Ready Set Retire

Farming: Investment Planning

If there is one lesson to be learned from the unstable land values that began in the 1970s and continues, it is that having all of a family's investments in one venture is risky. Farm families who planned to retire as millionaires, based on the value of their holdings in the 1970s, found themselves much poorer in the middle of the 1980s. The purpose of this pamphlet is to present issues in investment considerations before retirement and at retirement.

Investments Before Retirement

In spite of the recommendations of experts who suggest that retirement planning should begin early, many couples postpone planning for retirement until they are in their 40s or 50s. The children are on their own, the initial outlays for land, equipment, and machinery have been completed, and it is time to think about putting money aside for retirement.

Two basic financial instruments are especially advantageous for farm couples, an **individual retirement account** for each member of the couple, as detailed in *Ready, Set, Retire—Individual Retirement Accounts* (Pm-1167c) and **Keogh plans.** Keogh plans, established by Congress under the 1962 Keogh Act, are designed to provide retirement monies for self-employed individuals and would have advantages similar to the retirement plans of corporations. Basically, the Keogh plan allows a certain amount of each year's gross income ($30,000 or 25 percent of earned income, whichever is less) to be set aside in various types of approved investment funds. Any sums contributed to the plan are tax deductible, as is income earned by the investments. Income taxes on both the principal (the contributions) and the earnings from the investment are payable when money is withdrawn from the fund. Because withdrawals are usually after retirement, the tax liability is likely to be lower because the individual will be in a lower tax bracket. As with an IRA, an individual may begin to withdraw money from a Keogh plan after age 59½; withdrawals must start at age 70½.

The Keogh Act specifies that contributions to any plan under the act must be invested in approved ways. The Internal Revenue Service has approved various plans including trusts and savings programs, annuity contracts, retirement income insurance contracts, and certain types of high quality investments such as special government bonds, preferred stocks, and special types of savings accounts. Many savings and loan institutions, banks, and trust companies, even in small communities, are equipped to set up and administer Keogh plans.

Both IRAs and Keogh plans are **individual** retirement plans, owned by an individual, not by a couple. In general, the owner of the plan will designate the spouse as the beneficiary upon the owner's death. It will be advantageous for each partner to contribute to an IRA or Keogh plan. If a Keogh plan is established for the husband as a self-employed worker, and the wife works in the farm business but does not receive pay, it is often beneficial for the wife to be listed as an employee of the business, receive a salary, and to establish her own Keogh plan. The husband's taxable earned income would be reduced by the amount of her salary. In addition, there would be her Keogh plan contribution equal to 25 percent of that salary. He would contribute 25 percent of his remaining salary to his own Keogh plan. Furthermore, because there is now one employee of the business, additional contributions can be made to their Keogh plans, further reducing their current income tax liability while saving a substantial amount for retirement.

Cash value life insurance, particularly universal life, can ensure savings for retirement. The cash value of the life insurance can be used as security for a loan for special needs during retirement. Or the cash value can be converted to an annuity to provide retirement income. See *Ready, Set, Retire—Health and Life Insurance* (Pm-1167d) for a discussion of cash value life insurance as a part of a retirement plan.

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Probably the most important principle in investing prior to retirement is diversification. IRAs and Keogh plans should be considered first because of their preferential tax treatment. Then consider investment in stocks and bonds and real estate. The past 15 years have shown how risky land investment can be, when it is the **only** investment. Purchasing additional land to "provide for retirement" is probably not as good an investment as establishing a Keogh plan and an IRA for each member of the couple.

A financial plan can be thought of as a pyramid, with the base of solid, conservative investments. Once that base is built, the pyramid can be topped off with riskier investments that may give higher returns. Contributions and the accumulated interest on IRAs and Keogh plans, plus cash and equity in the dwelling should be the major components of the pyramid base at retirement. Next should be investment in land and other real estate, along with stocks and bonds. Finally, investments in business assets and commodities can top off the pyramid.

