WELLS FARGO Asset Management

# New rules of the road

## A ROAD MAP FOR PURSUING RETIREMENT SUCCESS

# You're in the driver's seat

If you're like a lot of other people, you've probably caught yourself daydreaming about retirement, pondering questions like where you'll want to live and how you'll spend your time. These questions inevitably lead to others: How much money will I need? Where should I save it? When will I have enough to be able to retire? Simple questions that beg for simple answers.

We prepared this guide to help you answer questions like these on your route toward achieving the financial independence you'll need to enjoy the retirement you want. In the process, we road-tested common rules of thumb on retirement saving and spending. The results of this research challenge long-followed rules and reveal some evolved insights that may offer stronger outcomes.

You're bound to come across plenty of twists and turns along the way, so it'll be important to regularly track where you are versus where you eventually want to be. This guide is meant to help you do just that. Like a road map, it contains essential information you can refer to as you make key decisions throughout your journey toward a bright, financially independent future.

The road to pursuing **RETIREMENT SUCCESS** lies ahead.

# Getting there: Crucial “rules of the road” toward retirement security

No matter which route you choose toward your retirement goal, four essential rules of the road should be the foundation of all your planning. Sticking to these rules may greatly improve your odds of avoiding delays and achieving your retirement goal when and how you planned to.

1 Start saving early

2 Save at a sufficient rate

3 Diversify

4 Stay the course

Rule 1

# Start saving early

When you start working, start saving for retirement as soon as you can. For people in their 20s, every dollar saved has more years to grow in value than the dollars they'll save in their 30s, 40s, or 50s. When dollars saved early in a person's working years generate investment gains year after year, they can have a much bigger impact on the size of an account balance at retirement than you might think.

This is due to the **power of compounding**: As the dollars invested earn returns, those returns start earning returns, and so on—year after year. So, the sooner you start saving, the more time your savings will have to continue compounding and growing toward your retirement savings goal.

On the flip side: Waiting until you're in your 30s or 40s to start saving can dramatically increase the amount of money you'll need to save to reach that same retirement goal. If this is the situation you're facing, don't despair—there are actions you can take right now to start getting your savings on track.

What about those pesky student loans? Paying off debt is a good practice, but don't put off saving for retirement—especially if your company offers a 401(k) matching contribution. Consider viewing your company's matching contribution as a return on your investment (your contribution), and compare it with the interest you'd pay on your student loans. For example: If your company offers a 50% match, then any matches earned reflect a 50% return on the corresponding contributions.

This is an easy one: Invest at least up to the full employer match. Don't leave money on the table.

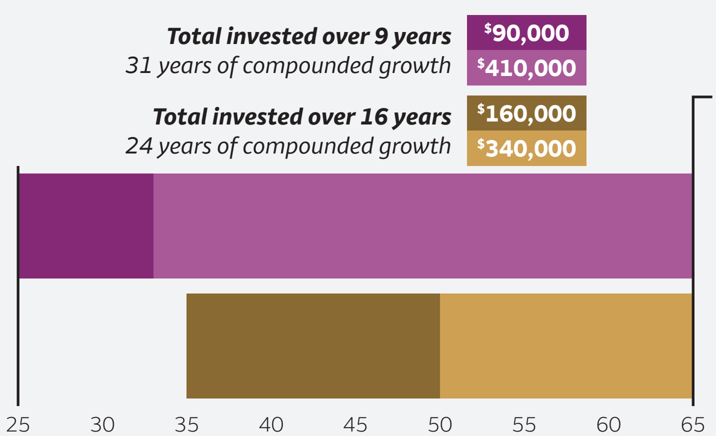
**RULE OF THUMB**

The sooner you start saving, the more time your savings will have to continue compounding and growing toward your retirement savings goal.

**RULE OF THUMB**

If your company offers a 401(k) matching contribution, be sure to use it—don't leave money on the table.

## Power of compounding and saving early: Start saving at 25 vs. 35




**$500,000 account balance at age 65**

**Investor A** opens 401(k) at age 25. Saves $10,000 per year for 9 years and stops annual contributions at age 33 but continues to allow the money to grow until age 65.

