It's Never Too Early

BY MICHAEL MELTZER ON *MARCH 24, 2014*

Roth 401(k)s and Other Fun Stuff

As one of the younger portfolio managers at Tocqueville, I tend to focus a lot of my time on developing investment strategies for my peers. Unfortunately, most people don't start thinking about their retirement until they are in their forties. Better late than never, but I believe there is a large missed opportunity here. By starting the process earlier one could drastically improve his/her ability to retire at a reasonable age. Let's take the example of a worker who wants to retire at age 60 and earn $200,000 from his/her investment portfolio annually. By using the 4% Rule (a rule of thumb used to determine the amount of funds to withdraw from a retirement account each year)[1], that investment portfolio would need to be $5 million. This is our ending point, so how do we get there?

The Sooner the Better

Many young workers contribute to their employer sponsored 401(k) plans, typically an arbitrary percentage of their salary rather than the maximum permitted. This tends to be the extent or at least the majority of their savings. For 2014 the maximum amount one can contribute to an employer sponsored 401(k) plan is $17,500. We are permitted to withdraw from retirement accounts at 59 ½ years of age without penalty, so we will use age 60 as our finish line. If you are 25 years old and start contributing $17,500 to your 401(k) every year[2], assuming an annualized, compounded return of 8% per year (a reasonable long-term estimate)[3], by age 60 your 401(k) could be worth $3.5 million[4]. If you start this same process just five years later at age 30, your 401(k) could still be worth $2.3 million[5] at age 60. Wait until age 40 and at age 60 your 401(k) may only be worth $950,000[6]. So you see, starting later could end up costing you a lot of money. This is why I encourage clients to contribute as much as they can, as early as they can.

Know How to Work Your Options

Not all 401(k)s are created equally. With the Roth 401(k), you contribute after-tax dollars rather than pre-tax dollars. You won't get the contribution tax deduction of a traditional 401(k), but all of the compounded return will forever be tax-free! What does this mean? In a traditional 401(k), funded with pre-tax dollars, you will have to pay ordinary income taxes on every dollar you withdraw from your IRA (this could be over 50% in a high tax state like New York or New Jersey, depending on your income tax bracket). Now if your 401(k) is a Roth 401(k), all of your withdrawals in retirement are tax-free. Who wouldn't rather have access to millions of dollars tax-free when they are 60 as opposed to a $17,500 deduction each year now?

Don't Rely on Your 401(k) Alone

Roth IRAs have been around since 1998, but there have always been income limitations on contributors, generally designed for lower income earners. This year, for example, those who earn less than $112,000 per year ($178,000 combined, if married) can contribute up to $5,500[7] to a Roth IRA. Every young worker earning less than that amount should consider doing this. If your earnings increase to above the aforementioned levels, there's an option available to keep the Roth IRAs growing. Since most young people save via 401(k) as we discussed above, they rarely have a traditional IRA. So they can open one, contribute up to $5,500 to it with after-tax dollars (anyone can do this regardless of income level), and the next day convert it to a Roth IRA. That's right – since 2010, anyone, regardless of income level, can convert an IRA to a Roth IRA. The caveat is that you must pay ordinary income taxes on the entire amount of the conversion the year you convert – but thereafter all your compounded growth is tax-free and withdrawals in retirement are tax-free. In addition, there are no required minimum distributions at age 70 ½ and above like there are from a traditional IRA. So, if by some good fortune you don't need the money in retirement, you don't have to take it!

The Roth conversion can also be an excellent strategy for job changers. Rather than roll your old 401(k) into your new job's 401(k), [when permitted] roll it over to an IRA and then convert it to a Roth IRA. Pay the taxes now, while it's still a relatively small amount, and then forever have tax-free compounded growth! Keep in mind that with the $5,500 contributions I mentioned above, there is no tax for the conversion from traditional to Roth, because the traditional IRA was funded with after-tax dollars. So basically, it's a way of contributing to a Roth IRA at any income level. This only works if you don't have another IRA, because in order for the conversion to be completely tax-free, your IRA essentially needs to be empty, a requirement many young people will fulfill. Again, to put some numbers around this, contributing an additional $5,500 a year to your Roth IRA (or contributing $5,500 to your IRA and then immediately converting to your Roth IRA) could result in an additional $1.1 million[8] by age 60, assuming you start at age 25, and assuming the same 8% rate of return. This is in addition to any monies contributed to the 401(k) (or Roth 401(k) if

available).

Most young people will still complain that they will never be able to afford to retire, but that's simply not true. With the strategies outlined above, the young worker who starts contributing the maximum amount allowable to both a Roth 401(k) and Roth IRA beginning at age 25, assuming an annualized, compounded 8% rate of return, could have accumulated $4.6 million[9] by age 60 – pretty close to the $5 million suggested in my opening paragraph; and, that's before any employer matches or any other money saved outside of retirement accounts.

The Take Away

I'm a numbers guy. I live and breathe the excitement of financial investments, but for those of you who don't, here's what I want you to remember:

1. Start saving as early as possible.
2. Whenever possible, max out 401(k) contributions.
3. Take advantage of a Roth 401(k) option, if available.
4. Seek to make maximum contributions to a Roth IRA, either directly, or through an otherwise empty traditional IRA.
5. Try to maximize your investment returns as much as possible without taking undo risk, such that this strategy pays off as best as possible.

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Footnotes

[1] Source: http://www.investopedia.com/terms/f/four-percent-rule.asp

[2] These maximum contribution amounts do increase over time with inflation but for simplicity purposes we will use this stagnant figure for our analysis. Additionally, individuals who are age 50 or over are permitted "catch-up" contributions, which allow them to contribute additional funds to 401(k) plans. For example, in 2014, this amounts to an additional $5,500 for 401(k) plans. As with regular contribution maximums, "catch-up" contribution amounts also increase over time. For simplicity purposes, we will ignore "catch-up" contributions from our analysis and calculations.

[3] A balanced portfolio of 50% large company stocks and 50% intermediate-term Government bonds, produced an annualized, compounded return of 8.1% from 1926 – 2013 according to the Stocks, Bonds, Bills, and Inflation® 2014 SBBI Market Report (Morningstar, Inc.). Portfolio allocations for each individual client will differ. Additionally, for simplicity, this analysis and following calculations assume an 8% return each year. In actuality, returns will vary from year to year and past performance is not an assurance of future results.

[4] The actual figure is $3,536,231. This figure is calculated assuming funds contributed in their entirety on the first day of each year and an 8% return for each year.

[5] The actual figure is $2,331,237. This figure is calculated assuming funds contributed in their entirety on the first day of each year and an 8% return for each year.

[6] The actual figure is $952,993. This figure is calculated assuming funds contributed in their entirety on the first day of each year and an 8% return for each year.

[7] As with 401(k)s and Roth 401(k)s, the maximum contribution amounts for IRAs and Roth IRAs increase over time with inflation as well, but again, for simplicity purposes we will use this stagnant figure for our

analysis. Additionally, individuals who are age 50 or over are permitted "catch-up" contributions, which allow them to contribute additional funds to IRAs. For example, in 2014, this amounts to an additional $1,000 for IRAs. As with regular contribution maximums, "catch-up" contribution amounts also increase over time. For simplicity purposes, we will ignore "catch-up" contributions from our analysis and calculations.

[8] The actual figure is $1,111,387. This figure is calculated assuming funds contributed in their entirety on the first day of each year and an 8% return for each year.

[9] The actual figure is $4,647,618. This figure is calculated assuming funds contributed in their entirety on the first day of each year and an 8% return for each year.

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