

How to Start Saving for Retirement

Everybody eats, everybody dies and (almost) everybody retires. My grandfather was an exception to this rule; he loved work so much that he never retired. If you're reading this, chances are you plan to kick back and enjoy your later years, so I'm here to explain how you can position yourself for success in retirement from a young age.

Retirement accounts are vessels for your retirement savings and, due to the power of compounding, it's best to start contributing to your retirement account as soon as you are financially able to. Better yet, someone should start an account in your name the day you are born—but you'd have to figure out how to communicate that from the womb!

Retirement will likely be your longest-term financial goal for most of your life, save for leaving an inheritance. This means you will spend most of your adult life saving for it and thinking about it. Given that large span of time, the earlier you begin thinking about retirement, the better off you will be.

What Do All Those Letters and Numbers Mean?

If you have any familiarity with what a 401(k) is, I'm sure that question is top of mind. If you work at a company with an employer-sponsored retirement plan in place, you probably have either a 401(k), a 403(b) or a 457(b) account. Apparently, whoever came up with these thought they would be easily distinguishable, but they pretty much all look like the same thing. Thankfully, that's because they are similar vessels for your retirement savings with different labels on them.

If we think of the 401(k) as the generic version of an employer-sponsored retirement plan, the 403(b) is the version for nonprofit employers, charities and other public education organizations, and the 457(b) is for local government employees.

Traditional Versus Roth Accounts

The traditional versions of employer-sponsored retirement plan accounts will take pretax money from your paycheck before you get paid. The advantage of this is that you don't miss the money if it gets taken out before you even see it. A traditional individual retirement account (IRA) is also funded with pretax money, but you have to claim the deduction when you file your taxes.

There are also Roth versions. A Roth retirement savings account allows you to invest for your retirement using aftertax dollars. This means you don't get the tax break up front. With a Roth employer-sponsored retirement account, your take-home pay will be less than it will be with a traditional account. The advantage to a Roth is that you won't have to pay any taxes when you eventually take distributions from the account in retirement. You won't claim any deduction on your tax return but you will need to tell the Internal Revenue Service (IRS) how much you contribute each year.

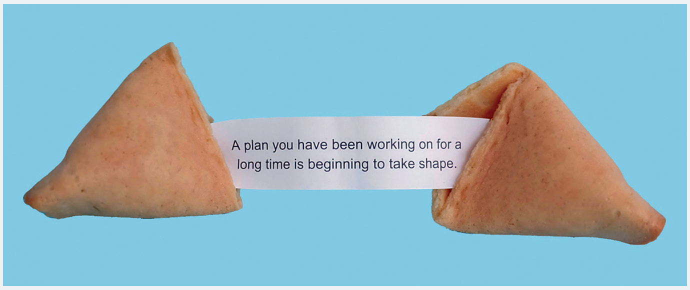
Which type of retirement account you choose is entirely up to you. All else being equal, the decision depends on what you think your tax rate will be in the future versus what it is now. If you expect to make a higher salary when you retire, putting you in a higher tax bracket, a Roth retirement account might make more sense.

When to Start Contributing

The easy answer to this conundrum is as soon as possible, but of course nothing is ever that simple. Many companies will require you to put in time working for them. After a certain period of time—e.g., 60 days, six months, one year or two years—you are able to take advantage of the employer contribution match when you contribute to an employer-sponsored retirement account. This amount is usually anywhere from 3% to 6%, so make sure you are contributing at least the same percentage as your company to qualify for the full match. If you are able to contribute even more than the percentage match, go for it! It will set up a nice cushion for you in the long run.

What if you can barely afford to pay your rent and monthly expenses when you first become eligible? If your budget is not lining up with what you want to save for retirement, don't sweat it just yet. First, see if there's anything you can cut from your budget (e.g., share a subscription with a friend, roommate or family member; make dinner at home more frequently; or sell something of value that has just been collecting dust). If this isn't possible, set up a plan for when you will be able to contribute to your retirement account. This could be a certain income threshold, or just a short-term decision for when you will have to crack down on expenses to save for your future. Living below your means is your best shot at having more to save.

Whenever you get a raise, increase the amount you are contributing to your retirement account. This process is



called paying yourself first. Having more money deposited into your checking account just means you will spend it. If you instead prioritize saving, you will increase your purchasing power in the future instead of spending your money now and seeing none of it later.

How to Choose Investments for Retirement

At AAII, we have a Vanguard 403(b) plan account that is eligible for employer-matched contributions after two years. When my two-year anniversary at AAII came around, I was faced with the decision of which Vanguard mutual funds to invest my future in. I recall reading very helpful commentary from our editor Charles Rotblut about his own Vanguard retirement account, and I looked for similar funds that would give me the proper diversification.

Diversification is the process of investing in different types of securities across size and industry types to reduce the chances that one investment's loss will devalue your portfolio. You can invest in anywhere from four to seven mutual funds, but anything more than seven will reduce your diversification benefits, so choose wisely! Most retirement accounts with Fidelity, Vanguard or T. Rowe Price will have their own mutual fund options to choose from.

AAII's Asset Allocation Models are a great place to start if you have no idea what diversification or allocation mean. The aggressive model calls for 90% invested in stocks and 10% in fixed income, like bonds. But when you're just starting out, I would recommend not worrying about the bond portion.

I chose to primarily diversify based on company size, investing in one small-cap, one mid-cap and one large-cap mutual fund. I also included one growth and one real estate mutual fund. I decided to prioritize growth over value for my retirement account back in 2019 when I made this decision, and growth stocks have been outperforming value stocks for the majority of that time.

Other Ways to Save

Simplified Employee Pension (SEP) plans can be used to supplement your primary employer-sponsored retirement account with your main employer. If you have a side hustle or you are self-employed, the SEP-IRA would be a good choice. Be sure to look into the taxes and limits for those accounts before investing.

You can also open a regular IRA if you're not yet eligible to contribute to your company's retirement account. This way, you can maximize your savings instead of just waiting around to save. You may also be able make contributions to a regular IRA even while participating in a 401(k) if your adjusted gross income (AGI) is below certain limits.

Taxes

I'll keep this brief and bloodless: You should understand the taxes associated with all your investment accounts, but especially your retirement accounts. You don't have to keep every detail in your head (that would be concerning!), but you should know why you are investing in a traditional retirement account versus a Roth account and what the other side of retirement will look like for you.

Tax-deferred accounts—the traditional ones you will pay taxes on when you withdraw money in retirement—lower your taxable income. This means you will pay less in income taxes each year you choose to invest in this account since the contributions come from your pretax income. They also have required minimum distributions (RMDs) for each year you are in retirement, and there's no way to get around taking the money out of the account at a specific time without paying hefty fees.

Aftertax accounts—those you are paying taxes on up front—allow your money to grow tax-free and have no RMDs. There are also income limits for Roth accounts, so do your research before making a decision.

Thankfully, none of these decisions are set in stone. You can change your retirement account investments, and you can even conduct a rollover from a traditional account to a Roth (there are a lot of rules involved in this as well, but it can be helpful for tax purposes).

Conclusion

The most important part of saving for retirement is increasing your contributions whenever you are making more income. I know it's tempting to keep your contribution the same, and you might want to make some room in your budget for a big purchase or a better apartment. However, the more you make, the more you should be saving. Think of it like when you have a whole bunch of berries about to go rotten (i.e., depreciate in value). If you don't make them into a pie, share them with neighbors or eat them all yourself today, they won't have much value for you tomorrow. ■

—Anine Sus, AAII associate editor