**Investor B** opens 401(k) at age 35. Saves $10,000 per year for 16 years and stops annual contributions at age 50 but continues to allow the money to grow until age 65.

*This is hypothetical data and is for illustrative purposes only.* Chart assumptions: 5% annual return and $10,000 annual contributions starting at age 25 versus age 35, but does not account for inflation. Source: Wells Fargo Asset Management (WFAM) Research

# Rule 2 Save at a sufficient rate

Many plan participants save just enough to get their full company match. Is that enough? Unfortunately, in most cases it's not.

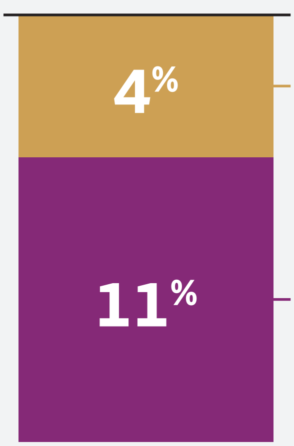
An often-cited rule of thumb is that starting in their 20s, workers need to save 10% to 15% of their pretax income to create a comfortable nest egg in retirement. Our research, however, suggests that a consistent 15% preretirement contribution (which includes any employer contributions) is needed in order to have a standard of living in retirement that's similar to the one enjoyed before retirement.[1]

How much is enough? Our research indicates that the target should be to accumulate, by the time of retirement, a total retirement account balance that's 11 times your estimated final preretirement income. For example, for a person whose income just prior to retirement is $50,000, we suggest aiming for a retirement account balance of about $550,000, which is 11 times that preretirement income.

Potentially, this amount should replace about 80% of preretirement income when combined with Social Security, which may enable you to enjoy a similar lifestyle postretirement.

## Take control of your future by saving 15%

15% total contribution




**Employer match**

In this example, the employer matches up to 4%. So, in order to take full advantage of this match, the employee will need to contribute at least 4%.

**Contribute the difference**

To reach a 15% total contribution, the employee will need to contribute 11% (15% minus 4% employer match).

*This is hypothetical data and is for illustrative purposes only.*

## RULE OF THUMB

We've found that a consistent 15% preretirement contribution is needed to accumulate the savings required to maintain a similar standard of living in retirement.

**11x**

We suggest aiming for a retirement account balance that's 11 times your estimated final preretirement income at retirement.

**80%**

An account balance 11 times your final income, combined with Social Security, is projected to replace about 80% of your preretirement income.

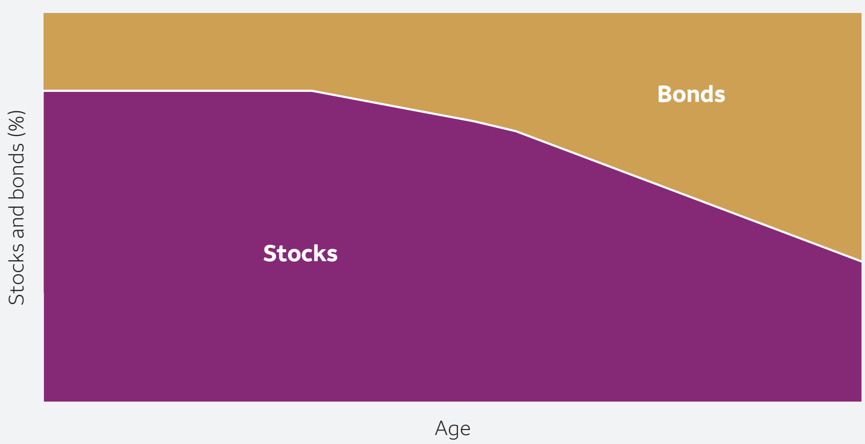
Rule 3

# Diversify

When deciding how to invest your retirement savings, the old adage "Don't put all your eggs in one basket" still holds true today. Fortunately, target date funds, which are diversified across asset classes, have become the predominant default investment in retirement plans.

The asset class allocations in target date funds adjust over time based on the levels of risk and return a target date fund manager determines are suitable as retirement draws closer. Because their portfolios are automatically adjusted as you approach retirement, target date funds potentially provide an effective way to maintain a diversified investment portfolio.

## Consider a professionally managed target date fund




Over time, a target date fund's asset allocation adjusts as retirement draws closer.

