Retirement looms ahead of all recent college graduates. Again and again, retirement is pushed at you, but when it seems so far away, why should you worry about it now? The average college graduate, graduates at the age of twenty-five, forty years before most plan to retire. Forty years is a long time – so why start thinking about saving for retirement now? Take for example the following scenario:

“A young recent college graduate, age twenty-five, finds his first employment after college. Although he may only be eligible for an entry-level position with a company, he sees the opportunities for promotions and upgrades down the road. Ultimately, this job will be worth it in the long run. The company offers him a reasonable salary, but not anything to brag about. A retirement consultant approaches him and talks with him about pulling money out of his check every month to send to his retirement fund. With student loans now due and other traditional expenses, he opts out of retirement for the time being. He reasons that paying off his student loans will help to save him more money in the long run, allowing him to start contributing to his retirement in five or ten years. This will still leave him at least thirty years to save for retirement.”

This has become an all too familiar scenario for recent college graduates. You will find yourself giving excuses – some of them very valid excuses – to wait to save until situations improve. So then, what is wrong with having this kind of attitude?

Every retiree has a number goal – an amount of money they hope to have saved when they retire. This number can be generated using a couple different methods, but ultimately, think of setting your own goal based on the following statement - At the time of retirement, you should not have a reduction in your quality of life. Here’s a little more insight into this idea.

The last few years of working, you will get used to a certain quality of living. The salary you are awarded from your job defines that standard. This quality of living will include things like cars, homes, vacations, monthly spending money (i.e. play money), etc. After retirement, your salary no longer comes each month, so where is your living allowance?

Whatever retirement money you have currently saved, will determine if your quality of life can stay the same. Ultimately, your goal should be that the lifestyle being led at sixty or sixty-five pre-retirement should be the same lifestyle continued after retirement. If quality or standard of living must change, then there was failure to save the appropriate amount of money.

This doesn’t necessarily mean that you’ll need to receive the same paycheck during retirement that you received your final years working, in fact for most people it is less, but that doesn’t mean the quality of life changes for them. They can still live in their current home, but consider that perhaps it is paid off. The same could apply for cars. But perhaps the most important thing to consider in your monthly budget is that you’ll no longer need to contribute any money into your retirement, since you are living it!

For most people, the closer they get to retirement, the more they invest in their retirement accounts. As we get older, our lives tend to become simpler rather than more complicated. Things like children and all their related expenses tend to be removed from the budget. Perhaps you are able to pay off your home, cars, and other toys that you had monthly payments on previously. Thus, there tends to be a surplus in your income, and most people, as they are anticipating retirement, contribute that surplus into those accounts.

**WHY START NOW?**

In the introduction, we looked at an example showing a typical college graduate faced with the decision to start saving for retirement now or put it off for a few years down the road. Understanding the benefits of saving now might sway his and your decision to start with the first paycheck.
The Benefits of Compounding Interest

Although there are many different retirement programs available (discussed individually in subsequent sections), the following example will help to illustrate a basic retirement saving principle.

Let’s take for example two employees at the same company. George chooses to contribute $100 every month from his first paycheck, or $1200 a year. He starts saving at the age of 25 and plans to retire at 65, thus giving him 40 years to contribute. For the sake of the example, George is going to continue to only invest $100 a month for forty years. Now, let’s look at a second employee, Jane, who chooses not to invest her money into retirement when she first starts working. Unlike George, Jane waits five years, at age thirty to start saving. She contributes the same amount, $100 each month, but now she only has 35 years instead of 40 to save her money. What is the difference in their two lump sums at the age of 65?

George will have saved just over $310,000 while Jane will have only saved $206,000. That five year’s difference cost Jane $100,000 in her retirement. How does this happen?

There are two types of interest that you could see when saving your money, simple and compound. Simple interest, is interest paid only on the principal amount; whereas, compounding interest pays interest based on the principal amount and the interest accrued. Let’s better understand this idea with an example.

Let’s say you have $10,000 sitting in your bank account. The bank tells you that they work on simple interest, paying you once a year. The interest rate is 5%.

