

The Developing Retirement Crisis and a Recommendation to Include Real Estate Investment in Retirement Plans

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Introduction

After a lifetime of dealing with rush-hour traffic; attending time consuming meetings; fearing layoff notices; and trying to please supervisors, peers, and subordinates, Americans generally look forward to “golden years” away from the world of work. Retirement has long been regarded as the time when people can sleep late, travel, play with their grandchildren, and pursue other interesting activities.

Retirees *can* look forward to financially sound lives if they have sufficient income from retirement plans, savings and investment portfolios, Social Security benefits, etc. Today, however, a retirement crisis is brewing, and unprecedented numbers of employees may be disappointed at retirement time because their retirement income turned out to be inadequate.

Some Issues Confronting Future Retirees

Lack of Retirement Plans

First of all, some employers do not offer any retirement plans for their employees. When federal regulations in the 1970s and 1980s forced businesses to improve the funding of their pension plans and reduce their vesting schedules, many companies, especially smaller firms, found their pension plans too expensive to carry, and thus eliminated them. According to 2005 data from the Bureau of Labor Statistics, only 67% of employees at companies with 100 or more employees were covered by one or more retirement programs. The figure was only 37% for companies with fewer than 100 employees (U.S. Department of Labor, Bureau 2005).

Insufficient Savings

Secondly, many employees are not saving enough for their retirement. It has long been observed that Americans have dismal savings rates. After paying bills and debts, and meeting other financial obligations, many families do not have enough money left over from their salaries to allocate to savings plans. A survey of working and retired Americans, sponsored by the Employee Benefit Research Institute (EBRI), found that 31% of all workers reported having saved nothing for retirement, and 21% had accumulated less than \$25,000 for retirement (Employee Benefit 2005). These employees either did not have the resources or the discipline to allocate substantial sums to their retirement plans.

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Even for individuals who have 401(k) plans, the savings rate leaves much to be desired. In a survey by Northwestern Mutual, only 6% of employees contributed sufficient amounts to their 401(k) plans to qualify for their company's entire matching contribution (Singletary 2002).

If the percentage in the entire population of 401(k) participants is anywhere close to that percentage, then millions of Americans are missing out on "free money" from their employers. Prior to the passage of the Economic Growth and Tax Relief and Reconciliation Act of 2001, many savings advocates had pushed for higher contribution limits. But since the great majority of 401(k) investors did not even invest enough to qualify for their company's total employer match, and thus were not close to the 2001 contribution limits, this change in the law, which did increase contribution limits, provided no benefit for the great majority of employees.

Elimination of Defined Benefit Plans

A third area of concern is related to the ability of firms to meet obligations in their defined benefit plans. In these plans, a predetermined monthly pension is paid to retirees based on final annual salary and term of employment. Each year the employer deposits money into a fund from which retirement payments will be paid. To comply with the requirements of the Employee Retirement Income Security Act, these deposits, plus earnings on the fund, must be sufficient to meet the projected pension benefits. Some firms also provide life insurance and medical benefits for their retirees, but most plans do not include automatic adjustments for inflation.

Since the amount of the pension payments is guaranteed by the employer, all of the risk of making the required payments lies with the employer, and employees generally show little concern about the plan's performance. But performance is all-important to the plan sponsor. Since the bulk of pension plan assets is invested in common stock, plan performance is highly correlated with the stock market. When prices are rising, excess pension fund assets accrue, and these funds, which are in excess of the minimum required to fulfill a fund's obligations to retirees, can improve a firm's reported profitability. But in a bear market, declines in asset values create pension liabilities that must be offset by additional contributions from the plan sponsor. These additional costs will decrease profits or increase losses. If the need for additional pension plan funding occurs at a time when the firm is experiencing substantial losses from operations, the firm may find it impossible to continue its pension plan, or even to remain in business. Thus, many firms have dropped their defined benefit plans.

The American steel industry is a case in which promised retiree benefits are in danger of being lost. Over the past four or five decades, steel workers have accepted lower wage increases in exchange for enhanced retiree benefits, which included expanded pensions, life insurance, and medical benefits. But providing these benefits to retirees, who now far outnumber active steelworkers, have helped make it difficult for many steel companies to make a profit. In fact, between 1997 and 2004, 44 steel companies filed for bankruptcy; some have been liquidated and some have reorganized. Those that were liquidated left thousands of retirees and their dependents without the retirement benefits that they had been promised (Matthews 2002; United Steelworkers, 2004). The problem is that many of these companies, as well as many others with

large numbers of retirees relative to current employees, cannot afford to pay the promised benefits.

