

## Retirement Planning for Generation Y

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### Abstract

Retirement is a fact of life, for those who make it that far. Planning for it should be a simple process, but with changes in the way it is funded and outside forces, it is anything but simple. Employers, employees, and society are faced with the same problem: how to provide a secure retirement in an ever-changing world. No group has more uncertainty in their retirement plans than Generation Y who, having just entered the workforce, are now faced with major decisions regarding retirement. Faced with declining employer contributions to pension funds and a Social Security meltdown, young workers must make their own path to retirement that will sustain them well into their twilight years. Tough decisions and sacrifice will be the options many will be faced with.

### Introduction

Retirement planning is a subject every American should be concerned with, unless they are among the wealthiest Americans. Those who are not in the possession of a financial fortune must do as those that have come before them, adequately plan and save or face their retirement years working.

Traditionally, there has been at least some sense of certainty in the arena of retirement income. American workers spent their lives working for businesses and entities that offered pensions. Social security was viewed as a certainty. Savings accounts earned a reasonable rate of return. Most Americans trusted a stockbroker or banker to choose appropriate investments that would appreciate. Americans made it through life with little to no debt outside of a mortgage on their primary home, which was usually paid in full by the time they retired. Retirees were able to live their retirement in a relatively comfortable manner, free of debt and bolstered with adequate financial resources.

Over the last several decades, there has been a decline in the presence of pensions. Social Security is predicted to become insolvent by 2037 (Social Security/Medicare, 2011). Savings accounts pay essentially no interest. Pension plans have been replaced with defined contribution plans thrusting retirement saving into the open market, subject to volatility. The era of concrete

retirement planning has ended, and Americans must find a way fund their golden years while still meeting the obligations of their working years.

The Baby Boomer generation, those born between 1945 and 1964, is in the first throngs of passage into retirement. Twenty-five percent of the United States population is relegated to the Baby Boomers (Estate Planning for Boomers and Beyond, 2009). The quarter share of the population may not be fully prepared for their retirement years. Longer life expectancy and active lifestyles will cost Baby Boomers significantly more than they have planned for. Many believe that there is a high possibility that Baby Boomers will be forced to return to work at some point in order to sustain their active lifestyles or to provide themselves with the basic costs of living (Estate Planning for Boomers and Beyond, 2009).

The children of the Baby Boomers will face some of the same issues as their parents. Generations X (those born between 1965 and 1981), and Y (those born between 1982 and 2003) are expected to enjoy longer life spans, so that leads to an increased need for retirement money. They are also saddled with more debt than the Baby Boomers. Credit cards, student loans, car loans, and other forms of credit hamper the amount of money that the younger generations are able to allocate towards their retirement. A tougher job market, low savings rates among younger Americans, and the lack of education on financial matters will adversely affect the amounts and ways they prepare for retirement. As Sullivan describes, “They spend more time planning a one week vacation than their retirement in twenty years” (2010).

Every generation has faced its own issues with retirement planning, but in today’s environment, there are stark differences in how retirements are planned. New ways of saving and less reliance on past assurances place Generation Y in a much different position than that of their parents and grandparents. Evaluating different components of the retirement picture for the so-called “Millennial Generation” will help to provide an understanding of how they should proceed and under what constraints they should focus their planning (Cudmore, Patton, Ng, and McClure, 2010).

## **Components of Retirement Planning**

### **Social Security**

Social Security has long been the saving grace of most retirees. Almost every American worker pays into the system during their working years counting on the promise of a monthly benefit when they reach retirement age. The system has provided benefits to millions of Americans since its inception; however, it has come under fire in recent years as the trust fund dwindles. This is due to more Americans drawing benefits and fewer paying into the fund.

