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When Plans Go Awry

Five unforeseen events can torpedo your retirement savings

No matter how carefully you've prepared for your retirement, some unforeseen events—such as losing your job, your health coverage, or a big chunk of your savings in a market crash—could derail your plans. This is a special concern if you're just a couple of years from retirement, when you don't have a lot of time to recover from negative setbacks.

Many soon-to-be retirees learned this the hard way during the recession, as the box below illustrates. To help minimize the blow some of those events could have on your retirement, it makes sense to do some advance planning, just in case.

"In the last three years, we've seen that people who prepare for tough times are in pretty good shape when emergencies happen," says Mari Adam, a fee-only financial planner in Boca Raton, Fla.

Here are ways you can minimize the financial impact of five "what ifs":

What if:

You stop working earlier than expected

If you read this newsletter regularly, you know we often point out the merits of working as long as possible so you can save more and cut the number of years your savings will need to last. But an employer might have other ideas, or you or your spouse could become ill or injured and unable to work.

What to do now

Beef up your savings and cut your debts. Make sure you have 6 to 12 months' worth of living expenses in a liquid emergency fund. Maintain a network of professional contacts you can reach out to if you have to search for a new job.

To prepare for an illness or injury that could keep you or your spouse out of the workforce, make sure you both have sufficient disability insurance. Your employers might offer a long-term disability plan, which will kick in when short-term coverage ends. Those group plans will usually pay you about 60 percent of your salary. You can also buy a supplemental plan or individual plan that will cover up to 70 or 80 percent of your earnings. Benefits will continue for a set number of years or until you reach retirement age. But individual plans can be costly. If you're over 55, a plan might cost 4 percent or more of your yearly income.

If it happens

Companies aren't required to offer severance pay to employees they lay off, but some do. You can generally expect one week of salary for every year you've been with the company. If your company lets you choose to take a lump sum or series of payments, consider taking the payments if your company is financially sound. Your employer might allow you to keep contributing to your 401(k) plan, and continue your health insurance, life insurance, and other retirement benefits for as long as the payments last.

Ideally you'll be able to find another job with health benefits quickly. But in today's job market, that could take a while. You might be able to join your spouse's workplace plan in the meantime. Or you might be able to stay on your former employer's plan for generally 18 months through COBRA, but you'll usually have to pay the premiums plus an administrative cost.

Contact your state's unemployment office right

away and apply for benefits. Most states begin the benefit period from the day you file your claim, not the day you were let go. It generally takes two to three weeks after you file to receive your first payment. Also start networking with business contacts to begin a new job search.

You can possibly keep your 401(k) funds in your current plan as long as you have more than $5,000 invested. Check with the human resources department to see if you'll be charged a fee for that privilege.

If you decide to roll the money into an IRA instead, make sure that the administrator of the plan transfers the funds directly to the new IRA custodian. If your former employer issues a check made out to you, the IRS will consider that a withdrawal, and you'll owe taxes on the total, plus a 10 percent early-withdrawal penalty normally applies if you are under age 55.

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What if:
Your investments tank

As we all know too well, crashes, bear markets, and recessions can wipe out years of gains, rendering your nest egg too small to generate the income you planned for. And sustained periods of low interest rates on savings can also crimp your expected cash flow.

What to do now

Make sure your and your spouse's asset allocations are appropriate for your ages and risk tolerances. Review your portfolios periodically and rebalance when your allocations drift away from your desired asset mix.

If it happens

Remember, you'll probably draw down about 4 percent of your assets each year. So a drop in the market won't necessarily mean you're in desperate trouble, especially after you factor in your other investments, Social Security, and any defined-benefit pension payments.

So try to resist the urge to sell your stocks after a market downturn. Besides, if you dump your stocks, you'll lock in your losses instead of giving your portfolio time to rebound. If you keep investing in your retirement accounts regularly in periods when the market is not so hot, you'll buy many shares at low prices and be in good shape when the market turns upward.

"But if you lose a significant amount," says Joshua Kadish, a wealth manager in Chicago, "you may have to consider working a little longer, or trim your retirement expenses, such as doing less traveling."

What if:
You lose your spouse

"This is the saddest scenario, as well as the one that can have the most devastating effect on your retirement plans," Kadish says. In this case, you have to deal with the death of your spouse and figure out how to adjust to the resulting loss of income.

What to do now

Your plan should include provisions that ensure a surviving spouse will have enough retirement income, says Jean Dorrell, a certified estate planner in Summerfield, Fla. She starts by looking at what income will be lost if either spouse dies. For example, if you and your spouse both worked long enough to collect Social Security, a survivor will lose the lesser of those two payments in most cases. (For more details, go to www.ssa.gov and click on the "Survivors" tab.)

"And you have to remember that you will need to earn even more to maintain your income level, because single filers have higher tax bills," Dorrell says. For example, a couple earning a taxable income of $65,000 in 2011 will be in the 15 percent tax bracket; single filers earning the same amount will be in the 25 percent bracket.

