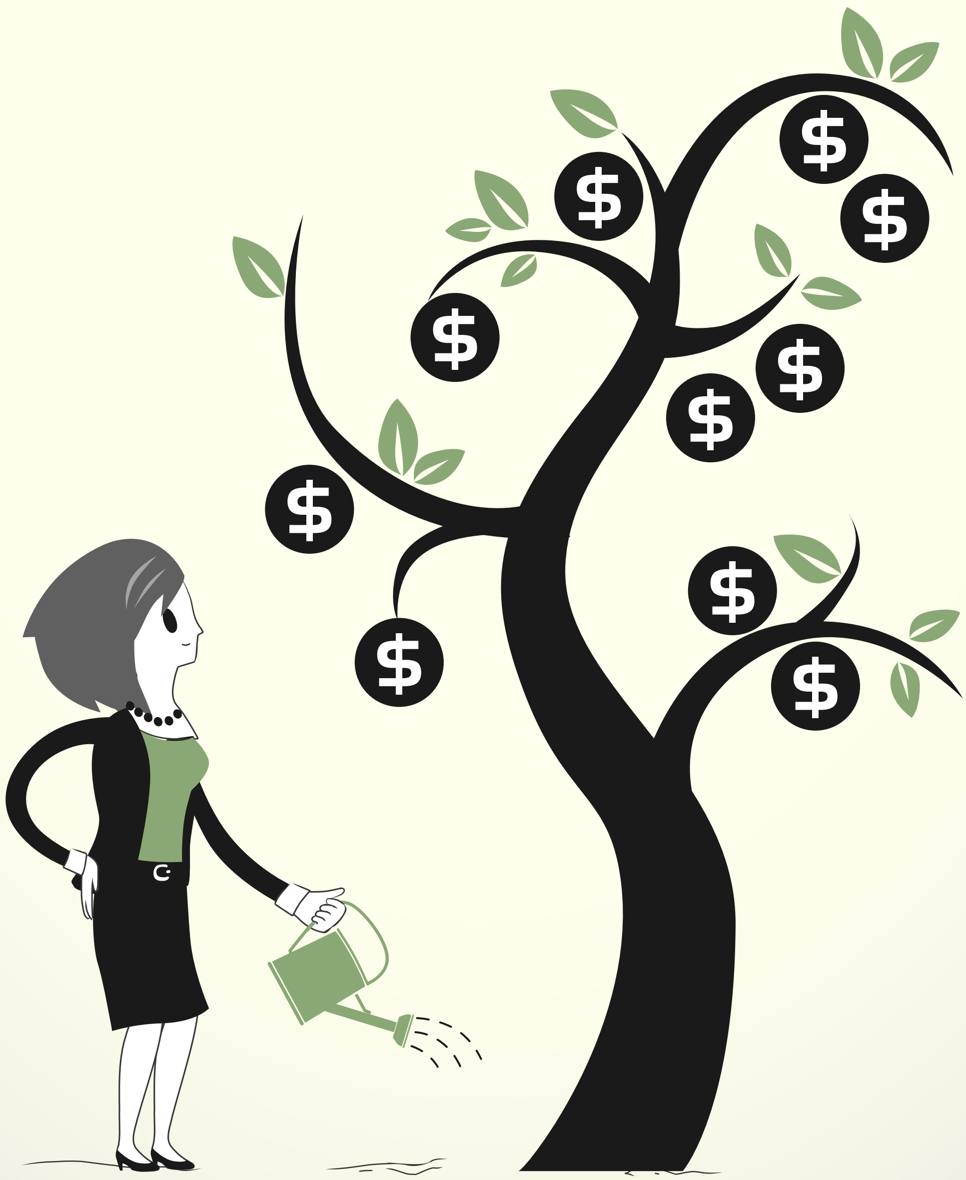
Saving early for retirement



Have you started saving money for retirement yet? It's more important than you may think—no matter your age.

Saving early for retirement is the best way to maintain financial independence and security later in life. "Regardless of the amount you save, you will definitely be in a better situation if you start early than if you wait until your mid-30s or 40s," says Jack VanDerhei, research director of the Employee Benefits Research Institute. "The longer you wait, the more you will have to save—until it becomes too great a burden."

