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Planning For Your Teens' Retirement

We've written a number of times about strategies and pitfalls to avoid for your retirement savings, but this week we thought we'd focus your attention on your children, grandchildren or other teenagers in your lives. While it may seem so (and certainly from a teenager's perspective), it is never too early to begin planning for the long term and retirement.

Because June and July are the start of the summer job season for high school and college students, we felt this would be a good time to remind you of the uses you can make of the Roth IRA, which is an excellent retirement savings vehicle for younger people.

Since their introduction in 1998, Roth IRAs have been garnering respect (and dollars) from knowledgeable investors for the advantages they have over traditional IRAs. While a traditional IRA allows you to deduct your contributions pre-tax, it also locks your money in until you are 59½ years old (unless you feel like paying a 10% fee on withdrawals, plus federal taxes), and forces you to take distributions upon reaching the age of 70½, paying federal taxes at your future—and possibly higher—tax rate.

In contrast, when contributing to a Roth IRA, you invest with after-tax dollars now and can withdraw funds tax-free after the age of 59½ or if you meet other IRS qualifications (for instance, if the distributions will be used for a first-time home purchase or to help with a disability). Once you do hit retirement, there is no requirement on distributions—if you don't feel like taking money out, you can leave it in there to continue growing.

So why are these great starter investments for teenagers or young adults? Simple: taxes and the power of compounding. If your child is only working for the summer, or just starting their professional career, they will likely be in one of the lowest tax brackets, making it a fantastic deal to pay taxes on their retirement savings now as opposed to when they are older and in a higher bracket.

The power of compounding is what makes any kind of tax-deferred investment a superb bargain. What do we mean by compounding? The definition of compounding is the act of generating earnings from previous earnings and here's an example: Let's say you make a \$100 investment in a fund that rises 20% in a year. After that year, you'd have \$120. Instead of selling your shares, you let them ride, and the fund gains another 20% the next year, bringing your investment value up to \$144. That's an additional \$4 in gains over the first year (or 4% on the original \$100 investment)

generated because you gained 20% not only on your original investment but also 20% on all the gains earned in the first year. While this may not seem like an impressive amount, with each passing year, that earnings potential grows even higher, so long as the investment prospers. If you start actively investing a set amount each year, adding to the amount generated by what the investment earns on its own, you create even larger potential earnings. Take a look at the table below to see what we mean.

We set up several different scenarios for the purpose of this table. All of them assume an 8% annual return, with the difference in scenarios being the amount contributed per year, increasing in \$1,000 increments from \$1,000 to \$5,000 (the maximum currently allowed under IRS rules for investors age 49 and younger for 2008) from the age of 15 to 70. The fifth scenario attempts to show a conservative, natural progression a young person might follow as they age and gain employment—starting with their first summer job at age 15, they invest \$1,000 a year until they graduate from college and get settled into a career, bumping their contribution up to \$2,000 a year by 25. By age 30, they will (hopefully) be well-established and able to again bump their contribution up to \$3,000, and again at 35 and 40 they bump that contribution up to \$4,000 and \$5,000 per year, respectively, continuing to contribute \$5,000 per year through age 70.

You can see that the greater the contribution and the greater the time that's passed, the larger and faster the account grows. That is the power of compounding—by constantly adding to your investment, you increase the potential return, going from what seems like a paltry \$1,000 initial investment at age 15 to almost \$420,000 by age 60, simply by adding \$1,000 a year to the account and achieving an 8% annual return (over the last five years through June, Vanguard's Total Stock Market Index has averaged an 8.6% annual return). With larger initial (and subsequent) investments, you get even more distance from your dollar. Even following the progressive contribution strategy, you end up, at age 60, with more money than the person who contributes \$2,000 per year from age 15 but never increases their contributions.

