INVESTMENT INSIGHTS

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THE TRUE COST OF WAITING TO SAVE FOR RETIREMENT

KEY POINTS

- Many Americans do not feel very confident about their retirement savings.
- Saving for retirement early is crucial for investors to meet their retirement goals.
- Having a financial plan can help you be more confident about your retirement savings.

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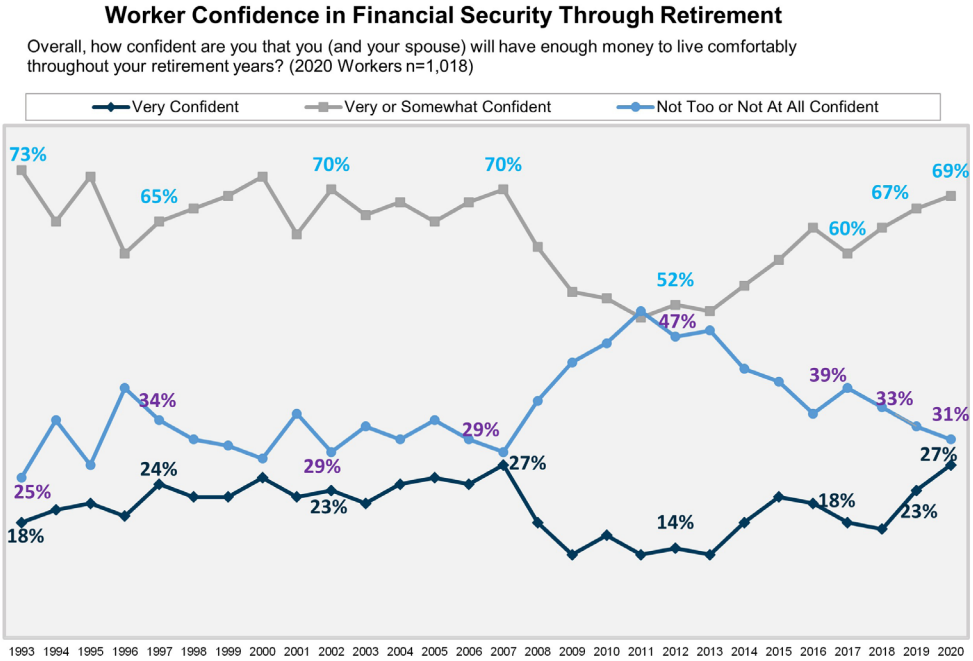
For many people, the start of a new year is the time to make new goals. One of the most important financial goals many investors have is to save adequately for retirement, and the sooner they begin to work toward that goal, the better. This issue of investment insights discusses the risks of waiting to save for retirement.

FINANCIAL CONFIDENCE IN RETIREMENT

One of the biggest regrets many investors have is waiting too long to start saving for retirement. In fact, if they could do it over again, nearly two-thirds of recent retirees would have started saving much earlier.[1] They may be among the more than 70% of Americans who do not feel very confident about their ability to have enough money to live comfortably throughout their retirement years.[2] Furthermore, as the graph on the next page shows, more than 30% of Americans do not feel confident at all about having enough money to live comfortably through retirement.

1 Real Deal Retirement
2 Employee Benefit Research Institute and Greenwald & Associates, 2020 Retirement Confidence Surveys.



Source: Employee Benefit Research Institute and Greenwald & Associates, 1993-2020 Retirement Confidence Surveys.