But many workers lack access to a retirement plan or decline to take part in one. According to the U.S. Bureau of Labor Statistics (BLS), less than one-third of nonfederal workers had access to a defined-benefit plan, better known as a pension, in March 2012. And although about half of workers had access to a defined-contribution plan, such as a 401(k), only 68 percent of them saved in one. (See table 1.)

Often, workers wait too long to start thinking about saving for retirement. According to the Center for Retirement Research at Boston College, of workers in 2010 who were eligible to participate in a 401(k) plan, 60 percent contributed to it when they were in their 20s, compared with 84 percent in their 50s.

Table 1: Retirement benefits for all civilian workers[1], March 2012

Retirement benefit	Access	Take-up rate[2]
All retirement benefits[3]	68%	79%
Defined benefit	29	91
Defined contribution	55	68

[1] Includes workers in the private nonfarm economy except those in private households, and workers in the public sector, except federal government.
[2] The take-up rate is an estimate of the percentage of workers with access to a plan who participate in the plan, rounded for presentation.
[3] Includes defined-benefit pension plans and defined-contribution retirement plans.
Source: U.S. Bureau of Labor Statistics, National Compensation Survey

Workers also are saving too little. Experts typically recommend that workers plan to save 8 to 11 times their annual income for retirement. But according to the National Institute on Retirement Security, 4 out of 5 working households had saved an amount less than their annual income by 2010. Even when the value of other assets, such as a home, is included, two-thirds of households approaching retirement had not saved enough.

Especially for workers just starting their careers, the message is clear: start saving now, no matter how far in the future retirement seems. "Learn from those who are retiring today," says Denise Appleby, owner of a retirement consulting business. "Otherwise, you might regret not saving enough, early enough."

This article provides an overview of different ways to start saving early for retirement. The first section describes retirement plans and investment options. The second section explains how to choose a plan and investments. The third section discusses ways to save more. Resources for more information are listed at the end of the article.

Dennis Vilorio

Exploring savings options

Before you begin saving for retirement, you need to understand your options for retirement plans and the investments found within them. The information in this section provides the basics you need.

Retirement plans

One of the best ways to prepare for retirement is with a retirement savings plan. There are three main types of retirement plans: defined-benefit plans, defined-contribution plans, and Individual Retirement Accounts (better known as IRAs).

Employers may offer one, both, or neither of the first two plans as part of your benefits package. On your own, you also can save in an IRA to complement the other plans or as your main retirement savings plan.

For many workers, one plan alone may not be enough. Workers with some combination of

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the three plans are likely to have better financial prospects in retirement than those with a single plan.

Defined-benefit (pension) plan. In a defined-benefit plan, more commonly known as a pension, employers put aside money for each eligible employee and invest it on his or her behalf. The employer guarantees a monthly benefit when the employee retires based on a number of factors, such as salary and length of service.

But becoming eligible for a pension usually means you must remain with one employer for a long time. Furthermore, to cut costs, many employers have either reduced pension benefits or switched to defined-contribution plans.

Defined-contribution plans. In a defined-contribution plan, the employees—not the employers—make most of the decisions. Employees set aside money for retirement directly from their paychecks, select and manage investments, and choose how much and when to withdraw money in retirement. Employees also accept the risk of losing money.

But employers still help in other ways. Employers administer the plans and choose investment options, for example. And, as an incentive, many employers match contributions up to a certain percentage of the employee's wages.

As of 2013, employees can save up to $17,500 per year in a defined-contribution plan. These savings are taxed, but the money gained from growth is not. Employees must pay taxes, either when they withdraw or when they contribute, depending on the type of defined-contribution plan: Traditional or Roth, respectively.

In a traditional plan, employees pay taxes on contributions when withdrawing the money. Employees who choose a Roth plan—named after its legislative sponsor, the late Delaware Senator William Roth—pay taxes upfront but withdraw their money tax-free. Employers who offer a Roth plan typically also offer a traditional plan.

Depending on who uses them, defined-contribution plans are more commonly known by other names that represent the section or subsection of tax laws under which they are identified. They are known as 401(k) plans for the private sector, 403(b) plans for schools and nonprofit organizations, and 457 plans for state and municipal government. Thrift Savings Plans for the federal government are

Many employers sponsor retirement plans to help employees begin saving for retirement from their first day on the job.

administered by the Federal Retirement Thrift Investment Board.

The most common defined-contribution plan is the 401(k) plan. This term is often used, including in this article, to represent all defined-contribution plans.