This example is for illustrative purposes only and depicts a target date fund composed solely of two asset classes: stocks and bonds.

Target date funds likely won't deliver the most eye-popping returns in any given year. What they've accomplished over time, though, is to deliver returns that—when combined with saving early and consistently saving enough—have helped many participants progress toward their retirement savings goals.

A recent study conducted by Wells Fargo Institutional Retirement and Trust shows the potential benefit to participants of having professionals diversify their portfolios. The study compared average portfolio outcomes—and the range of those outcomes—for participants who invested in target date funds ("do it for you") versus participants who made their own investment decisions ("do it yourself"). The study covered the five-year period that ended December 31, 2017.

Over those five years, the study's results show that the target date fund portfolios outperformed portfolios managed by participants themselves by 1.4% annually. Also, the target date funds delivered more stable portfolio growth over time than the self-managed portfolios did.[2]

Diversification does not ensure or guarantee better performance and cannot eliminate the risk of investment losses.

## Rule 4 Stay the course

You might decide to change employers a number of times during your career. According to staffing firm Robert Half International Inc., 64% of professionals believe it's beneficial to change jobs every few years, especially if they're looking for a higher salary.[3]

Whenever you do change jobs, you might be tempted to withdraw the retirement savings you had accumulated with the employer you're leaving, especially if that account seems like it's "too small to be worth the trouble of transferring elsewhere." However, if you cash out of the plan, your distribution will be considered income and subject to taxes—as well as an early-withdrawal penalty if you're under age 59½.

Consider alternatives to cashing out. These include: moving the balance into your new employer's plan, leaving the assets in the previous employer's plan (if the plan allows), or rolling the assets to an IRA. By keeping those retirement dollars in a tax-advantaged plan, you'll postpone paying income taxes, avoid any early-withdrawal penalty, and keep your savings compounding—undisturbed—on a tax-deferred basis toward your retirement savings goal.

Likewise: Consider alternatives to taking loans from your 401(k) account. Borrowing from a retirement plan is one of the most common ways people create detours that take them off the freeway, slowing down progress toward their retirement goal. Here's why: When you borrow from your retirement savings, your future contributions end up replacing what was taken out instead of increasing your account balance. In order to stay on track to reach your retirement goal in this situation, you'd likely need to decide on an alternate route (for example, increasing the amount being saved regularly and/or delaying retirement, among other options).

**RULE OF THUMB**

When changing jobs, consider your alternatives to cashing out of the plan. Let that money keep growing, tax deferred, toward your retirement goal.

**RULE OF THUMB**

Consider the impact on your retirement account balance before taking loans from your 401(k).

# Options to boost your savings

## You can save for medical bills *and* retirement in a health savings account (HSA)*

HSAs can be an effective, tax-efficient way to supplement your retirement savings.

An HSA is a tax-advantaged medical savings account available to participants who enroll in a high-deductible health care plan. It's potentially a great long-term savings vehicle to supplement your 401(k) savings due to its tax-efficient structure:

1. Contributions to an HSA aren't taxable
2. Earnings within an HSA account grow tax-free
3. Distributions for qualified expenses aren't taxed[4]

*If you have an HSA-eligible health insurance plan.
WFAM does not offer HSAs.

# Options to boost your savings *(continued)*

Preretirement, many HSA users tend to think of their HSA solely as a way to pay for near-term medical expenses with tax-free dollars. So, during each annual enrollment period, they estimate the amount they think they'll need for out-of-pocket medical costs in the coming year, contribute that amount to the HSA, and spend all or most of it by year-end.