Of course, retirees receive limited protection from the Pension Benefit Guaranty Corporation (PBGC), a government agency that insures pension benefits up to a limit of \$47,659 per year per employee in plans that terminate in 2006 because the insured plan sponsors are unable to meet their pension obligations. This limitation applies to employees who retire at age 65. The guarantee amount is lower for employees who retire before age 65, and higher for employees who retire after age 65. This \$47,659 annual limitation, which is set by law, means that some employees will not receive some benefits that they had anticipated; also, PBGC does not guarantee medical or life insurance benefits that some firms had promised their retirees.

Financial Difficulties of the Pension Insurer, the Pension Benefit Guaranty Corporation

A fourth factor fueling a potential retirement crisis is the financial health of the PBGC. When an insured firm is unable to pay its retirees their pensions because of bankruptcy or other reasons, PBGC must step in and make those payments. In the fall of 2000 the agency had a surplus of nearly \$10 billion; by the end of April 2002 it had shrunk to less than \$5 billion. The surplus continued to shrink as more businesses failed and the agency took over their pension obligations (Kirchhoff 2002). By 2005, the surplus had turned into a deficit of \$23.1 billion (Pension Benefit, 2005). The PBGC has legislative constraints not found with private insurers: it cannot decline to provide insurance coverage regardless of the potential risk of loss; it cannot raise premiums to reflect potential riskiness, since premiums are set by statute; and it must continue to guarantee basic benefits even when a plan administrator does not pay premiums when due. Each year corporate bankruptcies add more participants to the agency's books. Unless successful efforts are undertaken to improve the agency's financial soundness, we may see a repeat of the situation that arose in the Savings and Loan (S&L) industry, where taxpayers had to bail out the federal agency that insured these institutions.

The lesson learned from the S&L debacle was to monitor firms more closely and take action before insurance costs multiply. An action taken by PBGC in 2002 to reduce its potential losses infuriated the employees of bankrupt steel producer Republic Technologies International, which had under funded pension liabilities of almost \$310 million (FitzGerald 2002). This firm had agreed to permit employees who met certain requirements to receive their pension benefits when the firm closed (referred to as "shut-down" payments), rather than wait until they reached retirement age. PBGC decided to terminate Republic's pension plans and assume responsibility for the firm's 6,200 workers, including 2,000 retirees. Since PBGC does not cover payments to employees prior to retirement age, Republic's employees lost approximately \$170 million in "shut-down" payments (Kirchhoff 2002).

Difficulties with the 401(k) Alternative

A fifth factor helping to produce a retirement crisis is the cloud over 401(k) plans. Many firms that have eliminated their defined benefit plans offer the 401(k) plan for retirement purposes. The 401(k) is extremely popular and, in fact, has become the retirement plan of choice

by a large number of corporate sponsors. The plan is promoted by financial planners, corporate benefit officers, financial services organizations, and financial magazines. In addition to business firms, some state governments, school districts, and other non-profit organizations also provide the plan for their employees. In some cases, the 401(k) is an optional, supplemental plan that is offered in addition to a traditional defined benefit plan. In other cases, it is the only retirement plan available to the employees. In the latter situation, the employee still has a choice as to whether he will participate in the plan. Obviously, if he chooses not to participate, then he has no retirement plan.

Since a large percentage of 401(k) plans are invested in stock mutual funds, the large run-up in the market during the 1990s made the 401(k) seem like a certain way to wealth for retirement. There were a substantial number of mutual funds that sported ten year average returns in excess of 15%. Funds that achieved one year returns of over 100% were widely publicized and their managers were praised for their "investment savvy." 401(k) investors were told that the market would have its ups and downs, but that the bulk of their funds should be in the market because its long run potential was greater than that of other alternatives. Many investors, including 401(k) contributors, believed that average returns in the two digit range were not only possible but probable.

Then in 2000, for the first time in history, 401(k) plans on average lost money; the average return was negative. Values of 401(k)s were down further in 2001 when 9/11 occurred, propelling a further downward trend; and then thousands of employees saw their 401(k) retirement funds evaporate in the Enron debacle. Balances in 401(k) plans eroded even further in 2002. Some recovery took place in 2003-2005, but the two digit returns of the 1990's did not return.