IRAs. An IRA is a retirement plan that employees open and manage on their own—usually without help from an employer. As in a defined-contribution plan, with an IRA employees must select investments, decide how much money to deposit and when to withdraw it, and accept the risk of losing money. Savings are also taxed, but the amount they earn from growth is not. And there are traditional and Roth versions with the same tax benefits as described above.

But the similarities between IRAs and employered-sponsored plans end there. Compared with employer-sponsored plans, traditional and Roth IRAs have lower contribution limits, up to $5,500 per year in 2013. IRAs also have more flexible withdrawal rules, making it easier to access retirement savings for emergencies and big expenses. And, depending on the type of IRA, there are some eligibility restrictions, such as income and age.

There are other IRAs meant specifically for the self-employed and small businesses. These IRAs, called simplified employee pension (SEP) and savings incentive match plan for employees (SIMPLE) IRAs, are similar to traditional IRAs but have higher contribution limits.

In a SEP IRA, self-employed workers and small-business owners can contribute up to 25 percent of income or $50,000 per year, whichever is less. In a SIMPLE IRA, small businesses must contribute 2 percent of the employee's salary or match up to 3 percent of salary if the employee also contributes. Employees can contribute up to $12,000 per year.

Investment options

After setting up a 401(k) or an IRA, you need to select where to invest your savings. Although you can invest in almost anything, experts typically recommend investing in mutual funds.

Mutual funds pool money from many people and institutions to buy financial assets. There are four types of mutual funds: Index, exchange-traded, target-date, and actively managed funds. These funds are further classified by asset type, usually stocks or bonds. The value of stock is known as equity.

When you buy shares of an equity fund, you become part-owner of a number of companies. When you buy shares of a bond fund, you lend money to a number of companies or governments. You can also select funds that invest in domestic or international assets.

Mutual funds have annual management fees, called the expense ratio. These fees vary by the fund's provider and type. (See table 2.)

Index funds. Index funds are a simple, inexpensive way to invest in a financial market. An index fund replicates a market index—which tracks the total value of assets in a financial market over time—by holding financial assets in the same proportion. For example, if a stock makes up 5 percent of a market, the index fund would hold enough of that stock to make up 5 percent of the fund.

At the end of each business day, index funds automatically adjust to changes in the market indexes. For example, if a company's stock grew relative to the market, the index fund buys more to match the stock's new proportion in the market index.

Exchange-traded funds. Most exchange-traded funds, more commonly known as ETFs, are similar to index funds. ETFs track a

Table 2: Average expense ratio (fees) by type of mutual fund, 2012

Type of mutual fund	Expense ratio
Index bond	0.12%
Index equity (stock)	0.13
Target-date	0.58
Actively managed bond	0.65
Actively managed equity	0.92

Source: Investment Company Institute

market index, automatically adjust to changes, and have low fees.

But unlike index funds, ETFs adjust to market changes throughout the day. This makes ETFs easier to trade quickly but often also more expensive. For retirement purposes, experts typically recommend index funds over ETFs, which are usually better suited for people who trade often.

Target-date funds. Target-date funds bundle a diverse set of domestic and international mutual funds, usually index funds. Target-date funds hold each component fund in a predetermined proportion, called the asset allocation. They also adjust daily to changes in the markets and annually to keep your savings on track as you age.

Target-date funds are sometimes known as lifecycle or age-based funds.

Actively managed funds. Actively managed funds try to outperform the market index. A manager chooses assets based on a variety of factors, such as advanced metrics, specific investing strategies, and personal preferences.

The fund's fees include payment to the manager for administering the fund. As a result, actively managed funds are more expensive than index funds.

Choosing a plan and investments

Choosing among all the options for retirement saving can be confusing. You might not know which retirement plan to choose or how to sort through the many different investment options available in each plan. If you feel overwhelmed, financial professionals can assist.

You don't have to be a financial expert to save for retirement. The information in this section can help you narrow your options.

Which retirement plan?

Before you begin saving for retirement, you first need to open a retirement plan. Experts recommend choosing a Roth plan when available, opening a SEP IRA when self-employed, and opening IRAs with mutual fund companies.

Choose a Roth plan, when available. According to experts, workers just starting their careers benefit most from owning a Roth plan, such as a Roth IRA or Roth 401(k).