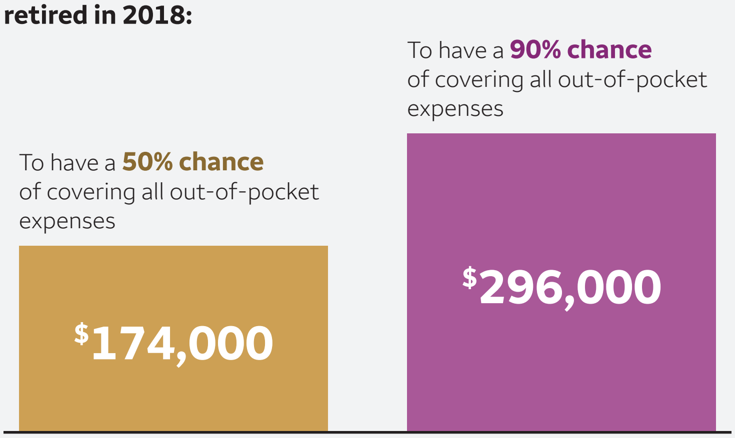
We think, however, it's a great idea to take a look at HSAs from a different, broader angle: As a vehicle for saving ***even more*** for retirement. An HSA can serve as a supplement to a person's 401(k), as any unused contributions within it will be rolled over and can be invested as a long-term, tax-advantaged investment account.

Saving as much as you can in an HSA is a tax-advantaged way to build an account to help you manage health care costs when you retire. One of the largest financial burdens for many retirees is paying for their health care needs, and these costs have continued to rise.

From 2011 to 2018, the estimated amount of savings retirees likely will need to cover their Medicare premiums, deductibles, and certain other health expenses rose by as much as 9%. Shown below are the dollar amounts that people who left the workforce in 2018 are projected to need to have saved to pay their out-of-pocket health care costs in retirement. The numbers reveal how significant these expenses could be.

## 2018 savings targets for out-of-pocket medical expenses during retirement

**Estimated savings* needed for a 65-year-old couple who retired in 2018:**




*Excluding the costs of long-term care. Source: Fronstin and VanDerhei. "Savings Medicare Beneficiaries Need for Health Expenses: Some Couples Could Need as Much as $400,000, Up From $370,000 in 2017." EBRI Issue Brief, no. 460.

### RULE OF THUMB

If you choose not to max out contributions to both your 401(k) and HSA, here's how we suggest prioritizing:

1. Contribute enough to your 401(k) to receive your company's full match
2. Keep contributing to your 401(k) and HSA at a 1-to-1 ratio up to the maximum allowed in each plan

Many retirees who have an HSA will find it most advantageous to pay these out-of-pocket expenses from the HSA because distributions for qualified medical expenses will be tax-free. If they instead paid their medical bills from tax-deferred income sources, like a 401(k), the money withdrawn generally would be taxed as ordinary income.

What if it turns out that you've accumulated more money in your HSA than you'll need for health care expenses? Good news! If you're 65 or older, this account can be used not just for medical expenses (which would be tax-free withdrawals), but also for anything else you choose to spend it on (taxable as ordinary income).

# Don't overlook after-tax 401(k) contributions*

Most of us think of our 401(k) as a pretax, tax-deferred account with an annual contribution limit. But actually, the IRS sets two annual contribution limits: pretax and total.

**Annual contribution limits for an individual in 2019**

| Pretax employee IRS contribution limit: | Total annual IRS contribution limit: |
|---|---|
| Pretax, tax-deferred account contributions | Employer contributions + pretax employee contributions + after-tax employee contributions |
| $19,000 | $56,000 |

**RULE OF THUMB**

After-tax 401(k) contributions may be rolled over to a Roth IRA. Earnings associated with after-tax contributions are pretax amounts and would need to be rolled over to a traditional IRA.

While your after-tax contributions won't reduce your taxable income, the earnings on that money will grow tax deferred until you take a distribution.

Another advantage of after-tax 401(k) contributions is the ability to convert that money to a Roth 401(k) or a Roth IRA. A Roth 401(k) and an after-tax 401(k) are similar in that contributions to both are made with after-tax dollars. However, they have one big difference: Earnings from an after-tax 401(k) are taxable when distributed, but qualified distributions of earnings from a Roth are tax-free.

Converting money from an after-tax 401(k) to a Roth 401(k) or Roth IRA enables people who earn more than the limit allowed for a Roth IRA (which phases out for higher incomes) to boost their tax-advantaged savings.

*If available in your employer's 401(k) plan.