For a number of reasons, employees may be disappointed at retirement time because their 401(k) plans turn out to be inadequate. There are several factors that might make one question whether the 401(k) is the true way to wealth in retirement; some are related to plan sponsors, some to employee participants, and others to the economy.

Many firms do not participate in 401(k) plans. A financial nightmare facing many families is the prospect of entering retirement with no retirement benefits beyond those provided by Social Security. The 401(k) is a very popular retirement program, but it is not available to a large number of employees. The results of the Small Employer Retirement Survey, conducted by the Employee Benefit Research Institute, listed several reasons why small employers do not offer retirement programs (CFO.com 2001). The major reasons were: company revenue was too uncertain; employees preferred other types of compensation; there was a high turnover among employees; and set-up and administrative costs were too high. In those cases where a retirement plan was available, it was most likely a 401(k).

Some companies that offer 401(k) plans match a portion of their employees' contributions. The matching contribution is one of the major advantages of the plan. Firms, however, are not required by law to make any match, nor is there any obligation to continue a match once it has begun (except in the case of collective bargaining agreements). Because of the

recent drop in profits, companies have been forced to look at all areas of their operations to see where cost savings can be obtained. Many companies, including General Motors, Daimler Chrysler, Ford, and Kmart have reduced or eliminated their matching contributions to their 401(k) plans (Shoring up your 401(k) 2002).

Many 401(k) plans are not adequately diversified. It was lack of diversification that led to the loss of millions of dollars in retirement benefits for thousands of Enron employees when the energy giant failed. Many of the employees held most or all of their retirement assets in Enron stock; they could have divested the Enron shares they had purchased, but chose not to. Employees at Enron were not the only ones who have held large amounts of company stock in their 401(k) plans. Employees at McDonalds, Anheuser-Busch, Proctor and Gamble, Target, Texas Instruments, and Campbell Soup held a higher percentage of company stock in their 401(k) plans than did the Enron employees at the time of the Enron bankruptcy filing (Wang, 2002). According to David Wray, president of the Profit Sharing/401(k) Council of America, company stock represents more than 40% of all assets in 401(k) plans with 5,000 or more participants (Franklin 2001). It is highly likely that additional employees will have Enron type experiences.

Some firms have adopted rules in their 401(k) plans that do not allow employees to sell their employer-contributed stock unless time and/or age requirements have been met; the age requirement is generally 50 or 55. Some employees at Enron, where the age requirement was 50, were especially incensed when the price of the stock was declining, top executives sold their stock, and they could do nothing with their employer-contributed stock but watch. (Of course, they could, and some did, sell Enron stock that they had purchased for their 401(k)s.).

In addition to load fees, 12b-1 fees, and operating expenses assessed by mutual funds, there may also be administrative fees imposed by the 401(k) employer sponsor. Some firms charge annual fees as high as 2% of assets; large firms have lower fees, some as low as .17% of assets; and some large firms pay all of the administrative costs of their plans (Woodruff, Check Out, 2002). A survey by Hewitt Associates found that 38% of companies with 401(k) plans imposed record-keeping fees on their participants in 1999, up from 22% in 1991 (Woodruff, Is Your Employer 2000).

Over a long period of time, annual fees can have a large impact on fund balances. For example, annual contributions of \$3,000 to a plan with a 10% rate of return would grow to \$449,063 in 30 years if the annual administrative fee was 0.5%; the final balance would be only \$339,850 if the annual fee was 2.0%, a difference of over \$100,000; almost ¼ of the fund's value would be lost at the higher fee level.

Employer fraud and embezzlement can also reduce employees' 401(k) assets. Some firms have raided their employees' 401(k) assets and used the funds to cover operating expenses. A firm that is having cash flow problems may find the employees' 401(k) contributions a tempting source of funds. If the funds are never replaced and the theft is not discovered, it is the employees who would be shortchanged at retirement.

In the mid-1990s Labor Secretary Robert Reich launched an investigation into employer fraud in 401(k) plans. Over 100 violations were uncovered, resulting in the recovery of over \$3.2 million for over 2,800 employees (U.S. Department of Labor, Pension 1995). The recent revelations of numerous scandals involving CEOs and other top level executives might suggest that violations in 401(k) plans could be taking place that have not yet been uncovered.