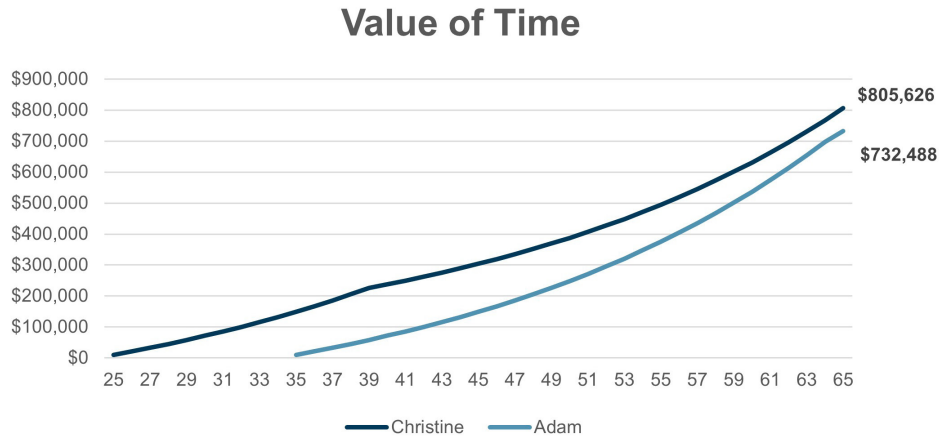
VALUE OF TIME

Interestingly, most working Americans start with the same amount of time to save for one of their most important financial goals – a financially stable retirement. Yet, not everyone treats this period of time as the valuable asset that it is. It is important to remember that time is an asset that loses value each day that money is not given the opportunity to work. As the value of time is wasted, the cost of your financial goals increases, sometimes to the point that they become prohibitively expensive and unattainable.

Consider the example of two young adults, both age 25. Christine commits to contributing $10,000 a year (or roughly $834 per month) toward her retirement savings. In this example, we assume her retirement savings earn an average annual return of 5%. She continues contributing $10,000 per year for 15 years until the age of 40, at which time she stops working due to health reasons and can no longer contribute toward her retirement savings. In total, she contributes $150,000 ($10,000 per year for 15 years).

Her friend, Adam, chooses instead to pursue a more expensive lifestyle and postpones saving until age 35. With 30 years until age 65, Adam assumes that is enough time to build his nest egg. Adam also saves $10,000 per year, and his savings are also assumed to generate an annual return of 5%. In total, he contributes $300,000 ($10,000 per year for 30 years).

In this example, while Adam was making his 30 years of contributions, Christine's account continued to grow in value, without any new contributions. As you can see in the graph below, even though Adam made contributions for twice as many years, by the time they both turned 65, Christine had saved more overall.



Note: Assumes a 5% rate of return compounded annually. The balances shown are approximate.

This is a hypothetical illustration, and your results will vary. The rate of return does not include fees that may be associated with an investment account or reinvestment of dividends.

The reason for this surprising outcome is the big difference in how they utilized their time. While it is possible for Adam to catch up with Christine, it would require substantially larger contributions or taking more risks to generate a higher return on his investments. The moral of the story is the more time you have, the less it may cost you to achieve your goals. Time can also mitigate risk, enabling you to assume less of it because your money has more time to work.

