A Supplement to

The Wall Street Traffic Light's
Chapter 6, User's Guide to Getting Started

(Read this material as if it appeared immediately before the "Yearly Use of the WSTL Model" section, p. 46.)

SETTING MONEY ASIDE FOR INVESTING

Individuals face the ongoing challenge of setting money aside for investing. The challenge tends to be greatest for people in their 20s and 30s, because their retirement is so far in the future. As an investor, you should start setting the money aside as early in your life as you can. Surveys consistently report that investors' biggest and most painful mistake has been *not starting to invest sooner than they did*. Each year you should set aside as much money for investing as you can. The amount will depend on your financial situation and your fiscal discipline.

Background Information

It is important to be aware of the following facts:

- In 2006, less than two-thirds of employees eligible to participate in a 401(k) plan actually did it, a statistic that is virtually unchanged since 2000, according to a 2007 survey by Vanguard Group. [The Wall Street Journal (September 1-2, 2007), p. B2.] Note that for convenience, this tutorial refers to 401(k)s, 403(b) s and 457s as 401(k)s.

- More than 70% of employees who participated in a national survey said they feel confident that they will have enough money for a comfortable retirement, yet 48% reported their personal savings and investments totaled less than $25,000, which excludes the value of the primary home and any defined-benefit pension plans. [Retirement Confidence Survey, 2007, Employee Benefit Research Institute (www.ebri.org) and Mathew Greenwald & Associates.]

- Only 29% of all employees who participated in the survey reported having savings of more than $100,000, despite the fact that U.S. couples are expected to need $300,000 to $500,000 just to cover health-care costs during their retirement years. [Retirement Confidence Survey, 2007, Employee Benefit Research Institute (www.ebri.org) and Mathew Greenwald & Associates.]

- As a rule of thumb, financial advisers say that, for a comfortable retirement, an individual (or a couple) needs between 70% and 80% of his or her pre-retirement income on an annual basis.

- Unfortunately, many Americans who change jobs cash out their 401(k)s instead of rolling the money over into another tax=deferred investment plan. A 1995 study released by the U.S. Department of Labor reported that 68% of those over age 40 who changed jobs cashed out their 401(k)s, and a staggering 84% under age 40 also cashed out. [*Sound Mind Investing* newsletter (June 2007), p. 93.]

Priority List

When you set money aside for investing, in which account(s) should it go? The answer is a priority list:

1. If you are eligible for a traditional 401(k) or Roth 401(k), fund it up to the point of receiving your employer's full matching contribution. Withdrawals from a traditional 401(k) are taxed as ordinary income. Withdrawals from a Roth 401(k) are generally tax-free. The employer's matching contribution can be likened to finding $100 bills on the ground. The Pension Protection Act of 2006, by its provisions for encouraging more automatic enrollment of employees, will increase the percentage of those participating in 401(k)s.

   If you are not covered by a retirement plan at work, that makes you eligible to fund a tax-deductible IRA. For 2007, the contribution limit was $4,000, plus an additional $1,000 contribution for those who are age 50 or older. Withdrawals from a tax-deductible IRA are taxed as ordinary income.

2. Fund a Roth IRA, if you are eligible. To determine if you are eligible, do a Google search of "Roth IRA." If the answer is not obvious, ask a financial adviser. For 2007, the contribution limit is $4,000, plus an additional $1,000 "catch-up" contribution for those who are age 50 or older. For 2008, the contribution limit is $5,000, plus an additional $1,000 catch-up contribution for those who are age 50 or older. Withdrawals from a Roth IRA are generally tax-free. If you are neither eligible for a Roth IRA nor a tax-deductible IRA, fund a traditional IRA. The annual limit for contributions to a traditional IRA is the same as for a Roth IRA. A traditional IRA is tax-deferred; withdrawals are generally taxable and can be made without penalty after age 59½.
3. Finish funding your 401(k) up to the maximum annual limit allowed. For 2007, the limit was $15,500, plus an additional $5,000 catch-up contribution for employees who are age 50 or older. . For 2008, the limit was $15,500, plus an additional $5,000 catch-up contribution for employees who are age 50 or older. About 9% of 401(k) participants contributed the maximum amount in 2006.
4. Fund a variable annuity. It is critical to choose a *low-cost* variable annuity. Low-cost variable annuities are available through mutual fund companies such as Fidelity and Vanguard. There is no limit on the annual contributions to a variable annuity. Withdrawals from a variable annuity are taxed as ordinary income.

Do You Need Help?

A financial adviser can help you determine how much money you need to set aside for investing in the years you have remaining before retirement.