Even where there is no fraud or theft of funds, record-keeping errors may have a negative impact on employees' 401(k) balances. There is a substantial amount of paperwork involved in administering a 401(k) plan, and numerous opportunities arise where errors may occur: recording the contribution amount properly, allocating contributions to the appropriate investment alternatives, calculating the correct employer match, determining the appropriate number of shares when matching is made in company stock, handling loans and loan repayments properly, preparing distributions for departing employees and accepting transfers from the 401(k) plans of new employees, and making sure that the plan is in compliance with federal regulations. Undetected errors may compound over many years, and have a large impact on workers' balances.

Plan trustees do not always manage funds prudently. It is the duty of a 401(k) plan sponsor to ensure that the plan is managed prudently and solely in the interests of the participants and their beneficiaries. Furthermore, the sponsor, when acting as a fiduciary, has a duty to inform and disclose complete and accurate information that may affect the participants' decision to make specific investments. And this duty supersedes any interest of the sponsor.

Several high profile cases have arisen where questions have been raised concerning plan trustees' performance of their fiduciary duties. Enron employees have sued the company, which acted as plan administrator, claiming that it misrepresented the company's financial position to induce the participants to continue to invest and maintain investments in the company's shares, and prevented employees from selling their shares during the weeks preceding the firm's filing for bankruptcy. The trustees sold their own holdings of Enron stock, but took no action to protect the employees. A similar suit has been filed against Global Crossing, Ltd., with similar circumstances and accusations.

The Labor Department settled a suit in 2002 brought against 27 union pension plan trustees who imprudently invested \$150 million with Capital Consultants LLC, an investment management firm that was allegedly involved with a pyramid scheme, resulting in millions of dollars of losses. The trustees allegedly ignored warnings from outside advisors about Capital Consultants, and they violated the plans' own investment rules. Also, one of the trustees acknowledged accepting a \$190,000 payoff from Capital Consultants (Chen 2002).

These cases involved large organizations, but hundreds of smaller firms are also involved in fiduciary breach cases every year. The *Wall Street Journal* reported that the number of these cases brought by the Labor Department has totaled over 2,000 cases annually in recent years (Chen 2002).

Some employees will be disappointed at retirement because they have withdrawn funds from their 401(k)s or they have borrowed and not repaid the loans. Loans and withdrawals were generally not possible with defined benefit programs; thus current “needs” and “emergencies” did not decrease future retirement benefits of workers under those plans. But the flexibility of the 401(k) allows for the potential reduction in benefits because of overuse of these features.

The portability of the 401(k) is one of its major advantages. When an employee changes jobs, he can leave the 401(k) with the former employer, roll it over into the new employer’s 401(k) plan (if the new employer permits), roll it over into an IRA, or take it in cash. A study by Putnam Investments revealed that 30% of workers who faced these alternatives chose the cash option (401kHelpCenter 2002). And among employees changing jobs aged 18 to 34, the figure was 39%. The temptation of remodeling the house, buying a new car, taking a “well-deserved” vacation, or paying off high interest rate credit card balances is sometimes too great when thousands of dollars suddenly become available. Those investors who spend the cash are missing out on long-term tax-deferred growth, and a large portion of the cash taken out will be owed in taxes. For example, a 35 year old employee in the 27.5% tax bracket who takes \$10,000 in cash will owe \$2,750 in taxes plus a penalty of \$1,000, or a total of \$3,750. And state taxes may take another \$700 or \$800.

A large number of 401(k) participants are woefully inadequate in their knowledge of finance and investment matters. The eighth national survey of 401(k) participants by John Hancock Financial Services revealed some disturbing facts (Singletary 2002): 10% of those surveyed did not know that they could lose money in stocks; nearly 40% didn’t know they could lose money in a bond fund; many thought that money market funds held stocks and bonds; and 40% believed that investing in their company stock was less risky than investing in a diversified portfolio of domestic stocks.

A survey of 401(k) plan participants by the consulting firm Towers Perrin showed similar disturbing results. About 39% of plan participants did not know how their plan assets were allocated; 32% thought that investments in bonds had no risk; and 14% thought that mutual funds had no risk (ABCNEWS.com 2001). Employees who lack such a basic understanding about investments are not likely to make wise decisions on their 401(k) plans.