THE POWER OF COMPOUNDING

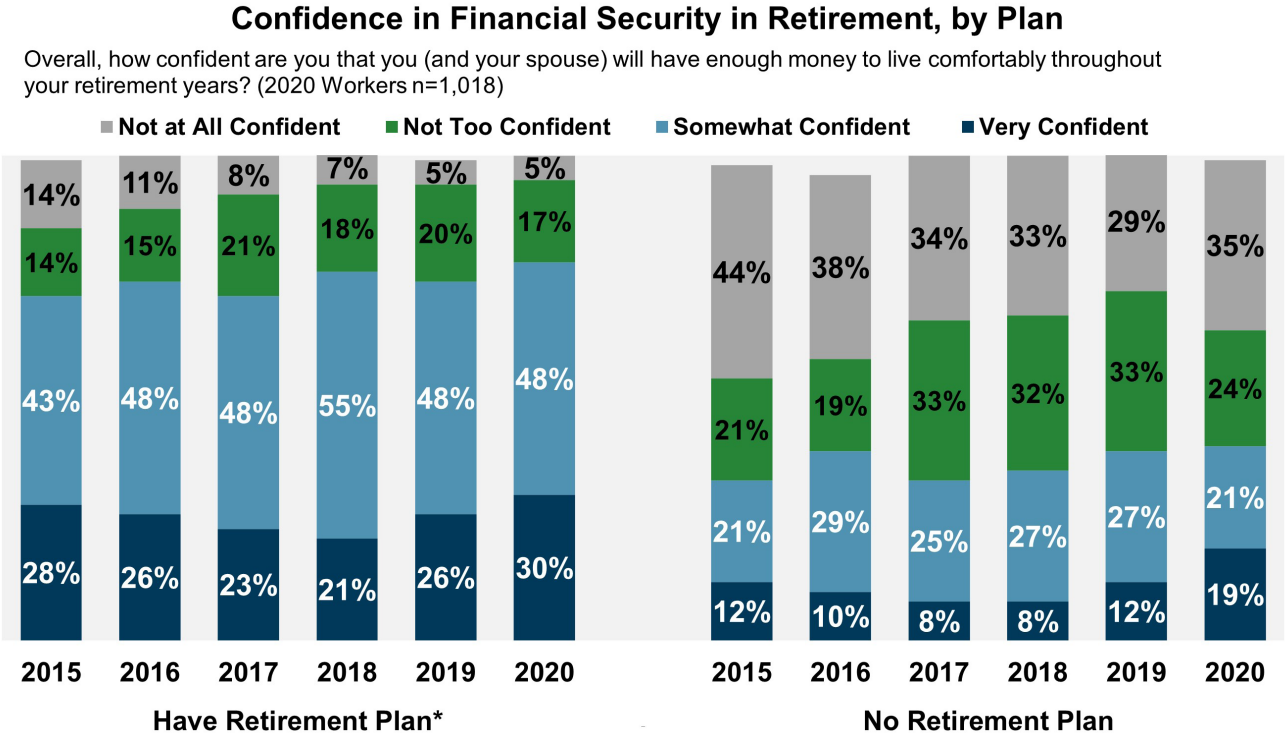
To fully appreciate the value of time for investing, we must understand how compounding works. If you were given the choice of receiving $10,000 each day for a month or a single penny that doubled in value each day for a month, which would you choose? If you chose the former, you may feel surprised to learn that, at the end of a month, your $10,000 daily gift amounted to $300,000, while the doubling penny would have produced more than $5 million. Such is the magic of compounding.

The magic of compounding interest stems from the fact that your money not only earns interest on the principle but also on the interest that is earned. One thousand dollars earning 5% a year (compounded annually) will grow to $1,050 at the end of the first year. In the second year, the money earns interest on both the original $1,000 and the $50 of interest, for a total amount of $1,102.50. That is the compounding effect of interest earning interest. At this rate, your account is expected to double to $2,000 in about 14 years. When the compounding effect of interest earned is combined with time, the growth of your money at work becomes exponential, as is the case with the penny and Christine/Adam examples above.

VALUE YOUR TIME WITH A PLAN

For anyone with aspirations of building wealth, time is your most valuable asset. Most people start out with little money, a lot of time, and a similar opportunity to build wealth. However, each day that passes without some contribution of money – either savings or interest – the cost of achieving our financial goals increases. That is why many people at or near retirement, who will never get that time back, wish they had saved early and often.

The importance of starting early is clear, but where do you start? It may be helpful to start with a financial plan. According to the Retirement Confidence Survey (see below), 78% of respondents felt confident about retirement when they had a plan. In contrast, less than 40% of individuals felt confident about retirement when they did not have a retirement plan.



*Have Retirement Plan defined as respondent or spouse having at least one of the following: IRA, DC plan, or DB plan.
Source: Employee Benefit Research Institute and Greenwald & Associates, 2015-2020 Retirement Confidence Surveys.

Many investors find it helpful to have an advisor to guide them in developing a plan and to keep them on track toward their goals. Advisors can be like coaches; they help you identify ways to save for retirement, encourage you to remain focused on your long-term goals, and revise your plan if life throws you a curveball. To develop or revisit your financial plan, contact your financial advisor today.

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