The current age for full benefits is sixty-seven for those born after 1960. This is not the age at which most plan to retire, and for that reason Social Security allows early retirement beginning at age sixty-two. There is a major down side to taking the early payments – the monthly benefit would only amount to seventy percent of what a retiree would receive had they waited until age sixty-seven to retire. Taking Social Security benefits earlier may only be a smart idea if the retiree has other adequate means of financially supporting themselves throughout their retirement years.

According to the Social Security Benefit Calculator on the Social Security Administration website, a person born in 1985, earning fifty thousand dollars a year on average will receive a benefit of \$1779.00 (in today's dollars) per month if they wait to retire at age 67. Taking into account Cost of Living Adjustments (COLA) and inflation, the amount is projected to be \$8199.00 per month (Administration, S. S., 2011). One can assume that the actual amount of monthly benefits would be somewhere in between due to adjustments that will be made for COLA and inflation in the future.

A looming question over the solvency of Social Security has troubled both the public and lawmakers for years. As the number of retirees grows and the number of workers and employers paying in Social Security taxes decreases, there will be a point of insolvency. That year is currently projected to be 2037. This does not necessarily spell the end for Social Security. Current projections show that in 2037 there will be enough inflow from current workers to cover seventy-eight percent of the scheduled payments (Social Security/Medicare, 2011). What happens when this occurs is an unanswered question. Lawmakers must find a solution that will not turn constituents against them, and yet it must not cause undue financial hardship to the federal budget. This problem must be addressed long before 2037. The financial future of millions of Americans is on the line.

### **Employer Funding**

**Pensions/Defined Benefit Plans.** Americans have grown accustomed to the retirement plans of the past—employer-funded pensions. These are known as defined benefit plans. The retirement benefit is defined by a calculation outlined by the employer and is based on a combination of years of service and amount of pay. The employee may or may not be required to contribute to the plan, and the future benefit is guaranteed by the employer once the employee is vested. Usually the biggest hurdle for the employee is to remain employed in the plan long enough to vest—usually 3 to 10 years.

In the corporate world, these plans are increasingly viewed as too costly to maintain. Companies, and indeed entire industries, have been burdened to the point of bankruptcy trying to make good on defined benefit pension promises made decades ago. Add to this that the employer assumes all market risk to maintain the fund, and it is no surprise that these plans are virtually disappearing (Hoffman, 2012).

A prime example of this situation is the Auto industry in America owing billions in defined benefit pension obligations to retirees. Automakers were at the mercy of the unions when these agreements were first made; sales were through the roof, they needed a reliable labor base, and they were willing to agree to such generous pensions. As auto sales declined in the last few decades, the pension expense became a looming problem with no solution. Automakers were beginning to have trouble meeting the obligations and thus decided to end the costly pension plans. The United Auto Workers (UAW) negotiated on behalf of its members to assure that the automakers would fund the pensions as promised (Surowiecki, J., 2008). As time passed and financial conditions worsened, the UAW had one option, to accept substantially less than originally promised to its members (Associated Press, 2008).

The problem of defined benefit pensions is not an entirely unique corporate problem. Municipalities and other governmental entities are facing the same crisis. Traditionally, government workers have found security in their jobs in the form of a great pension plan. Some workers have chosen the public sector with its reduced earning potential because of the promise of a pension. As time has passed and these government entities have become more budget conscious, defined benefit pensions have been eliminated or altered to make the municipalities themselves more viable.

In San Diego, California, they addressed their looming \$2.1 billion unfunded pension liabilities with a set of reforms that serve as an example of how entities must find a way to meet obligations. At first the goal was to simply meet their obligations through a sales tax increase. Voters failed to approve the measure, leaving the city to find ways to reduce expenditures. Pension costs were placed in the crosshairs. While San Diego did not eliminate its pension plan, a hope that their Mayor had vied for, it did alter the pension formulas. These formulas were reduced to provide lower amounts of benefits to those who retired at younger ages and rewarded those who worked until they were older. This plan helped to alleviate the problem whereby pensioners withdraw significantly more benefits than they paid in due to living longer lives. The reductions were met by criticism from some workers, but most were happy to still be afforded a pension by the city. It should be noted that these measures did not affect the current employees due to laws protecting the vesting rights of employees. All new hires will be subject to the new guidelines (Jensen, R., 2011).