Investments Upon Retirement

In addition to pre-retirement investing, many farm couples are faced with decisions about investments at retirement. Such decisions are especially important if the couple has sold all or part of the farm and has received a lump sum as partial or total payment. The investment decisions made should be geared toward using the money to provide housing and current income for both spouses until their deaths. If the sale of the farm business involved the sale of the couple's residence, one of the obvious investments could be a different dwelling. A couple choosing to rent would, of course, not make this investment. The estimated monthly housing expenses (see *Ready, Set, Retire—Farming: Special Considerations,* Pm-1167e) would need to be adjusted accordingly. After the living arrangements have been secured, at least a portion of the remainder should be invested in such a way that adequate monthly income is ensured.

Types of Investment Available

There are two basic classes of investments. The first involves lending to others through savings accounts, bonds, mortgages and installment contracts, and annuities. The second is equity ownership, in which all or a portion of something is owned through outright purchase (as in the purchase of real estate), or the purchase of stock directly or through mutual funds.

Savings Accounts

These are probably the most familiar of the investment instruments, and can be savings deposits like passbook savings and NOW accounts (in which there is ready access to the funds) or time deposits (in which there is a penalty if the funds are withdrawn prior to the maturity of the deposit). In general, time deposits earn a higher rate of return than passbook savings accounts.

Bonds

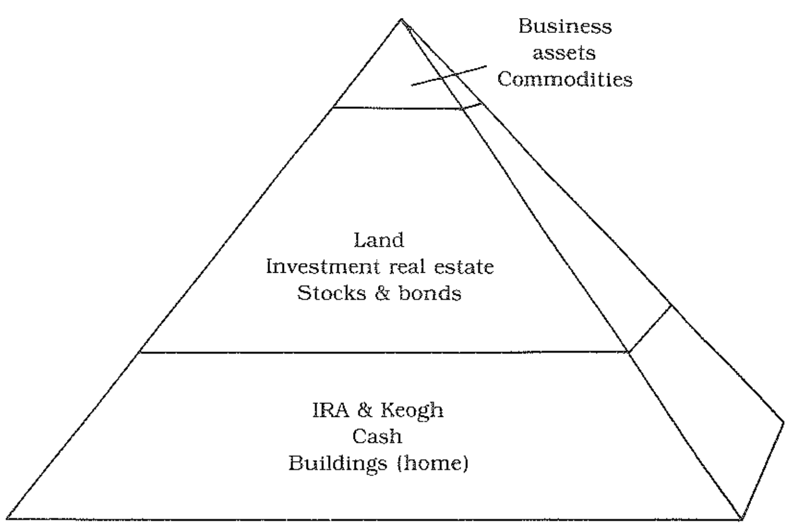
Bonds are instruments issued by governmental units or by corporations for the purpose of raising funds, usually for capital improvements. Bonds can be issued by governmental units, including the federal government, state governments, and local governments. Bonds are available from the issuing body, through stock brokers, or through a mutual fund. A mutual fund is so named because the funds of an investor group, both large and small investors, are pooled to purchase bonds from a variety of issuers for a diversified portfolio. Some mutual funds specialize in municipal bonds, others in corporate bonds.

Mortgages and Installment Contracts

Selling the farm on a land contract with the sellers receiving interest and principal payments amounts to lending money to the farm purchasers.

Life Insurance and Annuities

Purchasing life insurance or an annuity (see *Ready, Set, Retire—Income Sources,* Pm-1167b, for a complete discussion of annuities) can take alternate forms. Essen-



tially, the purchaser deposits a sum of money and is returned the principal plus interest in a single payment at a later date or in a series of periodic payments, depending on the terms of the annuity or the life insurance policy.

Common or Preferred Stock

Owning a share of stock in a corporation essentially means owning a part of the corporation. Stock can be purchased directly, through a stock broker, or through a mutual fund that specializes in stock purchases.

Real Estate

Real estate can be purchased in an exchange between private individuals, as in the purchase of rental property, or it can be purchased through investment in a real estate trust or syndicate. In general, if the latter course is

Table 1. Investment alternatives compared by evaluation criteria.