With a Roth plan, young workers pay taxes on retirement savings at the time of investment, when their incomes and tax rates are likely to be low, and withdraw the money tax-free at retirement. Another advantage to Roth plans is that current tax rates are near historic lows.

But not all workers have access to a Roth 401(k) plan. If your employer offers a traditional 401(k) plan, or no plan at all, you still have another Roth option. After saving enough in a traditional plan to get your employer's full matching contribution, for example, you can save in a Roth IRA to guard against rising tax rates.

Self-employed? Open a SEP IRA. If you're self-employed or own a small business, experts recommend that you open a Simplified Employee Pension (SEP) IRA. With a SEP IRA, you can save up to nine times more money than with a traditional or Roth IRA.

And having a SEP IRA doesn't rule out having a Roth IRA. Because you make SEP IRA contributions as an employer, opening a Roth IRA could provide another source of retirement savings.

Open IRAs with a mutual fund company. Because mutual fund companies typically offer the best investment options at the best price, experts recommend opening an IRA there. But these companies have strict conditions, which often include requiring you to automate contributions, keep a minimum balance, and invest a minimum amount (often between $1,000 and $3,000). Some companies reduce the minimum investment requirement if you agree to make a minimum monthly contribution.

Another option is to open an IRA at a discount brokerage. Brokerages, which have few or no requirements, make investment easier if you can't afford the minimum required by mutual fund companies. But discount brokerages charge a transaction fee, usually between $5 and $15, which can apply each time you contribute to or change your investments.

Understanding mutual funds

Once you have a retirement plan, you must decide where to invest your money. Experts recommend choosing target-date funds, opting for funds with low fees, and avoiding expensive actively managed funds.

Confused? Choose a target-date fund. If you're uncomfortable investing on your own, experts recommend that you choose the target-date fund that most closely matches the age or year when you plan to retire.

Target-date funds are available in many retirement plans. If your plan doesn't offer them, you can invest in a few index funds to replicate a target-date fund's asset allocation for your age. This tactic requires periodic adjustments to follow the target-date fund as you age and as the markets change. For example, some experts recommend adjusting every month or when an asset's desired allocation changes by 5 percent or more.

Choose funds with low fees. When presented with an overwhelming number of investment options in a retirement plan, you might be tempted to look only at funds that have recently done well. Experts caution against doing that. "A fund's past performance tells you next to nothing about how it will perform in the future," says Anthony Webb, a senior research economist at the Center for Retirement Research.

Instead, they say, look at the fees or expense ratio. "Fees seem small but, over time, they really eat into your savings," says Angela Hung, director of the RAND Center for Financial and Economic Decision Making. Unlike a fund's future performance, you can control how much you pay in fees. Choosing funds with low fees allows you to keep more of your money. (See table 3.)

Avoid actively managed funds. In a given year, some actively managed funds perform better than the market. But investors usually come out ahead with index funds, which have lower fees. That's especially true over the long term, say experts, which is what you need to consider when saving for retirement. "There's no evidence that actively managed funds outperform index funds," says Webb. "What you're doing is transferring money from your pockets to those of the fund manager."

Because the long-term performance of actively managed funds rarely justifies higher fees, say experts, it's best to avoid them when saving for retirement.

Consult a professional

A financial professional can create a customized plan for your financial goals, including retirement. Seek out professionals who charge

Table 3: Net value over 30 years for two average equity funds with an initial investment of $10,000 and a 10-percent annual return

Years later	Index fund (0.13-percent expense ratio)	Actively managed fund (0.92-percent expense ratio)	Difference
1	$10,987	$10,908	$79
5	16,010	15,443	567
10	25,633	23,848	1,785
15	41,038	36,828	4,210
20	65,703	56,873	8,830
30	168,412	135,629	32,783

Source: Expense ratio calculator at the Central Provident Fund Board (**www.cpf.gov.sg/cpf_trans/ssl/financial_model/expense_cal2.asp**) a flat fee and are legally required to serve in your financial interest, called a fiduciary duty.

Currently, only registered investment advisors have a legally mandated fiduciary duty. Other financial professionals have a voluntary or unclear fiduciary duty. Financial professionals who do not have a legal fiduciary duty may have conflicts of interest, such as recommending an investment for commission. If you're unsure about investing for retirement, you may prefer to hire a registered advisor.