The formula for calculating what you will have in a year is:

\[ \text{Interest} = \text{Principal} \times (\text{Rate}) \times (\text{Number of times accumulated}) \]

So in our case the equation would look like this:

\[ 10000 \times (0.05) \times (1) \]

With the answer being 500.

So every year you keep your money with that bank, you’ll see an increase of $500. So consider if you wanted to see what would happen to your money in 20 years.

\[ 10000 \times (0.05) \times (20) \]

With your final answer being 10000. Now remember this is the amount of interest you will have accrued in 20 years. So your ending balance will be $20,000. Not too bad, right?

Well let’s look at the same numbers, but with compounding interest, rather than simple interest. Essentially, the first year will remain the same. You’ll still receive $500 in interest at the end of the year, but here is where the bonus comes. As you start the second year, you build interest on $10,500 rather than your original principal amount. And each year going forward will be the same. You will continue to see the amount of interest you earn increase as your principal + interest increases.

Here is a formula for compounding interest:
Future Value = Principal Value \times (1 + \text{interest rate})^n \quad \text{Where } n = \text{the number of years}

So let’s use the same numbers as above to illustrate the point. You have $10,000, with an interest rate of 5%. After twenty years ...

?? = 10000 \times (1 + .05)^{20} \text{ with your answer being }$26,532.98.

Pretty stark differences, right? With compounding interest, you have earned an additional $6,500.

Retirement plans, like a 401k or 403b, all work with compounding interest. This is one of the major factors that influenced how much money was saved in our earlier example with George and Jane. By using the principle of compounding interest effectively, George was able to accumulate $100,000 more than Jane, simply by starting five years sooner.

It may be hard for you to think about retirement now, in your twenties, but you’ll find that it’s much easier to start now than later. By waiting even a year or two, you’re costing yourself large amounts of money in the long run. Thus, even if you can only spare $100 a paycheck, it will be worth it.

**Instability of Government Programs**

It is important to start now and rely on yourself for retirement. One factor that you haven’t seen presented in any of the aforementioned scenarios is Social Security or any other government sponsored retirement help. With our generation, we just can’t assume anything.

For those unfamiliar with Social Security, it works like this. Every paycheck you receive has federal taxes removed from it. Depending on your situation, when you file your taxes in April each year, you can receive part of that money back. But two parts you will never see returned to you are Medicare and Social Security. Out of every paycheck you’ll see a percentage taken for these two programs. Both of these programs exist for those who are retired. The idea is that you will pay into these programs for thirty to forty years, and then you’ll receive a paycheck each month from the government giving you your money back – this is Social Security. Medicare is health insurance specifically offered to those in retirement. The government steps in to help those in retirement with insurance since they are not employed to receive insurance benefits. It is also assumed that receiving a private insurance is difficult for most elderly because of their age and/or health conditions. These two programs are something you pay for while you still have a job, so that you can reap the benefits when you are no longer working. It’s not exactly that simple, but theoretically, that’s how it works. The amount you receive changes, depending on the cost of living each year and your annual salary.

The important thing to understand is that by 2033 it is estimated that the government will only have 77¢ for every dollar they owe back in Social Security. So in order for the government to ensure it has enough money to sustain the Social Security Program, it will need to find 33¢ somewhere else for every dollar it owes. This can be done by raising taxes or cutting back in other programs. And the biggest problem is that it’s only going to get worse. If you’re twenty-five in 2013, then you probably won’t be retiring until sometime around 2053. That’s twenty years after the government is expected to already be bleeding money from Social Security.

One of the biggest reasons the Social Security Program is struggling so much and will struggle in the future is life expectancy. When the Social Security Program was first started, most people didn’t live much past their age of retirement. Even twenty years ago, the life expectancy was only five to seven years after retirement. So that means the government was only issuing retirees Social Security checks for five years. Now, however, the life expectancy is much higher than that. It is not uncommon for people to live well into their eighties and even their nineties. This means the government is issuing Social Security checks for twenty or twenty-five years rather than five. Now you see the dilemma.
the government is faced with. So essentially, we better not count on any money from the government and then if there is some, it’ll be a nice monthly bonus we weren’t planning on getting.

