes to retire soon.

Now is the time to figure out how much money you’ll really need for the lifestyle you want as a retiree. If you’re planning to travel around the world and stay in luxury hotels most of the time, then you may need more than 100% of your current income. But if you’re content to live frugally, then you may need much less.

Some expenses that shouldn’t be overlooked

As you plan, don’t forget to think about taxes—which can have a significant effect on the growth of retirement assets and on the amount you realize when you sell them. In general, you’ll probably want to keep investments in tax-deferred and tax-free accounts as long as possible.

Keep in mind that out-of-pocket living expenses are only a portion of the bills you’ll face in retirement. Most employers provide at least some benefits that you will now have to replace—health, dental, and vision insurance, perhaps some disability income coverage, and life insurance. You may also begin incurring some added expenses as you age—such as prescription drugs, medical devices, or payments for long-term care insurance.

Many people who hope to retire in the next few years don’t yet know what they’ll receive in Social Security and pension benefits. And they may not fully understand what the federal Medicare health insurance program covers—or, more importantly, what it doesn’t cover, which is a lot. Without planning, you may not be aware of some of the expenses you’ll face during retirement. Therefore, the first step in planning for your retirement is preparing a budget for your retirement years.
Where estate and retirement planning overlap

Given that you are only a few years (or less) from retiring, you should have a full estate plan in effect. If you already have a plan, then retiring is one of those major life changes that should trigger a comprehensive review of your estate planning goals and documents. If you don't have a plan, now is a good time to prepare one with the help of estate planning experts. People who don’t have estate plans (or who have inexpertly prepared ones) run a serious risk of leaving legal and bureaucratic problems for their families and of incurring unnecessary taxes and administrative costs. In fact, those people with significant wealth should be more concerned about estate planning than about budgeting and investing for a retirement they can easily afford. Anyone concerned about estate planning can call Vanguard to request Estate Planning Basics, another brochure in the Plain Talk Library.

In 2001, federal law allows each individual to leave $675,000 to beneficiaries without incurring any estate or gift taxes. This amount will increase, in increments, to $1 million by 2006. A good estate plan will ensure that your family receives the full benefit of such provisions.

Some of the key areas where retirement and estate planning intersect are beneficiary designations and life insurance.

- **Beneficiary designations** involve assets such as retirement accounts and insurance contracts in which you dictate what should happen to those assets in the event of your death. For instance, you may have designated your spouse as the beneficiary on a traditional IRA when you set up the account years ago. But now you may decide that your spouse has plenty of assets and that you'd rather designate one of your children. As beneficiary, your child could receive distributions from the IRA over many years (based on life expectancy) or in a single payment.

- **Life insurance** may no longer be needed during retirement—unless you and your spouse are dependent on income (perhaps from a pension or legal settlement) that would cease should one of you die. You could give a life insurance policy to an irrevocable life insurance trust—thereby removing the insurance proceeds from your estate. Or, if there is a cash value associated with the policy, you may want to cash it in now or convert the cash value to an annuity that could grow on a tax-deferred basis until your later retirement years. Some or all of your life insurance coverage may be provided by your employer. If you need life insurance after you retire, that coverage will probably have to be replaced at your expense. Now is a good time to research how much that will cost.
Before you begin the transition from worklife to retirement, you should carefully evaluate your current and future needs, as well as the financial resources available. Be sure to include your spouse in this planning process: All too often the person who manages the family finances becomes unable to oversee them because of illness or death. Unless the other spouse understands the family’s finances, he or she can then be vulnerable to poor financial advice or even fraud.

Start by creating a realistic budget that reflects (with as much accuracy as you can reasonably achieve) what you will actually be spending. Many retirees find that they spend more during retirement—especially on things such as travel, hobbies, and entertainment—than they did while still working. In addition, you may need to begin paying for some expenses such as health care or prescription medicines that are now paid for by insurance from your employer. Now is a good time to contact your employer's benefits office to obtain a complete list of the benefits you are receiving now and those that you will receive after retirement—including how much you and/or your spouse will receive from any traditional (defined benefit) pension plans. With those lists you can begin to evaluate what benefits (primarily insurance coverage) you will need to replace or supplement on your own. (On page 7, we provide a worksheet that can help you estimate your expenses during retirement.)

You might have more retirement expenses than you expected, and those expenses are likely to rise over time. The damage that inflation causes to retirement budgets is often much greater than people anticipate—especially since retirements are lasting longer than ever.

The impact of longer life expectancies

As you prepare a budget, keep in mind that people now are living longer in retirement. The average life expectancy at retirement age has risen, as shown in Figure 1, and chances are that you'll live longer than your parents or grandparents. Some of your expenses will be covered by regular income such as Social Security or a pension, but a significant amount will probably have to be paid from the retirement investments you've made over the years. And the assets you've accumulated for retirement will probably need to last a very long time.

<table>
<thead>
<tr>
<th>Year</th>
<th>Females at Age 65</th>
<th>Males at Age 65</th>
</tr>
</thead>
<tbody>
<tr>
<td>1900-1902</td>
<td>12.2</td>
<td>11.5</td>
</tr>
<tr>
<td>1909-1911</td>
<td>12.0</td>
<td>11.2</td>
</tr>
<tr>
<td>1919-1921</td>
<td>12.7</td>
<td>12.2</td>
</tr>
<tr>
<td>1929-1931</td>
<td>12.8</td>
<td>11.7</td>
</tr>
<tr>
<td>1939-1941</td>
<td><strong>13.6</strong></td>
<td>12.1</td>
</tr>
<tr>
<td>1949-1951</td>
<td>15.0</td>
<td>12.7</td>
</tr>
<tr>
<td>1959-1961</td>
<td>15.8</td>
<td>13.0</td>
</tr>
<tr>
<td>1969-1971</td>
<td>16.8</td>
<td>13.0</td>
</tr>
<tr>
<td>1979-1981</td>
<td>18.4</td>
<td>14.2</td>
</tr>
<tr>
<td>1989-1991</td>
<td>19.0</td>
<td>15.1</td>
</tr>
<tr>
<td>1998</td>
<td><strong>19.2</strong></td>
<td>16.0</td>
</tr>
</tbody>
</table>

The amount of time that 65-year-old Americans could expect to live during retirement increased during the twentieth century—and is probably still increasing. For example, women who turned age 65 in 1940 were expected to live 13.6 additional years (until about age 79). But women who turned age 65 in 1998 were expected to live 19.2 additional years (past age 84).

Source: National Vital Statistics Reports, United States Life Tables, National Center for Health Statistics.
In planning, be careful about using assumptions based on average life expectancies. Because they are averages, almost half of the population will live longer—often significantly longer. Retirees who plan to use up their assets upon reaching the average life expectancy run a nearly 50-50 chance of running short of money—a grim prospect. A better way of thinking about life expectancies is to consider how many 65-year-old Americans are expected to live to later ages, as shown in Figure 2. Given that almost half of 65-year-old women and a third of 65-year-old men are expected to live past age 85, it’s prudent to manage your retirement assets so that they’ll last well past age 85.

The long-term dangers of inflation

Not only do your retirement assets need to last a long time, they also need to protect you from the damage done by rising prices. Of course, Social Security benefits increase along with the general rate of inflation, but many other sources of income (such as most traditional pensions) do not. Consider an investor who needs $40,000 to meet her expenses in the first year of retirement. Figure 3 shows how much money she’ll need each year after various periods at different rates of inflation. If inflation averages 5% a year for 15 years, for instance, she’ll need $83,157 to match the purchasing power of the initial $40,000 budget.

While the rate of inflation has been relatively low in recent years, prices could start rising rapidly at some point during your retirement. The general inflation rate may not be the best gauge for you as a retiree: The prices of the goods and services you will need could rise at a much faster rate. For instance, the cost of health care and prescription drugs—expenses that typically affect older people much more than younger people—have been rising faster than the overall inflation rate in recent years. In estimating future expenses, you may want to assume a “personal inflation rate” that is higher than the general inflation rate. Between now and your retirement, you could monitor the prices of those goods and services that you’ll need during retirement to estimate a personal inflation rate.
Health insurance for retirees

One expense overlooked by some people approaching retirement is health insurance. Many incorrectly assume that Medicare will provide comprehensive health insurance after they turn age 65. That’s not usually the case. Medicare currently does not cover most outpatient prescription drugs, routine physical exams, most dental care, or routine eye care—or other expenses such as copayments and deductibles. Retirees who paid Medicare taxes when they were working do not have to pay for Medicare hospital insurance (Medicare Part A), but most retirees have to pay $50 a month in 2001 for Medicare medical insurance (Medicare Part B). The monthly Medicare premiums will increase each year with inflation.

Most retirees need more coverage than Medicare provides, and many purchase a Medicare supplemental insurance policy. These policies, which fill the “gaps” in Medicare coverage, are often referred to as “Medigap.” The ten standard Medigap policies, each of which provides a different mix of coverage, are described in a free booklet from Medicare titled Medicare Supplemental Insurance (Medigap) Policies and Protections. (See the box to the right for instructions on obtaining a copy of the brochure.)

In many areas, retirees can join a Medicare managed care plan rather than use regular Medicare coverage. A managed-care plan may cover some expenses that regular Medicare does not cover, but participants can only go to certain doctors and hospitals. Participants in a Medicare managed care plan do not need to purchase Medigap insurance.

Long-term care insurance

As people age, more and more find that their daily activities become limited by chronic health conditions affecting their physical or mental well-being. In the mid-1990s, more than half of Americans who were age 65 or older reported having some disability, compared with less than 20% of those ages 15 to 64.* Most of those older Americans are able to care for themselves despite their disability, but some must be cared for in a nursing home—at an average cost of more than $56,000 a year.**

Some affluent retirees may be able on their own to pay the cost of a nursing home or an assisted-living facility, but others purchase long-term care insurance to cover this potential cost. This insurance can be expensive, so many financial planners recommend that you purchase this coverage while you are still relatively young (age 55 or so) and in good health, as the cost will rise sharply as you age or if your health deteriorates. Nursing home patients who do not have long-term care insurance may qualify for coverage under Medicaid—but generally only after their assets are exhausted.

---

**Source: Long-Term Care fact sheet, AARP and the Public Policy Institute.
More information on long-term care insurance

If you are considering long-term care insurance, you may want to review A Shopper's Guide to Long-Term Care Insurance, a free publication from the National Association of Insurance Commissioners. Write to the NAIC at 120 W. 12th Street, Suite 1100 Kansas City, MO 64105, or call 816-842-3600.

Life insurance

If you determine that you'll need life insurance after you retire, you may want to purchase the policy now. The cost of buying a life insurance policy rises with the age of the person to be insured—but the rate of increase accelerates dramatically for people in their 60s.

Tax considerations

Many (but not all) people enjoy a decrease in taxes when they retire. With no employment income, they no longer pay Social Security and other payroll taxes, and their income tax bills may drop significantly. When people reach age 65, they also receive increased standard deductions that can lower their federal income tax bills if they don't itemize. Other taxes—property taxes, for instance—may increase during retirement. Even income taxes can rise again when retirees begin taking required minimum distributions from IRAs and other retirement plans.

One tax-saving strategy that you might consider is to convert some assets in traditional IRAs to Roth IRAs, which feature tax-free withdrawals. This could be an attractive strategy for someone who is temporarily in a lower tax bracket. (In the year you convert traditional IRA assets to a Roth IRA, you must pay income taxes on any IRA earnings or tax-deductible IRA contributions that you convert.) If you could convert to a Roth IRA by paying taxes at a 15% rate and then withdraw them tax-free after your tax rate rises to 28% several years later, then you might be better off—despite having paid the taxes earlier. Of course, your actual results will depend on how your investments perform and on what your actual tax rate is when you withdraw the traditional IRA assets. The Roth IRA must exist for at least five years before you can make tax-free withdrawals. State taxes are an important consideration too: Some states have no income tax, but the ones that do have varying rates. Many of the states that do have an income tax offer tax breaks to retirees who receive Social Security or pension benefits. Check with your tax adviser or state tax authorities for more information.