**For information and help regarding tax planning specific to your situation, consult your tax professional.**

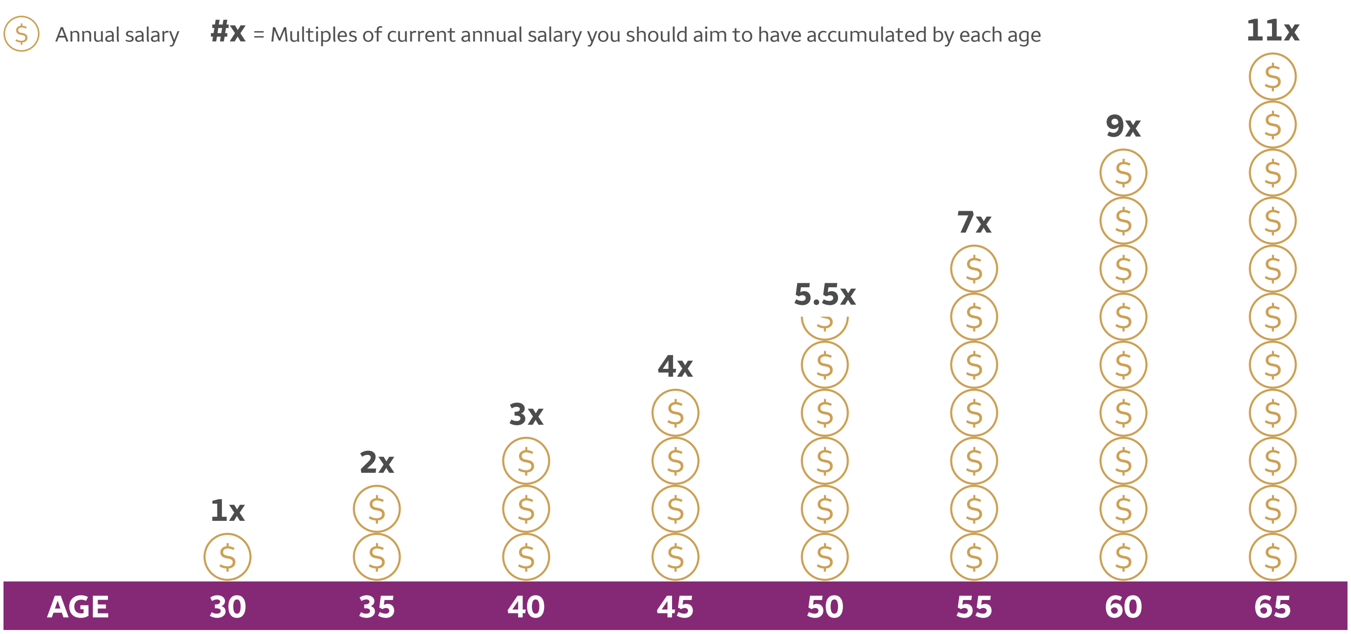
# Are we there yet?

We stated earlier that based on our research, the target should be to accumulate 11 times your estimated final preretirement income by the time you retire in order to replace about 80% of your preretirement income when combined with Social Security. This amount potentially can enable you to maintain your lifestyle during retirement.[5]

The checkpoints below will help you gauge your progress toward the 11-times-income savings goal you're aiming to achieve by the time you retire. It shows—in terms of ***multiples of your current annual salary***—the amount of savings you should aim to have accumulated at different ages as you journey toward retirement.

For example, if your annual salary is $40,000 at age 35, you should aim to have $80,000 saved for retirement by then. **These checkpoints are based on the assumption that a person starts saving 15% of pretax income each year at age 25 and retires at age 65.**

## Income savings goal checkpoints




Source: WFAM

Remember: These are rules-of-thumb estimates intended to assist your decision-making. They aren't etched in stone. If you find your savings falling short of the income-multiple checkpoints, don't despair! There are actions you can take to close the gap.

# Getting back on track

You have options to pick from for closing your savings gap:

- Make catch-up contributions

If you're age 50 or older, you can take advantage of catch-up provisions to contribute more to your 401(k) and HSA plans.

**Annual contribution limits for individuals age 50 and older in 2019**

| | | |
|---|---|---|
| **401(k)** | **Pretax employee IRS contribution limit:** Pretax, tax-deferred account contributions | **Total annual IRS contribution limit:** Employer contributions + pretax employee contributions + after-tax employee contributions |
| | $25,000 | $62,000 |
| **HSA** | **Single coverage** | **Family coverage** |
| | $4,500 | $8,000 |

**RULE OF THUMB**

For ages 50+, take advantage of catch-up contributions to your 401(k) and HSA plans for long-term savings.

