Convincing young clients to save earlier

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This article is intended for you to share with your young clients to help them see the long-term financial picture for American workers. It could be titled "This Is Your Life," and it goes like this …

- You start working at age 25 making $35,000. (Hopefully, you will actually make more at the start, but that figure is not unrealistic for some 25-year-olds, so let's go with that for now.)

- Your income increases 2.5% each year during your working career.

- When you retire around age 70, your final salary is roughly $103,000 a year.

- During your 45-year working career, you will earn about $2.85 million — hopefully more.

If you saved 10% of your annual income during your 45-year working career and earned zero interest on your saving, you will have around $285,000.

But if you save 10% of your salary and experience a 6% average annual return in your investment portfolio, your account value at the start of retirement at age 70 will be around $1,072,671. This is a slow and steady "crockpot" approach.

USING A CROCKPOT

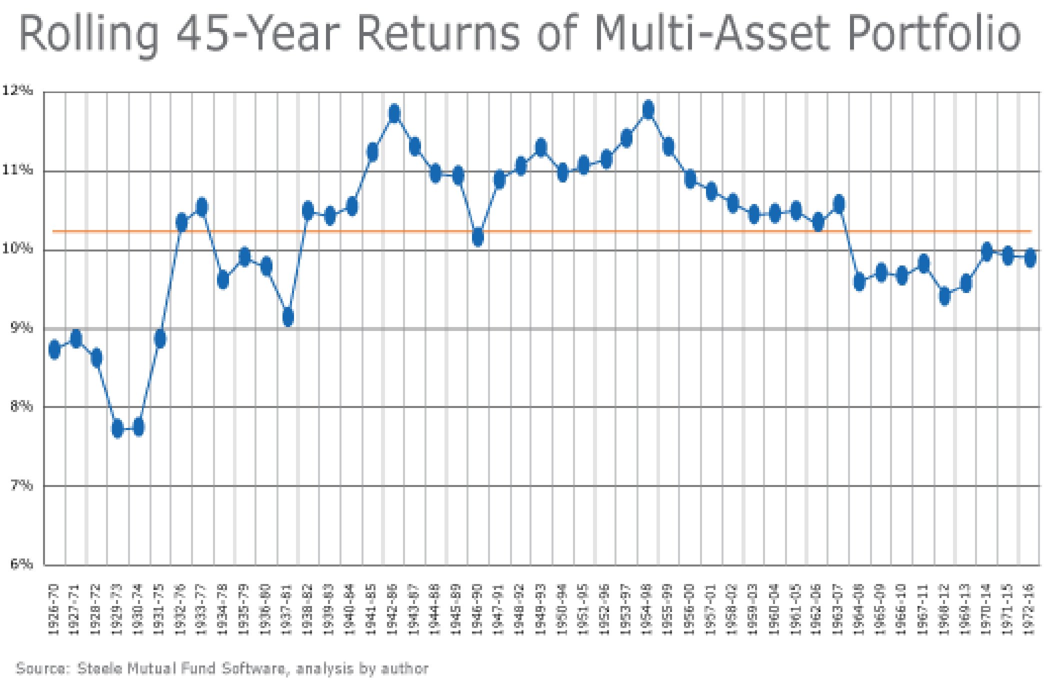
The idea is very simple. Preparing a meal in a crockpot takes advance planning. You need to start cooking hours in advance because the crockpot works slowly. But the effort is minimal. Toss the ingredients in the crockpot and then let time do the work.

Conversely, if you wait until the last minute, a microwave can be used to prepare a meal. But the outcome is hardly the same. A roast that does not fare well in a microwave is fabulous coming out of a crockpot after six hours.
Is this all too simple? Can you actually pull off this prosperous retirement despite having minimal investment expertise and without spending a lot of hours on your portfolio?

Well, the annual saving part is up to you, but getting a 6% annual return from a portfolio over the long haul is very likely.

Historically, a multi-asset portfolio consisting of 40% large-capitalization U.S. stocks, 25% small-cap U.S. stocks, 25% U.S. bonds and 10% U.S. cash has never experienced a 45-year annualized return of less than 7.7%.

Look at the graph "Rolling 45-Year Returns of Multi-Asset Portfolio." Each dot in the graph represents a 45-year period. The first blue dot represents the 45-year annualized return in 1926-1970; the second dot is the period 1927-1971; and so on.



The average 45-year annualized return of a multi-asset portfolio between 1926 and 2016 was 10.2% (as shown by the horizontal red line). There were even two 45-year periods where the annualized return was almost 12%. If given adequate time (such as 45 years), a diversified portfolio will not be the weak link in this story.

It all comes down to investor behavior — will you adequately contribute to the portfolio each year?

STARTING EARLY

What happens if you wait to start saving for retirement? That's not a good idea.

Let me give you an idea of what has to happen to hit your target of $1 million in a retirement portfolio at the age of 70. (See the chart "Crockpot Versus Microwave.")

Based on historical returns, if you wait until age 30 to start your retirement savings, you will need to earn a return of 7% each year in your diversified four-asset portfolio to hit $1 million. If you wait until age 35 to get started, you'll need an 8% annualized return. If you wait until age 40, you will need a 10% return.

If you start investing at age 45, the needed annual return goes to 13%. If you wait until age 50 to get started, you'll need an 18% annualized return to have $1 million by age 70. And if you wait until age 55, you'll need a 27% annualized return. Trust me, that won't happen.