Now that you've reviewed some of the key expenses you can incur during retirement, use Worksheet 1 on page 7 to help you create a realistic budget. The worksheet isn't an exhaustive listing; you may need to add some categories. Once you've computed your total projected expenses, it's time to figure out how you'll pay for them. In Step 2, which begins on page 8, you'll be guided through the process of evaluating the ongoing income, such as pensions and Social Security, that you'll receive during retirement.
Your projected retirement expenses

This worksheet can help you estimate your expenses, but you may be able to create a more accurate budget using a personal computer and personal financial software or Vanguard's interactive retirement planner at [www.vanguard.com/?planner](http://www.vanguard.com/?planner).

<table>
<thead>
<tr>
<th>Your projected expenses</th>
<th>Monthly Amount</th>
<th>Annual Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Housing</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Mortgage/rent</td>
<td>$</td>
<td></td>
</tr>
<tr>
<td>Property taxes</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Utilities/phone</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Insurance</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Maintenance</td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Autos/transportation</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Loan or lease payment</td>
<td>$</td>
<td></td>
</tr>
<tr>
<td>Insurance</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Fuel</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Maintenance/other</td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Food</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Groceries</td>
<td>$</td>
<td></td>
</tr>
<tr>
<td>Dining out</td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Health care</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Insurance premiums</td>
<td>$</td>
<td></td>
</tr>
<tr>
<td>Health</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Medicare</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Medigap</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Long-term care</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Copayments</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Uninsured expenses</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Prescriptions</td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Personal</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Life insurance</td>
<td>$</td>
<td></td>
</tr>
<tr>
<td>Clothing</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Cosmetics/toiletries</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Entertainment</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Hobbies</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Subscription/dues</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Travel/vacation</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Gifts</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Charitable contributions</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Alimony</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Dependant care (parent or child)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Pet care</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Other</td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Total Expenses</strong></td>
<td>$</td>
<td></td>
</tr>
</tbody>
</table>

*This figure will be used in later worksheets to help you evaluate your overall retirement finances.*
How much are you due in Social Security benefits?

Since October 1999, the Social Security Administration has been mailing annual statements to the 125 million working Americans age 25 or older who are not receiving benefits. This four-page statement will provide a record of the earnings that have been posted on your Social Security records and an estimate of your potential benefits. You should automatically receive the statement about three months before your birth month.

If you would like to order a statement, you may do so by completing Form SSA-7004 and submitting it to the Social Security Administration. The form may be ordered by calling 1-800-772-1213. You can also go to the Social Security website www.ssa.gov and either complete the form online or download a copy to submit by mail.

Most retirees have two main sources of money to pay their living expenses:

- Ongoing sources of income such as part-time employment, Social Security, and pensions.
- Principal and income from investments.

This step will focus on evaluating your sources of retirement income and on how you might manage them most effectively. Worksheet 2 on page 14 will help you estimate your income during retirement. By comparing your income with your anticipated expenses, you can estimate how much money you will need to draw from your investments each year. Beginning with Step 3, this booklet will discuss how to manage your investments.

Working during retirement

More and more people are retiring gradually—giving up a full-time career for part-time work or a less stressful job. Others are simply retiring from one career to pursue another that they hope will be more fulfilling—perhaps by starting their own business. About 12% of older Americans are either employed or actively seeking a job, and about half of those working hold full-time jobs.* As life expectancies increase and the health of older Americans improves, a typical retiree may hold one or more jobs for at least a few years after retiring.

If you hope to work after leaving your current career, remember that your new job will have a number of implications for your personal finances—some good and some not so good. Your new job may be a challenging experience that is a satisfying way to spend time—and it may replace expensive hobbies that would otherwise occupy you. Those savings—and the income from your job—may be a big help in making ends meet. The drawbacks to a new job are that it could increase your annual income tax bill, push you into a higher tax bracket, or cause a temporary reduction in your Social Security benefits.

Understanding Social Security benefits

The creation of the Social Security system in the 1930s radically changed the idea of retirement in the United States. Before Social Security existed, few people retired to a life of leisure; it was much more likely that they were forced into retirement by illness or disability. But Social Security, combined with the improving health and life expectancies of older Americans, has created (for many) an expectation of a retirement of leisure and comfort.

The Social Security system was never intended to pay the entire cost of retirement; it was only meant to supplement pensions and personal investments. The average monthly benefit paid to an individual retired worker is $845 and the average paid to a retired couple (each of whom qualifies for benefits) is $1,410.

Increases in the life expectancy of Americans have contributed to strains in the Social Security system’s finances. A child born in 1940, several years after the creation of Social Security, was expected to live (on average) for 63.6 years—so only half the population was expected to reach the Social Security system’s normal retirement age of 65. By the mid-1990s, however, a newborn was expected to live 75.8 years—meaning the system will have to pay, on average, for several more years of retirement for every person than originally intended.

The federal government has responded to these increasing life expectancies by raising the contributions that workers and employers make to the Social Security system and by restricting the benefits paid. One of the key restrictions on benefits is an increase in the retirement age at which people can begin to collect full retirement benefits, as shown in Figure 4.

Starting your Social Security benefits

The decision on when to start taking Social Security involves a balancing of several factors. If you plan to work during retirement, it may pay to delay taking Social Security, to avoid having benefits withheld and, perhaps, to qualify for a larger monthly benefit. But if you don’t plan to work after retiring or if you have a pressing need for the income early in retirement, you may decide to begin taking benefits earlier.

Another factor to consider is your likely lifespan. A retiree in good health may live longer and benefit from a larger monthly payment; a retiree in poor or failing health may be better off starting benefits early.

You may begin collecting benefits at age 62, but you will receive less than the full monthly Social Security benefits throughout retirement. Monthly benefit payments were reduced 20% for people who were born in 1937 or earlier and who retired at age 62. The reduction in benefits is more than 20% for people born after 1937 who choose to retire at age 62. The reduction in benefits is prorated for retirees who elect to begin receiving benefits after age 62 but before their normal retirement age. In effect, people who retire before their normal retirement age are trading a few months or years of benefits for a lifelong cut in benefits from age 65 on. Given your situation, that tradeoff may or may not be attractive.

<table>
<thead>
<tr>
<th>Year of Birth</th>
<th>Full Retirement Age</th>
</tr>
</thead>
<tbody>
<tr>
<td>1937 or before</td>
<td>65 years</td>
</tr>
<tr>
<td>1938</td>
<td>65 years and 2 months</td>
</tr>
<tr>
<td>1939</td>
<td>65 years and 4 months</td>
</tr>
<tr>
<td>1940</td>
<td>65 years and 6 months</td>
</tr>
<tr>
<td>1941</td>
<td>65 years and 8 months</td>
</tr>
<tr>
<td>1942</td>
<td>65 years and 10 months</td>
</tr>
<tr>
<td>1943–1954</td>
<td>66 years</td>
</tr>
<tr>
<td>1955</td>
<td>66 years and 2 months</td>
</tr>
<tr>
<td>1956</td>
<td>66 years and 4 months</td>
</tr>
<tr>
<td>1957</td>
<td>66 years and 6 months</td>
</tr>
<tr>
<td>1958</td>
<td>66 years and 8 months</td>
</tr>
<tr>
<td>1959</td>
<td>66 years and 10 months</td>
</tr>
<tr>
<td>1960 or later</td>
<td>67 years</td>
</tr>
</tbody>
</table>

Even if the retirement age shown above for your year of birth is greater than 65, you’ll still be able to start collecting Social Security benefits at age 62—but your monthly benefits will be less than 80% of your full retirement benefit. For instance, if your full retirement age is 67 and you retire at age 62, you will receive about 70% of the full benefit at age 63, 75%; at age 65, about 87%; and at age 66, about 93%.

Source: Retirement Benefits; Social Security Administration.
In addition, people under age 65 will have some Social Security benefits withheld if they have earned income that exceeds certain limits. In 2001, $1 in benefits is withheld for every $2 a Social Security recipient (under age 65) earns in excess of $10,680. (Earnings up to $10,680 do not affect Social Security benefits.) The federal government repealed similar limits on earnings for Social Security recipients who are ages 65 through 69. That change is retroactive to January 1, 2000.

An important note: The full retirement benefit paid to people who begin receiving Social Security benefits at age 65 is not the maximum monthly benefit they could receive. If you delay taking benefits beyond full retirement age, Social Security will increase your monthly benefits—with the maximum benefit paid to those who begin collecting benefits at age 70 (see Figure 5).

For instance, a 65-year-old single person could retire in 2001 and receive $800 a month, or $9,600 a year. But if she waits until she's 66 to retire, her monthly benefit would be $848 ($800 plus 6% of $800)—not counting any inflation adjustment. The retiree gave up $9,600 in benefits in exchange for an additional $576 a year ($48 a month for 12 months). She'll have to collect the higher benefit for almost 17 years (until she's nearly 83 years old) before she breaks even and recoups the $9,600. And the breakeven point might come much later if she'd taken the $9,600 and kept it invested all those years.

### Understanding a defined-benefit pension

A defined-benefit pension plan is one that provides a specified benefit. Usually that benefit is a fixed monthly payment for life. The normal retirement age for most plans is 65, but some plans allow participants to retire earlier with a reduced monthly benefit. The monthly payment is usually not adjusted for inflation, so a defined-benefit pension is likely to provide a shrinking portion of your retirement income as inflation erodes the value of the payment. You should contact your employer for information on your pension plan, including the amount of benefits you're due.

The typical defined-benefit plan offers a few options for distributions, and you should consider the pros and cons of each carefully.

- **Single life.** A fixed amount is paid each month until the retiree dies, and then all pension benefits stop. This option is appropriate for single retirees, but it is usually a poor choice for a married couple. Although single life payments typically provide the largest monthly income during the life of the pension recipient, a surviving spouse would be left with no pension income when the retiree dies.

- **Joint and survivor.** A fixed amount is paid each month until the retiree dies, and a percentage of that benefit is then paid each month to the surviving spouse until he or she dies—after which all pension benefits stop. Although the amount of the original monthly benefit is smaller than it would be under...
the single life option, this option protects a surviving spouse. The monthly payment received by the survivor is usually (but not always) less than the original benefit. For instance, a couple was receiving a 50% joint-and-survivor pension payment of $2,000 a month while both were still alive. After one died, the survivor received payments of $1,000 a month.

- **Term certain.** Some pension plans allow retirees to specify that monthly payments continue for a minimum number of years (usually 5 to 20), even if the pension recipient (either the retiree or the retiree’s spouse) should die before the end of that period. Typically, term certain is offered in conjunction with the other payment options, so that a retiree would choose “single life with term certain” or “joint and survivor with term certain.” The possibility that payments will continue after the retiree’s death means that the amount of each monthly payment must be reduced. The addition of the term certain option might be useful if your family is counting on your pension to meet a pressing financial need within the first several years of your retirement. For instance, your family may be counting on your pension to make mortgage payments until your home is paid off in five years. To ensure that the mortgage payments can be made, you might select a term certain of five years.

- **Lump sum.** A single payment, rather than a series of monthly payments, is made to the retiree. The lump sum usually represents the amount the pension plan theoretically needed to invest to make monthly pension payments to the retiree. A disadvantage of a lump sum is that the retiree could lose a significant amount of the distribution to income taxes—unless the money can be transferred into a tax-deferred account. (How to handle a lump sum from an employer-sponsored plan such as a 401(k) or 403(b) is discussed on page 16.)

Transferring a lump-sum pension distribution into a tax-deferred account offers several possible benefits:

- You can defer taking payments and allow the assets to grow tax-deferred until at least age 70½.

- You may invest well enough that you actually get more income out of the lump sum than you would have in monthly payments.

- You own the lump sum, and you can leave it to your family—increasing the financial security of later generations.

- You can withdraw any amount that you want, whenever you want it.

There are also some potential dangers in taking a lump-sum distribution—even when it goes into a tax-deferred account.

- You could suffer poor investment returns, and the lump sum could be depleted while you are still alive.