But hiring a financial professional is an expense you may not want. If you find a target-date fund that meets your investment needs, you may not have to consult a professional.

Saving more

Saving for retirement requires planning. Take charge of your personal finances and how you contribute to retirement so you can save more—regardless of your financial circumstances.

Managing finances

Managing your personal finances, especially early in your work life, helps you plan ahead and save. Learning about personal finance, limiting expenses, avoiding high-interest debt, and building an emergency fund are four ways to build a solid savings foundation.

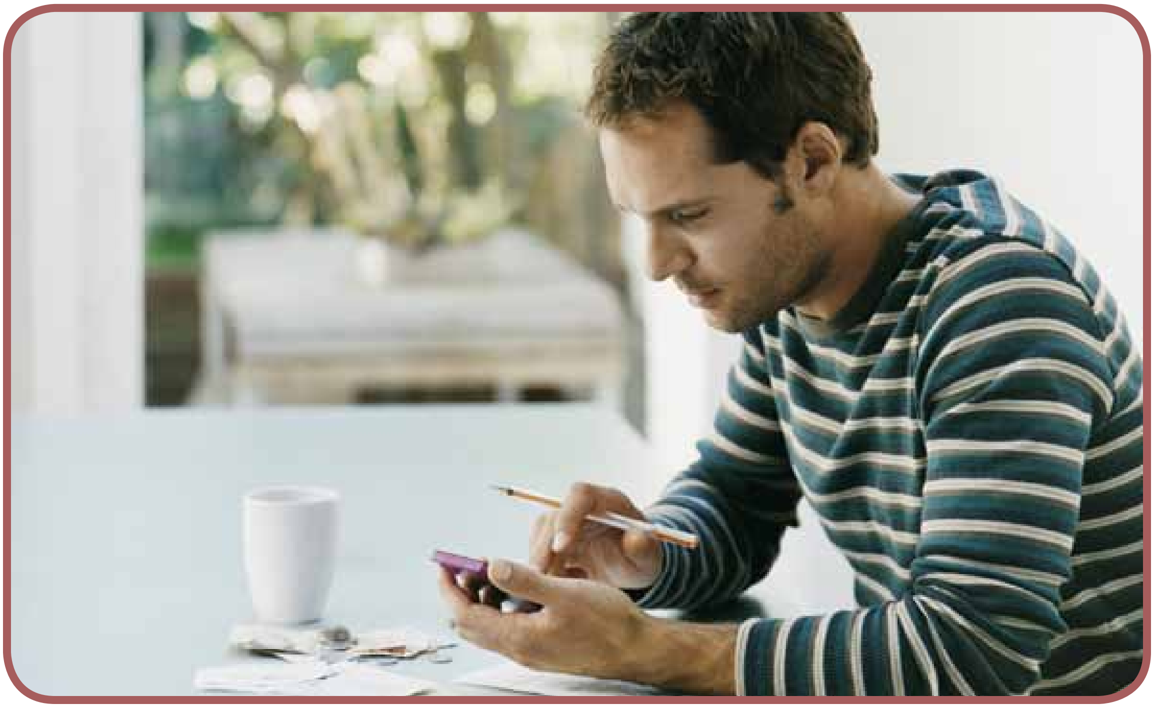
Learn personal finance. By learning personal finance, you discover how to manage your money and control your expenses. Free personal finance lessons are available online; some schools and libraries offer courses. Topics covered usually include budgeting, saving, and debt management.

Limit expenses. Everyday living expenses add up quickly. Limiting these expenses frees up money you can save for retirement. "Unfortunately, a dollar can only be spent once," says Webb. "If you want to save more, you'll need to spend less."

Discretionary spending is usually the easiest place to start. This includes optional expenses, such as dining out or traveling for vacation. To save even more, limit how much and how often you spend money on things you want but don't need.

Avoid high-interest debt. Carrying balances on high-interest debt, such as credit cards and payday loans, can hurt your finances. Mounting debt from the combination of high interest rates and penalty fees

Learning personal finance can help you limit discretionary spending so you can save more for retirement.



may become overwhelming. By living within your means and paying your credit card bill in full each month, you'll stay out of financial trouble.

If you already have high-interest debt, focus on paying it off. The reason, say experts, is that the amount this debt costs you is unlikely to balance out against future retirement gains. "Credit card debt can easily come with an interest rate of 12 to 15 percent," Webb says. "There's no investment in your retirement plan that can consistently offer that rate of return."

