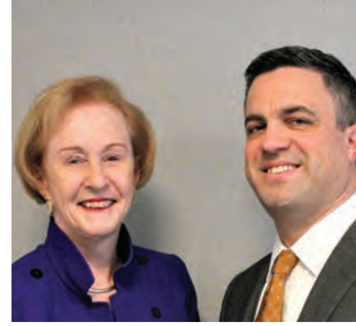
With 30 or 40 Years of Retirement to Finance, You Need to Stash a Significant Sum Away

Your 401(k) Plan and Your Future



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Intellectually we know that it's important to contribute the maximum we can to retirement plans. As science and health care continue to improve, life spans continue to increase, making proper planning and saving crucial. We know that we should save as much as we can and use all the tools at our disposal to provide for what may be a 30- or 40-year retirement!

As we navigate through our careers, however, more immediate financial goals such as the purchase of a home, educating our children or starting a business get in the way. We realize with the demands of day-to-day financial needs, it can be hard to set money aside for tomorrow. In previous generations, most workers were covered by employer-sponsored pension plans. Today, according to Bureau of Labor 2018 statistics, only 13 percent of retirees are eligible to receive a pension, down from 80 percent in the mid-1980s. Even if you're eligible, few people stay long enough with a company to qualify for a pension.

Instead of pensions provided by our employer, it's up to us to contribute to an employer- sponsored retirement plan, typically a 401(k) or 403(b) plan. In this article we focus on 401(k) plans, but the concepts generally apply to both types of plan. Unfortunately, according to a recent study by Fidelity Investments, only 9 percent saved the maximum possible to their retirement plans in 2017, based on a study of 15.3 million plan participants. In this article, we review the basics of saving for retirement and try to motivate you to contribute the maximum you can!

Benefits of a Traditional 401(k) Plan

The amount you can contribute to a traditional 401(k) plan increased in 2019. You can contribute as much as 100 percent of your salary up to the limits shown below. These limits are adjusted periodically for inflation. (*See top graphic on next page.*) The amount you contribute to a traditional 401(k) plan is excluded from current federal and state taxation, which means Uncle Sam actually helps you save for retirement. The tax savings makes the traditional 401(k) option particularly attractive to those in higher tax brackets. For instance, if you contribute $100 a month for a total of $1,200 annually and are in the 22 percent federal tax bracket, your out-of-pocket cost would really be $78 a month, or $936 annually. If you were in the 32 percent tax bracket, your federal tax savings would be $384, and your out-of-pocket cost just $816. In addition to federal tax savings, if you live in a state that taxes your income, you'd save on state taxes as well. In addition to the tax savings, the dividend income and growth generated by your retirement account investments are sheltered from current taxes. This means your money grows faster than if it were taxed. When you reach retirement, the money that you withdraw from a traditional 401(k) is taxed at your ordinary income rate, similar to a paycheck. You can have taxes withheld from the distributions or you may satisfy your tax obligation through quarterly estimated tax payments to the Internal Revenue Service.

The Roth 401(k) Option

Today many 401(k) plans are now providing a Roth option as well. This option essentially reverses the tax structure of the traditional 401(k). With a Roth 401(k) you contribute money after it's been taxed at your current rate. These contributions don't reduce your current year taxes in any way but similar to a traditional 401(k), the money in the plan grows tax-free. But in retirement, any and all withdrawals from a Roth 401(k) are completely tax-free. Thus, the decision to choose a traditional or Roth 401(k) often comes down to a decision to pay taxes now or later. People early in their careers, who expect to have higher income in the future, may benefit from choosing the Roth option and paying taxes now at a relatively low rate. Having said that, one attractive feature of the Roth 401(k) is that unlike a Roth IRA, there's no income limit. Although contributing to a Roth IRA is only available to those with modified adjusted gross income less than $137,000 (or joint filers below $203,000), Roth 401(k) options have no income limits. Thus, they can be attractive for high earners otherwise prevented from making Roth contributions.

Start Early

There's a real advantage to starting contributing to your retirement plan as early as you can because of the advantage of compounding. Take the case of two investors: Lisa, who starts saving at age 25 by contributing $150 per biweekly paycheck to her plan, and Steve, who waits until age 40 but contributes twice as much — $300 per paycheck — to try to catch up. For this example we assumed a conservative return of 5 percent per year. (*See bottom graphic on next page.*)

Under this scenario, by age 65 Lisa will have contributed $144,000 to her account and the account will have grown to roughly $460,000. Steve, meanwhile, will have contributed $180,000 to his account by age 65 but would end up with a balance of $359,000. Thanks to the power of compounding, Lisa was able to contribute less than Steve and retire with a larger nest egg because her money had an additional 15 years to grow, thus proving the adage that money can't buy time.

Your Employer's Match

The majority of employers match a portion of your contributions to the plan. For instance, an employer might contribute 50 cents for every $1 you put in a retirement plan, up to 6 percent of your salary. If your employer matches, it's important to contribute at least enough to get the maximum employer match. The money your employer contributes is tracked separately and typically becomes yours to keep over a schedule, called a vesting schedule. Although some matching contributions vest immediately, it's more common for an employer to use a vesting schedule that results in matching contributions becoming fully vested over a period of two to six years. When you're fully vested, you can take all matching contributions plus their earnings with you, should you change jobs. Note that you're always 100 percent vested in your own contributions plus their earnings.

Increase Your Contributions

When you first start working, it can be difficult to contribute the maximum you're allowed to contribute, or even the maximum that the company matches. As time progresses and your compensation increases, it's crucial that you build in the habit of increasing your 401(k) contributions. When you receive a raise or a bonus, designate a portion toward increased retirement plan contributions. In the past, plans typically allowed you to change the amount you can contribute only twice per year, but modern payroll systems typically allow you to make changes throughout the year. In fact, some now allow you to set an automatic increase (say, 5 percent) each year. If that feature isn't available, set a reminder on your calendar or phone to increase you contribution at least once per year.

Maximum 401(k) Contributions by Age

	Under Age 50	Over Age 50
Maximum Contribution	$19,000	$25,000

Growth in 401(k) Contributions

	Lisa	Steve
Starts contributing at age	25	40
Biweekly contribution	$150	$300
Total contributions by age 65	$144,000	$180,000
Balance at age 65	$460,000	$359,000

Assumes annual growth rate of 5 percent. This is a hypothetical example and is for illustrative purposes only. No specific investments were used in this example. Actual results will vary. Past performance doesn't guarantee future results.

Investing Your Contributions

Your employer works with an investment adviser to design a menu of investment choices for the plan, and you choose from among them to determine how you want your money invested. Your choice should be based on your time horizon, tolerance for risk and overall financial situation. Your plan will have an online portal that will allow you to track your growth, monitor your investments and make changes to the way your money's allocated.

Your plan provider should also provide you with ongoing investment education. Typically, the financial adviser who helps the employer select investments for the plan comes in periodically to talk to the staff about the various options and answer questions. Typically, the plan's adviser is available to consult with you individually. This education component is built into the plan's costs, so don't hesitate to take advantage of this opportunity.

Conclusion

The shift away from corporate pension plans combined with ever-increasing longevity makes retirement saving in the 21st century a necessity rather than a choice. If you start now, maximize your contributions and take advantage of the tools available, you'll help make your retirement years your "golden years" — not your "nickel-dime years"!

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