- You could be tempted to spend the lump sum rather than leave it invested for your future.
While a good defined-benefit pension could be a retiree’s most valuable retirement asset, the pension must be used carefully to ensure that its benefits carry over to the family in the event of the retiree’s death.

“Pension maximization” plans

As you near retirement, you may be approached by an insurance agent offering a “pension max” plan. Be wary. This plan would have you take the higher, single life payment option on your pension and use the difference between that and the joint and survivor payment option to buy life insurance on yourself. If you die before your spouse, the insurance could be used to buy an annuity that would replace the income that your spouse would have received under the joint and survivor option. If you outlive your spouse, you can cancel the policy and spend the savings on other expenses.

For a pension max plan to be beneficial for you and your spouse, it must meet a number of conditions:

- The premium for the life insurance must be less than the after-tax difference between the single life payment option and the joint and survivor payment option. If the cost of the insurance exceeds the difference in the payment options, then you are effectively taking a cut in income during your lifetime.

- The insurance payoff must be large enough to buy an annuity whose payments would match or exceed the monthly payments your spouse would receive after your death under the joint and survivor payment option. If the annuity payments do not at least match the joint and survivor pension payments, then your spouse will have a reduced income after you die. The cost of an annuity that pays a certain amount each month will likely be more expensive for a younger retiree than for an older retiree (perhaps by a large amount), because the payments are expected to continue longer. The cost of the insurance policy needed to fund such an annuity may be prohibitive.

Before signing up for a pension max plan, consider its potential drawbacks:

- You face a variety of risks. You may not be able to pay the insurance premiums at some point in the future, forcing the insurer to cancel the policy. Or the insurance company could fail, leaving you uninsured.

- While pension benefits are insured by the federal government’s Pension Benefit Guaranty Corporation, neither the life insurance benefit behind the pension max plan nor the potential annuity payments to your spouse are backed by the federal government.

Finally, consider the administrative and other costs incurred by the insurance company under the pension max plan. The insurer must provide a stream of income to your spouse that’s equal to your pension, cover expenses (such as reviewing your policy application, billing for premiums, and processing the claim on the policy), earn a profit, and pay an agent’s sales commissions. Given those demands, it could be difficult for the insurer to provide a better deal than your pension plan, so you should review any pension max plan with great care.
Adding it all up

In *Worksheet 2* on page 14, list the monthly and annual amounts of income you and your spouse will receive during retirement, and add up your “total income.” Using your total income and your “total projected expenses” from *Worksheet 1*, calculate any surplus or shortfall on *Worksheet 3* on page 14. Even if your income appears to be adequate for your expenses, ask yourself: How well will the value of my income keep pace with inflation over the long term? Any shortfall will have to be made up by your financial investments such as IRAs, employer-sponsored retirement plans, certificates of deposit, stocks, bonds, and mutual funds. To maintain a comfortable lifestyle, many retirees will have to spend—at least occasionally—a portion of their investment principal.

Beginning with the next section, this booklet will deal with your financial investments and help you decide how much you can withdraw without dangerously depleting those assets. *Worksheet 4* on page 17 will help you calculate what percentage of your assets you’ll need to withdraw in your first year of retirement.

---

**Fact**

After adjusting for inflation, the median income for older couples rose 95% from 1962 to 1998, while the median income of older single people rose 98%.

— Social Security Administration, August 2000.
### Your ongoing retirement income

<table>
<thead>
<tr>
<th>Income</th>
<th>Monthly Amount</th>
<th>Annual Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Social Security</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>You</td>
<td>$______________</td>
<td>$______________</td>
</tr>
<tr>
<td>Your spouse</td>
<td>---------------</td>
<td>-------------</td>
</tr>
<tr>
<td><strong>Wages</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>You</td>
<td>$______________</td>
<td>$______________</td>
</tr>
<tr>
<td>Your spouse</td>
<td>---------------</td>
<td>-------------</td>
</tr>
<tr>
<td><strong>Pensions</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>You</td>
<td>$______________</td>
<td>$______________</td>
</tr>
<tr>
<td>Your spouse</td>
<td>---------------</td>
<td>-------------</td>
</tr>
<tr>
<td><strong>Other income</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Reverse mortgage</td>
<td>$______________</td>
<td>$______________</td>
</tr>
<tr>
<td>Rental income</td>
<td>---------------</td>
<td>-------------</td>
</tr>
<tr>
<td>Royalties</td>
<td>---------------</td>
<td>-------------</td>
</tr>
<tr>
<td>Veterans' benefits</td>
<td>---------------</td>
<td>-------------</td>
</tr>
<tr>
<td>Other income</td>
<td>---------------</td>
<td>-------------</td>
</tr>
</tbody>
</table>

**Before-tax income**

$______________ x 12 $______________

### Estimated annual income tax liability

To estimate the effects of federal income tax on your retirement income, use the table on page 15. Each state has its own income tax rules, so you will have to check your state's tax publications for information on rates. A number of states do not tax certain types of retirement income, including Social Security and pensions. For more information, consult your tax adviser.

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Federal (Line 56 on Form 1040)</td>
<td>$______________</td>
</tr>
<tr>
<td>State</td>
<td>---------------</td>
</tr>
<tr>
<td>Local</td>
<td>-------------</td>
</tr>
</tbody>
</table>

**Total estimated annual income tax liability**

- $______________

**Total after-tax income** (subtract annual income taxes from annual before-tax income)

$______________

Now that you’ve calculated your ongoing income and your annual expenses, it’s time to see how they compare. If your expenses exceed your income, then you have a shortfall that will have to be made up by withdrawals from your retirement investment. If your income exceeds your expenses, remember that the surplus is for this year only; it may disappear as inflation increases your annual expenses.

### Worksheet 3

#### Your annual retirement surplus or shortfall

Subtract your total expenses (calculated on **Worksheet 1** from your total after-tax income (calculated on **Worksheet 2**).

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Total after-tax income (Worksheet 2)</td>
<td>$______________</td>
</tr>
<tr>
<td>- Total expenses (Worksheet 1)</td>
<td>$______________</td>
</tr>
</tbody>
</table>

**Surplus or Shortfall**

$______________

($______________
Before deciding to retire, it's important to evaluate your investments to make sure you have enough to retire and to ensure that your assets are invested appropriately. You may find it helpful to create an inventory of your financial investments and to sort them into the following categories:

- **Taxable accounts** holding assets such as mutual fund shares, stocks, bonds, or certificates of deposit. Current income such as interest and dividends is fully taxable as ordinary income in these accounts, but most long-term capital gains (on investments held longer than one year) are taxed at a maximum rate of 20% for most taxpayers. The usual long-term capital gains rate for people in the lowest tax bracket is a maximum rate of 10%. As of January 1, 2001, taxpayers in the 15% bracket will pay a maximum of 8% on gains from the sale of assets held longer than five years. Other taxpayers will pay a maximum of 18% on gains from the sale of assets purchased after January 1, 2000, and held longer than five years. The federal tax rates for ordinary income in 2001 are shown in Figure 6.

- **Employer-sponsored plans** such as 401(k)s, 403(b)s, and profit-sharing plans may also hold a variety of assets. These assets can grow on a tax-deferred basis, but all income (including long-term capital gains) is taxed as ordinary income when the retiree withdraws assets from the plan. Employer-sponsored plans typically restrict investment choices to a limited number of mutual funds and, sometimes, the employer's stock. Withdrawals taken before age 59½ may be subject to a 10% penalty tax unless certain IRS exceptions apply. (Early retirees may take annual withdrawals as substantially equal periodic payments based on their life expectancy.) Annual withdrawals, known as required minimum distributions (RMDs), must begin in the year after the owner turns age 70½.

- **Individual retirement accounts** such as traditional IRAs and Roth IRAs also may hold a variety of assets—often from a wider variety of mutual funds (plus individual stocks and bonds) than offered in most employer-sponsored plans. Assets in traditional IRAs can grow tax-deferred until the retiree withdraws them, and earnings and any pre-tax contributions are then taxed as ordinary income. Withdrawals taken from a traditional IRA before age

---

**Figure 6**

Federal income tax rates in 2001

These rates are applied to “taxable income” (Line 39 on IRS Form 1040), which is your income after taking deductions and personal exemptions. Each rate is a “marginal rate,” meaning that it is applied only to the income in the range listed below it. For instance, a single taxpayer with a taxable income of $30,000 would pay 15% on the first $27,050 of taxable income. The remaining $2,950 would be taxed at a rate of 28%.

<table>
<thead>
<tr>
<th></th>
<th>15%</th>
<th>28%</th>
<th>31%</th>
<th>36%</th>
<th>39.6%</th>
</tr>
</thead>
<tbody>
<tr>
<td>Single</td>
<td>Up to $27,051</td>
<td>$65,551</td>
<td>$136,751</td>
<td>$297,351</td>
<td>$297,351</td>
</tr>
<tr>
<td></td>
<td>$27,050 to $65,550</td>
<td>$136,750 to $297,350</td>
<td>$297,351</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Married</td>
<td>Up to $45,201</td>
<td>$109,251</td>
<td>$166,501</td>
<td>$297,351</td>
<td>$297,351</td>
</tr>
<tr>
<td>Jointly</td>
<td>$45,200 to $109,250</td>
<td>$166,500 to $297,350</td>
<td>$297,351</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Married</td>
<td>Up to $22,601</td>
<td>$54,626</td>
<td>$83,251</td>
<td>$148,676</td>
<td>$148,676</td>
</tr>
<tr>
<td>Separately</td>
<td>$22,600 to $54,625</td>
<td>$83,250 to $148,675</td>
<td>$148,676</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

**Note:** Income brackets are adjusted annually for inflation.

Source: Internal Revenue Service.

---

Step 3

Managing Your Assets as You Near Retirement
59½ may be subject to a 10% penalty tax unless certain exceptions apply. Early retirees may take annual withdrawals as substantially equal periodic payments based on their life expectancy. Roth IRAs can provide a retiree with tax-free investment growth, as long as the account is at least five years old when the assets are withdrawn. For traditional IRAs, RMDs must begin in the year after the owner turns age 70½. Roth IRAs do not require that distributions be taken during the owner’s lifetime.

- **Annuities and other insurance contracts.** Assets held in these contracts can grow on a tax-deferred basis. In the case of annuities, withdrawals may not be required until the owner is older than age 70½. Other insurance contracts, such as life insurance policies, may not require that assets ever be withdrawn. The choice of annuity investments is limited to those permitted by the issuer of the contract, while there may be no choice whatsoever in other insurance contracts. An annuity investment involves expenses (paid by the investor) that do not exist for other types of investments.

---

**Employer-sponsored retirement plans**

When you retire, you’ll have to decide what to do with the assets in any retirement plan—such as a 401(k) or 403(b)—that your employer offers. Carefully consider the options:

- **Leave the assets in the plan.** This may seem the most convenient option, but some employers restrict your ability to move the assets after a certain period of time. And you might decide later that you want to invest in funds or securities that are not offered by the plan.

- **Take the assets in cash.** This is almost always a poor choice because you will have to pay income taxes on the distribution (and a 10% penalty tax if you are not yet age 59½). Even if you invest the distribution, you will have lost the tax deferral offered by the plan.

- **Move the assets to an IRA.** This enables you to invest in the securities of your choice and to maintain the tax-deferred status of the investment. In addition, you could then convert some or all of the assets to a Roth IRA, which offers the possibility of tax-free withdrawals later in your retirement. Make sure you move the assets to an IRA by using a direct rollover, which means the assets go directly from the employer’s plan to the IRA and you never take possession of them. That way, you’ll avoid any tax withholding or liability that could result from moving the assets.

Many retirees choose to roll retirement plan assets into an IRA in part because it allows them to consolidate their investments with a single company. The consolidation simplifies their financial affairs, allowing them to look at just one statement for an overview of their tax-deferred (or tax-free) and taxable accounts. They can quickly track their asset allocation and evaluate how their investment plan is working. Another benefit is that they receive fewer IRS 1099 tax forms, so tax preparation is simpler.
**Using your investments during retirement**

Most people will need to draw from their retirement assets at least occasionally after they retire—and some will need to spend some principal regularly. Use [Worksheet 4](#) to calculate the total value of your retirement assets. If you calculated a shortfall at the end of [Worksheet 3](#), then go on to determine what percentage of your retirement assets you will need to withdraw to make ends meet during the first year of your retirement.