Build an emergency fund. An emergency fund is an adequate amount of money reserved for unplanned expenses, such as costs incurred from an accident, illness, or job loss. Having an emergency fund can mean the difference between a setback and financial disaster. The money should be kept safe and easily accessible; for ideas on where to keep your emergency fund, see the box on page 22.

Experts typically recommend an emergency fund equal to about 3 to 6 months of your wages, depending on your risk of job loss.

Managing contributions

Managing your contributions well can improve how you save for retirement and increase current savings. Strategies include taking an employer's matching contribution, automating contributions, sticking to your plan, not withdrawing money early, and reinvesting when changing jobs.

Take the employer's match. Your employer's matching contribution to your retirement plan could double how much you save for retirement. For example, if your employer matches contributions up to 5 percent of your wages, you bump your savings rate to 10 percent by taking part. Half would come from your contributions and the other half from your employer's match.

Experts say that participating in the matching option makes good financial sense. "Whenever possible, you should contribute the maximum your employer will match," says VanDerhei. "Otherwise, you're just leaving free money on the table."

Automate. For some workers, the biggest obstacle to saving for retirement is setting up a plan. To help employees overcome this difficulty, many employers automatically enroll them in a retirement plan.

Once employees have a retirement plan in place, they're likely to carry on with contributing. "Automatic enrollment and contributions have powerful effects on people's saving behavior," says Hung. And people who contribute automatically from their paychecks usually save more, because they never see the money to spend it; instead, it goes directly into their retirement fund.

Stick to your plan. Misguided emotion can lead to investment mistakes, caution experts. "Don't let your emotions guide what you do," says Chuck Yanikoski, president of a retirement planning software company. "You might invest in something you don't understand or buy and sell at the wrong time."

Creating a plan, and sticking with it, helps you avoid emotion-driven pitfalls. One of the advantages of target-date funds, for example, is that they follow predetermined investing strategies. By minimizing mistakes, you can get more out of your retirement savings.

Don't withdraw early. Most retirement plans have a tax penalty, usually 10 percent, for withdrawing money before age 59½. The purpose of the penalty is to encourage investment until retirement age.

If you need money from the plan before you're eligible to withdraw it, there are ways to avoid the penalty. Withdrawal exceptions for defined-contribution plans, such as a 401(k), are typically stricter than those for IRAs. For example, 401(k) plans may allow withdrawal only in situations involving disability or financial hardship. By comparison, Roth IRAs offer more flexibility: after 5 years, you may withdraw penalty-free to help pay for expenses such as a first home, college, or large medical bills.

(Continued on page 23)

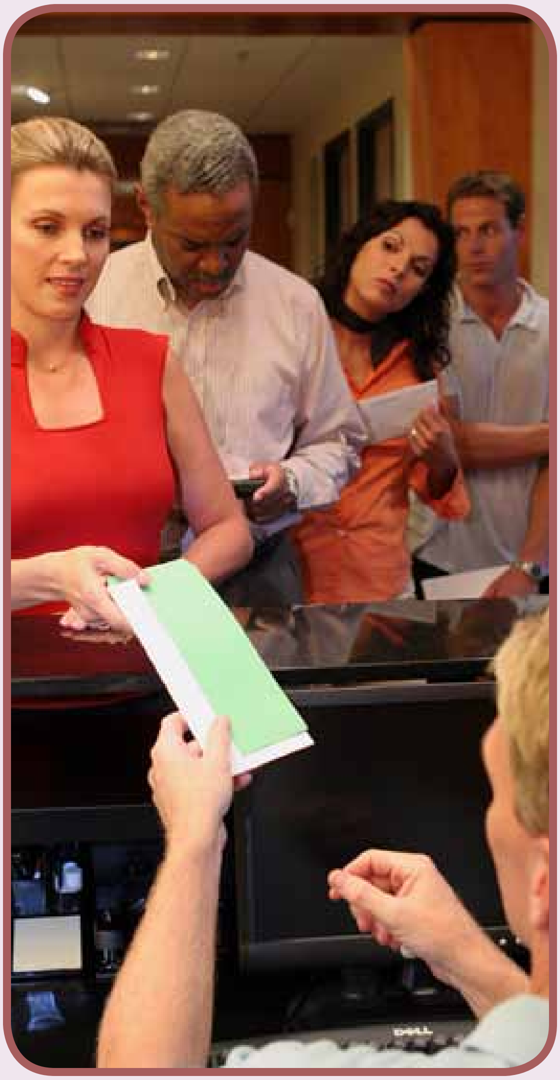
Short-term savings options

Saving early for retirement isn't possible for everyone. Some people have more immediate financial goals, such as saving for an emergency fund. Others prefer to pay off debt, such as student loans or credit cards.