Many employees have unrealistic expectations concerning the returns on their investments. The average annual return that one earns on his investment is one of the most important factors determining the value of assets at retirement. In the 1990s 401(k) investors talked about early retirement and a relaxed lifestyle when returns of 15% and 20% were commonplace. Although the economy has changed drastically, many investors continue to expect double digit returns. In the John Hancock survey referred to above (Singletary 2002), 35% of the respondents expected average annual returns in the stock market over the next 20 years of nearly 16% (the historical rate was 11%), 34% expected average annual returns of 10% on bonds (the historical rate was 5.77%), and 32% expected average annual returns of 9.8% on money market funds (the historical rate was 3.81%).

Other surveys have yielded similar overoptimistic results. In a Scudder & Dalbar survey, investors over 68 expected 16% average annual returns and investors aged 18 to 23 expected annual returns of 26%. In a Vanguard survey, investors expected a return of 7% for the next couple of years, but then a return to 15%. About one fourth of the respondents expected stock prices to increase 30% to 100% annually over the next 20 years (Farrell 2002).

A major consequence of expectations of high rates of return is that investors may be induced to invest relatively small amounts in their accounts. For example, if a 35 year old investor wanted to have \$1 million in his retirement account at age 65, he would have to invest \$1,886 per year if the fund had an annual return of 16%. But he would need to invest \$8,827 per year if the annual return was expected to be 8% and \$15,051 per year if the expected annual return was 5%.

Perhaps the most important factor that will result in disappointing retirement balances is a **low** rate of return earned on 401(k) investments. Although many investors expect returns of 14% - 16% and above, financial experts generally disagree. The exuberance of the 1990s is probably gone forever; the stock market returns of that decade are not likely to be repeated any time soon. The stock market high of 1966 was followed by a period of decline and then slow growth. Similarly, the high of 1929 was followed by a market decline and slow growth. The high reached in March 2000 has also been followed by substantial decline and slow growth. Farrell (2002) reported that Roger Ibbotson of Yale University projected long-term equity returns of 9.4%; Eugene Fama of the University of Chicago suggested that long term stock market returns would not be above 7.5%; Standard & Poor's predicted returns in the range of 5.5% to 7.5% until 2010; and 282 global fund managers in a Merrill Lynch survey expected average annual returns of 6.7% over the next decade.

Inadequacy of the Social Security System

The final issue related to the retirement crisis is the financial health of the Social Security system. It is widely recognized that Social Security faces serious financial problems and is not sustainable in its current form. Various dates have been projected when the Social Security "fund" will run out of money, and Congress and President Bush have considered several reform alternatives to fix the system. The problem is so serious that many financial planners do not include Social Security benefits in their financial plans, especially for their younger clients. Their rationale is that they are not sure what form the benefits will be in or whether they will be available at all (Most, 1999). Because of the political ramifications of a breakdown in the system, it is likely that some plan will evolve to provide for a more dependable system for retirees, a plan likely to reduce current expected benefits.

Because of these various problems with the current retirement system, most employees are likely to retire with less income than they had anticipated, and some will have nothing more than Social Security to depend on. Even for those employees who are serious about retirement planning, who are contributing substantial annual amounts to 401(k)s, IRAs, and other defined contribution plans, there is likely to be some disappointment at the time of retirement.

A Neglected Alternative – Real Estate Investment in Retirement Plans

Investments in stock mutual funds for retirement purposes should certainly not be abandoned, but other alternatives should be considered for a portion of employees' annual retirement contributions. Investment in real estate is an area that has received very little attention by financial planners in retirement programs, and most corporate sponsors of 401(k) plans do not include real estate related investments as alternatives from which employees may choose. The tax consequences of real estate investments generally differ from those of the 401(k) and other tax advantaged retirement programs; most real estate investments are made with after tax dollars, and annual returns are not tax deferred. (The exception is real estate investments made under a self-directed IRA.) But real estate investments can provide added security and income to retirees who invest a portion of their retirement funds into real estate related investments.

Investment in real estate for retirement purposes can take several forms. Perhaps the simplest is to divert a portion of one's monthly retirement investments to extra payments on one's mortgage. Making additional principal payments on the mortgage would enable one to retire the mortgage earlier, and may make it possible for the homeowner to enter retirement without a mortgage. For some workers, a paid-up home is their largest retirement asset. According to the Fannie Mae Foundation, homes are the most important vehicle for retirement savings for lower-income families (McKinnon, 2002).