### Worksheet 4

**Your retirement investments**

**Taxable accounts**

<table>
<thead>
<tr>
<th>Short-term investments</th>
<th>Bank accounts</th>
<th>$ __________________________</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Money market funds</td>
<td>$ __________________________</td>
</tr>
<tr>
<td></td>
<td>Certificates of deposit</td>
<td>$ __________________________</td>
</tr>
<tr>
<td></td>
<td>U.S. Treasury bills</td>
<td>$ __________________________</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Long-term investments</th>
<th>Stocks</th>
<th>$ __________________________</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Bonds</td>
<td>$ __________________________</td>
</tr>
<tr>
<td></td>
<td>Stock mutual funds</td>
<td>$ __________________________</td>
</tr>
<tr>
<td></td>
<td>Bond mutual funds</td>
<td>$ __________________________</td>
</tr>
</tbody>
</table>

**Employer-sponsored plans**

<table>
<thead>
<tr>
<th>Keogh accounts</th>
<th>$ __________________________</th>
</tr>
</thead>
<tbody>
<tr>
<td>Employer savings plans such as 401(k) or 403(b)</td>
<td>$ __________________________</td>
</tr>
<tr>
<td>Pension (lump-sum value)</td>
<td>$ __________________________</td>
</tr>
</tbody>
</table>

**Individual retirement accounts**

<table>
<thead>
<tr>
<th>Traditional IRAs</th>
<th>$ __________________________</th>
</tr>
</thead>
<tbody>
<tr>
<td>Rollover IRAs</td>
<td>$ __________________________</td>
</tr>
<tr>
<td>Roth IRAs</td>
<td>$ __________________________</td>
</tr>
</tbody>
</table>

**Annuities and other insurance contracts**

| Accumulated value of annuity | $ __________________________ |
| Cash value of life insurance | $ __________________________ |

**Total value of retirement assets**

$ __________________________

\[
\text{Annual shortfall (from Worksheet 3)} + \frac{\text{Total assets}}{= \text{Share of assets needed to make up shortfall (as decimal figure)}}
\]

\[
\text{Percentage of assets needed to make up shortfall (multiply the decimal figure by 100)} = \frac{\text{Annual shortfall (from Worksheet 3)} + \frac{\text{Total assets}}{= \text{Share of assets needed to make up shortfall (as decimal figure)}}}{\times 100} = \frac{\text{Annual shortfall (from Worksheet 3)} + \frac{\text{Total assets}}{= \text{Share of assets needed to make up shortfall (as decimal figure)}}}{\times 100}
\]

---

17
Your financial fitness for retirement

Now that you've determined how much of your expenses will be covered by ongoing income such as Social Security and pensions, you can determine how financially ready you are for retirement. Figure 7 on page 19 measures your financial fitness and offers some preliminary suggestions on how you should invest your assets to reduce the risk of running out of money during retirement. (The guidelines on this page are not definitive.)

You also need to think about what types of investments are suitable for you, given your attitudes about investing and your personal financial situation. Those issues will be addressed later in this booklet, with the Investor Questionnaire on page 26. In choosing a mix of investments, don't forget these very important caveats:

- **Nothing is certain in the financial world.** Your expenses could rise much faster than anticipated, and your investment returns could be very small gains or out-and-out losses. The less you withdraw from your investments, the better off you'll be.

- **Your investments must offset the inflation damage done to income that isn't adjusted for inflation.** If your traditional pension pays $40,000 a year and inflation is running 5% a year, then next year your investments will have to provide $2,000 (5% of $40,000) to maintain your purchasing power.

- **Retirees need to monitor their personal finances regularly and adjust as needed.** While it's okay for the size of your portfolio to shrink a little in some bad market years, in general it should be growing some during early retirement to offset inflation over the long term. If your portfolio is shrinking regularly, then you need to adjust—perhaps by cutting your spending or returning to work.

The guidelines in Figure 7 are based on the expectations that the portfolio is needed for 30 years, that withdrawals will increase with inflation, and that principal will (eventually) be spent at higher withdrawal rates. Don't forget that you'll have to pay taxes on most withdrawals. If you plan to retire early, you should reduce the percentage you withdraw so that your portfolio will last longer.

Retiring with surplus income

If you have a surplus, that's good news, but remember that the surplus may not endure. Your retirement expenses could grow faster than your ongoing income, forcing you to withdraw money from your investments at some point in the future. Whether you will need to tap your investments depends on two main factors:

- **The size of your surplus.** The greater your surplus, the less likely you are to need to tap your investments later on.

- **The amount of income that is adjusted for inflation.** The greater the percentage of your income that is adjusted for inflation, the less likely you are to need to withdraw money from your investments in the future.
If you have a substantial surplus and significant investments, then you probably need to be more concerned about estate planning than about retirement planning. But you may want to continue the retirement-planning process if only to reassure yourself and your spouse about the strength of your retirement finances.

**Make your investments last**

A very simple way to think about how much you will be able to withdraw from your investments each year is to compare the expected total return on your portfolio with the anticipated rate of inflation. For instance, if your portfolio returned 8% last year and inflation totaled 3%, you could withdraw up to 5% of your portfolio without losing ground to inflation.

---

### Using your retirement investments

Rates of withdrawal are based on those calculated in Worksheet 4.

<table>
<thead>
<tr>
<th>Rate of Withdrawal</th>
<th>Your Financial Fitness</th>
</tr>
</thead>
<tbody>
<tr>
<td>0%</td>
<td>You are in excellent shape and have a lot of flexibility in choosing an asset allocation. Keep in mind that some income won’t keep up with inflation, so you may need to tap your investments at some time in the future.</td>
</tr>
<tr>
<td>1% - 2%</td>
<td>You are in very good shape, with a lot of flexibility in choosing an asset allocation. Keep in mind that some sources of income won’t keep up with inflation, so your withdrawals will have to increase to make up for the damage done by inflation to the value of your withdrawals and to the value of any fixed income such as pensions.</td>
</tr>
<tr>
<td>3%</td>
<td>You’re in okay shape. You’ll need to have at least 10% to 35% of your investments in stocks to keep pace with inflation. Keep in mind that you’ll need to monitor your portfolio carefully in retirement. You may have to cut spending or return to work if investment returns are low or inflation is high. Some retirees would find this situation uncomfortable.</td>
</tr>
<tr>
<td>4%</td>
<td>You’re close to the limit of safe withdrawals. At least 50% of your portfolio should be in stocks. During retirement, you’ll need to monitor your portfolio very carefully. Be prepared to adjust spending or even return to work if investment returns are low and/or inflation is high early in retirement. Keep in mind that your portfolio will eventually be shrinking as you spend principal. Many retirees would find this situation uncomfortable.</td>
</tr>
<tr>
<td>5%</td>
<td>You’re at the outer limit of acceptable levels of withdrawals. You’ll need to have 80% to 100% of your portfolio in stocks—a level that few retirees would find comfortable. You’ll be depleting principal from the start, and you still need to monitor your situation very carefully. Most people would find this very uncomfortable, and they’ll probably want to postpone retirement until their situation improves.</td>
</tr>
<tr>
<td>6% or more</td>
<td>You probably should not retire yet. Look for ways to save and invest more. Consider reducing your spending during retirement. In many cases, postponing retirement means that your Social Security and traditional pension benefits will increase—helping to make up your shortfall.</td>
</tr>
</tbody>
</table>
If you expect to be making regular withdrawals from your retirement investments, there are two important facts to keep in mind:

- The less you withdraw each year, the longer your portfolio is likely to last.
- The higher your investment returns, the longer your portfolio is likely to last.

Of course, the rate of inflation varies substantially from year to year and even decade to decade, so the amount you need to withdraw each year can rise significantly and unexpectedly. When inflation is running at a high rate, it can quickly erode the value of your investments. The returns on stock and bond investments are similarly unpredictable. The timing of major market moves—up or down—can have a big effect on your retirement security. It’s important to build a margin of safety into your retirement planning and to monitor the performance of your plan periodically as you approach retirement.

**Inflation and investment returns**

This section illustrates how two similar retirement plans can provide very different results. In both cases, the retiree withdrew investments at an aggressive rate—6% in the first year and then an amount of equal value after adjusting for inflation. In the first case, the result was a disaster for the retiree; in the second case, the retiree was very, very lucky.

The first case is Dennis, who retired at the end of 1972. Inflation was running high at the time, and the stock market plunged almost 40% in 1973–1974. Dennis had assumed that he could withdraw $18,000 (6% of his $300,000 portfolio invested half in stocks and half in bonds in tax-deferred accounts such as IRAs) in the first year of retirement and an amount equal in value (after adjustment for inflation) in each subsequent year. As you can see in Figure 8, Dennis exhausted his portfolio in 1985. Of course, Dennis likely would have returned to work, cut back on spending, or somehow adjusted his lifestyle to prevent such a dire outcome. But the example does make clear the terrific damage that poor market returns and inflation can have on an investor early in retirement—especially when the investor is withdrawing assets at an aggressive rate.

![Figure 8](image-url)

**How Dennis fared in retirement**

Value of $300,000 retirement portfolio in tax-deferred accounts at the end of each year. Initial withdrawal is $18,000 (6% of portfolio); subsequent withdrawals are adjusted for inflation. Assets are split 50–50 between stocks and bonds.
Now consider the case of Sandy, who had the good fortune to retire at the end of 1982—early in one of the greatest bull markets in U.S. history and in a period of relatively benign inflation, as shown in Figure 9. The value of her portfolio was equal to the value of Dennis's after adjustment for inflation over the years, and it was also invested half in stocks and half in bonds. Sandy, too, assumed she could safely withdraw 6% from her portfolio in the first year of retirement and an equal inflation-adjusted amount in subsequent years.

Instead of seeing her portfolio wiped out within 13 years, Sandy actually saw it grow faster than inflation—even after taking her withdrawals each year. Thanks to extraordinarily favorable stock and bond market conditions and low inflation, her inflation-adjusted withdrawal amounted to a little more than 2% of the value of her portfolio by 2000.

The point of this comparison isn't that your retirement experiences will match those of either Dennis or Sandy. Dennis faced an unusually difficult mix of high inflation and poor market returns, while Sandy enjoyed a highly favorable mix of low inflation and extremely good market returns. Your experience is likely to fall somewhere between those two cases—but it could also be more extreme.

One reasonable conclusion is that it's prudent to make conservative initial projections about investment returns (assume they'll be lower than historical averages) and inflation (assume it will be higher than historical averages). Once you've retired, you will need to regularly reassess your projections about investment returns and inflation. If the markets have performed poorly, you may want to reduce the amount of your annual withdrawals. This is especially true in the first ten years of retirement, when poor investment returns and excessive withdrawals can permanently damage your retirement investments—as shown in Dennis's case.

As a rule of thumb, you might consider limiting your initial withdrawal to no more than 3% to 5% of a portfolio that you want to last 30 to 35 years after you retire. The dollar amount you withdraw would then be adjusted each year to compensate for inflation, and it might become either a higher or lower percentage of your portfolio in future years. If the percentage rises, then it's time to think about cutting back on your spending.
Investments to offset inflation

When retirement is many years away, investors are often willing to take investment risks, because there's time to overcome any downturns in the market. In addition, they know that they won't soon be dependent on those assets to meet day-to-day expenses, so fluctuations are easier to accept. Indeed, market downturns are sometimes viewed as opportunities to buy securities “on sale.” Finally, investors who are still accumulating assets could reduce or delay expenditures and use those savings to bolster their investment portfolios to offset declines in the markets.

Not surprisingly, investors who are close to retirement or in retirement tend to be more risk-averse than those with many years to go. They're afraid of meeting a fate similar to the one that befell Dennis in the 1970s and early 1980s. You may have friends or colleagues who believe that retirees shouldn't invest in stocks and that they should invest only in income-producing securities such as bonds. But you should be careful about such a strategy—investing strictly for income or yield limits how hard your investments can work for you.