Investment	Risk	Annual return	Liquidity	Management required	Protection against inflation	Protection against deflation	Income tax
Savings accounts	None, if insured	Low	High	None	None	Good	Interest taxed as ordinary income
Bonds	Low to moderate	Low to moderate	High	Very little	None	Good	Interest taxed as ordinary income, some exempt or deferred
Mortgages and installment contracts	Variable	Low to moderate	Low	Low to moderate	None	Variable; may risk forfeiture	Interest taxed as ordinary income
Life insurance and annuities	None, if company is financially sound	Low	High	None	Almost none	Good	Interest income deferred to maturity unless paid
Common and preferred stock	Moderate to substantial	Moderate to high	High	Moderate to substantial	Variable but generally good	Poor	Dividends and capital gains taxed as ordinary income
Mutual funds	Moderate to substantial	Moderate to high	High	Very little	Variable but generally good	Variable	Same as above
Business	Moderate to substantial	Variable	Moderate	Moderate to substantial	Variable	Variable	Same as above
Real estate	Variable	Variable	Moderate	Moderate to substantial	Generally good	Moderate	Same as above
Real estate trust or syndicate	Moderate	Variable	Variable	Very little	Generally good	Moderate	Same as above
Limited partnerships	Moderate to substantial	Variable	Variable	Low to moderate	Depends on investment	Depends on investment	Same as above

Adapted from NCR 49, Retirement Planning for Farm Families, 1981, Ralph Hepp, Michigan State University, and Michael Boehlje, Iowa State University.

chosen, there will be management fees. If the former alternative is selected, the investor will be the manager, responsible for property upkeep, rental, and the like. Investment in farm land is a particular type of investment in real estate, with many of the same limitations.

Business
An investment could be made in a business venture, including but not limited to, the farm business. The investor puts up capital and receives both the gains and the losses. Investment could be through a general partnership or a limited partnership. Investing in business assets, as in machinery, livestock, and the like is another way to invest in a business.

Investment Criteria
When considering either equity investments or investments in loans, there are several criteria that should be considered. They include: degree of risk, annual return, liquidity, marketability, personal management required, protection against inflation, and the tax treatment of the investment. Table 1 compares investment alternatives according to these criteria.

Risk
The major risk is the loss of the capital invested. At retirement, the couple should minimize this risk by selecting low-risk investments. This does not necessarily mean the couple is limited to insured deposits and U.S. government saving bonds. There are excellent low-risk investments available in municipal bonds, mutual funds, and annuities offered by life insurance companies.

Annual Return
A general principle is that the higher the rate of return, the greater the risk. The goal in investing is to maximize the annual return while minimizing the risk. The highest returns in the past few years have been in stocks, available directly or through participation in one of a number of strong mutual funds. To measure the returns accurately, income from both the principal and growth of the principal must be combined.

Liquidity and Marketability
Liquidity refers to the degree to which the purchase or selling price approximates the cost or value that is assigned to the investment. The marketability of an asset refers to the ease with which an investment can be bought or sold. The ideal is good marketability and good liquidity. Savings accounts generally have this combination; bonds have good marketability and average liquidity; common stocks have good marketability and poor liquidity. Depending on the economic climate, real estate often has high marketability and low liquidity. In general, the greater the risk associated with the investment, the lower its liquidity.

Management Required
Investing in a certificate of deposit requires no management, once the decision has been made to invest. The certificate is purchased, and, at maturity, redeemed. Not so with an investment in a four-plex that is rented. The real estate investment requires constant attention in terms of maintenance, tenant relationships, and the like. True, such services can be purchased, but there is a fee that can subtantially reduce the rate of return.

Protection Against Inflation-Deflation
Lending to others traditionally has provided steady but fixed returns with no opportunity for the growth of the capital invested. In times of inflation, the returns on this type of investment have fallen behind the returns on equity ownership. Equity ownership, on the other hand, has traditionally provided greater returns during times of inflation and greater losses during times of deflation. If inflation and deflation could be predicted accurately, shifts would be made from lending instruments to equity ownership when inflation is on the rise, and back during times of deflation. Since even the best financial analysts are not able to forecast economic cycles with that level of accuracy, the key to sound investing is diversification.

Taxation
The final consideration is the tax treatment on returns from investments. In general, returns are taxed as ordinary income in the tax year during which those returns are realized. The 1986 Tax Reform Act eliminated preferential tax treatment for capital gains on the growth of the principal. Taxes on the appreciation will be deferred until the investment is sold, but the capital gain will be taxed as ordinary income during the year the property is sold. Careful planning needs to occur to minimize the impact of capital gains on income tax liability when equity in anything is sold.

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