If you have a traditional defined-benefit pension plan, federal law requires the option to provide your surviving spouse with a joint and survivor annuity, which allows him or her to receive benefits if you die first. "In many cases, pension owners have the option to take their money as a lump sum, in which case there are no payments to a surviving spouse," says Steve Vernon, an actuary in Oxnard, Calif.

Because a joint and survivor annuity covers two lives, the payments are smaller than those from a single-life annuity. You might have several payment options, such as an annuity that pays your spouse 50, 75, or even 100 percent of the benefit you were getting. Vernon suggests taking the 100 percent option for the greatest protection.

Social Security and pension-plan rules are complex, so this might be a good time to get some advice from a certified financial planner who specializes in estate issues. A fee-only planner is paid a fee for his services instead of paid from the commission earned from selling you an investment. You can search for one on the site of the National Association of Personal Financial Advisors.

If you see that your spouse will suffer a significant loss of income if you die, or if you still have dependent children, life insurance can fill the gap. We generally recommend that people buy term insurance because it is less expensive than cash-value policies. In some cases, cash-value insurance can provide estate-planning and tax advantages. A financial planner can work the numbers with you.

You'll also want to make sure all your estate-planning documents are up to date. If they aren't, an estate-planning attorney can help. You can find one in your area by going to the website of the American Academy of Estate Planning Attorneys.

If it happens

If you planned ahead, you'll have enough available cash to sit tight for about six months and see whether your estimates were correct or whether you need to tweak your budget. "It's also a good idea to take that time because you should avoid making any major financial decisions while you're grieving," Vernon says.

As long as property passes outright to the surviving spouse through a will, trust, or by law, it should qualify for the unlimited marital deduction and not be subject to estate tax. But the surviving spouse will have to create a new estate plan to minimize any future estate taxes that might occur at his or her death. Beneficiaries on life insurance, annuities, and retirement accounts will also have to be updated.

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What if:

Your kids need financial help

Fifty-nine percent of parents are providing or have provided some kind of monetary support to their adult children (ages 18 to 39) who are not in school, according to a May 2011 survey by the National Endowment for Financial Education. It also found that 7 percent of parents had to delay retirement as a result, 26 percent took on more debt, and more than one in 10 had to delay a major life event such as buying a new home.

What to do now

If you think that one of your children might need a hand sometime soon, examine your financial situation. Consider nonmonetary ways to help, such as offering a family car that you no longer need, drawing on your professional network to help your child land a better-paying job, or watching the grandchildren while he or she goes on job interviews or works extra shifts. If your child has ongoing financial issues, offer to help draw up a detailed budget plan.

If it happens

First, assess the seriousness of your child's situation. "Of course you will want to help them out" in a serious emergency, says Barry Picker, a CPA and CFP in Brooklyn, N.Y. But, he says, consider the impact on your finances. In particular, avoid tapping your retirement accounts or taking on more debt.

If a child needs a place to live, for example, consider letting him move in with you but charge rent, even if it's a small monthly payment. And set up a list of household chores he can do to help out. Most important, pick a target date when your child should have enough saved to move out.

Avoid giving children money to pay off credit-card balances and student loans. "If you give them money to pay off a debt, there's no learning experience there," Adam says. "Your goal is for them to become financially independent."

If you need to lend them money for another purpose, try to structure the loan so that everyone benefits, she suggests. For example, you can take money out of a savings or a money-market account with an anemic interest rate, and charge your child 4 or 5 percent interest on the loan. You'll probably end up earning more, and your child will pay less in interest than most personal bank loans or credit cards charge. Have the money deposited from your child's paycheck directly into your account. Put the agreement in writing and have everyone sign it to minimize the chance that there will be any misunderstandings. And keep in mind that the IRS requires you to report interest earned on a family loan, and that if the rate is below a level set by the IRS each month, you'll also have to report forgone interest on your tax return.

If your child needs medical coverage, note that the new health-care law allows parents to keep children on their employer-provided insurance policy as a dependent until age 26. When your child is no longer considered a dependent, he or she can extend coverage through COBRA for three years, though the premiums will probably be higher than those under your plan. If your child is older, consider lending her the money to buy individual coverage.

What if:

You can’t sell your home

It might be your biggest asset, but you shouldn't expect to make much money by selling it. Historically, real estate has returned less than a percentage point a year since 1960 after taking inflation into account. The amount you can get for your home in the near future doesn't matter if you have no plans to move anytime soon. But it certainly can be an issue if you're ready to retire and pull up stakes.

What to do now

Base your retirement assumptions on how much your total savings will be worth, excluding anything you might earn on the sale of your home.

If it happens

You might want to delay selling by a year or two to give the market in your area some time to recover, as long as you can afford to stay in your home. "However, if you are going to buy a smaller place in an area where prices have fallen as well, it may be a wash because although you are getting less, you're also spending less," Kadish says.

To speed up a sale, make sure your home is priced right. Buyers have lots of homes to choose from today, so a home sells most quickly if its price is just a bit lower than similar homes in the area.

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