# Getting back on track

*(continued)*

## • Save more and/or work longer

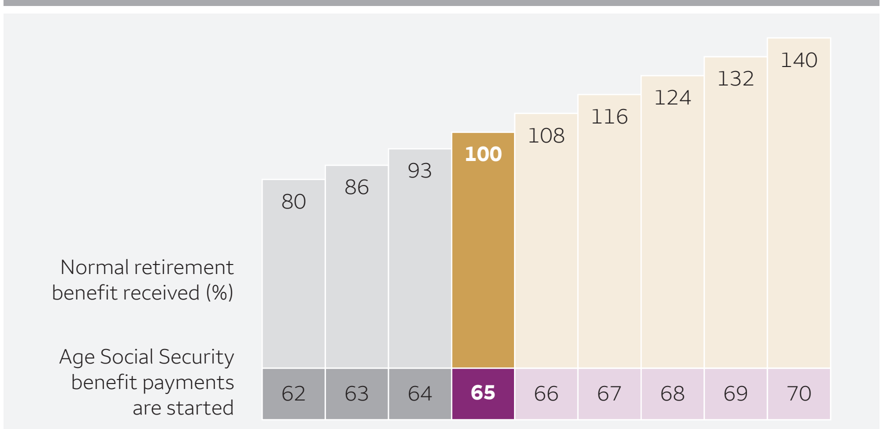
If you can do both—save more and delay retirement—this approach generally will close a savings gap the fastest. But if you're making a choice between saving more or working longer in order to hit your retirement savings target, research shows that working longer is a more powerful method of increasing a person's standard of living postretirement.

Fortunately, it doesn't take much extra work time to make up for having had a lower savings rate early in your career. Delaying retirement by as little as three to six months potentially has the same impact on a person's standard of living postretirement as saving 1% more for 30 years![6]

Here's a good rule of thumb for calculating the impact of working longer: For every year that retirement is delayed, reduce your savings target by 0.7 times your final preretirement income.[7]

Working longer is even more powerful when combined with waiting longer to start taking a Social Security benefit. Delaying the start of Social Security benefit payments increases the monthly payment amount by roughly 8% every year, up until you reach age 70.

### Delaying Social Security can increase your benefit payments




Assumption: This person's full Social Security retirement benefit starts at age 65. (To learn when you'll be eligible for your full Social Security retirement benefit, contact the U.S. Social Security Administration [SSA].)

Source: SSA

### RULE OF THUMB

Delaying retirement by as little as three to six months potentially has the same impact on a person's standard of living postretirement as saving 1% more for 30 years!

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# Can I manage retiring early?

**At whatever point you start thinking you might want to retire early, the best first action you can take—right then—is to increase your savings target and your retirement contributions.**

That's because when people retire early, their retirement savings will need to last longer, and they'll also make fewer contributions to those savings than they would've made if they'd continued working until 65.

Here's a good rule of thumb when planning to retire early: Increase the savings target by 0.7 times for every year between retirement and age 65.[7]

If your calculations show that in order to retire early you'd have to save more money each year than you can afford to, you still may have options that provide you with more free time. For example, you could consider transitioning to a part-time job. While it might require delaying full retirement, you'd be creating additional time away from work for other endeavors.

**RULE OF THUMB**

If you plan to retire early, consider increasing your savings target by 0.7 times for every year between retirement and age 65.

# You've arrived!

It's time to spend with confidence in retirement. Hopefully, you've done all the right things leading up to retirement to reach your savings goal. Naturally, following a thoughtful spending plan—like the often-cited 4% spending rule of thumb—should be a cinch, right?

The 4% rule of thumb suggests that if you withdraw 4% of your savings each year, adjusted for inflation, that rate of spending down assets potentially will sustain you throughout your retirement.