**Types of Employer Sponsored Retirement Plans**

When you first interview for a job, most likely the employer will mention their retirement options. The part about retirement may be the last thing you are worried about when he’s mentioning your salary, healthcare benefits, etc. But, as we’ve already discussed, understanding your retirement is vital to your future final stability, so it’s important you understand what different retirement plans you might see.

It’s crucial you understand a few key things before we talk specifics. First, companies may offer a **matching program**. This means that for every dollar you place in your retirement, they will match it up to a certain percent. For example, your company will match 100% of your annual contribution up to 3% of your annual salary. So if your salary is $65,000, and you choose to invest $5,000 a year into your retirement fund, the company will add an additional $1,950 just for working for their company. Most people consider this “free money,” and would strongly suggest taking advantage of it.

Second, it’s important for you understand that some plans are **tax-deferred** and some are not. We will talk more later about the tax benefits associated with retirement. However, if a plan is tax-deferred, it means the money is removed from your paycheck prior to taxes being taken out. If the plan is not tax-deferred, the money invested into your retirement comes out after taxes are removed from your paycheck.

Third, retirement money is set for retirement, and shouldn’t be pulled out early. When you invest money into a tax-deferred retirement plan, you are not required to pay any taxes on that money until retirement. However, if you elect to remove your retirement early for any reason, you will face penalties from the IRS. This rule is mainly in place for you. It makes you think long and hard before dipping into your retirement early. Of course there are circumstances that might warrant you pulling your money out early, but realize that you will be required to pay those penalties as well as taxes on the money before you use it. For the majority of retirement plans the golden number is 59 and ½ years old. Once you have reached that age, you can remove your money without penalty.

**401k Retirement Plan**

Many employers will offer a 401k retirement plan. Only an employer can sponsor this plan. A 401k is tax-deferred. So basically any contribution you make into this plan will have great tax benefits. The contribution amount is taken out of your paycheck pre-tax, which brings your taxable income both for each paycheck and for the year down based on how much you contribute. Ultimately, by investing money into your 401k each month, you will save yourself in the amount of tax you owe at the end of the year.

Once you have put your money into your 401k, it will be invested in different areas of the financial market. It may be invested in stocks, bonds, mutual funds and money market accounts. Your employer will have partnered with a financial institution to take their company’s retirement funds and invest it. You will be introduced to a retirement representative from that company. The representative will talk with you about how much you want to invest and how you would like to invest it. You can choose to have a high-risk, medium-risk or low risk portfolio. We will discuss these different types of plans later. However, it is important you make time to meet with your company’s representative in order to ensure your money is placed where you feel comfortable.

**403b Retirement Plan**

A 403b Plan is very similar to a 401k. Again, any money you invest in your plan is tax-deferred and saves you in taxes owed each year. The biggest difference between these two plans is that 401k retirement plans are offered by for-profit
organizations and 403b retirement plans are offered by non-profit organizations. You will most likely see a 403b if you work for a school district, a hospital, a church, or some other non-profit organizations (501(c)(3) organizations).

Essentially, a 403b and 401k are different based on the tax codes the government assigns them. All of your money will still be taken by an investment company and invested into the type of portfolio of your choosing.

**Pensions**

Pensions are not as popular as they used to be. In the past, instead of a 401k, 403b or 457b, a company would offer a pension. With economic struggles, most pensions are being reduced or completely discontinued and replaced with a 401k, 403b or 457b. The main reason companies are shying away from pensions is the immense cost to a company. An employer offers a pension plan and generally the only money contributed into the pension plan comes from the employer. There are two different types of pension plans – a defined benefit pension plan and a defined contribution pension plan.

With a defined benefit pension plan, an employer promises an employee a certain amount of money at retirement. Generally these plans include required years of service in order to receive a full pension. For example, a correctional officer is required to work for twenty years in the department. After twenty years of service, the employer will pay 75% of the officer’s last year of service. This amount is guaranteed every month until death.

When you have a defined contribution pension plan, your employer will invest a certain amount into your plan, and however much you have at retirement is what you have. Your employer may invest money monthly, quarterly or annually. As these contributions grow, so does your retirement. You may also lose money, depending on the market, but overall your money will grow in the long run. The disadvantage of this type of pension is that it is very hard to determine how much you will have at retirement. The employer may also require a certain amount of years of service to receive your pension, but not always. Some employers will give you your pension wherever it currently sits if you decide to leave before retirement.

