[Why Retirement Is a Young Person’s Issue]

Why should someone in their 20s worry about retirement? Retirement is probably 40 years away, twice as long as you have been alive. There is plenty of time to save for the golden years.

That is the thought process of most young adults. Plus it is more fun hitting happy hour after work on Friday than investing in a mutual fund or stock that will probably fall in value anyway.

I get it. Does not mean I agree, but I understand how most people think.

However, I still urge young investors to save a little upon starting out in the work world.

U.S. News & World Report outlines, [“7 Ways Retirement Is a Young Person’s Issue”]. Well worth a read if you want added incentive to start saving for retirement today. As per usual, a few added thoughts from my side.

Social Security Reform

There will be substantial changes in social security payouts in the near future.

Yes, politicians keep kicking the can down the road as implementing change will be political suicide. But at some point, changes must be made. Deferring eligibility until one’s 70s, reduced payouts, thresholds based on wealth or income, etc. Whatever the actual mechanics, the bottom line will be less money in your pockets. Governments just do not have the money to continue financing retirees at current levels.

And this problem exists pretty much worldwide.

So be prepared for significantly less in government retirement pensions (but expect to continue to contributing to the pot!).

Debt

I think this is a bit of a catch-22 issue.

Yes, it is a legitimate concern that impacts a growing number of retirees. And it will likely affect many young adults reading this post.

But the need for personal debt in retirement is probably caused by the fact that the person did not start saving until relatively late in life. If you start saving now, you will not require external debt to live as a retiree.

Longevity and Inequality

With each passing decade, life expectancy in developed countries seems to increase.

Perhaps you can calculate annual savings, return, and expenditures up to and through retirement. But what happens if you expect to die at age 75 and find yourself living on into your 90s? Better to accumulate more than you require – to cover for unexpected costs, longer life, etc. – than to face a shortfall.

Also, as the old saying goes, make hay while the sun shines. You never know what will happen down the road. You get ill, lose your job, lose your spouse, etc. All these can impact your ability to save. So start as soon as possible and give yourself a buffer against unanticipated future shocks.

Given all the unforeseen events that can arise over the next 40 years, I suggest that you can never save enough.

Bonus Thoughts!

Not directly mentioned in the article, but worth considering:

Detroit

Or a bunch of other cities, states, and countries.

They are bankrupt. Or will be bankrupt. That means existing contracts will not be honoured. If you work for the bankrupt (or future bankrupt) entity, you may not receive your contractual retirement benefits.

The same concern should apply even if you work for a private company. If you are part of a defined benefit plan, you want to be sure the plan is fully funded. Underfunded plans run the risk of non-payment should the company go insolvent. For company plans, I prefer defined contribution plans that are funded on an ongoing basis (and with a few other protections).

Compound Returns

I have written about the power of compound returns previously.

It is an extremely important concept and a huge advantage for young investors. The sooner you start to save, the higher your wealth will grow over time. So start saving, even if just a little, as soon as possible. It will be worth the sacrifice in the long run.

Financial Tips for College Graduates

U.S. News offers 10 financial tips for young adults.

Actually, financial advice for anyone starting out in the work world. Or even for those who have been working for awhile and now want to begin investing.

Good advice. A few comments from my side.

I shan't cover all the points, but do want to make a few observations.

Start Saving From Day One

Good investors save, invest, and grow their funds.

Enroll immediately in a plan where money is automatically deducted from your pay each period. Company plan, personal tax-deferred investment account, etc.

You did not have any income yesterday. Missing $50 or $100 per pay period will not be felt. But if you wait and get used to the extra cash in your chequing account, it will be more difficult to lose it later on.

Invest for the Long Term

How you invest should, in large part, reflect your phase in the life cycle.

Presumably you are young. With 40 plus years until you need to access your retirement funds. Starting out in the world, you hopefully are entering an accumulation stage of life.

With a long time horizon, you can handle some volatility in your portfolio. That means you should consider relatively riskier assets when you are young.

