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Good Retirement Savings Habits Before Age 40

Some early financial behaviors that may promote a comfortable future.

You know you should start saving for retirement before you turn 40. What can you start doing today to make that effort more productive, to improve your chances of ending up with more retirement money, rather than less?

Structure your budget with the future in mind. Live within your means and assign a portion of what you earn to retirement savings. How much? Well, any percentage is better than nothing – but, ideally, you pour 10% or more of what you earn into your retirement fund. If that seems excessive, consider this: you are at risk of living 25-30% of your lifetime with no paycheck except for Social Security. (That is, assuming Social Security is still around when you retire.)

Saving and investing 10-15% of what you earn for retirement can really make an impact over time. For example, say you set aside $4,000 for retirement in your thirtieth year, in an investment account that earns a consistent 6% a year. Even if you never made a contribution to that retirement account again, that $4,000 would grow to $30,744 by age 65. If you supplant that initial $4,000 with monthly contributions of $400, that retirement fund mushrooms to $565,631 at 65.[1] This is a hypothetical example used for illustrative purposes only, and does not represent the return of any specific investment. Actual rates of return will vary over time, particularly for long-term investments.

Avoid cashing out workplace retirement plan accounts. Learn from the terrible retirement saving mistake too many baby boomers and Gen Xers have made. It may be tempting to just take the cash when you leave a job, especially when the account balance is small. Resist the temptation. One recent study (conducted by behavioral finance analytics firm Boston Research Technologies) found that 53% of baby boomers who had drained a workplace retirement plan account regretted their decision. So did 46% of the Gen Xers who had cashed out.[2]

Instead, arrange a rollover of that money to an IRA, or to your new employer's retirement plan if that employer allows. That way, the money can stay invested and retain the opportunity for growth. If the money loses that opportunity, you will pay an opportunity cost when it comes to retirement savings. As an example, say you cash out a $5,000 balance in a retirement plan when you are 25. If that $5,000 stays invested and yields 5% interest a year, it becomes $35,200 some 40 years later. So today's $5,000 retirement account drawdown could amount to robbing yourself of $35,000 (or more) for retirement.[3]

Save enough to get a match. Some employers will match your retirement contributions to some degree. You may have to work at least 2-3 years for an employer for this to apply, but the match may be offered to you sooner than that. The match is often 50 cents for every dollar the employee puts into the account, up to 6% of his or her salary. With the exception of an inheritance, an employer match is the closest thing to free money you will ever see as you save for the future. That is why you should strive to save at a level to get it, if at all possible.[4]

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Saving enough to get the match in your workplace retirement plan may make your overall retirement savings effort a bit easier. Say your goal is to save 10% of your income for retirement. If the employer match is 50 cents to the dollar and you direct 6% of your income into that savings plan, your employer contributes the equivalent of 3% of your income. You are almost to that 10% goal right there.[4]

Think about going Roth. The younger you are, the more attractive Roth retirement accounts (such as Roth IRAs) may look. The downside of a Roth account? Contributions are not tax-deductible. On the other hand, there is plenty of upside. You get tax-deferred growth of the invested assets, you may withdraw account contributions tax-free, and you get to withdraw account earnings tax-free once you are 59½ or older and have owned the account for at least five years. Having a tax-free retirement fund is pretty nice.[4] Retirement plan withdrawals may be subject to taxation and penalties when withdrawn early.

To have a Roth IRA in 2016, your modified adjusted gross income must be less than $132,000 (single taxpayer) or $194,000 (married and filing taxes jointly).[4]

Set it & forget it. Saving consistently becomes easier when you have an automated direct deposit or salary deferral arrangement set up for you. You can gradually increase the monthly amount that goes into your accounts with time, as you earn more.

Invest for growth. Much wealth has been built through long-term investment in equities. Wall Street has good years and bad years, but the good years have outnumbered the bad. Early investment in equities may assist your retirement savings effort more than any other factor, except time.

Time is of the essence. Start saving and investing for retirement today, and you may find yourself way ahead of your peers financially by the time you reach 40 or 50.

Citations.

1 - investor.gov/tools/calculators/compound-interest-calculator [7/7/16]
2 - marketwatch.com/story/millennials-can-save-more-for-retirement-by-learning-from-baby-boomers-mistakes-2016-06-30 [6/30/16]
3 - thefiscaltimes.com/2015/11/20/7-Ways-Millennials-Are-Getting-Retirement-Saving-Wrong [11/20/15]
4 - kiplinger.com/article/retirement/T001-C006-S001-retire-rich-saving-for-retirement-in-your-20s-30s.html [2/4/16]