Many workers entering retirement still have mortgages outstanding. Some have moved up to a larger and more expensive home; others have refinanced and thus have extended the term of the mortgage; and others have been forced into an early retirement because of job cutbacks or health related problems. At retirement, they are often faced with the problem of a fixed monthly payment taking up a larger percentage of a reduced monthly income. If the mortgage had been paid up at retirement, funds could be available for other purposes, and the homeowner would never have to worry about losing his home because of the inability to make mortgage payments.

Another way to consider this situation is to determine the fund necessary to pay the remaining monthly payments. Consider a retiree who has 15 years remaining on a mortgage that is being amortized at a rate of \$1,200 per month. At a rate of 5%, a fund of \$151,746 would be needed to make the remaining payments. For this retiree, then, paying off the mortgage early and entering retirement with no mortgage would be the equivalent of having a fund at retirement of \$151,746 (assuming a return on the investment of 5%).

Of course the homeowner would lose the tax deductions from the interest that would no longer be due. But the real issue is what return the homeowner would earn from the additional principal payments if they were invested elsewhere. Actually, making additional mortgage payments is the equivalent of making an investment at the after-tax equivalent of the mortgage interest rate.

A second real estate alternative for a portion of one's retirement funds is the investment in a second home. This investment can provide living space in another location and an asset that has the potential to grow in value over the years. The second home could be rented for a portion of the year to provide income and could be sold at retirement to augment other retirement funds.

A third real estate alternative is to invest in a real estate investment trust (REIT). An REIT consists of a diversified, professionally managed portfolio of real estate income producing properties. Equity properties include shopping centers and other retail outlets, apartment buildings, hotels, office buildings, factories and other industrial properties, health care facilities, and resort properties. Some REITs are mortgage REITs; they lend money to owners of real estate or they purchase existing mortgages or mortgage backed securities. And some REITs are hybrids; they make both equity and mortgage investments. REITs allow individuals from all income levels to participate in the real estate market since the required minimum investment is generally quite low. Many REITs also have dividend reinvestment plans. Shares in REITs are quite liquid since a majority of them are traded on the major stock exchanges. REITs are required to distribute at least 90% of their taxable income to investors, and thus they provide a stable income that has the potential to rise over time.

REITs are very effective in reducing the risk in a worker's retirement portfolio. Historically, there has been a low correlation between the returns on REITs and the returns on common stocks. Ibbotson Associates examined the historical investment performance of REITs and found that there has been a decline in the correlation of REIT returns with other asset classes over the past 30 years (National Association, 2006). Since most 401(k) plans do not provide an option for including real estate stocks in the retirement portfolio, an employee who wanted to take advantage of the REIT benefits would have to add these real estate stocks outside of the employer sponsored plans.

It is possible that the management team of an REIT will select several large properties that do not perform as expected, resulting in losses for the REIT. To reduce the risk of investing in an REIT that generates substantial losses, an investor might choose to invest in a mutual fund that invests in REITs. Most of the major mutual fund families have one or more REIT mutual funds.

A fourth real estate option to consider for retirement savings is direct investment in residential rental properties. In a typical case, an employee might consider purchasing single family houses, condominiums, or town houses and renting them to carefully selected tenants. Appropriate properties can provide income, appreciation, and limited tax benefits for the investor. It is important that a careful evaluation of down payment requirements, financing arrangements, income, property expenses, and property condition be undertaken prior to any purchase of the properties. Rental income must be sufficient to cover all of the expenses of the property including insurance, maintenance, management, utilities (if paid by the owner), taxes, and mortgage loan payoff, so that cash flow will be positive.

Properties located in desirable areas have the potential to appreciate in value. Properties that are acquired over an employee's working career can be liquidated at retirement, or they can

be held for retirement income. Funds raised from the sale of the properties, after the payment of capital gains taxes, can be invested in low-risk securities for retirement income.

Investors who actively participate in the management of their properties can deduct accounting losses from other, non-real estate income. Active management would include setting rental rates, choosing tenants, authorizing repairs, and approving funds for property improvement. The total amount that the investor can deduct is limited to \$25,000, and this amount is phased out at higher income levels. Tax credits are available for investment in houses rented to low-income families, houses in historic districts, and older houses that have been rehabilitated.

