How to Save Your Retirement

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With the risk to your No. 1 goal growing, you may be wondering what to do now. Walter Updegrave, retirement expert, takes your questions.

Without a doubt, the past few months have ranked as the most tumultuous - and scariest - times that I've seen in the more than 20 years I've been at *Money* magazine. We've witnessed events that up to now had been almost unimaginable: the stock market fluctuating wildly and governments around the globe taking extraordinary steps to unlock frozen credit markets. And it's still unclear when the economy and the markets will hit bottom.

Given the unprecedented level of fear and uncertainty, it's no surprise that readers of my Long View column in *Money* and my Ask the Expert column on CNNMoney.com have inundated me with retirement planning questions. These five common ones cover your biggest concerns.

Should I Put Less Money Into My 401(k)?

Q. I am contributing 15% of my salary to my 401(k). With the crisis taking a toll on the stock market, would it be a good idea to reduce my contribution to 10% and place the additional 5% somewhere else? --*Verona, Savannah, Ga.*

A. I can understand why you're tempted to scale back. But reducing your 401(k) contributions now would be a mistake.

To begin with, you'd be giving up lucrative tax benefits. You pay no income tax on your 401(k) contributions, or on your investment gains, until you make withdrawals. Plus, if your company matches what you save, you are turning away free money. With a match of 50¢ to the dollar, you'd be giving up an instant 50% return on your contribution. That's a terrific deal at any time, but especially today. (For more on how 401(k)s work, see the Ultimate Guide to Retirement)

And be honest. Ask yourself whether you'll end up saving the 5% you're planning to divert. Without the convenience of a 401(k)'s payroll deductions, good intentions to save can too often succumb to the temptation to spend. By forgoing the tax breaks, the match and the automatic savings, you will almost certainly end up with a smaller nest egg when you retire.

That's an important consideration. The debt that the government is taking on to deal with today's crisis will strain the federal budget in coming years, increasing the possibility of cutbacks in programs like Social Security and Medicare. Your retirement security will depend more than ever on how successful you are at managing your 401(k). This is not the time to cut back - with one possible exception.

With the ranks of the unemployed swelling, it's especially crucial to have an emergency cushion of three to six months' living expenses tucked away in a highly secure stash, such as a bank account or a money-market fund. If you don't have a reserve, start building one pronto. Ideally, you'd do this by tightening spending. But if that's not possible, you may have to resort to saving less in your 401(k). I can't stress enough, however, that such a move should be temporary. Once you have your emergency fund, bump your 401(k) contributions back to where they were before, if not higher to make up for lost ground.

Is My Pension Safe?

Q. Does the crisis have any effect on my defined-benefit pension plan? I just turned 55 and was getting ready to start drawing from it. *--Lynn, Hephzibah, Ga.*

A. The fact that the stock market is reeling doesn't mean your employer can slash your pension or take it away from you. With a traditional defined-benefit pension, the size of your check is based on the number of years you worked and your salary. Once you're vested, your employer must pay you the pension you've earned.

Of course, since pension managers generally invest about 65% of their assets in stocks, plummeting prices have put a strain on the funds employers are counting on to pay retirees. But that doesn't mean promised benefits are in peril. Pensions are paid over decades. There's plenty of time for assets to bounce back.

Besides, even if your company were to go bankrupt, you would likely collect all or most of your pension. The federal Pension Benefit Guaranty Corporation would step in and cover your pension, up to certain limits. For a 65-year-old, the PBGC's maximum payment for plans ended in 2008 is $51,750 a year (for more, go to pbgc.gov).

There's one way that the current crisis could hurt your pension, however. If a pension fund's investment losses are deep enough, your employer could be required to inject big sums of cash just as profits are being squeezed. If that happens, the company might follow the example of Equifax, Gannett, IBM and others, which have frozen or plan to freeze their pensions. In that case you would typically no longer accrue additional benefits in the plan. But you would still be eligible for whatever benefits you had already earned.

Should I Still Stick With Stocks for the Long Term?

Q. My 401(k) is invested entirely in stocks and has dropped 30% over the past two months. Should I move my account out of stocks now? Help! *--Leslie, Fairfield, Conn.*

A. At times like these, it's natural to want to do something - anything - to stem the bleeding. Just about any move has to be better than staying in stocks, right?

Wrong. Switching your 401(k) into bonds or cash may make you feel better today. But by allowing fear to dictate your investing strategy, you are undermining your chances for a comfortable retirement. Stifle the urge to flee stocks, step back and assess this situation coolly.

Despite the steady drumbeat of bad news, the U.S. economy isn't going to disintegrate. Yes, we're likely in or entering a recession. When we'll come out of it, frankly, no one knows. Recessions typically last about 10 months, but the length and severity of this one depends a lot on how well the various rescue measures work and when the housing market recovers. But we will rebound from this crisis, just as we recovered from previous recessions.

When that happens, stocks will still offer you the best shot at long-term growth. I realize that notion may be a hard sell: The market is down more than 30% this year, and stock returns have actually lagged those of bonds over the past 10 years.

But steep price setbacks aren't new, and while the decade has been discouraging, it's an anomaly. Of the 73 rolling 10-year periods since 1926, stocks have beaten bonds 85% of the time. There's no guarantee that the future will repeat itself. Then again, the case for stocks is even stronger when they're selling well below their peak.

Remember, stocks typically lead an economic recovery. By the time you feel more comfortable investing in them, the market may already have begun to rally. If you aren't there for the initial part of a rebound, you may miss out on the biggest gains. When the market exploded from its low in the 1982 recession, it gained 59% over the next year. But 70% of that return came in the first six months.