Here's something surprising that we've learned: Retirees haven't been spending much of their hard-earned savings. Recent research revealed that about half of the retirees in the study had nearly as much savings 18 years into retirement as they did when they retired. Even more startling, about one-third of the retirees had even more savings after 18 years than they did when they retired.[8]

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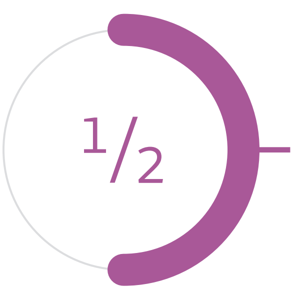


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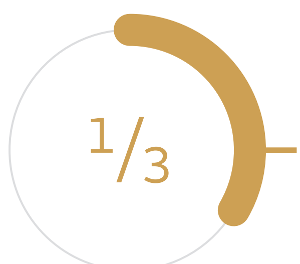



About one-third of the retirees had even more savings after 18 years than they did when they retired.

# Why aren't retirees spending much?

Two explanations seem most likely:

1

## Retirees are concerned about outliving their assets.

People don't know how long they'll live, so they have no idea how long their savings will need to last. Reluctance to spend is a natural response to this uncertainty. If retirees could be sure they won't outlive their income stream, they may not feel as compelled to restrict their spending—potentially freeing them to enjoy a better quality of life.

2

## There's a human bias toward preserving assets.

Retirees have been conditioned to view their retirement savings as assets that must be preserved instead of potential income to be spent. That perception not only makes people reluctant to spend the money they'd saved for retirement income, it also decreases the satisfaction they derive when they do spend any of it.[9]

# Retirement income: A new foundation for retirees*

The "three-legged stool" used to represent how employees were supposed to think about retirement planning. The foundation for retirement rested on three legs: employer pensions, employees' savings, and Social Security.

But with the decline in employer pension coverage over the past decade or so, employees now need to rely on their own savings and Social Security to finance their retirement, resulting in a somewhat wobbly "two-legged stool." It's a natural response for retirees to self-insure by cutting back their spending and limiting themselves to a more frugal lifestyle than they'd planned on.

We think there's a potentially better solution—one that we believe returns us to a sturdier retirement foundation. It's not the 4% spending rule. From our perspective, the 4% spending rule is overly conservative—yet many retirees aren't even spending at that conservative level.

The term ***retirement income*** refers to a range of guaranteed and non-guaranteed solutions that are intended to pensionize some or all of a person's retirement savings to provide a reliable income stream throughout retirement (no matter how long retirement lasts).

From our perspective, the following combination may offer the best opportunity to maximize your spending rate and eliminate the risk of outliving your assets after age 85:

- A managed drawdown fund that's designed to pay out a regular income stream until age 85 (with a remaining balance at that age)

**Plus**

- A deferred income annuity that provides for guaranteed lifetime income after age 85

*If available in your employer's 401(k) plan.

Annuities are not offered by any WFAM entity. These products are offered by third-party companies, which are not affiliated with WFAM entities. Annuity guarantees are subject to the claims-paying ability of the issuing insurance companies

## RETIREMENT INCOME

A range of retirement solutions that are intended to *pensionize* some or all of a person's retirement savings into a recurring income stream that lasts a lifetime.

## Here are two scenarios to illustrate how this approach would work:

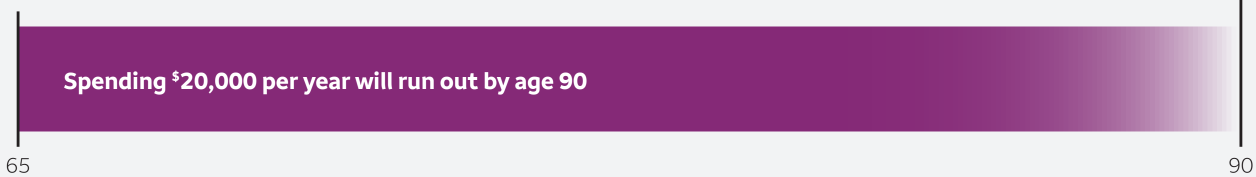
### Scenario 1: The 4% spending rule

#### $500,000 spending portfolio

A person retires at age 65 with **$500,000** and withdraws, according to the 4% spending rule, **$20,000 per year**.

Let's assume for the sake of this example that inflation and investment growth offset each other and have no net impact.

