Save Enough for Retirement – with These Three Strategies

Accumulating enough for a comfortable retirement can seem utterly daunting. But if you're smart about it, you may be able to lessen the financial pain, possibly trimming your required annual savings rate to just 8% or 9% of income. The trick? Get as much help as you can – by using these three strategies.

1. BUYING TIME

If you're in your 20s, you may not have much money. But you do have time, which can be just as valuable. Suppose you start salting away money for retirement as soon as you join the work force, so your initial retirement savings might enjoy 40 years of investment returns.

Assuming a 7% return, $1,000 will grow to almost $15,000 over those 40 years. But if you delay saving for retirement by ten years, so you have 30 years to invest, your $1,000 will grow to just $7,600 – or barely half as much.

Getting an early start on retirement savings is especially important for women. Why? Women typically live longer than men, while also earning lower salaries. That means they may need to fund a longer retirement with less income.

If you start saving for retirement when you're young, you may also be willing to invest more heavily in stocks, because you have longer until retirement and hence more time to ride out market declines. With any luck, that higher stock allocation might translate into higher returns.

Don't overdo the stocks, however. As you approach retirement, you should probably ease up on stocks and stock funds, and instead invest more in bonds. Partly, that's because your time horizon is shorter.

But also, this shift to bonds reflects the dwindling of your human capital, which is your ability to pull in a paycheck. During your working years, your income-earning ability is like a bond, providing you with regular income. Once you retire, you will no longer have this human capital "bond," so you may want to compensate by boosting your portfolio's bond holdings.

2. GIVING AT THE OFFICE

In addition to getting time on your side, see if you can get some help from the boss. Many employers have ditched traditional pension plans and replaced them with "defined contribution" plans, such as 401(k) and 403(b) plans.

These plans allow employees to invest their own money in the plan's series of investment options. If a company is publicly traded, those options may include the company's own stock.

In a typical arrangement, an employer will kick in 50 cents for every $1 that an employee contributes, with this matching contribution capped at 3% of pay. In other words, if you invest 6%, your employer would contribute another 3%, for a total of 9%. The employer match can be considered free money – and you don't want to pass it up. Indeed, failing to invest enough to get the full employer match ranks as one of investing's most foolish mistakes.

In 2010, you can save as much as $16,500 in a 401(k). Those age 50 and older can make an additional catch-up contribution of $5,500, boosting their total allowable investment to $22,000.

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3. TRIMMING THE TAX TAB

Even if a 401(k) or 403(b) doesn't have an employer match, these plans are still a great savings vehicle, thanks to the tax benefits. Not only do your investments grow tax-deferred, but also your initial contributions are tax-deductible.

Some folks are leery of 401(k) plans, because all taxable withdrawals are dunned as ordinary income. But if you do the math, you often find the initial tax deduction pays for the final tax bill.

To understand why, imagine you are in the 25% federal income tax bracket now – and you are still in the 25% federal income tax bracket when you retire. If you earn $1,000 and don't invest it in your 401(k), you will immediately lose $250 to taxes.

But if you invest in the 401(k), you get to sock away the full $1,000 because your contributions are tax-deductible. Fast forward to retirement, by which time the $1,000 might have grown 200% to $3,000. You withdraw the $3,000, losing 25% – or $750 – to taxes, assuming your tax bracket stays the same. This $750 reflects 200% growth on $250, which was your initial tax savings. In effect, the initial tax savings paid for the final tax bill,

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leaving you with tax-free growth on the remaining money.

Even if you don't have a 401(k), you can get the same tax advantages by funding a tax-deductible individual retirement account. In 2010, you may be eligible to invest as much as $5,000 in an IRA, or $6,000 if you are age 50 or older.

Alternatively, you could fund a Roth IRA, assuming you meet the income requirements. The same $5,000 and $6,000 annual contribution limits apply. A Roth, however, doesn't give you an initial tax deduction. Instead, all withdrawals should be tax-free – which makes the Roth a great complement to a regular tax-deductible 401(k).

How so? If your tax bracket goes down in retirement, that will be good for your tax-deductible 401(k), because your withdrawals will be taxed at a modest rate. What if your tax bracket goes up? That will be bad for your 401(k), but this tax risk is somewhat reduced, because your Roth withdrawals should be tax-free.

You may even be able to get this tax diversification within your employer's plan. Some companies now offer both a regular tax-deductible 401(k) and a Roth 401(k), which means employees can spread their tax bets – without leaving the office.

WORKING TO RETIRE

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- Get some ideas for what you might do in retirement at **www.mynextphase.com** and **www.myplanafter50.com**.

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