

Money and You: When it comes to saving, how much is enough?

by *Carrie_Schwab_Pomerantz*

Recently, a friend came to me for advice on how to tell her 25-year-old daughter about the importance of saving money. The daughter had just gotten her first career-focused job, but felt she wasn't making enough money to save, especially for retirement. My friend knows how important saving is - and saves as much as she can herself - however, she didn't have enough information to have a substantive discussion with her daughter.

This made me think about the bigger picture surrounding savings. It is essential for everyone to understand not only the general concept of saving, but also the particulars of how much to save, where to put your money, and how to prioritize your savings.

The low savings rate in America is the subject of much concern and debate in economic circles. Perhaps where this hits home most dramatically is the finding from the 2007 Employee Benefit Research Institute that almost half of workers saving for retirement report total savings and investments of less than \$25,000 (not including the value of their homes or a defined benefit plan).

Given this grim reality, here are some things to consider - and do - to make sure you (and your loved ones) are on a positive savings track.

WHAT YOU SHOULD BE SAVING

When it comes to saving, you need to consider three important factors: time, the amount you save and your rate of return. While you can strive for a certain rate of return, there are no guarantees. I'm going to focus on the first two, where you have the most control.

Let's first talk about time. It's a simple equation. Start young and you have more time to save and take advantage of the power of compounding. Compounding occurs when your earnings are reinvested back into your original investment to continue earning. Over time, these compounded earnings can really add up.

As I said to my friend, when you're young, it's more about how long you have to save rather than how much. Her daughter needs to realize the value of her youth. Because she has time ahead of her, even if she sets aside a small amount every month, it can pay off in a big way down the road.

When it comes to the all-important goal of saving for retirement, time plus the amount you save work hand in

hand. Here's why: The sooner you start saving, the smaller percentage of your income you need to keep to receive potentially big rewards. Conversely, the longer you wait, the larger amount of your salary you're going to have to put away each year to make sure your money will last as long as you do.

So how much is enough?

Here's a general guideline:

- In your 20s: Start now and you can feel pretty secure if you save 10 percent to 15 percent of your annual salary for the rest of your working life. You won't have to increase that percentage because, as your salary increases, you'll automatically be putting away more dollars.

- In your 30s: If you're just getting started now, try to save between 15 percent and 25 percent of your yearly income.

- In your 40s: If you haven't started yet and you're still looking to retire at age 65, you'll need to save between 25 percent and 35 percent of your income for retirement.

As you can see, the challenge increases the longer you wait. But no matter when you get started, there are some tactics you can use to make saving easier and more effective.

WHERE YOU SHOULD SAVE

A regular savings account is a good place to put your emergency fund or your savings for a short-term goal; you won't earn a lot of interest, but you'll have easy access to your money. A tax-deferred account like a 401(k) or an IRA, on the other hand, is designed for retirement savings. Your earnings can grow - and compound - income tax free. The power of compounding, together with tax-deferred growth, can create the potential for a significantly larger nest egg than with a taxable account.

Again, I encouraged my friend to give her daughter a simple example to show that it doesn't have to cost a lot to save in a tax-deferred account. For instance, even in the 15 percent tax bracket, a \$100 contribution "costs" just \$85 when you factor in the tax deduction.

Once you understand that you really can afford to save, it's easier to focus on the type of retirement account that's best for you.

Here are some options:

- Contributing to a 401(k): If your employer offers a 401(k) or other plan, start there. Your contribution generally comes right out of your paycheck, making it easy and automatic. Also, if your employer offers a company match, take advantage of it. It's virtually free money, but look into the details.

Today, many employers offer automatic enrollment in a 401(k) at low initial contribution rates. Don't settle for the lowest. Up your contribution to the amount that's right for your age and goals.

Choosing an IRA: This depends on your own tax and income situation, so it requires a little more thought. It's probably a good idea to talk with your tax adviser about the IRA that's right for you.

Here are some initial things to consider:

Contributions to a traditional IRA may be tax-deductible depending on your income and whether or not you participate in a 401(k) or other employer-sponsored plan. Your earnings can grow tax-free but are taxed as ordinary income when you withdraw them. A traditional IRA can make sense if you qualify for the deduction and think your income tax bracket will be lower when you retire than it is today.

- A Roth IRA can be the right choice if you think your tax bracket will be higher when you retire (this can be especially valuable for a young person like my friend's daughter). There's no up-front deduction, but you can withdraw the earnings income tax-free at age 59 and a half. There are income limits for contributing fully to a Roth IRA; therefore, you'll want to check to see if you qualify.

SAVING BEYOND RETIREMENT

While I believe saving for retirement should be your No. 1 long-term goal, I realize that at different life stages other goals such as saving for a home or your child's education can be equally important.

Do you have to sacrifice one for the other? Not if you plan ahead and prioritize. Whenever anyone asks me

how to manage and save for multiple goals, I suggest thinking about this order:

- 1) Contribute to a 401(k) up to the maximum company match.
- 2) Pay off your credit cards.
- 3) Put three-month's expenses in a short-term emergency fund.
- 4) Contribute the maximum to your 401(k) or your IRA (this is beyond the "match" in step 1).
- 5) Put money toward your child's education.
- 6) Save for the down payment on a home.
- 7) Consider paying down a large mortgage.
- 8) Contribute to taxable accounts.

Granted, you'll fine-tune this list based on your own circumstances, but it gives you a good starting point. And once you decide what and where to save, it's easier to figure out how. Track your expenses and find ways to economize. Don't increase your lifestyle just because you have a few extra dollars. Put salary increases or bonuses toward one of your goals.

Finally - and this is especially important - make saving automatic. Think of it as "paying yourself first." Have a portion of your paycheck deposited directly into your IRA or brokerage account.

Once you get into the savings habit, it's easier than you think. And you'll thank yourself later when you have the peace of mind that comes from financial security.

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