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Retirement Planning at Graduation

By Cliff Pletschet

It's college graduation time again, a life-changing moment for young people as they abandon the relatively safe confines of academic life and face the cruel world of job hunting, living on their own, money management, marital relationships, home buying and upkeep, and, possibly, child-rearing.

They may envision some of these struggles as around the next corner, but what most of them fail to calculate is the importance and cost of putting away money for retirement — which, of course, is completely out of sight, 40 years or more down the road.

It's hard for them to savor the last day of work when they have not yet experienced the first day. But they must focus on the fact that working for a living is not just earning money to spend, but earning money to salt away.

It seems a bit out of touch with reality to suggest that graduates inflict on themselves a crash course in saving money for retirement. They probably received little or no help from their parents, they themselves are just finding out they should have started saving retirement money years ago.

Today's graduates went four years to high school and four years to college and probably were not even taught the importance of compound interest, once acclaimed by Albert Einstein as "man's greatest invention."

Pop quiz: What's compound interest? It's the mathematical opportunity to enhance the growth of savings through interest earned on principal and on interest that was earned earlier. For example, $100 invested at 10 percent works out to $110 at the end of the first year and $121 at the end the second

year, with that extra $1 the result of compounding.

Will young workers face savings-account losses at the outset due to a sagging economy? It's possible. But Pamela Villarreal, investment analyst at the non-profit National Center for Policy Analysis, says that now is the time for graduates to get a savings plan under way because they can afford to take losses at this age. She suspects that this is not the only meltdown the young savers will face over their lifetime, and they must learn to live with reversals.

In interviews, seminars and on the Internet, Villarreal preaches the importance of early on participation in a 401(k) plan at work and setting up an Individual Retirement Account (IRA).

She lauds the Pension Protection Act of 2006 which allows a company to automatically enroll employees into a 401(k) workplace pension plan and any employer who opts to do that must match employee contributions, following a formula set up in the act.

Employees start with a minimum contribution mandated by the act and employees who fail to take advantage of the employer contribution are in effect "turning down a pay raise," says Villarreal.

On top of that, the law allows an employer without a 401(k) plan to make payroll deductions into an employee's IRA as long as all employees are included.

Villarreal tries to encourage graduates to launch a savings program by looking at some dismal figures. In 2005, she says, only 3.2 percent of workers aged 21 to 24 owned an IRA and only 9.3 percent participated in a 401(k) pension plan. Among workers aged 25 to 34 only 15 percent owned IRAs and only 28.6 percent participated in a 401(k).

She says, "Delay is costly. Under current law, today's 21-year-old will not be eligible for Social Security until age 67. It's easy to put off saving for retirement because the view is there's plenty of time. But procrastination can significantly reduce potential retirement savings. A 25-year-old who waits 10 years to save is forgoing a decade's worth of compounding. Regularly setting aside a little bit of money early in one's career produces a greater nest egg than setting aside a larger amount later on."

Examples she uses: A 25-year-old who puts away $100 a month for 40 years at a 7 percent nominal interest rate will have more than $260,000 by age 65. But if that person waits until age 45, doubling the monthly contribution to $200, he or she will have only $104,000 by age 65.

Saving consistently is just as important as saving early, Villarreal says. It's tempting to stop or reduce contributions to a pension account when the stock market is down.

But contributing a fixed amount at set intervals into a particular stock or stock fund (called dollar-cost averaging) can maximize the long-term returns.

When the market is up, a regular contribution will purchase fewer shares, but when the market is dropping an investor's contribution will purchase more shares. This can result in a lower average cost per share over time.

More information on retirement plans, including Social Security, can be found on NCPA's Web site, www.ncpa.org.

Convincing a graduate to launch a retirement account is a tough job.

But any retiree who is happy that he or she started early and created a fruitful nest-egg should grab a graduate and do a little preaching.