Many companies have done away with their pensions plans altogether in favor other retirement options. Pensions, once a staple of the American retirement landscape have now been relegated to a select few, namely those in the civil service. This loss leaves a large gap in the way people plan for their retirement.

**Defined Contribution/401(k).** As defined benefit pensions are on the way out, defined contribution plans are becoming the standard retirement vehicle for major corporations. These plans place more of the responsibility of retirement planning, and the function of asset allocation, on the employee. Employers contract with a financial services provider to set up these accounts for their employees. The employee may or may not be required to contribute to the plan via pretax payroll deductions, and these funds then may or may not be matched by the employer. If the employer contributes, their contribution would be a fixed amount or percent for each employee, thereby limiting their liability to the amount of the contribution. When an employee retires, quits, changes jobs, etc. there is no future obligation of the employer. The popularity of these plans for employers is ubiquitous. They like the idea of helping their employees plan for retirement, and they are also drawn to the cost effectiveness these plans offer; however, the plus side experienced by the business community does not always extend to the employee.

The employee's retirement benefit depends on the amount accumulated in their tax-deferred account via the total deposits and interest earnings at the time of their retirement. Many of these plans are directed by the employee as they are required to select asset allocations and investments from a list of options provided by the plan. Commonly, employees find themselves ill-prepared to make such choices. In addition, retirement accounts experience gains and losses based on selections made as well as market conditions, so it is difficult to predict how much the

employee will have upon retirement. That uncertainty can be very stressful, especially as one nears retirement age.

A similar retirement option is known as a 401(k), which is also a salary deferral plan. These plans are also established by employers for their employees. The employee has the option of whether or not to participate and the employer may or may not choose to match any of the employees' contributions. Again, the employee selects the asset allocation and investments based on the options offered by the plan. Earnings grow tax-free until withdrawn as retirement, and future retirement benefits depend strictly on how much the employee can accumulate in the account. Funds of this type are immediately vested.

As previously noted, employees are most often at a disadvantage when it comes to retirement fund decisions. Many defined contribution/401(k) plans allow for "do-it yourself" investment decisions (Bhatt, N., 2010). This can create more of a mess than a plus for employees as most people are not well-versed in the nuances of retirement investing. Risky investments may show a high rate of return or stellar previous performance, but these are by no means predictors of future success. Most individuals have little to no education in the field of financial planning, and yet they are asked to make decisions that will have a huge impact on the final outcome of their retirement income. This issue has become important in the debate over the privatization of Social Security where opponents of the idea have suggested it could lead to the same types of reckless investing sometimes seen in 401(k) accounts (Bhatt, N., 2010).

Another problem with 401(k)s has been the participation rates by employees. Employees are less likely to contribute to the plans if their employers do not offer a match. Amongst those that do offer a match, the higher the match, the higher the rate of employee participation (Redesigning 401(k) match can..., 2011). This fact is not surprising because the match is free money from the employer. Sound advice to employees would be: If an employer offers a plan, use it. If they offer a matching contribution, take advantage of it. Contribute up to the amount of the match and pursue other types of investments to reach your goals.

It has also been argued that as people enter retirement age they should convert part of their 401(k) to an annuity. This would serve the function of a guaranteed form of retirement income. Furthermore, it has been suggested that retirees convert as much as seventy percent of their 401(k) into this form as a backstop against running out of money (Bhatt, N., 2010).

## **Personal Funding**

**IRAs.** On the other end of the spectrum are Individual Retirement Accounts (IRAs). These accounts differ from 401(k)s in two main ways: (1) the amount of contributions that are allowed to be made annually and (2) the fact that an IRA is funded 100% by the individual. IRAs also offer significant tax advantages based upon which particular type of IRA--Traditional or Roth--an individual has (Adelman and Cross, 2010).