Most Americans who retire in the next few years can expect to live many years in retirement, so their investments will need to hold up well over time. Even a low rate of inflation can severely damage the purchasing power of assets over long periods, so it's important to invest with an eye on inflation. The best financial investment for protecting people against inflation has historically been stocks, so most, or perhaps all, retirees should have a meaningful portion of their assets invested in the stock market.

Figure 10 shows the total returns for the three major asset classes from 1926 through 2000, both before and after adjusting for the average annual inflation rate (3.1%) over that period. The returns on bonds and cash investments have historically been far lower than the investment return on stocks. A comparison of total real returns (the returns after adjusting for inflation) shows the advantage of stock investing even more dramatically. If you regularly withdraw more than the total real return earned by your portfolio, then you will be systematically reducing the value of your retirement investments.

<table>
<thead>
<tr>
<th>Inflation reduces real returns</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Cash investments (Treasury bills)</strong></td>
<td><strong>3.9%</strong></td>
</tr>
<tr>
<td><strong>Real return (inflation-adjusted)</strong></td>
<td><strong>0.8%</strong></td>
</tr>
<tr>
<td><strong>Bonds (long-term U.S. corporate)</strong></td>
<td><strong>5.6%</strong></td>
</tr>
<tr>
<td><strong>Real return (inflation-adjusted)</strong></td>
<td><strong>2.5%</strong></td>
</tr>
<tr>
<td><strong>Stocks (S&amp;P 500 Index)</strong></td>
<td><strong>11.0%</strong></td>
</tr>
<tr>
<td><strong>Real return (inflation-adjusted)</strong></td>
<td><strong>7.9%</strong></td>
</tr>
</tbody>
</table>

Stock and bond investments can fluctuate in value. Unlike stocks and bonds, Treasury bills are guaranteed to pay interest and principal in a timely fashion. Past performance is no guarantee of future results.

Source: The Vanguard Group.
To many investors approaching retirement, the idea of spending some investment principal—as opposed to spending just investment income—is almost unthinkable. But keeping ahead of inflation during retirement requires investing in stocks, which fluctuate in value. As your investments fluctuate, you probably will need to spend some principal, at least in some of the market’s down years. If you manage your finances carefully, the spending of some principal is not only acceptable, it will be a positive factor in helping you enjoy a comfortable retirement.

**Stocks as a source of rising income**

Another reason, often-overlooked, for having stocks in your retirement portfolio is that they provide steady dividend income that has tended to increase over time. In fact, the dividend income provided by an investment in the stocks of the S&P 500 has increased an average of 4.6% a year since 1926—a period in which inflation averaged 3.1% a year. The growth in stock dividend income has, in the past, offset the long-term effects of inflation.

The actual amount of dividends paid has continued to increase in recent years, even though the dividend yield on an S&P 500 investment has fallen to around 1%. The yield (the value of the dividends expressed as a percentage of stock prices) has dropped only because stock prices rose so rapidly in the 1990s. Of course, dividends may increase at a much slower rate in future years—and it’s possible they could even decline. There could also be periods when inflation outpaces increases in stock dividends.

**Bonds with inflation protection**

One alternative to holding traditional bonds and stocks is to invest in the U.S. Treasury’s inflation-indexed securities. These investments are the only ones guaranteed by the U.S. government to maintain their real (inflation-adjusted) value over both the short and long runs.

The interest rate paid on an inflation-indexed security is constant over the life of the bond, but the principal is adjusted semiannually to reflect changes in the level of consumer prices. In periods of rising prices (inflation), the principal of an inflation-indexed security will increase. This means the interest payments will also rise because they are based on a larger principal amount. As a result, the buying power of the interest payments and principal should remain steady even during periods of rapid inflation. The amount of the increase in principal is taxable as ordinary income in the year of the adjustment—even though you won’t receive that principal until the bond matures. Because of that, some people may decide that they prefer to hold inflation-indexed securities in an IRA rather than a taxable account.

Of course, prices don’t always rise. In a period of deflation (falling prices), the principal amount of an inflation-indexed security will be reduced. However, when the principal amount is repaid at maturity, the investor receives the larger of the inflation-adjusted principal or the face amount—even if deflation has reduced the adjusted principal amount to a sum that is less than the security’s face amount.
Allocating Your Assets

As you approach retirement, the time when you will spend some of your investments is also drawing near. When you retire, you’ll no longer have the options of putting off expenditures or offsetting a decline in the markets by increasing the amount you save.

What’s the right mix of investments—stocks, bonds, and cash investments—as you approach retirement? The answer varies for every individual. But four key factors should be considered in determining how you allocate your assets:

- Your investment objective. The objective is to pay for a comfortable, secure retirement. Unless your retirement lifestyle plans change dramatically between now and the day you retire, this should remain fairly constant.

- Your time horizon. This can be thought of as your average life expectancy (plus a cushion of several years) from the date of your retirement, something that, again, should not change significantly.

- Your risk tolerance. Many people do become more risk-averse when they retire, but if you are becoming much less tolerant of risk, then you should consider whether you have enough set aside for retirement.

- Your personal financial situation. This factor may be changing more than the others—but the net effect may not be terribly great. You will no longer collect a salary after you retire, but you will begin collecting Social Security and, perhaps, a pension. You may lose some benefits provided by your employer, but you will become eligible for Medicare and other programs.

The process of preparing a retirement budget should give you a good idea of how much money you will need to draw from your investments each year during retirement. It’s wise to be cautious in considering this aspect of your finances— inflation could take a greater-than-expected toll, and unexpected expenses will probably occur.

Many people, especially those investing for a retirement that is many years away, think of retirement as a single goal. Now that you’re just a few years (or less) from retiring, it’s clear that retirement isn’t really a single goal. You need to pay your expenses in the short term as well as in the distant years of later retirement. To simplify your planning, you might use your average life expectancy plus several years as your investment time horizon. This means you are still investing for the long run—so there may actually be little reason to make big changes to your investment strategy as you approach retirement.
Your ability to tolerate risk—to stay the course during periods of market volatility—may be even more important during retirement than it was when you were saving for retirement. When you retire, you’ll be entering a financial situation that’s quite different from the one you’re in now. Think carefully and honestly about how you might react to market turmoil when your working days are over.

Finally, your personal financial situation—sources of income, total assets available, major upcoming expenses, and your investment experience—is an additional element to consider. The strength of your finances will go a long way in determining how you manage your investments.

If it seems difficult to balance all the factors needed to determine an appropriate asset allocation, the Investor Questionnaire on pages 26 and 27 can help. The questionnaire and the sample portfolios on the following page take those four factors into account and can offer some guidance in developing an investment portfolio that’s appropriate as you approach retirement.
Investor Questionnaire

This questionnaire is designed to help you choose an appropriate asset allocation strategy for your retirement investments. (Our Investor Questionnaire is not designed for goals that would require you to spend all of your money for the goal in two years or less. Savings for such short-term objectives should be invested in stable investments—primarily cash investments like money market funds.)

Answer the questions below, then add up your points and record the number at the bottom of page 27. Now match the total points with one of the asset allocations suggested on page 28. Once you have decided on an asset allocation, you can begin to consider specific mutual funds.

1a. I plan to begin taking withdrawals from this portfolio in . . .
   a. Less than 1 year (0 points)
   b. 1 to 2 years (1 point)
   c. 3 to 5 years (4 points)
   d. 6 to 10 years (7 points)
   e. 11 to 15 years (12 points)
   f. More than 15 years (17 points)

   Points: __________

1b. I plan to spend the money in this portfolio over a period of . . .
   a. 2 years or less (0 points)
   b. 3 to 5 years (1 point)
   c. 6 to 10 years (3 points)
   d. 11 to 15 years (5 points)
   e. More than 15 years (8 points)

   Points: __________

2. When making a long-term investment, I plan to hold the investment for . . .
   a. 1 to 2 years (0 points)
   b. 3 to 4 years (1 point)
   c. 5 to 6 years (3 points)
   d. 7 to 8 years (5 points)
   e. 9 or more years (7 points)

   Points: __________

3. In October 1987, stocks fell more than 20% in one day. If I owned an investment that fell by 20% over a short period, I would . . . [if you owned stocks in October 1987, select the answer that corresponds to your actual behavior]
   a. Sell all of the remaining investment (1 point)
   b. Sell a portion of the remaining investment (3 points)
   c. Hold the investment and sell nothing (5 points)
   d. Buy more of the investment (6 points)

   Points: __________

4. Generally, I prefer investments with little or no fluctuation in value, and I am willing to accept the lower returns associated with these investments.
   a. I strongly agree (0 points)
   b. I agree (1 point)
   c. I somewhat agree (3 points)
   d. I disagree (5 points)
   e. I strongly disagree (6 points)

   Points: __________

5. When the market goes down, I tend to sell some of my riskier assets and put the money in safer assets.
   a. I strongly agree (1 point)
   b. I agree (2 points)
   c. I somewhat agree (3 points)
   d. I disagree (4 points)
   e. I strongly disagree (5 points)

   Points: __________

6. I would invest in a mutual fund based solely on a brief conversation with a friend, coworker, or relative.
   a. I strongly agree (1 point)
   b. I agree (2 points)
   c. I somewhat agree (3 points)
   d. I disagree (4 points)
   e. I strongly disagree (5 points)

   Points: __________

7. During the first half of 1994, some bond investments fell more than 10%. If I owned an investment that fell by 10% over a short period of time, I would . . . [if you owned bonds during the first half of 1994, select the answer that corresponds to your actual behavior]
   a. Sell all of the remaining investment (1 point)
   b. Sell a portion of the remaining investment (3 points)
   c. Hold the investment and sell nothing (5 points)
   d. Buy more of the investment (6 points)

   Points: __________
8. The chart below shows the greatest one-year loss and the highest one-year gain on three different hypothetical investments of $10,000.* Given the potential gain or loss in any one year, where would you invest your money?

a. Fund A (1 point)
b. Fund B (3 points)
c. Fund C (5 points)

Points: 

<table>
<thead>
<tr>
<th>Fund A</th>
<th>Fund B</th>
<th>Fund C</th>
</tr>
</thead>
<tbody>
<tr>
<td>$4,500</td>
<td>$1,921</td>
<td>$4,229</td>
</tr>
<tr>
<td>$3,000</td>
<td>$1,020</td>
<td></td>
</tr>
<tr>
<td>$1,500</td>
<td>$6593</td>
<td></td>
</tr>
<tr>
<td>0</td>
<td>$-164</td>
<td></td>
</tr>
<tr>
<td>-1,500</td>
<td></td>
<td></td>
</tr>
<tr>
<td>-3,000</td>
<td></td>
<td></td>
</tr>
<tr>
<td>-4,500</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

*The maximum gain or loss on an investment is impossible to predict. The ranges shown in the chart are hypothetical and are designed solely to gauge an investor’s risk tolerance.

9. My current and future income sources (such as salary, Social Security, pension plans) are . . .

a. Very unstable (1 point)
b. Unstable (2 points)
c. Somewhat stable (3 points)
d. Stable (4 points)
e. Very stable (5 points)

Points: 

10. When it comes to investing in stock or bond mutual funds (or individual stocks or bonds), I would describe myself as a/an . . .

a. Very inexperienced investor (1 point)
b. Somewhat inexperienced investor (2 points)
c. Somewhat experienced investor (3 points)
d. Experienced investor (4 points)
e. Very experienced investor (5 points)

Points: 

Add your points, and record the total point score below.

Your asset allocation strategy

Based on your total point score, select a suggested mix of asset classes from the table on page 28. The asset mix indicated by your score is only a suggestion, and you still might reasonably select a different mix, one with slightly higher or lower risk. Record your choice in the space below since you’ll need to refer to it when you select specific funds.