No, not betting double zero on the casino roulette wheel. Nor even putting half your money in corn futures. This is speculation. I am talking investment risk. Based on your personal risk tolerance and individual circumstances. For a typical young investor, that often means a well-diversified portfolio with an emphasis on equities.

Do not shun risk at a young age. Risk can be an asset for young investors. Just make sure it is well considered, prudent investment risk.

As your time horizon decreases and your personal circumstances change, then you can slowly move to a lesser risk portfolio.

Maintain an Emergency Reserve

Last in, First out (LIFO). An inventory term in accounting.

But also a reality for young employees who lack seniority within a company. If things go sour, new employees often suffer.

Start investing on day one. But also start accumulating an emergency reserve in case you suffer a loss of employment income. The amount should be based on various factors. A good benchmark is often 3 to 6 months of living expenses.

Don’t Live Like a King

Or queen. Or my nephew.

Yes, it is nice to finally get out of your parents’ basement and begin earning real money. But live within, or even below, your means.

Try to keep life frugal and invest any spare cash. Take advantage of your youth and the power of compound returns. Yes, you may enjoy that week in the Dominican Republic. But investing the money and watching its compound growth over time will allow for many more weeks vacation down the road.

Financial Advice for Younger Adults

The New York Times offers some “Financial Tips for Younger People”.

Not bad financial advice for young investors. Worth a read.

Key points offered:

Those Under 40 Are Not Saving Money

> *With stagnant wages, a tough job market and heavy student debt, American under about age 40 have accrued less wealth than their parents did at the same age, even as the average wealth of Americans has doubled over the last quarter-century, according to a new study by the Urban Institute.*

You can substitute “American” for most nationalities.

With government deficits and heavy debt levels, ever increasing tax rates, and high unemployment, the ability for individuals to save and create real wealth will get even tougher. That is why it is crucial to start saving as soon as possible. The earlier you begin to save, the less actual money you have to set aside (thanks to the power of compound returns!).

Develop a Saving Habit Today

Individuals, especially younger ones, must see savings as a habit. They:

> *… need to start saving — even if it’s as little as $10 a month, if money is tight — to get in the habit. With the uncertainty about the future of Social Security benefits, he said, “There’s a high likelihood they’re going to be*

> *personally accountable for their own retirements."*

Do Not Overspend on Homes or Cars

Younger adults should:

> *not to aim to buy a big, expensive house right away, because they are likely to move around before settling down. Ditto for fancy cars.*

I would differentiate between homes and vehicles.

Not buying too big a house now may save significantly on mortgage interest. Buy something reasonable, then pay down any debt as quickly as possible. In the early years, interest takes up the vast majority of mortgage payments. Take steps to reduce the principle and the overall cost of the house (purchase price plus mortgage interest) will be much lower.

One may make an argument to invest in a large home now, given current popped housing bubbles in many locations. Over the long run, real estate has been a good investment. If you can find a large home, at a reduced price, fine. But remember that your true cost will include interest on any assumed debt. So be cautious about overextending.

Vehicles are different as they are depreciating assets. We are not talking classic collectible cars, but vehicles you use for day to day use. You buy a new car and the second you drive off the lot it is worth substantially less. Vehicles are not investments.

A good rule of thumb is to invest in appreciating assets and minimize purchases of depreciating assets.

Spend money on items that will retain their value or increase in price. Spend as little as possible on wasting assets.

College is an Investment

Another good piece of advice is:

> *taking only as much college debt as they can reasonably expect as their first year's salary in their chosen field.*

I am not sure I agree with the ratio, but the point is valid.

Education, job training, etc., is an investment to help increase earnings during your lifetime. You must always consider the return on that investment before spending your money or taking on high debt levels.

A few other pieces of advice are offered in the article. So please give it a read.

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3 Ways Financial Advisors Mislead You

Probably way more than three ways personal financial advisors can mislead clients. But the article I want to link mentions three, so we will start there.

I agree with two of the three, but you can come to your own conclusions.

Okay, so what are these evil secrets financial advisors use to hurt clients?