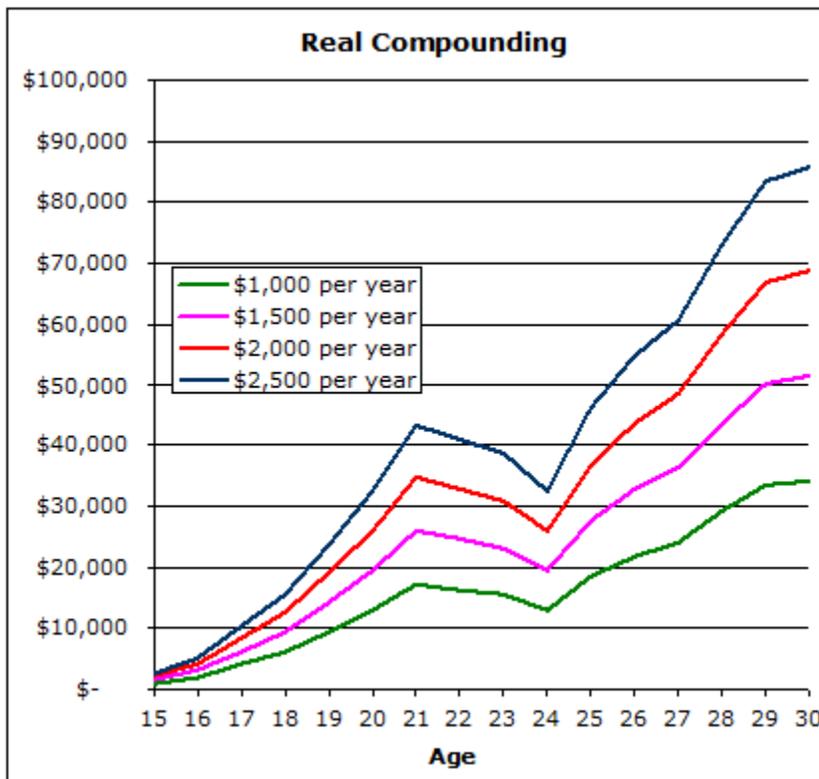
Roth IRAs Improve with Age

| Age | \$1,000/year | \$2,000/year | \$3,000/year | \$4,000/year | \$5,000/year | Increasing Contributions |
|-----|--------------|--------------|--------------|--------------|--------------|--------------------------|
| 15 | \$1,000 | \$2,000 | \$3,000 | \$4,000 | \$5,000 | \$1,000 |
| 30 | \$29,324 | \$58,649 | \$87,973 | \$117,297 | \$146,621 | \$42,972 |
| 60 | \$417,426 | \$834,852 | \$1,252,278 | \$1,669,704 | \$2,087,130 | \$921,794 |
| 70 | \$916,837 | \$1,833,674 | \$2,750,511 | \$3,667,348 | \$4,584,185 | \$2,052,667 |

Note: Table assumes a steady 8% annual return

But we've also put together another scenario that may be more realistic, particularly when we're talking about real markets and real teenagers. First off, few teenagers are probably going to be able to earn \$4,000 in a summer (though they might be able to hit that number or higher if they work during the school year as well).

Also, as you know, markets don't compound in a straight line. They go up and down. So, in the chart below, we've assumed that our teen is not only stashing away more modest sums in his or her early years, but that returns from the market mimic those of the past 15 years or so (using returns from Vanguard's Total Stock Market Index over that period). As you can see, someone who starts with \$1,000 and adds just \$1,000 every year for 15 years actually earns a better return than illustrated in the "perfect world" compounding table—\$34,332 for the "real life" scenario versus the \$29,324 compounded from a simple 8% annual return.



Hopefully our explanation of compounding and the two scenarios we created have made the benefits of investing for retirement early clear. But the question remains: How can we get a teenager to save for retirement?

Our advice: lend a helping hand (or dollar, in this case). Let's assume you can afford to match their summer earnings. Do it. Let them have their hard-earned money, but open a Roth IRA in your child or grandchild's name and add the money yourself. Remember, the child may earn \$1,000, but with taxes will not bring it all home. That doesn't keep you from putting a full \$1,000 into a Roth.

Perhaps you can't afford to add the full amount, however. In that case, consider making a deal with your teen to match a portion of their earnings that they add to the Roth as well. If the teen contributes \$250, maybe you'll contribute \$500. Grandparents, obviously, can get into this act as well.

Finally, there's the issue of fund minimums. Fidelity requires a minimum of \$2,500 for most funds and Vanguard has \$3,000 minimums on most of their funds. One option would be to start your child in Vanguard's STAR fund of funds for just \$1,000. Or, if you have a personal representative at Fidelity or Vanguard, see if they'll waive the minimum for your child or grandchild. Obviously you won't be making regular contributions to the IRA since its deposits are contingent on the child's income stream, but if the firm's are smart, they'll see this as a way to grab a potential long-term client at an early age.

Remember, the longer you or your children wait, the smaller your potential compounded earnings. Of course, with income comes taxes, and your child will need to begin filing their own tax returns. And, as we mentioned earlier, contributions to a Roth IRA are not made pre-tax, as they would be on a traditional IRA. In addition, be aware that if you do help your child by contributing on their behalf, the total amount put into the IRA cannot exceed their total earnings in any given tax year. (This will be more of a concern for the youngest investors.)

In any case, helping to put your teenage child or grandchild on the road to a more comfortable retirement may be one of the best gifts you can give them, and to boot, you'll be teaching them fiscal responsibility and the importance of long-term planning from an early age. If your child or grandchild has plans to work this summer or already has started working, we urge you to steer them towards a Roth IRA.

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