Never, ever too early to be saving for retirement

Q: My daughter is spending all of her income on travel and having fun. Last week she asked me how and when she should start saving for retirement. What should I tell her?

A: First let's answer the "when" – she should start as soon as possible. The earlier she starts saving, the less she needs to save.

By investing $250 a month (20 lunches at $12.50 each, including the tip), and assuming an 8% average annual return, and starting at age:

25: She'll accumulate $878,570 by age 65
35: She'll accumulate $375,073 by age 65
45: She'll accumulate $148,236 by age 65

This very important concept is known as the power of compound interest. Gains generate their own gains each year, thus the power of compounding. Think of it as making money without working.

As for the "how" – tell her to pay herself first. There will always be bills and unexpected expenses. Be smart and let the money do the heavy lifting.

Combine the power of compounding with the tax advantage of tax-deferred savings. If her employer offers a retirement plan, and she is eligible, this is the place. The maximum deferral this year is $18,500 for participants under age 50. Ask if there's a match. This is the "free" money that 401k type plans (or 403b plans for non-profits) gift to employees annually, usually with a vesting schedule of six years or less. Deferrals go into these plans tax free, so part of the funding is done with the tax savings by adjusting federal withholding.

If her employer doesn't offer a retirement plan, she may be eligible for a deductible IRA. Another strong consideration is a Roth IRA that, although it is not deductible, grows tax free forever. The maximum contribution is $5,500 for the under 50 crowd. There are a multitude of rules, so refer to the www.IRS.gov website.

Self-employment opportunities include the Simple IRA with a $12,500 contribution limit, SEP IRA where 25% of income is allowed up to $55,000 and Solo 401k plans that are similar to the SEP IRA with a catch up provision to add another $6,000 for the over 50 year olds. The choice is influenced by income, the age of the participant and whether there are employees.

Systematic investing can be used to make dollar cost averaging easy. Whether it's from a paycheck to a 401k or the bank to the IRA, this investment technique can be used to automatically buy a fixed dollar amount of an investment on a regular basis regardless of the share price. When prices are low she buys more shares – when prices are high, she buys fewer shares. The concept of buying periodically is automated.
When considering how much of her salary to save for retirement, the Center for Retirement Research at Boston College found that individuals who earn an average wage and save about 15% of their earnings each year will replace about 70% of their salary at age 65.

By starting early and paying herself first, she takes advantage of compound interest, matching employer contributions, tax deferrals, and dollar cost averaging. And if she skips lunch, she can still travel and have fun!

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