Ramit Sethi writes about financial "experts" who offer advice that never actually works. In his article, Mr. Sethi describes three "money secrets that the money pros won't tell you."

Secret #1: Cutting back on lattes almost never works

I would have linked to the article just for this point alone. So, so, true.

"Latte" can be substituted for many other things advisors tell you to skip and invest the savings.

The issue is never saving $3.00 per day by not buying the latte (and I would like to know where I can get a $3.00 latte these days!). The issue is more fundamental. For most individuals, $3.00 is not the tipping point to wealth creation. It is the reasoning behind the spending, as well as the other daily expenditures that occur.

If you can develop an ethos to save and invest, your daily caffeine high will not get in the way. But you need to develop a saving mentality. That usually requires a fundamental change in behaviour, not giving up one coffee a day.

Yes, I know the longest journey begins with a single footstep, every penny helps, and so on. But I would rather focus on positive techniques that aid in the investing process. Tools that may still allow for your daily dose of joy.

Secret #2: As an individual investor, you're probably being ripped off

Ripped off? Toi? Say it ain't so.

1. High fees

High fees? Where have we heard that one before?

As a small investor, use low cost index funds!

2. Commission-based financial advisors get fat fees recommending inappropriate funds

Commission-based financial advisors make their living from product sales. Does not make them bad people (or at least most of them), nor do I think that all of them recommend inappropriate funds. But that is how they pay their own bills, so be aware that a potential conflict of interest exists.

Same with bank employees providing in-house products to clients.

Always know how your advisor is compensated and apply a healthy degree of skepticism to recommended products. You do this when buying a car, television, etc. Financial products should be treated exactly the same.

And understand whether your advisor will be a fiduciary or not. An important distinction.

Also, those high priced mutual funds and structured products generally do not outperform passive investments or designated benchmarks. If someone tries to get you to invest in a product with high annual fees, demand to see performance comparisons to benchmarks and peers. Perhaps the fees are worthwhile. But I doubt it.

In my opinion, active portfolio management is not optimal for smaller investors (and large ones for that matter). Put your money to work for you. Do not let it go into the pockets of the bank, fund company, brokerage house, or product salesman. Minimize your costs and you will maximize your long-term growth.

3. Unnecessary accounts

True, except for the part on using target date funds.

Also, smaller investors should try and consolidate investment accounts with one bank or firm. The more assets in one place, the more leverage you may have when negotiating loans or other financial services. For example, many online brokerage houses offer reduced transaction fees if you maintain (say) $50,000 in bankable assets with the institution. Often, this threshold applies to family assets (those who reside in same household).

If you are starting out and still live at home (or use your family address), you may be bundled in with your parents, thereby allowing you preferential fees. But you usually need to specifically request the linkage. So check the small print at your financial institution and see if you can reduce your costs.

Once you develop a substantial asset base, diversify between at least two banks. Partly for protection in case one bank fails. But mainly to play one against the other when negotiating for products and services. Banks live for new assets under management. The promise of new money coming in is a big motivator for flexibility.

Secret #3: Getting a tax refund is a good thing

I see the point. People take positive wealth accumulation steps with the refunds, but would (foolishly) spend it otherwise (probably on lattes).

But I do not agree. That is why I like individuals to contribute to their tax-deferred investment accounts as early in the year as possible, then have their source deductions reduced to reflect the tax-deductible contribution.

First, the interest foregone is small at today's rates. Fine. But when rates were 10% or more (not that long ago), that $3000 refund lost interest becomes much more significant.

Second, there is the whole time value of money thing. A dollar today is worth more than a dollar tomorrow. If you are not getting a return on your cash (as is the case with tax refunds), you want the money in your jeans (to start earning a return) as fast as possible.

Third, and perhaps most important, is the stronger compounding.