In this case, the money would last **25 years**. If the retiree lived past age 90, the **savings would run out**.




*This is hypothetical data and is for illustrative purposes only.* Source: WFAM, December 2018

### Scenario 2: Retirement income

#### $425,000 spending portfolio and $75,000 allocated for lifetime income

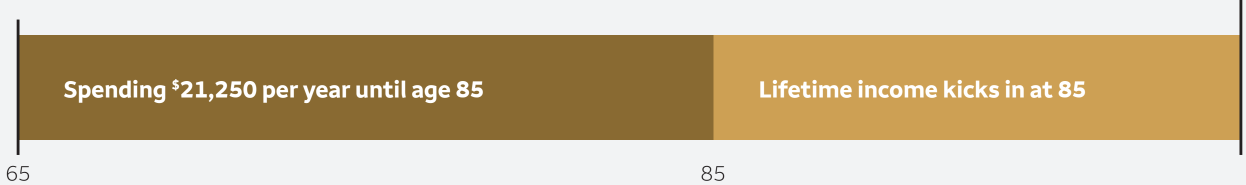
Now, consider a hypothetical scenario in which the employee could allocate **15% ($75,000)** of the $500,000 in savings to secure guaranteed lifetime income, provided by a deferred income annuity, that begins at age 85—and that these payments, combined with Social Security, would provide **80%** of the person's preretirement income.

This would leave the person **$425,000** to spread over exactly **20 years** of retirement (from age 65 to age 85), after which the guaranteed income would kick in. Between ages 65 and 84, the retiree could take a withdrawal of **$21,250 each year** (4.25% of the original $500,000 amount).

As in Scenario 1, let's assume no net impact from investment returns or inflation.

This approach would increase the retiree's annual income from ages 65 to 85 by **$1,250** compared with the 4% withdrawal rate, a boost of **6.25%** in annual spending. Even better: In this scenario, the retiree wouldn't face the risk of outliving his or her assets.

This approach to planning retirement income guarantees consistent lifetime income after age 85. By doing so, it likely may help retirees feel more confident about the amount of money they can spend annually until they turn 85, enabling them to enjoy their retirement years more fully.




*This is hypothetical data and is for illustrative purposes only.* Source: WFAM, December 2018

# The road ahead

No matter where you are on the road to retirement, we believe these guidelines may help you achieve retirement success while avoiding blind spots along the way.

The information provided is rooted in our latest research regarding retirement planning. It's designed to help obtain the financial independence needed throughout retirement.

The time has come for innovative solutions to help retirees unlock their savings and potentially a higher quality of life. WFAM is committed to answering the call.

You're in the driver's seat. The road to pursuing **RETIREMENT SUCCESS** lies ahead.
Let us be your guide.

## Your action items for pursuing a successful retirement journey

- Start saving early for retirement. Target a savings rate of 15% of pay (your contributions + your employer's).
- When you change jobs, stay the course. Consider keeping your retirement savings invested in a tax-advantaged account.
- If your employer offers an HSA, consider using it as a long-term savings vehicle to accumulate tax-advantaged retirement savings.
- Keep track of your progress toward your 11-times-income retirement savings goal.
- Take advantage of catch-up contributions you can make starting at age 50.
- Explore retirement income solutions that generate a reliable income stream (no matter how long retirement lasts).

**Endnotes:**

1. Wells Fargo Asset Management
2. Wells Fargo Institutional Retirement and Trust, 2017.
3. "Changing Jobs: Is It Good for Your Career to Do It Often?" The Robert Half Blog, April 5, 2018.
4. Employee Benefit Research Institute. "The Triple Tax Advantage of an HSA." Fast Facts, no. 292.
5. Aon Consulting. "Replacement Ratio Study. A Measurement Tool for Retirement Planning." 2008.
6. Bronshtein, Scott, Shoven, Slavov. "The Power of Working Longer." National Bureau of Economic Research. 2018.
7. Aon. "The Real Deal: 2018 Retirement Income Adequacy." 2018.
8. Sudipto Banerjee. "Asset Decumulation or Asset Preservation? What Guides Retirement Spending?" Employee Benefit Research Institute, April 3, 2018.
9. Wells Fargo Featured Insights—Help Retirees Spend With Confidence

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