Traditional IRAs are investment vehicles that allow individuals to contribute up to \$6000 per year (if under age 50, amount is \$5000) pre tax as of 2010. These investments grow, tax deferred, until distributions begin, as early as age 59 ½. These accounts also offer the benefit of having the contributions being tax deductible under certain circumstances. These accounts also

allow for early distributions under certain circumstances: higher education expenses, disability, medical expenses, purchase of one's first home, and payment to beneficiaries, all without restriction or penalty. Withdrawals made outside of these restrictions are subject to penalties and could be considered an addition to one's taxable income in the year of distribution (Adelman and Cross, 2010).

Roth IRAs are the same concept as the traditional IRAs, but with a few major differences. Roth contributions are made on an after-tax basis. This allows the contributions to grow tax free once the account has been opened for five years and after the owner reaches age 59 ½. The contributions are not deductible as in the case of traditional IRAs. Being after tax, these contributions are also allowed another important feature: contributions may be withdrawn at any time, tax-free and penalty free. After the five-year period, the earnings may also be withdrawn free and clear for disability, death, or first time home purchase. Roth IRAs are ideal to avoid taxation in retirement (Adelman and Cross, 2010).

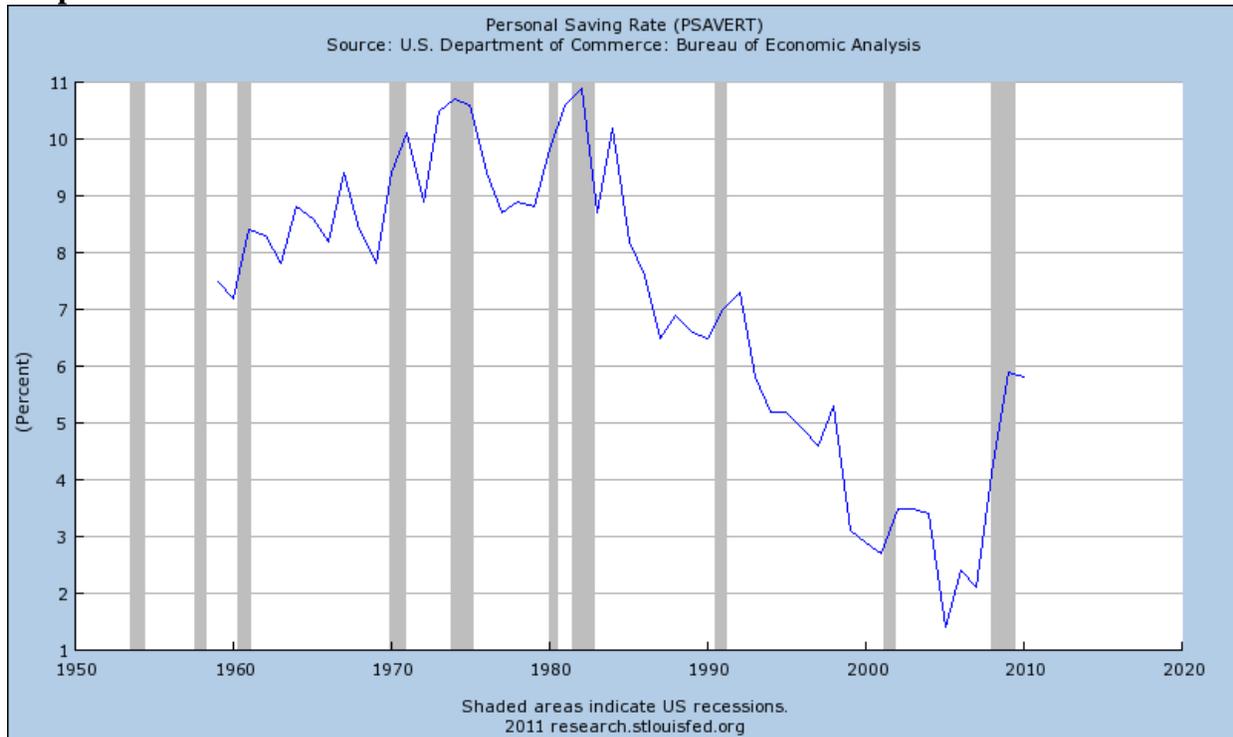
Younger taxpayers may consider opening Roth IRAs because of the flexibility to withdraw some funds after five years. As income rises, Traditional IRAs may be appealing for the current tax deduction. A Traditional IRA can be converted to a Roth IRA, but it requires payment of taxes previously saved. One may consider converting if the taxpayer experiences a particularly low income year during their working career.