You contribute $3000 annually for 20 years, earning a return of 8% each year. You make the contributions at year end, reflecting your tax refund. At the end of 20 years, you have $137,286. Or you decide to make the contributions at the start of each year and not wait for a tax refund. After 20 years, your capital would be $148,269. By investing at the beginning of each year, you would accrue $10,983 more than by waiting until year end. Or in easy to understand terms, 3,661 lattes at today's prices.

Yes, I agree that psychologically it may be easier to wait for a tax refund, then invest it or pay down debt.

But from a pure finance perspective, get the money owed to you back in your pocket as fast as possible. Then put it to work immediately. The extra wealth that you will accumulate over the long-term is worth it.

A Good Investor Always Saves

I am not a fan of Jim Cramer. Simply because he plays to the cameras. And I hate the theatrics.

But he talks about a time when he was doing poorly in life. And he makes a great point that should apply to all investors. So we shall give him a listen.

Good Investors Always Save

According to Jim Cramer, good investors must:

> *Save. Whatever you can – whenever you can. But always save.*

I agree this is pivotal for successful long term wealth accumulation.

Quite simply, a good investor always saves – period.

Learn to become disciplined and consistent in saving. Even if only a little each period.

It may take a few months to adjust to having less disposable income, but you do adjust. If your rent goes up $100 per month, you adjust. You have to. Pretend your rent, car loan, utilities, etc., went up and put the difference into your investment account, rather than your landlord's.

How to Save

Take advantage of automatic deductions from pay cheques to make direct deposits into investment accounts. If you are able to use tax-deferred accounts, so much the better.

Sign up for dividend reinvestment plans (DRIPs) where available. Over time, you must watch the tax liability on income earned but not received. But starting out, there should be no issues.

Note that you can invest directly in some public company shares using DRIPs or Direct Stock Purchase Plans (DSPPs). Also, if employed by a public company, there may be Employee Stock Purchase Plans (ESPPs) available. All of these provide the opportunity to periodically invest small amounts while saving on costs.

While I prefer exchange traded funds (ETFs) in general, consider open-ended, low-cost, no-load index mutual funds when beginning to invest. Why?

Most ETFs have transaction fees when you buy or sell. There are a few no-transaction fee ETFs out there, but most ETFs charge brokerage fees. Even if you only pay $9.99 per transaction, that is 10% on a $100 purchase. If you wish to invest in ETFs (because they are cheaper than mutual funds, allow intraday trading, etc.), I recommend you accrue your periodic deposits, then purchase an ETF once you reach a critical mass (say $1000).

Mutual funds tend to be more expensive than comparable ETFs. However, when starting out, you may choose to pay more in annual expense ratios to avoid transaction fees. If you stick with no-load funds you will not pay any fees when buying or selling (but watch for potential charges or penalties if you sell a no-load fund within a certain period from purchase date). At this stage of life, do not even consider any mutual fund with loads.

If you look for low-cost index mutual funds, annual expense ratios may not be too insane. They will be higher than the same ETF though. But in the first few years of saving, the tradeoff between higher annual costs versus paying transaction fees on ETFs may be worthwhile.

Often the initial investment index mutual funds is relatively low, $500 or $1000. This may take a few months to build to with minimal savings. But for many of these funds, once you have met the initial minimum you can usually make additional purchases for extremely small amounts, such as $50 to $100. This helps the wealth accumulation process.

Also, these small subsequent purchase thresholds lend themselves well to dollar cost averaging. An excellent tool to build wealth slowly, while reducing some of the volatility impact on your holdings. So this is another advantage of no-load mutual funds over ETFs in your early years.

But we still want to keep costs down in the long run. Over time you can sell your mutual fund and replace it with a less expensive ETF. But wait until you have adequate capital for this to make sense.

One final thought – remember our previous discussions on the power of compound returns. The sooner you start to save, the less you actually have to save over time to reach the same result. Similarly, the more you save now, the much greater it will grow over time. Look at Nicole and Matt to see what I mean.

Even a little saved consistently when you are young will grow significantly by retirement. As Lao Tzu supposedly said, “A journey of a thousand miles begins with a single step.”

So take even a small step today and start on your path to amassing wealth.