Experts say that temporarily putting off retirement savings is OK. "Thinking early about retirement is good, but saving for retirement is a personal decision," says Chuck Yanikoski, president of a retirement planning software company.

If you decide to delay retirement savings for other priorities, you still have short-term options for stashing your money that offer better returns than a low-interest savings account. High-yield bank accounts, money market accounts, and Series I Savings Bonds (I Bonds) keep your money safe and accessible in the short term until you're able to save for retirement.

Many banks offer high-yield and money market accounts with higher interest rates in exchange for meeting certain conditions.



High-yield bank accounts. Some financial institutions, especially credit unions and online banks, offer checking and savings account options that have high interest rates. These high-yield accounts require you to meet certain monthly conditions, such as setting up direct deposit, using your debit card a number of times, and receiving account statements online.

Along with high-interest yields, banks may offer other rewards, such as ATM fee refunds, for meeting their conditions.

Money market accounts. Money market accounts, available at most banks, usually offer higher interest rates than a traditional savings account in exchange for keeping a high minimum balance—ranging from $500 to $25,000. As in high-yield bank accounts, your savings are insured and accessible by using an ATM. Many money market accounts limit the number of transactions you can make each month, however.

I Bonds. I Bonds use a composite interest rate, which combines a fixed rate and an inflation rate to ensure that your savings maintain their purchasing power. Until October 31, 2013, the composite rate for new I Bonds is 1.18 percent. The federal government adjusts the inflation rate semiannually and guarantees your money.

For up to 30 years, I Bonds earn the interest rate set at the time of purchase. You can cash them in after 1 year, but you lose the last 3 months of interest. After 5 years, there is no penalty. If the composite rate for new I Bonds rises significantly, you might benefit from cashing out early and buying again at the new rate.

I Bonds are most useful when saving for expenses a few years into the future, such as a downpayment for a home. You also can use them to store some of your emergency fund.

(Continued from page 21)

Even if you can withdraw penalty-free, however, experts recommend against it. Instead, they advise, tap into retirement savings only when absolutely necessary.

Reinvest when changing jobs. When you change jobs, you have the option of withdrawing your 401(k) savings, but you will pay penalties in the process. However, you also have the option of rolling over, or reinvesting, the balance penalty-free into an IRA.

Still another option is to leave your money where it is and start another plan with your new employer. This may be an attractive choice if your existing retirement plan offers good investment options with low fees. For example, experts advise that workers who leave the federal government should keep their savings in the Thrift Savings Plan.

For more information

There is a wealth of retirement information available, although no single source provides comprehensive information concerning all aspects of retirement. You can continue your research by exploring some of the resources suggested in this section.

The U.S. Department of Labor hosts a website with general information about retirement for both employees and employers. Visit **www.savingmatters.dol.gov**.

The April 23, 2013, episode of the Public Broadcasting Service news show *Frontline* studied the current state of retirement savings. Topics include the shift from pensions to contribution plans and advice about getting the most from your retirement dollars. Watch at **www.pbs.org/wgbh/pages/frontline/retirement-gamble**.

For more information about federal tax rules and incentives for retirement, visit the Internal Revenue Service's resource at **www.irs.gov/Retirement-Plans**.

The U.S. Securities and Exchange Commission offers detailed information about investing. Topics include investment products, guiding principles, and tips for avoiding fraud.

Call toll free, 1 (800) 732-0330, or visit online at **www.investor.gov**. A guide to mutual funds is available at **www.sec.gov/investor/pubs/sec-guide-to-mutual-funds.pdf**.

To learn more about why saving early helps you save more, try the interactive savings calculator at **www.econedlink.org/interactives/EconEdLink-interactive-tool-player.php?filename=interest.swf&lid=603**. This tool shows the effects of compound interest on your savings over time.

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