Alas, neither I nor anyone else can say when the market will recover. But if you want to participate in the recovery, you need to have your 401(k) positioned right. The younger you are, the more you should tilt your mix toward stocks. You don't have to be so concerned about stock market setbacks, even frightening ones, since you've got plenty of time to bounce back.

Generally, if you're in your twenties or thirties, you should probably invest 80% to 90% of your retirement savings in stock funds, with the rest in bond or stable-value funds. As you get older and have less time to recoup losses, you can gradually scale back on equities, although you'll still need stocks for growth. You should have 70% or so of your retirement portfolio in stocks by the time you're in your fifties and perhaps 60% by the time you turn 60. Create your own stock-bond mix using the Asset Allocator.

I think investing 100% of your 401(k) in stocks is too aggressive for nearly all investors. It's the kind of approach people adopt when the market is flying high - and come to regret when a bear market sets in. What you don't want to do, though, is get so freaked out that you dump stocks altogether. You'll be setting yourself up for a more devastating setback later: entering retirement with a nest egg that's too small.

How Can I Protect My Retirement Income?

Q. I'm 61 and plan to retire in about eight months. Should I withdraw some or all of my 401(k) money and put it in a safer place? *--Peggy Wagstaff, Marietta, Ga.*

A. There's no doubt that the closer you are to retirement, the more alarming this economic crisis is. You simply don't have as much time to wait for stock prices - and your 401(k) account balance - to rebound. Older investors face another challenge: If you're collecting income from your portfolio at the same time you're suffering market losses, you'll have an even smaller investment pool left when stocks recover.

But moving your retirement savings into safe options like CDs or money-market funds isn't the right response. The yields are just too low to keep pace with inflation over a retirement that could last 30 or more years. While the stock market may be the last place you want to be, you still need the long-term growth that equities have historically provided.

That said, one reason so many pre-retirees and retirees are hurting as badly as they are now is that they went into this crisis with far too much money in stocks. A year before the bear market started, nearly 40% of 401(k) participants in their mid-fifties to mid-sixties had 80% or more of their account invested in stocks, according to the Employee Benefit Research Institute. That's too aggressive.

Reasonable people can disagree about the perfect blend of stocks and bonds, but for anyone on the verge of retiring or a few years into retirement, something in the neighborhood of 55% stocks and 45% bonds is more appropriate. As long as you have a suitable stock-bond mix, the key question you should be asking yourself is this: Given the value of your 401(k) today, can you still draw enough to live comfortably for 30 or more years?

A financial planner should be able to help with that analysis, or you can do it on your own with an online tool like the Retirement Income Calculator in the Investment Guidance and Tools section at troweprice.com. You plug in your planned retirement date and key financial information such as your projected living expenses, your savings and investments and how much you'll get from Social Security and a pension. The tool will then project how much income you can reasonably count on and how that compares with what you'll need.

If you find you have enough, great. But if you come up short - and I suspect many people will - you'll have to make some changes. One option is to work a couple extra years. That would enable you to save more, give your portfolio a chance to recover and pad your eventual payout from Social Security. Each year you delay taking benefits beyond age 62, you can boost your payout by about 8%. For a look at what you can expect, go to ssa.gov/estimator.

Working longer may not be an option, of course, once you've retired and have already begun taking withdrawals from your retirement accounts. If your 401(k) has taken a big hit early in your retirement, the odds that your money will last 30 years have plummeted.

In that case, you may want to cut back your spending so that your savings well doesn't run dry. After all, what could be more disconcerting than to realize that you're in good enough shape to go another 10 or 20 years but that your portfolio is only healthy enough to make it another five?

Is My Annuity Still Safe?

Q. I have $100,000 in an annuity with AIG that my mom and I depend on. Should I cash it out even though I would suffer a loss? *--Kitty Schwartz, Plano, Texas*

A. Most people buy an annuity at least in part because they see it as a refuge from market tumult. But that faith has been tested as the government has stepped in to cover the debts of AIG, the nation's largest insurer. I have been flooded with questions about annuity safety. I would love to be able to offer a simple reassurance. But annuities are too complicated for that. Instead, here's what you need to know.

First, if you own a variable annuity, your money is likely invested in one or more subaccounts, or mutual-fund-like stock or bond funds. Neither the insurer nor its creditors can tap these funds. So while the value of your variable annuity may decline, your investment would be safe if the insurer went out of business.

With a fixed annuity, you're protected by a network of state guaranty funds. When an insurer fails, most states cover up to $300,000 in life insurance death benefits, $100,000 in life insurance cash surrender values and $100,000 in withdrawals and cash value for annuities. This coverage is per person per insurer. As long as your annuity's value is within your state's limit, your money is secure.

If your annuity is worth more, you've got to weigh the cost of getting out against the risk of staying in. With most annuities, you pay a stiff penalty for pulling money out early: Surrender charges typically start at 7% and then fall over seven years.

Plus, when you withdraw money, you owe tax at ordinary income tax rates. You can get around the tax hit by exchanging your annuity for another, but that won't exempt you from surrender charges.

As for assessing the risk, the best you can do is see how highly your insurer is rated by companies like A.M. Best, Moody's and Standard & Poor's. It's hard to draw a dividing line between what rating equals an acceptable level of safety and what doesn't. But it's reasonable to want a rating of A or better.

If your insurer is highly rated and the surrender charges are still high, you might prefer to hold on for now. But if the insurer has a low rating and the surrender penalty isn't too severe, consider a switch. Other precautions: Try to spread your money among two or more insurers and, if possible, stay below the guaranty fund limit for your state.

Annuities can be complicated. But there's one aspect of them that has become painfully obvious: Getting into them is a lot easier than getting out.

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