A worker who decides to invest a portion of his retirement savings into income producing properties may be able to acquire one or more properties during each of his working years. After a real estate acquisition program has been implemented, equity funds for additional investments can come from retirement savings not committed to 401(k)s or other retirement plans, income from properties acquired earlier, and tax savings. Since real estate is really a borrowed money business, it is crucial that reliable sources of mortgage funds be arranged. Conventional lenders, city and state rehabilitation agencies, Federal government agencies, and nonconventional lenders can all be used in various situations. In some cases real estate that is owned can be used as collateral to borrow more money so that additional income-producing properties can be acquired. Owner financing may also be desirable in some situations.

Aggressive investors who become adept at maneuvering in the real estate market can enhance their investments through a number of innovative procedures:

1. Purchase rundown properties, repair them, and resell them at a profit.
2. Purchase properties at foreclosure sales at a discount from market value.
3. Purchase properties from owners who are facing foreclosure and negotiate an advantageous price.
4. Purchase properties from owners who are under other pressures to sell.
5. Find sellers who are willing to take back a second mortgage so that down payment outlays are minimized.

The final real estate related option considered in this paper is investment in Ginnie Mae pass-throughs. The Government National Mortgage Association, nicknamed "Ginnie Mae", is a governmental agency within the Department of Housing and Urban Development created to provide additional funding for the housing market. Ginnie Mae buys residential mortgages that are originated by commercial banks, savings and loan associations, mortgage companies, and other financial intermediaries. It then aggregates these mortgages into a pool and issues securities that are collateralized by the mortgages in the pool. The securities are called "pass-throughs" because interest and principal payments made by homeowners, minus a processing fee, pass through to the holders of the mortgage-backed securities on a pro-rata basis. These payments are guaranteed by Ginnie Mae, and this guarantee is backed by the full faith and credit of the U.S government.

Similar mortgage-backed securities are also issued by the Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac).

These corporations also guarantee the payment of interest and principal to the security holders, but the guarantees are not backed by the U.S. government.

There are two issues that may concern some investors. One is the risk that homeowners will refinance their loans when interest rates fall and thus prepay their loan. These prepayments would flow through to the holders of the mortgage-backed securities, and they would no longer have the investment that they had anticipated holding. The other issue is the minimum investment required for these securities. The minimum investment required for Ginnie Mae pass-throughs is \$25,000 and the minimum for Fannie Mae and Freddie Mac pass-throughs is \$1,000.

These pass-through securities offer a moderate return with minimal risk. Investors who are concerned with the prepayment risk or the minimum investment amount could invest in a mutual fund that purchases mortgage-backed securities. As was the case with REITs, most of the major mutual fund families have one or more of these mutual funds available for purchase.

Concluding Remarks

There are some individuals who never plan to retire. They enjoy their work so well that they cannot conceive that retirement would offer a more attractive alternative. Most workers, however, look forward to the time when they can avoid the 9-5 crowd and spend time doing what they really want to do. Retirement can be a pleasant phase of life if sufficient assets have been accumulated from which an income can be drawn to finance one's needs and desires during this period.

This paper can be considered a wake-up call for financial planners who can take action to brighten the retirement picture for their clients and potential clients in a number of ways. First of all, firms in their market areas, especially smaller ones, can be contacted to determine which ones do not offer any type of retirement plan for their employees. These firms could be encouraged to implement relatively simple plans where the cost to the sponsoring firm is minimal.

Secondly, financial planners should encourage their clients to increase their contributions in 401(k)s, IRAs, and other defined contribution accounts. If a specific dollar retirement goal has been identified, a larger periodic payment will be necessary at a lower annual rate of return. Current savings rates are abysmally low, and if actual returns are lower than expected, retirement balances will be extremely inadequate. The double digit returns seen in the 1990s are unlikely to be seen again soon; thus, larger contributions will be necessary to obtain future balances that were based on higher anticipated annual returns.

Finally, the concept of a diversified retirement portfolio should be expanded to include real estate investments. When financial planners review portfolios for diversification, the concern is usually with too much invested in the shares of one company (for example, shares of the sponsoring firm in a 401(k) plan) or too many of the same types of mutual funds in the portfolio. But diversification beyond the securities that are stock market oriented should be considered. Investments in various types of real estate, as well as diversified stock market

investments, would produce retirement portfolios that are better suited to withstand the shocks to retirement plans than have the plans of many employees and retirees recently.

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