**Traditional Savings/Other Investments.** Traditional savings have long been the way Americans save money. Saving a portion of each paycheck after all monthly bills are paid is the primary way Americans prepare for the future. Parking these funds in savings accounts is a way to provide certainty that the money would be there when needed. These funds historically earned a reasonable rate of interest. As time has passed, savings accounts have declined in number and the amount of interest has fallen sharply. Americans are saving less as well (Feldstein, 2006).

Since the 1970s savings rates have decreased in the United States from around seven percent to a paltry one percent in the second half of 2005 (Feldstein, 2006). One percent savings would amount to \$500 of savings for every \$50,000 in income. This phenomenon is believed to have occurred as individuals looked at retirement account balances, home values, and other assets and decided that they did not need to save more, that their savings were adequate. As the economy turned downward, it became evident that the rate of savings was inadequate, more liquid cash was needed, and indeed, more overall savings would be necessary (Feldstein, 2006). In 2011 savings rates, as shown in Graph 1, have jumped to nearly 6 percent. Savings rates have not been that high since the early 1990s (Federal Reserve Bank of St Louis, 2011).

Individuals in America also rely on other investments outside of their retirement accounts to provide additional retirement funding. The stock market is viewed as a hedge against inflation, mutual funds as a way to reach various sectors or entire markets with ease, and bonds as a secure place to park retirement funds. Exchange traded funds, and even commodities, can play an important role in retirement planning. These investments will have their own unique characteristics that may aid or hinder retirement planning, tax implications, market fluctuations, etc. These investments also allow for diversification, which is ideal for riding the vicissitudes of the market. Individuals should decide for themselves how to allocate their investments. The

Graph 1



(Federal Reserve Bank of St Louis, 2011)

advice of a qualified and certified financial planner is also wise to seek. An early start coupled with a plan and a willingness to stick to it is the only assurance of an adequate and successful retirement.

**Savings bonds.** Savings bonds offer guaranteed returns and deferred taxes. Individuals generally pay tax on the interest from a savings bond only when they cash the bond; therefore, tax can be deferred and one can potentially increase their returns by cashing the bonds after retirement when their tax rates are lower. If the proceeds are used to pay for higher education, one may be able to avoid taxes altogether on interest earned on the bonds.

**Estates and Trusts.** Upon their death, Baby Boomers may choose to pass their assets on to younger generations. It is prudent for the Baby Boomers to first seek advice on preparing a will and on estate planning. Trusts can provide individuals with control of their assets during their lifetime and then serve as a vehicle for passing the assets to their heirs at the time of the Baby Boomers' death. Proper planning could save taxes and administrative fees at the time of death, thus saving more for their heirs. In addition, during their lifetime, annual gifts of \$13,000 each (2010 limit) may be made to heirs tax-free. Common uses for gifts of this type include education, purchase of a home, or other significant life events.