Crockpot Versus Microwave

Start your retirement savings at age...	Needed annualized return over 45 years to have $1 million in a retirement account by age 70 (assuming an annual savings rate of 10%)	Start your retire-ment savings at age...	Needed annual savings rate to have $1 million in a retirement account by age 70 (assuming a 45-year annualized portfolio return of 8%)
25	6%	25	5.50%
30	7%	30	7.50%
35	8%	35	10%
40	10%	40	14%
45	13%	45	20%
50	18%	50	30%
55	27%	55	45%

Source: Author's calculations.

In short, it is really hard to microwave your retirement savings account in a short time period later in life.

Or we can flip this analysis around and assume an 8% portfolio return and then calculate what the needed annual savings rate would need to be over the various time frames. As a reminder, the average 45-year annualized return of our four-asset portfolio over the past 91 years was 10.2%, so an assumption of 8% is actually a conservative estimate.

As shown on the right side of the graph, a $1 million retirement account balance is achieved at age 70 if you save 5.5% of your annual income each year starting at age 25 and if you achieve an average return of 8% in your portfolio.

(Of course, there's no reason to dip down to 5.5% if you can handle a 10% annual savings rate. If you did, in fact, save 10% each year and you achieved an 8% annualized return in your portfolio, you'd have over $1.8 million saved up by the age of 70).

If your portfolio earns 8% and you wait until age 30 to start saving, you will need to save 7.5% of annual income. Wait until 35, and the needed savings rate goes to 10%. Delay until 40 and you will need to save 14% of your income each year. If you start at age 45, plan on saving 20% of your annual income. At 50, you will need to save 30% of your annual income. At 55, you will have to save 45% of your annual salary to hit $1 million in your retirement account.

SPECIFIC SITUATIONS

Now, all these figures are based on a starting salary of $35,000 at age 25 and a 2.5% annual increase in pay.

Your specific situation may be very different, but the core relationships remain the same. For example, let's say your starting salary is $70,000 at age 25. In that case, your target account balance at age 70 might be $2 million.

The relationships in "Crockpot Versus Microwave" are unchanged. If you start saving 10% of your annual income at age 40, you will still need a portfolio return of 10% to hit your $2 million target at age 70. Or, if you assume a portfolio return of 8% and you start saving for retirement at age 40, you will need to save 14% of your income each year to achieve your $2 million goal.

Assuming a starting salary of $35,000 at age 25 and a 2.5% annual increase in salary

We must acknowledge that a person's annual savings rate may fluctuate over her lifetime. For instance, early in her career the actual saving may start well below the annual savings goal of 10 to 15%, but then accelerate later.

Or a young worker may get off to a great start by saving 15% each year into a diversified portfolio, only to experience a disruption in employment for a period of time in which nothing is contributed to the retirement account. Later, after finding a new job, the savings pattern begins again.

DO YOUR BEST

At the risk of sounding like a coach giving a halftime speech, the key in any scenario is to do your best at every life stage. If your best is saving 5% of your income, then you do that. If your best is saving 8%, then do that. A well-diversified portfolio will do its job over time, but you just have to do yours by giving it a sufficient amount of money to hit the desired target.

Preparing for retirement is more about persistence, and less about brilliance. Ideally, it's a crockpot commitment rather than a microwave mad dash at the end.

In summary, the road map to adequate retirement savings is quite straightforward. But even though the path is clear, it's not necessarily easy.

- Start investing early in life.
- Set a goal to invest at least 10% each year, but start at whatever level you can.
- Invest in a broadly diversified portfolio, even more diversified than the four-element portfolio shown in this article. (Ideally, it should include U.S. stocks, non-U.S. stocks, real estate, commodities, U.S. bonds, non-U.S. bonds and cash.)
- Automate the savings process if possible.
- Stick to it for 40 to 45 years.
- Stay diversified in retirement.

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The college graduate's guide to saving for retirement

Young people are advised to start building their nest egg as soon as they land a job after graduating from college, according to this article on Washington Post. They may start contributing even a small amount to a retirement plan, as the money grows considerably over time through compounding. When investing for retirement, young clients should have basic knowledge about the market, consider setting up an IRA, and increase their contributions every year.

(Bloomberg News)

How entrepreneurs can use IRAs to finance startups

IRA investors who consider launching their own business have the option to tap their savings with the "rollover as business startup plan" or ROBS to finance the startup, according to this article on The Wall Street Journal. While many entrepreneurs use ROBS, financial advisers are not keen on recommending it to their clients. The ROBS plans, "while not considered an abusive tax avoidance transaction, are questionable in that they may serve solely to benefit one individual's exchange of tax-deferred assets for currently available funds," according to an IRS report.

Pulling money from your Roth IRA? Read this first

Although withdrawals from a Roth IRA are not subject to tax even before retirement, investors should make sure that they reach the age of 59 1/2 to make the withdrawals tax- and penalty-free, according to this article on Morningstar. They should also ensure that the funds are in Roth IRA for at least five years so they won't owe any taxes and penalty on the withdrawal. Roth IRAs have different five-year rules apply for direct contributions and for assets converted from traditional IRAs.

5 considerations to help you retire wealthy

To secure retirement, investors are advised to reduce the risk in their portfolio and develop a solid financial plan that will ensure that they have enough income for their needs, according to this article on Kiplinger. They should also maintain a well-diversified portfolio to hedge the risk and make decisions based on realistic expectations. Clients may also consider getting valuable advice from people they know who have experience in tax, estate planning and other areas of personal finance.

5 benefits of delaying retirement

Delaying retirement allows clients to have more time to build their nest egg, according to this article on Motley Fool. People who also opt to push their retirement date could also defer Social Security for increased benefit payment and continue receiving healthcare and other benefits from their employer. Their pension benefits would also increase if their employer has a defined-benefit plan, and they would continue to be socially engaged which is good for their mental health.

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