Pension plans are very expensive for an employer. Since the employer is generally the only contributor, pensions will cost the company immense amounts of money each year. Especially now that the retirement years are longer due to life expectancy, companies are struggling to maintain their pensions. This is why you will see pensions fading in the job market over the years.

**Stock Options**

Some companies will offer new employees stock options as part of a retirement plan or as a sole retirement option. In order for this option to be available you must work for a company that has stock. If you work for a company that does have stock, your employer may offer you a “deal” to purchase stock in the company at a good price. Sometimes this price may be half the current market value. This still requires you to purchase the stock outright, but then instantly after purchase you have doubled your investment (if purchased at 50% the current market value). There is always a designated time frame for you to use your stock options.

The idea is for you to invest in your own company. As the company improves, so will your stock. If, however, the company fails or struggles, your stock will drop in value, ultimately hurting your retirement investment. Even though this can be a great buy, it’s quite risky.

An advantage of having stock options is that there is no specific age at which you can cash out your stocks. However, there are penalties now in place if you buy the stock and then sell it again within a short period of time. Understandably, employers will be disappointed if they give you stock options only to have you sell them shortly
after being hired. Generally, when an employee sells his/her stock, it means there is or will be a termination of employment.

**Non-Employer Sponsored Retirement Plans**

Obviously, some of you won’t have a retirement plan offered through your work. Don’t worry; there are options for you, too. Some employers don’t offer retirement options through their company, and some of you might be entrepreneurs starting your own start-up business. If you are doing any type of freelancing work, you can also take advantage of these retirement opportunities since you won’t have a company to offer you any type of plan.

**Roth IRA**

A Roth IRA is a retirement plan available to any individual. Roth designates the type of investment you are making and IRA stands for Individual Retirement Account. Even if you have a 401k with a company, you can still obtain a Roth IRA. For example, if you have maxed out the 401k you have with an employer, but you want to contribute more in a year, using a Roth IRA just may be the answer. You can also open a Roth IRA if you have no other retirement plan.

There are a few restrictions for Roth IRAs. There are restrictions on how much you can contribute in one year. In 2013, the maximum you could contribute as a single person or as head of a household was either $5,500 or your taxable compensation for the year – whichever number is smaller. Also, the money you contribute into a Roth IRA is not tax-deferred. Instead, you pay into your Roth IRA with after-tax dollars. However, the growth and earnings you receive in your Roth IRA are not counted against you in taxes each year. You’ll pay regular income tax when you begin withdrawing your money.

Like other retirement plans, you cannot withdraw your money until you are 59 and ½ years old without penalty. In the case of a Roth IRA, you’ll pay a 10% penalty if you withdraw your funds early. One benefit to a Roth IRA is that you can begin taking your money any time after 59 and ½. Some retirement funds require that you begin your withdraws at a certain age, regardless of if you need them or not. With a Roth IRA, you can wait until you are 65 or 70 if you choose, depending on your living situation.

There are also income limits to Roth IRAs. If you make less than $112,000 a year you can contribute up to the limit discussed earlier. If you make between $112,000 and $127,000 you can still contribute, but it is a reduced amount based on your income and situation. If you make over $127,000 a year, you cannot contribute to a Roth IRA and you’ll need to look into other retirement plan options.

**Traditional “Deductible” IRA**

A deductible IRA is a tax-friendly Individual Retirement Account. When you contribute to a deductible IRA, you use after-tax dollars just like the Roth IRA. However, unlike the Roth IRA, you can use your total contribution amount to add as a deduction each year on your taxes. There is a limit to this that changes every year, so beware that not all of your money may be used as a deduction if you contribute over that limit. Additionally, your money is put away tax-deferred until you start to withdraw it at which time you’ll pay income tax.

Also unlike the Roth IRA, there are typically no income limits to participate in a deductible IRA. As with many of the other retirement plans we’ve talked about, there is a 10% penalty for withdrawing any money before the age of 59 and ½. In addition, you have to start withdrawing your money by age 70 and ½ regardless of your living situation.