<table>
<thead>
<tr>
<th>Total Point Score</th>
<th>Asset Allocation</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>% stocks</td>
</tr>
<tr>
<td></td>
<td>% bonds</td>
</tr>
<tr>
<td></td>
<td>% cash investments</td>
</tr>
</tbody>
</table>
Choose an asset allocation strategy according to your score*

<table>
<thead>
<tr>
<th>Your Total Point Score</th>
<th>Suggested Allocation**</th>
<th>Average Annual Return (1926 - 2000)</th>
<th>Worst Annual Loss (1926 - 2000)</th>
<th>Number of Years With a Loss (1926 - 2000)</th>
<th>Types of Funds to Include in Your Portfolio</th>
</tr>
</thead>
<tbody>
<tr>
<td>69–75 points</td>
<td>100%</td>
<td>11.0%</td>
<td>- 43.1%</td>
<td>21 of 75</td>
<td>Stock funds: Actively managed growth or value funds, or index funds that track the total stock market or segments of it.</td>
</tr>
<tr>
<td>59–68 points</td>
<td>20% 80%</td>
<td>10.3%</td>
<td>- 34.9%</td>
<td>20 of 75</td>
<td>Bond funds: Actively managed short-, intermediate-, or long-term corporate, government, or tax-exempt funds, or index funds that track the total bond market or segments of it.</td>
</tr>
<tr>
<td>51–58 points</td>
<td>40% 60%</td>
<td>9.3%</td>
<td>- 26.6%</td>
<td>18 of 75</td>
<td>Money market funds: Actively managed taxable or tax-exempt funds that invest in cash investments issued by governments, corporations, banks, or other financial institutions.</td>
</tr>
<tr>
<td>40–50 points</td>
<td>50% 50%</td>
<td>8.8%</td>
<td>- 22.5%</td>
<td>16 of 75</td>
<td>Balanced funds: Actively managed or index funds that hold a mix of stocks, bonds, and (sometimes) cash investments. This type of “all-in-one” fund can automatically maintain your target asset allocation through a single investment.</td>
</tr>
<tr>
<td>32–39 points</td>
<td>60% 40%</td>
<td>8.2%</td>
<td>- 18.4%</td>
<td>16 of 75</td>
<td>**Cash investments are represented by U.S. Treasury bills, bonds by long-term U.S. corporate bonds, and stocks by the S&amp;P 500 Index. **</td>
</tr>
<tr>
<td>23–31 points</td>
<td>80% 20%</td>
<td>7.0%</td>
<td>- 10.1%</td>
<td>13 of 75</td>
<td>Source: The Vanguard Group.</td>
</tr>
<tr>
<td>7–22 points</td>
<td>10% 10% 80%</td>
<td>6.2%</td>
<td>- 6.7%</td>
<td>10 of 75</td>
<td>Note: The returns shown include the reinvestment of income dividend and capital gains distributions; they do not reflect the effects of investment expenses and taxes.</td>
</tr>
</tbody>
</table>

*These are sample portfolio allocations only. Depending on your tolerance for risk or your individual circumstances, you may wish to choose an allocation that is more conservative or more aggressive than the model suggested by your score. Keep in mind that these allocations are for longer-term financial goals. You may very well hold cash investments for shorter-term goals and emergencies.

**Cash investments are represented by U.S. Treasury bills, bonds by long-term U.S. corporate bonds, and stocks by the S&P 500 Index.
Maintaining an emergency fund

Many experts recommend that you set aside an emergency fund equal to three to six months of your living costs (depending on your circumstances) to protect against unforeseen expenses or a loss of income. While key sources of retirement income are very secure (Social Security and pensions) unforeseen expenses cannot be avoided. During retirement, some people use an emergency fund to ride out downturns in the financial markets so they don’t have to sell assets at a depressed price.

Such a financial cushion should be placed in a safe, accessible investment such as a money market fund* unless you have substantial total assets. Some people rely on a home-equity line of credit for an emergency fund. They are then able to invest the money that would have been held in an emergency fund more aggressively—in stock or bond funds that are likely to provide higher long-term returns.

Whether you choose to maintain an emergency fund—and how big that fund is—depends on your personal situation. If you have very stable retirement income, then you may choose not to have a fund. But if your income is not stable, then you might feel more comfortable maintaining one.

*An investment in a money market fund is not insured or guaranteed by the Federal Deposit Insurance Corporation or any other government agency. Although a money market fund seeks to preserve the value of your investment at $1 per share, it is possible to lose money by investing in such a fund.

Choosing an asset allocation

After you complete and score the questionnaire, review the historical returns and losses shown in Figure 11 on page 28. For example, if your score was between 40 and 50, the asset allocation is 50% stocks and 50% bonds. The average annual return for this asset allocation was 8.8% from 1926 through 2000. During this period, the worst annual return was a loss of 22.5%, and losses occurred in 16 of the 75 years.

Before investing to achieve any of the suggested asset allocations, make sure you’re comfortable with the number and severity of the short-term losses that such an allocation has suffered in the past. But keep in mind that past investment performance is no guarantee of future results—your experience could be better or worse than what happened in the past. If the asset mix suggested by your score on the questionnaire would cause you to worry or to lose sleep, you should choose a less aggressive allocation. You may prefer to put some assets in cash investments for greater stability—or perhaps to ride out a one- or two-year downturn in the financial markets without selling longer-term investments. Alternatively, your personal finances may be strong enough that you decide on a more aggressive allocation.

In selecting an asset allocation for the few years you have until retirement, consider the choices from two perspectives:

- **Which portfolios are likely to provide adequate returns, given the assets available and my need for income?** This is the issue addressed in Figure 7, “Using your retirement investments,” on page 19.
- **Which portfolios have a level of risk and volatility that I can live with?** This is the issue addressed in the Investor Questionnaire on pages 26 and 27.

If no portfolio makes both lists, then you may want to postpone or rethink retirement. A portfolio that will provide the returns needed, but at an unacceptable level of volatility, is one that could cause discomfort during periods of market turmoil, perhaps causing you to abandon that allocation for one that provides adequate returns. And any portfolio that provides inadequate returns will fail to achieve your goal—in this case adequate resources to pay for a comfortable retirement. That’s a serious failure for someone about to retire.

Monitoring your asset allocation

The Investor Questionnaire and sample portfolios suggest an initial asset allocation. As the years go by, you should review your finances annually to ensure that you’re still comfortable with your asset allocation. You may also want to complete the Investor Questionnaire every couple of years—especially after significant life changes such as your retirement.

Fluctuations in the financial markets may also necessitate a reassessment of your portfolio. For example, because of a bull market, you may find that your planned mix of 60% stocks and 40% bonds has become 75% stocks and 25% bonds. If so, you should probably modify the percentage holdings of stocks and bonds to bring
your allocation back to your target. If you don’t make adjustments, you could end up with higher total returns over time—but your portfolio would be significantly riskier than you intended.

Until you retire, you can reallocate assets by making new investments in the asset class you wish to augment, by reinvesting all dividend and capital gains distributions in that asset class, or by selling investments in one asset class and using the proceeds to build up the other. Keep in mind that selling assets in taxable accounts could result in a tax liability.

Once you have retired, you can also reallocate by selling investments in the asset class that’s over-represented in your portfolio and using the proceeds to meet expenses. The next section will discuss some of the issues involved in pursuing such a strategy.

**Which investments should you spend first?**

Many people approaching retirement are concerned about which investments they should spend first to meet expenses in retirement. Should they use assets in taxable accounts first? Or traditional IRAs? Or assets in some other type of account?

The answer will vary, depending on your circumstances and the type of investment involved. In general, Vanguard suggests spending assets in taxable accounts first, then assets in tax-deferred accounts, and, finally, assets in tax-free Roth IRAs. (You’ll likely spend less—or even nothing—from taxable accounts when you begin taking required minimum distributions from your tax-deferred accounts.)

First, you will already be paying income taxes on the earnings you’ll receive from your taxable account, so you won’t increase your tax bill by spending those income and capital gains distributions. In addition, any taxable retirement plan distribution is treated as ordinary income and taxed at rates up to 39.6%, compared with a maximum of 20% on long-term capital gains in a taxable account. Taking $10,000 out of a 401(k) plan could leave you, after taxes, with just over $6,000 to spend. But selling an asset that you’ve held longer than a year in a taxable account will leave you more than $8,000 since only the increase in the asset’s price is taxable and then at a lower rate (no more than 20%). Finally, by postponing the use of retirement-plan assets, you will enable them to grow without being taxed for a longer period—keeping more of your investments at work for you.

If you want to avoid spending assets in a retirement plan, you may find that you have to sell some taxable investments and spend the principal to make ends meet. Some retirees dislike the idea of spending any principal, but it’s all right if it’s done prudently. Once you retire, don’t forget that the purpose of your retirement investments was to enable you to enjoy a comfortable, secure retirement. Spending some principal can help you accomplish that.
Improving your financial situation

When you complete your retirement plan, you may decide that you can't yet afford to retire. Don't despair: A number of factors can quickly improve your finances as you near retirement.

Consider Doris and Ed, a couple who were both 62 years old in 2000 and had a combined income of $90,000 a year. They figured they would need $80,000 a year during retirement and would be comfortable taking 3% each year from their retirement investments, which totaled $1 million. Doris and Ed together can begin collecting a total of $25,000 a year in pensions from earlier jobs when they turn 65—the age at which they hope to retire. (The pension plans' rules prevent them from collecting benefits before age 65.) As part of their retirement planning, they calculated what their income would be at different retirement ages, from 62 through 70.

First they estimated their annual Social Security payments based on a full retirement benefit of $18,000 a year (which they can begin collecting after they turn 65 years old), as shown in Figure 12. Then they estimated the value of their retirement savings and how much a 3% withdrawal would be. They each were contributing $2,000 a year to IRAs and 10% of their salaries to 401(k) plans. (Their employers each were contributing 3% to those plans.) Given their mix of investments, they believed it was reasonable to expect a total return of about 6% a year.

If Doris and Ed retired a few months after reaching age 62, they would have had combined income (including the 3% withdrawal from their investments) of $44,400—far less than what they needed. By waiting until age 65, they would have a combined income (including the 3% withdrawal) of $80,230, including the $25,000 in pensions that they can begin collecting at that age. The picture improves even more if they delay their retirement; for instance, at age 67, they could expect more than $88,000 a year.

Of course, postponing retirement wasn't the only way Doris and Ed could have improved their financial situation. After leaving their current jobs, they could have taken on part-time work (although that might affect their Social Security benefits) or they could have adopted a less expensive lifestyle—perhaps with fewer or cheaper vacations. Another option would have been to move to a less expensive home, perhaps using some of the proceeds from the sale of their current home to bolster their retirement savings. Such options are worth keeping in mind during retirement. When the financial markets suffer a severe downturn, many retirees will want to shore up their savings or reduce their expenses, at least for a while.
If you hope to retire within the next five years, you should start planning now. Careful preparation is the way to ensure a smooth transition to a comfortable and fulfilling retirement. Here are some issues to address as you pass various milestones on the road to retirement.

**Five years to go**

Think about what you want to do in retirement. If you are married, discuss those plans in detail with your spouse. With retirement only a few years away, you should have a very good idea of how you’d like to spend retirement—and what those plans will cost. Once you have planned your retirement lifestyle, it's easier to prepare an expense budget such as the one outlined in Worksheet 1 on page 7. As you prepare a budget, don't forget to factor in inflation. Keep in mind that any hobbies you now pursue infrequently (such as travel) may end up being very expensive if you indulge in them more often.

Check with current and former employers about the amount of any pension benefits you’ll be due during retirement, as well as the distribution options you’ll have. Review and save the annual benefits statement provided by the Social Security Administration. Compare your ongoing sources of income with your expected retirement expenses to determine how much you’ll need to draw from investments each year. You can then evaluate the adequacy of your investment portfolio and make a preliminary estimate of when you’ll actually be able to retire. If there's a shortfall and you haven't been contributing the maximum to any employer-sponsored retirement plans or to your IRA, now's the time to increase those contributions as much as you can.

Compare your insurance needs with any retirement benefits your employer will provide, and decide what additional coverage, if any, you will need to purchase on your own. In some cases, such as long-term care insurance, it may be wise to purchase coverage before you retire because the premiums will be significantly lower.