## Constraints to Planning

### Job Market

Every generation has faced its own unique job market. During the Great Depression there were no jobs to be had, and Social Security was a byproduct of the age. During World War II there was a shortage of male workers that was filled by females. In post war America the boom of American manufacturing created a ripple effect that employed millions of people in new industries. The housing market also became a huge contributor to the United States economy, providing millions of jobs directly and indirectly.

Over time, America has weathered the ups and downs of the job market surprisingly well. There is, however, another side to the volatility of the labor market. Fluctuating employment does not lend itself to consistent savings rates (Feldstein, 2006). The current economic downturn, often described as the Great Recession, has created a tight job market to say the least. In times such as these, the balances of retirement accounts are adversely affected due to constraints such as limited earnings and debt payments.

### Debt

A major factor in the accumulation of retirement savings is the amount of debt carried by individuals. Debt has become a rising concern not only to those saving for retirement, but for society at large. The emergence of the high debt levels, now held by most Americans, is an effect of the mantra of consumption. The world economy is based upon an endless requirement of consumption and the growth of that consumption. An environment of increased spending in the face of tight labor and flat wage growth has led to the creation of debt (Cudmore, Patton, Ng, and McClure, 2010).

Debt is a multi-generational problem, but in true American fashion, Generation Y appears to be leading the pack with debt. In the 1990s credit card debt amongst young adults jumped 305 percent over the course of ten years, from \$900 at the start of the decade to \$2,748 by 2000 (Cudmore, Patton, Ng, and McClure, 2010). By 2011 the average American owes more than \$4,200 in credit card debt (Ellis, 2011). That sort of increase denotes a serious problem with adults in regards to money matters.

The problem is further exasperated when you look at the student loan situation. With average student loan debt of \$23,485, equating to a monthly payment of \$184 for 20 years under standard repayment plans; students are saddled with a large burden from the start of their working years. Furthermore, 36 percent of students say they are not prepared to pay their student loans. The situation looks even bleaker when 59 percent say they are unable to fulfill other financial plans. The biggest impact to the retirement planning function lies in the fact that 41% are delaying contributing to their retirement to meet the obligations of student loans (Korn, 2005). These figures paint a sad portrait of the state of retirement savings for the younger generation in America.

The debt burden carried by Generation Y has left them in a precarious position. While 62 percent view themselves as financially independent, 45 percent have borrowed money from family or friends, or have received government assistance, to make ends meet (Estate Planning for

Boomers and Beyond, 2009). Overcoming their debt load appears to be the largest hurdle to a good retirement planning strategy.

## The Plan

### How Much Is Enough?

What amount of money will be needed to sustain a Generation Y member throughout his or her retirement? That question is subject to various answers all of which take into account previously discussed matters and individual situations. There is no “one size fits all” answer; however, there are some guidelines that provide a reasonable outlook on the amounts and types of assets needed.

A study has shown that Generation Y can expect sluggish wages and a decline in the funding of pensions and retiree health benefits. This outlook has been taken into account by Ackermann (2010), who projects that Generation Y will find it necessary to accumulate 18.7 times their last year’s net pay in retirement funds. That amount seems daunting. For an idea of what that may look like for someone, consider the following: A worker retires with a final year, take home pay of \$80,000. By the Ackermann’s calculations, they would need to have at least \$1,496,000 in retirement-marked funds. According to his research, Americans are only on track to accumulate 12.4 times their last year’s wages. That gap will create an issue, possibly not in the beginning years of retirement, but surely in the end years. Those who live extra long lives will be the ones who need excess. As mentioned earlier, this shortfall is mainly related to the debt burden carried.

A rule of thumb would be to plan to live until the age of 100. That may seem unreasonable since the life expectancy for men born in 1981 is 70.4 years and for women, 77.8 years (US Census Bureau, 2011).

