

The Eighth Wonder of the World

By: Kristin Carlton

How many 18-year-olds do you know that are planning for their retirement? Probably about as many as I know. Zero! Maybe you have heard, or even said, some of the following statements, “I don’t need to worry about retirement, I’ll live off Social Security!” “I don’t have the extra money right now, I’ll start next year.” Or “I have plenty of time to save for retirement, after all I don’t retire for another 50 years!”

We all know the first excuse is not a safe assumption. The fact is Social Security will run out by the year 2040 or be paid only by entitlement. If the laws don’t change soon, most 18-year-olds won’t see a penny of Social Security. This could have a devastating effect on their lives. For example, the elderly poverty rate for 2006 was 10%. If this same group did not receive any Social Security benefits the poverty rate increases to 48%! As you can see, the earlier we prepare for no Social Security, the better off future retirees will be.

The graph on page 3 demonstrates the benefits of early contributions to Roth IRAs. For example, if 18-year-old Ima Procrastinator receives at least \$4,000 annually in income, she can contribute the maximum amount to her Roth IRA (\$4,000 for 2007). If we assume that the portfolio is invested 80% in equities and 20% in fixed income or cash the portfolio could earn an average of 7.6% per year (net of fees). For each option we assume Ima contributes the maximum of \$4,000 annually for seven consecutive years.

If Ima contributed from age 18 – 24 (a total of \$28,000), when she retires at age 66 she would have \$857,000. And don’t forget the main benefit to a Roth IRA: all withdrawals are tax-free. Therefore, the only tax paid on the \$857,000 is on the \$28,000 in contributions that Ima made almost 40 years before.

If Ima waited until age 25 and contributed the same amount spread over seven years, she would have \$504,000 at age 66. Still nice, however she receives less since the investment horizon is shorter.

Finally, if she waited until age 32 to begin saving for retirement (we do not recommend this!) and all the above assumptions stay the same, she will retire with \$297,000. Not bad, but if Ima had made the same deposits starting fourteen years earlier, her earnings would have been up over three fold. What a difference time can make!

Albert Einstein said that compounding interest is the eighth wonder of the world, and he said that before Roth IRAs were invented. So, take advantage of this gift – encourage all twenty-and thirty-somethings to open and contribute to a Roth IRA. If you have any questions on how you or someone you know can better prepare for retirement, give us a call. Let us put your mind at ease!