If you are thinking of moving to a new area when you retire, plan to take some vacations there at various times of year so that you can make sure the area is really right for you. While you're there, do some research on state and local taxes so you can understand how they’ll affect your retirement plans. Periodically review your retirement preparations—perhaps once a year—and adjust them as necessary. The financial markets and your personal situation can change significantly in a short period of time, and that could warrant significant revisions in your retirement plans. During one of these periodic reviews, you’ll realize that you can afford to retire within one year.

---

**Some Concluding Thoughts**

Fact: The more money you spend now, the more you’re likely to spend after you retire. Retirees with incomes of $70,000 or more spend as much as they did when they were still working.

— Bureau of Labor Statistics
One year to go

With retirement just a year away, contact your employer’s benefits manager to begin paperwork and to make a final evaluation of your retirement plan options. If you have a traditional pension, ask that the benefits be calculated based on different distribution options and several possible retirement dates. Postponing or moving up your retirement date just a few months could affect the amount of your monthly benefit.

Finalize your retirement budget, and make sure you’ve obtained all the additional insurance coverage you’ll need. (Review your Medigap insurance options and decide on the plan you’ll choose when you retire.) Apply for Social Security benefits three months before you want the payments to begin. You may decide not to begin collecting Social Security for months or even years after you leave the workforce so that your monthly benefit will be larger when you start to take it.

Pay off any loans from employer-sponsored retirement plans such as a 401(k). Once you leave your employer, any outstanding loan balance is usually regarded as a cash distribution that is taxable and, if you are not yet age 59½, subject to a 10% penalty tax.

While you are still covered by your employer’s medical and dental insurance, undergo any procedures or treatments that you may have been postponing.

Don’t forget that the act of retiring is one of those major life changes that require a thorough review of your estate plan. Your investment plan, however, should probably not change significantly because your investment goal, time horizon, and risk tolerance will remain basically the same.

Planning pays off

Careful planning is essential to safeguard a comfortable retirement. Too often people decide to leave their jobs after a few quick calculations that indicate they can replace their current income with a pension, Social Security, and some investment income. Those people frequently overlook future expenses that could have been easily predicted, or they fail to account for inflation or changes in investment performance. Sadly, that means they can’t really afford the retirement they wanted.

Sometimes retirees are able to make up a shortfall in income, but doing so is rarely pleasant. Closing an income gap may involve returning to work—possibly at jobs they really don’t enjoy. Or they may have to sell the home in which they raised their children, giving up a lifetime of memories for themselves and their families.

Creating and implementing a sound retirement plan is a complex undertaking. Given the stakes, it’s not surprising that many people have their plans reviewed by a trusted financial planning service.
A Vanguard Invitation

The Vanguard Group invites you to discover our wide range of programs and services that can help you develop and maintain a sound retirement plan. For information about Vanguard® funds and services, to learn more about investing, or to open an account online, visit our website at www.vanguard.com. There you'll find our complete Plain Talk® Library, Retirement Center, and our popular Education Center. Register for immediate secure access to our online investment-management center, and you can monitor your accounts, conduct transactions, trade securities, and invest in both Vanguard and non-Vanguard funds—24 hours a day.

Or you can speak with a Vanguard associate by calling us at 1-800-662-7447 on business days from 8 a.m. to 10 p.m. and on Saturdays from 9 a.m. to 4 p.m., Eastern time. Our associates are always pleased to answer your questions or provide information about our funds and services.

Retirement Resource Center 1-800-205-6189

A dedicated team of retirement specialists provides efficient, expert assistance for all retirement issues—selecting investments, managing IRAs, rolling over assets from employer-sponsored plans, designating beneficiaries, and more.

Vanguard® Personal Financial Planning Service 1-800-567-5162

At an affordable fee, this service offers customized one-time analysis and advice to help you plan for and meet your retirement goals. We can also help with investment and estate planning.

Vanguard® Asset Management and Trust Services 1-800-567-5163

Individuals who have a minimum of $500,000 in investable assets can receive comprehensive, ongoing wealth management services at a very reasonable fee. We can also act as your corporate trustee—serving your beneficiaries impartially and objectively.

Vanguard® Mutual Funds 1-800-662-7447

The Vanguard family of more than 100 mutual funds spans the entire spectrum of investment objectives—so you can build a complete investment program, whatever your financial goals.

Vanguard Brokerage Services® 1-800-992-8327

Through Vanguard Brokerage, you can invest in individual stocks, bonds, options, and more than 2,600 non-Vanguard mutual funds. You can open an account and trade on our website as well.

Voyager and Flagship Services

Vanguard offers special services for clients with substantial assets.

- **Voyager Service®,** for clients investing more than $250,000 in Vanguard mutual funds, offers the expert assistance of a special service team.

- **Flagship Service,** for clients whose Vanguard mutual fund investments exceed $1 million, offers personal service from a dedicated representative.

Eligible clients are invited to call Vanguard at 1-800-337-8476 for more information.
Vanguard® Variable Annuity Plan  1-800-522-5555

For investors who can benefit from an annuity's tax advantages, the Vanguard Variable Annuity Plan offers a wide variety of low-cost investment options and a selection of payout options.

Individual Retirement Plans  1-800-823-7412

Self-employed individuals and small-business owners can find out how to establish and administer retirement plans for themselves and/or their employees.
## A Listing of Vanguard® Funds

### Stock funds

#### Domestic

**General**
- 500 Index Fund
- Calvert Social Index™ Fund
- Convertible Securities Fund
- Equity Income Fund
- Growth and Income Fund
- Growth Index Fund
- M organ™ Growth Fund
- Strategic Equity Fund
- Tax-M anaged Capital
- Appreciation Fund
- Tax-M anaged G rowth and Income Fund

**Total Stock M arket Index Fund**
- U.S. Growth Fund
- U.S. Value Fund
- Value Index Fund
- W indso r™ Fund
- W indso r™ II Fund

**More aggressive**
- Capital O pportunity Fund
- Explorer™ Fund
- Extended M arket Index Fund
- G rowth E quity Fund
- M id-C ap Index Fund
- P R I M E C A P Fund
- Selected Value Fund
- Small-C ap G rowth Index Fund
- Small-C ap Index Fund
- Small-C ap Value Index Fund
- Tax-M anaged Small-C ap Fund

**Industry-specific**
- E nergy Fund
- G old and Precious M etals Fund
- H ealth Care Fund
- R E I T Index Fund
- U tilities Income Fund

**International/global**
- D eveloped M arket Index Fund
- E merging M arket Stock Index Fund
- E uropean Stock Index Fund
- G lobal E quity Fund
- International G rowth Fund
- International Value Fund
- Pacific Stock Index Fund
- Tax-M anaged International Fund
- Total International Stock Index Fund

### Bond funds

#### Taxable

**Short-term**
- Inflation-Protected Securities Fund
- Short-Term Bond Index Fund
- Short-Term Corporate Fund
- Short-Term Federal Fund
- Short-Term Treasury Fund

**Intermediate-term**
- G N M A Fund
- H igh-Yield C orporate Fund
- Intermediate-Term Bond Index Fund
- Intermediate-Term Corporate Fund
- Intermediate-Term Treasury Fund
- Total Bond M arket Index Fund

**Long-term**
- Long-Term Bond Index Fund
- Long-Term Corporate Fund
- Long-Term Treasury Fund

**Tax-exempt**
- H igh-Yield Tax-E xempt Fund
- Insured Long-Term Tax-E xempt Fund
- Intermediate-Term Tax-E xempt Fund
- L imited-Term Tax-E xempt Fund
- Long-Term Tax-E xempt Fund
- Short-Term Tax-E xempt Fund

**State-specific**
- C alifornia Insured Intermediate-Term Tax-E xempt Fund
- C alifornia Insured Long-Term Tax-E xempt Fund
- F lorida Insured Long-Term Tax-E xempt Fund
- M assachusetts Tax-E xempt Fund
- N ew Jersey Insured Long-Term Tax-E xempt Fund
- N ew York Insured Long-Term Tax-E xempt Fund
- O hio L ong-T erm Tax-E xempt Fund
- P ennsylvania Insured Long-T erm Tax-E xempt Fund

### Balanced funds

#### Domestic

**Asset Allocation Fund**
- Balanced Index Fund
- LifeStrategy® Conservative Growth Fund
- LifeStrategy® Growth Fund
- LifeStrategy® Income Fund
- LifeStrategy® Moderate Growth Fund
- S T A R™ Fund
- Tax-M anaged Balanced Fund
- W ellesley® Income Fund
- W ellington™ Fund

### Money market funds

#### Taxable

**Admiral™ Treasury M oney M arket Fund**
- Federal M oney M arket Fund
- P rim M oney M arket Fund
- T reasury M oney M arket Fund

#### Tax-exempt

**Tax-E xempt**
- Tax-E xempt M oney M arket Fund

**State-specific**
- California Tax-E xempt M oney M arket Fund
- N ew Jersey Tax-E xempt M oney M arket Fund
- N ew York Tax-E xempt M oney M arket Fund
- O hio Tax-E xempt M oney M arket Fund
- P ennsylvania Tax-E xempt M oney M arket Fund
Invest with a leader

The Vanguard Group traces its roots to the opening of its first mutual fund, Wellington™ Fund, in 1929. The nation’s oldest balanced fund, Wellington Fund emphasized conservatism and diversification in an era of rampant market speculation. Despite its creation just before the worst years in U.S. financial history, Wellington Fund prospered and within a generation was one of the largest mutual funds in the nation.

The Vanguard Group was launched in 1975 solely to serve the Vanguard mutual funds and their shareholders. From its start as a single fund in an infant industry, Vanguard has become one of the largest investment management firms in the world. Today, some $550 billion is invested with us in more than 100 investment portfolios. And some 11,000 crew members now serve millions of shareholders who have entrusted their investment assets—indeed, their financial future—to a company that they believe offers the best combination of investment performance, service, and value in the industry.
The Vanguard Variable Annuity Plan is a flexible-premium, multifunded variable annuity issued by Peoples Benefit Life Insurance Company, Form No. Series NA100A (in Florida, Form No. NA100A-FL; in Oregon, Form No. NA100A-OR) and, in New York State only, by AUSA Life Insurance Company, Inc., Form No. AV423 101 109 498 CRIT, without agent representation. The Vanguard Group administers the Vanguard Variable Annuity Plan for its issuers.

Neither The Vanguard Group, Peoples Benefit Life Insurance Company, nor AUSA Life Insurance Company, Inc., provides tax advice. Investors are encouraged to consult a tax adviser for information on how annuity taxation applies to their individual situations.

Vanguard Brokerage Services is a division of Vanguard Marketing Corporation.

**Standard & Poor’s®**, **S&P®**, **S&P 500®**, **Standard & Poor’s 500®**, and **500** are trademarks of The McGraw-Hill Companies, Inc.

**Wilshire 5000®** is a trademark of Wilshire Associates Incorporated.

World Wide Web
www.vanguard.com

Toll-Free
Investor Information
1-800-662-7447

Vanguard funds, non-Vanguard funds offered through our FundAccess® program, and the Vanguard Variable Annuity Plan are offered by prospectus only. Prospectuses contain more complete information on risks, advisory fees, distribution charges, and other expenses and should be read carefully before you invest or send money. Prospectuses for Vanguard funds can be obtained directly from The Vanguard Group; prospectuses for the Vanguard Variable Annuity Plan can be obtained by calling 1-800-522-5555. Prospectuses for non-Vanguard funds offered through FundAccess can be obtained from Vanguard Brokerage Services®, 1-800-992-8327.
The $1.35 trillion tax cut enacted in June is the largest federal tax cut in 20 years. Not only does the new law, the Economic Growth and Tax Relief Reconciliation Act of 2001, mean that you’ll probably be paying less in income tax—it also allows you to set aside more money in your retirement accounts.