Advances in medicine and a health conscious population could lead to superannuation. A retiree who saved only to meet their predicted life expectancy might wish otherwise, if they suddenly find themselves in their eighties or nineties and destitute. It is much better to have too much money than not enough. Not having enough will lead to something one rarely thinks of in retirement – returning to work. According to a study conducted by MetLife, “87 percent of Americans over 60 said they are feeling a pinch, and cutting back on spending” (Morgan and Executive, 2008). That information viewed in conjunction with another study on men and women over age 65 showed that 10 percent of men and 9 percent of women were employed at least part-time (Purcell, 2009). This may not be a bad thing - it will keep retirees active and give them something to do in between vacations if they have planned effectively.

### How and When to Utilize the Funds

Once an individual has completed the phase of earning and accumulating retirement funds, the next phase—utilization—begins. For those who planned and waited to age 67 to retire, there is one leg up—a full monthly benefit from Social Security. A pension, if a retiree is lucky enough to have one, will also allow for much greater flexibility in the retirement years. For those without pensions, and those with pensions that do not cover all expenses, they are faced with a different situation.

Karl Putnam (2010) advises that retirees set a percentage to withdraw from their total retirement funds on an annual basis. Five percent in his view is an amount that can be withdrawn on an annual basis without putting a strain on the assets. He calls his view “Tighten your belt, happy beneficiaries.” Making 5 percent the annual withdrawal does not mean that the monetary amount will always be the same. In one year 5 percent may equal \$50,000, and in the next year, 5 percent might only be \$40,000. This is what he calls the “tighten your belt” phase. Retirees would have to cut expenses in the lean years, but may end up with a surplus in other years. The “happy beneficiaries” part comes into play as the retiree will not be withdrawing too large a portion of their retirement funds.

Putnam’s (2010) theory takes into account market fluctuations. The steady rate of withdrawal should allow the assets to maintain their purchasing power as retirement goes on. He also notes that the best investment to achieve this goal is the stock market. Other mixes and forms of retirement funds may provide the same scenario that will allow for his theory to be perpetuated.

How to utilize retirement funds so that they may last over the course of retirement is again a highly subjective notion. The constraints of each individual and their particular situation will dictate how their retirement funds need to be disbursed.

## Summary and Conclusions

Planning for retirement is a multifaceted problem that requires the individual to analyze various factors to determine which approach and methods will be appropriate for them. There is no panacea for what plan will effectively garner the results required by any individual. Factors such as their working situation, debt obligations, job market, and goals in retirement will dictate the amounts and ways that individuals are able to save.

Once the plan has been followed and retirement age is achieved there is still a further question of how to use the funds that were accumulated over a lifetime. There is no “one size fits all” answer to this question. Various factors will influence how funds are used and at what rate, the goal of course being to maintain a level of retirement money that will sustain the individual through the end of their life.

Retirement planning is more or less a game of how long will an individual live and how much will it cost to do so. Taken in such simple terms, it is quite easy to see why so many avoid the topic until it is nearly too late.

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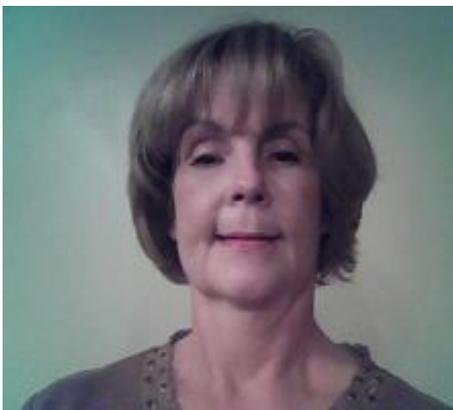
## Biographies



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**Teresa K. Lang** has 15 years of accounting experience working for both large and small CPA firms in the U.S. and civil service operations overseas. She has experience in audit and taxation and has practiced in the states of Kansas, California, Alaska, and Florida. Her Bachelor's Degree is from the University of Florida, and her Masters of Accountancy and PhD are from Auburn University. Dr. Lang is an awarding winning teacher and an Associate Professor of Accounting at Auburn University Montgomery in Montgomery, Alabama.