

## Intelligent Investing

# Applying Murphy's Law To Retirement

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**If you can envision all that might go wrong with retirement planning, you can take steps to reduce your risk.**

As a CEO I constantly consider risk in every area of the business--especially in areas where I am not an expert, such as technology. When we develop a new product or service, or make substantial improvements to an existing one, we put it through a thorough testing process where the main goal is to try to "break it." In business, this way of thinking is essential to success, and it occurred to me that it also may be essential in retirement planning.

Basically, we are applying Murphy's Law: "If anything can go wrong, it will." As you may know, Capt. Edward A. Murphy was an engineer who was involved in a 1949 Air Force project MX981 to test how much deceleration a person could withstand in a crash. When the technician wired all of the 16 sensors for the test backward, Capt. Murphy was heard muttering his famous phrase and his smart project manager wrote it down. At a press conference a short time later after a successful test, the pilot, Dr. John Paul Stapp, credited the success of his being able to sustain 40 Gs of pressure to the firm belief in Murphy's Law and how the engineers on the project circumvented it.

Now let's apply this line of thinking to your retirement plan. Ask yourself, "What could break my plan?" When you know what can break your plan you will be able to do something about it before it happens. Assume there are mistakes in your plan and ferret them out, finding your stress points. Think about what would happen if the day before you announce your retirement:

Review how your retirement accounts will be taxed at distribution. I remember years ago, when I first started my financial education company, speaking to a newly retired business owner who had invested all of his retirement funds in his Simplified Employee Pension. Every dollar he took out of his plan was taxed as current income subject to ordinary income tax rates. During his years as a business owner, he focused his attention on his business planning and not his own personal retirement planning. Granted, he was a good saver and investor, but his plan left him vulnerable to rising tax rates.

If you have significant assets in tax-deferred investment vehicles such as traditional 401(k)s, SEP plans, or IRAs, consider putting money in tax-free vehicles such as Roth IRAs or Roth 401(k)s. Also consider

investing in tax-exempt bonds or capital assets like stocks, mutual funds or real estate. Capital assets receive favorable tax treatment when held longer than a year, and losses may be used to offset gains.

### **Interest rates drop.**

It takes a stretch of the imagination to think that interest rates could drop lower than they are right now, but remember that many retirees favor certificates of deposit (CDs) because of the FDIC insurance or the NCUA guarantee at the credit union. As expected, retirees are feeling a pinch now with the one year CD rate barely at 1% when just a few years ago 6% was not out of the question. Consider how your future retirement income would be cut if interest rates dropped again.

One strategy to consider is to ladder CDs, especially during times of moderate to high interest rates. This helps to generate higher income from longer-term interest rates while reducing exposure to short-term fluctuations.

### **Your company pension is reduced.**

A few years ago United Airlines filed for Chapter 11 bankruptcy to restructure the company. The retired employees receiving a pension were covered under the Pension Benefit Guaranty Corporation but there is a maximum limit many didn't consider. One of our planner's former clients was one of those employees--a pilot whose income was cut by \$7,200 per year, essentially without warning. This pilot had an additional income source he could tap into so his retirement was not significantly affected.

How would your retirement hold up under similar circumstances? Since the PBGC has a maximum benefit based on your age, consider running a calculation using that maximum pension amount. Those limits can be found on the PBGC site.

### **The stock market drops.**

You've probably already considered this scenario. Test your portfolio to find your breaking point. How much could you sustain in losses and still maintain your retirement goals?

### **You have a large, unexpected out-of-pocket expense.**

If there is anything you can expect in life it is that unexpected things will happen. Ask yourself, "How big of an emergency can I handle?" Do you have enough saved so that your next unexpected event doesn't throw you for a loop?

### **Here are some other scenarios to consider:**

- Congress decides to tax the full amount of your Social Security benefit while reducing the payout at the same time.
- Your property taxes double.
- We see an extended period of high inflation.

Thinking of all that can go wrong might make us feel like we've developed a sick sense of humor, but in reality it's a valuable exercise to do now while there is still time to do something about it. Take these questions to your advisor and have them run a stress test using these various scenarios to see how your portfolio stands up under pressure. Don't throw in the towel on securing your retirement if your plan fails under one of these scenarios. Instead, take steps to better prepare for those circumstances that would cause you the most trouble. In the end, it boils down to one of Murphy's other laws: "Left to themselves, things tend to go from bad to worse."

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*The original article can be found online here:*

<http://www.forbes.com/2010/02/25/davidson-murphys-law-risk-intelligent-investing-retirement.html>

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