Some of the new tax-law provisions will be phased in over the next several years, but most taxpayers will get a tax rebate check in 2001, and the taxes withheld from paychecks may also decline this year. If you’ve been having trouble saving enough for retirement, the extra money you’ll have from the rebate—and possibly in your paycheck from the lower taxes—will provide you with a painless way to catch up. If your retirement plan is on track, you’ll be able to accelerate it—so you can retire sooner or enjoy a more prosperous retirement.

While the new tax law also affects the federal estate tax and education savings accounts, this bulletin will focus on how you can take advantage of the provisions involving retirement investments. Future bulletins will address how the new law affects estate planning and financing education.

These Tax Breaks May Not Last Forever

All the provisions of the new law are scheduled to expire at the end of 2010. While it’s unlikely that all the improvements in retirement funding will disappear, a wise investor will try to take full advantage of them until then—in case some are repealed or reduced.
Putting the New Tax Law to Work for You

Ben Franklin once wrote that nothing is certain “except death and taxes.” He might well have added “changes in the tax laws” to his list. The federal income tax laws have changed repeatedly over the years and no doubt will change again. But the latest version offers some real improvements over previous laws.

In the following sections, we’ll discuss how much the federal income tax will decline and the terrific new opportunities you’ll have to save and invest for your retirement.

Invest Your Tax Cut in Yourself

The new tax law cuts federal income tax rates retroactively to January 1, 2001. This means that you will likely see lower tax bills in the future, and you’ll probably get a tax rebate check this fall for taxes you overpaid in the first half of 2001.

Depending on their earnings, single taxpayers will receive rebates of up to $300 and married taxpayers filing jointly up to $600. When the check arrives, you’ll have a great opportunity to add to your IRA or other retirement investments, including those in taxable accounts. Don’t miss your chance!

Why is the government giving you cash back? Some income that had been taxed at 15% is taxed at only 10%, effective January 1, 2001. The 15% rate still applies to some income, but other rates will decrease, as shown in the table below.

There’s Still More Good News

The new tax law didn’t just lower rates. It may also reduce your total tax bill because of changes to the child tax credit, the child and dependent care credit, and the so-called marriage penalty.

For higher-income families, the law phases out the existing limitations on the use of personal exemptions, so the affected individuals will be able to take full advantage of these exemptions. The law also phases out the income thresholds that limit the use of itemized deductions. You may wish to consult a tax adviser to learn how these changes may affect you.

Save More for Retirement

Virtually all taxpayers will enjoy more after-tax income than they would have under the old tax law. An important question is how you can use this extra income to your best advantage. The new tax law provides unprecedented opportunities to bolster your retirement savings—both through your IRA and, potentially, your employer-sponsored plan. Savvy investors will take full advantage of these new tax breaks.

Everyone Can Contribute More to IRAs

The government is raising the limits on contributions to both traditional IRAs and Roth IRAs, making it possible to accumulate a much larger pool of retirement assets. The first increase will be in 2002, and the limit will go up in steps until it reaches $5,000 in 2008. After 2008, the limit will be increased periodically to offset inflation.

And the increases apply to all IRAs, including those for spouses who do not have earned income. So a married couple with one wage earner and one person staying at home may be able to contribute a total of $10,000 to their two IRAs in 2008 (if they file jointly).

<table>
<thead>
<tr>
<th>Scheduled Tax Cuts</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>When</strong></td>
</tr>
<tr>
<td>2001*–2003</td>
</tr>
<tr>
<td>2004–2005</td>
</tr>
<tr>
<td>2006 and later</td>
</tr>
</tbody>
</table>

*As of July 1, 2001.

Note: A growing number of taxpayers will be subject to the alternative minimum tax (AMT) and will not enjoy the benefits of the tax cut. You may want to consult your tax adviser to learn how the AMT might affect you.
Larger Contributions Can Make a Difference

What do the higher contribution limits mean for you? As the chart below shows, contributing as much as possible can boost your retirement savings significantly. A retirement fund of $247,115 will buy a lot more than one of $98,846.

The Payoff From Saving More in an IRA

A retirement investor who takes full advantage of the new tax law will likely enjoy a more prosperous retirement. The example below shows what would happen if Investor A contributes $2,000 a year for 20 years (a total of $40,000) while Investor B contributes $5,000 a year (a total of $100,000)—and their investments both return 8% a year after expenses.

Watch for Improvements in Employer Plans

The limits on the total amount that can be contributed by you and your employer to a defined-contribution retirement plan will be increased in 2002. Depending on a plan’s rules, both employees and employer could contribute more to the retirement plan. But many of the changes are optional, meaning that an employer must change a plan’s rules to take advantage of the new limits.

Some of the key changes for employer-sponsored plans are the following:

- The limit on the total compensation used in determining retirement plan contributions will be increased from $170,000 to $200,000 in 2002. That limit will then be periodically increased to account for inflation.
- The maximum exclusion allowance for 403(b) plans will be repealed in 2002, so calculating the maximum contribution will become easier, and, in some cases, larger contributions will be permitted.
- For participants in SIMPLE retirement plans, the limit on annual contributions will be increased in steps from $6,500 now to $10,000 in 2005, after which it will be increased periodically to account for inflation. SIMPLE plans will be allowed to accept “catch up” contributions from participants age 50 or over.

Faster Vesting in Employer Plans

Under the new law, there will be a decrease in the maximum length of time that employees must wait to become “fully vested” in an employer’s matching contributions to a retirement plan. The rules will not change for other employer contributions.

Beginning with contributions made in 2002, the schedules for the two types of vesting will be the following:

- If a plan uses incremental vesting, beginning with a participant’s second year of service, the participant must become vested in increments so that he or she is fully vested after six years of service (down from seven).
- If a plan does not use incremental vesting, a participant must become fully vested in three years (down from five).

Vesting in contributions made before 2002 may still follow the old schedule.

A New Chance to Catch Up on Your IRA

The new tax law will also provide extra help for retirement investors who are age 50 or over. Beginning in 2002, these investors will be allowed to contribute even more to their IRAs than the standard IRA limit. The “catch up” provisions are available to anyone who meets the age requirement and who is eligible to contribute to an IRA. This includes people who have earned income as well as their spouses who have little or no earned income, if they file jointly.

The table below shows how much can be contributed to an IRA in the coming years.

Catching Up on Your IRA

<table>
<thead>
<tr>
<th>When</th>
<th>Regular Contribution for Everyone</th>
<th>Catch-Up Contribution for Those 50 or Over</th>
<th>Total Possible Contribution for Those 50 or Over</th>
</tr>
</thead>
<tbody>
<tr>
<td>2001</td>
<td>$2,000</td>
<td>$0</td>
<td>$2,000</td>
</tr>
<tr>
<td>2002–2004</td>
<td>$3,000</td>
<td>$500</td>
<td>$3,500</td>
</tr>
<tr>
<td>2005</td>
<td>$4,000</td>
<td>$500</td>
<td>$4,500</td>
</tr>
<tr>
<td>2006–2007</td>
<td>$4,000</td>
<td>$1,000</td>
<td>$5,000</td>
</tr>
<tr>
<td>2008 and later</td>
<td>$5,000</td>
<td>$1,000</td>
<td>$6,000</td>
</tr>
</tbody>
</table>

*Our hypothetical example does not represent the return on any particular investment.
The Potential to Catch Up Through Your Employer Plan

Employees age 50 or over may make catch-up contributions in addition to their regular contributions—if the plan permits the catch-up contributions. The limits are shown in the table below.

### New Employee Deferral Limits for Employer Plans

The limits apply to 401(k) plans, 403(b) plans, 457 plans, and SAR-SEP plans.

<table>
<thead>
<tr>
<th>When</th>
<th>Regular Contribution for Everyone</th>
<th>Catch-Up Contribution for Those 50 or Over</th>
<th>Total Possible Contribution for Those 50 or Over</th>
</tr>
</thead>
<tbody>
<tr>
<td>2001</td>
<td>$10,500</td>
<td>$0</td>
<td>$10,500</td>
</tr>
<tr>
<td>2002</td>
<td>$11,000</td>
<td>$1,000</td>
<td>$12,000</td>
</tr>
<tr>
<td>2003</td>
<td>$12,000</td>
<td>$2,000</td>
<td>$14,000</td>
</tr>
<tr>
<td>2004</td>
<td>$13,000</td>
<td>$3,000</td>
<td>$16,000</td>
</tr>
<tr>
<td>2005</td>
<td>$14,000</td>
<td>$4,000</td>
<td>$18,000</td>
</tr>
<tr>
<td>2006 and later</td>
<td>$15,000</td>
<td>$5,000</td>
<td>$20,000</td>
</tr>
</tbody>
</table>

Consolidating Your Retirement Assets

The new tax law provides greater flexibility for investors who want to simplify their finances by consolidating their retirement assets. Beginning in 2002, you will be able to roll over assets from more types of plans to your IRA or your current employer plan (if the plan accepts such rollovers). In addition, you will be able to roll over after-tax contributions you may have made to your employer plan into an IRA or another retirement plan that accepts after-tax rollovers.

Also beginning in 2002, if you inherit assets in your spouse’s employer-sponsored plan, you will be able to consolidate those assets in either an IRA or an employer’s retirement plan in which you are participating. Currently, the assets can only be rolled into an IRA.

Most investors are likely to decide to consolidate those assets in their IRA because an IRA offers more investment options than employer-sponsored plans.

Note: If you have questions about how your employer-sponsored retirement plan might change as a result of the new tax law, you should contact your employer’s benefits office.

Simplify Your Financial Life—With Vanguard

Tax laws are complex and ever-changing. You can count on Vanguard to stay on top of any changes and to keep you fully informed. For more information or to learn more about how you can take advantage of the latest changes, visit [www.vanguard.com/?2001pensionreform](http://www.vanguard.com/?2001pensionreform), or call [1-800-205-6189](tel:1-800-205-6189) to speak with one of the knowledgeable retirement specialists in our Retirement Resource Center. Our specialists are available on business days from 8 a.m. to 10 p.m. and on Saturdays from 9 a.m. to 4 p.m., Eastern time.

Are your retirement assets here, there, and everywhere? Make your financial life easier by consolidating all your retirement assets in a convenient, low-cost Vanguard IRA. Our retirement specialists will help you make tax-free asset transfers or direct rollovers by working with your other investment companies—and spare you the cumbersome details.

[www.vanguard.com](http://www.vanguard.com)
Four Ways to Make the Tax Law Work for You

The new tax law offers unprecedented opportunities for you to save and invest for retirement. To make the most of the new law, consider taking the following actions.

1. Increase your savings goals.

   Income taxes are being cut, putting more money in the pockets of most taxpayers. You can squander this newfound cash, or you can put it to work in your retirement accounts so you’ll have more to spend in the future.

2. Contribute even more to your IRA.

   The higher limits on IRA contributions beginning in 2002 provide the best opportunity to use your tax savings for your long-term benefit. By adding more to your IRA each year, you may be able to retire early or enjoy a more affluent retirement.

3. Catch up on your retirement savings.

   Many people haven’t taken full advantage of their retirement savings opportunities in the past—possibly because they were financially strapped by student loans, child-care costs, paying a home loan, or any number of other reasons. Beginning in 2002, if you are age 50 or over, you can take advantage of the even higher limits on your retirement contributions to accelerate your retirement plan.

4. Consolidate your assets, and simplify your financial life.

   The new tax law will make it possible to move assets from any type of retirement account to any other—whether they be IRAs or any type of employer-sponsored plan. (You can only move assets into an employer-sponsored plan if you are an active participant and the plan accepts such rollovers.) If you’ve changed jobs over the years and now have assets scattered among several plans and accounts, soon you’ll be able to consolidate your retirement investments in a single type of retirement plan at one company. Then you’ll be able to manage the progress of your retirement plan more easily—with just one statement to track. An IRA is typically the best choice for consolidation because it offers the greatest range of investment options.
For more information, including risks, charges, and expenses, about any Vanguard fund, obtain its prospectus from The Vanguard Group. Read it carefully before you invest or send money.

This bulletin is intended to provide general information about the tax law and should not be considered tax advice. Investors are encouraged to consult a tax adviser for information on how the new tax law applies to their individual situations.