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summaries

SIGMA INVESTMENT COUNSELORS

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Retirement for Twenty-Something's

When asked to write this month's Sigma Summaries with an emphasis on retirement, I decided to focus on the concept of savings, thrift and fiscal responsibility. In my mind, the biggest obstacle related to a secure retirement is a lack of financial literacy and accountability among Americans. I'm afraid that even a bipartisan utopia and perfectly balanced budget in Washington won't be enough to make up for the personal financial mismanagement on the part of American workers. Being the youngest member of the Sigma team at 26 years old, I find this general lack of personal fiscal responsibility to be especially prevalent among my fellow twenty-something's. We've become a generation of cash flow rich, asset poor, credit driven consumers who thrive on instant gratification.

I've had the benefit of being exposed to core concepts of personal finance on a daily basis from the time that I joined Sigma four years ago. From the wisdom that has been imparted upon me by my mentors, to the stories of hard work and decades' worth of personal fiscal restraint that clients have shared with me, I've seen how successful a well thought out retirement plan can be. Sadly, these are concepts, lessons and stories that the average person my age is not privy to.

While a lack of financial education can be found across generations (I'm willing to concede that there are plenty of exceptions), my biggest concern is for my peers. This includes not only those who are uneducated and unemployed, but also those who have recently graduated with good degrees from solid universities and have landed solid jobs. It includes those who grew up in well-to-do neighborhoods, always had nice clothes, were given nice cars and had hardworking parents who paid for college. It is now time for these twenty something's to make it on their own and despite having been afforded a huge head start in life they are totally unprepared to make good financial decisions.

One contributing factor to our problem is the fact that lifestyles are very fluid on the way up and painfully sticky on the way down. It is very easy to go from driving a 10 year old used car in college to taking on a $500 monthly payment for a brand new car upon graduation. On the flip side, those who have become accustomed to having that new car find it nearly impossible to revert to their old ways. Today, many of my peers have fallen victim to sticky lifestyles. Having gotten used to the nice things that they had growing up, my fellow twenty-something's want to skip the 25 years of hard work and sacrifice that their parents put in, but choose to assume that higher standard of living and the costs that go with.

My generation tends to exhibit a mentality of "live for today because there might not be a tomorrow." However, we need to realize that in all likeliness there will be a tomorrow and that we need to be prepared. A sense of immortality and eternal youth that is embodied in most young people makes retirement seem like something that only our parents and grandparents should be worried about. The truth is that by the time most people begin to worry about retirement it is already too late.

To make matters worse, more than ever, today's youth will be solely responsible for funding their own retirement. Employer funded pension plans are a thing of the past, as are employer funded healthcare plans in retirement. It is also likely that my generation will have to wait until age 70 or 75 to receive Social Security benefits, if any benefits are received at all. I'm personally willing to accept all of this, but in order to make things work it is going to take planning, commitment and a mountain of savings on my part. I am not convinced, however, that many of my peers are aware of, let alone prepared for the gap in retirement funding that they are up against.

The most frustrating part for me about the financial situation of the average twenty-something is the fact that the whole concept of savings, thrift and fiscal responsibility can be very simple. Yet, so few of us realize the opportunity that we have been given to write our own retirement ticket until it is too late. We've all heard comments from those who are older saying "if only I had started earlier." For those who are lucky enough to have youth and time on their side, I ask that the following points be considered.

1. The opportunity cost of a dollar spent today becomes enormous over time.

Opportunity cost is the value foregone by the choice of another activity. This is a concept that I often think about in my own situation and the numbers are staggering. For example, consider the opportunity cost of a $4.00 latte from Starbucks that is purchased three times per week starting at age 20. Assuming the price increases annually at three percent and this habit is continued until age 60, one will have spent just over $47,000 on their morning coffee. Further, if that money is saved instead of spent and earns an average return of seven percent per year, by age 60, the benefit of having forgone one's morning Starbucks run would yield nearly $183,000.

The coffee example is small in relation to other things that people regularly spend their money on. Let's focus on something larger like the opportunity cost of driving a nice car. Again, for simplicity I will focus on the 40 year period between age 20 and 60. Assume that a new car is leased every three years for $500 per month, or $18,000 for the life of the 36 month lease. Also assume that at each lease renewal, the next lease will be roughly nine percent higher (three percent annual inflation). Over the course of 40 years, 13 leases will have yielded over $420,000 in lease payments. What if, instead, a car is purchased once every eight years for the equivalent of $30,000 in today's dollars, again inflated at three percent per year. Over the course of 40 years, five cars will cost $254,000, a significant savings. Now, if the money saved from buying instead of leasing is invested over time at a rate of seven percent per year, an accumulated total of nearly $593,000 will exist at the end of 40 years.

The above example can be extrapolated again and applied to buying a house, yielding even higher numbers. However, some may argue that at least with a house you have something to show for your payments (i.e. homeownership). In the case of a coffee or car lease, once the money is spent there is no tangible asset that you own and no future recovery of your investment. I would be careful in making this argument regarding homeownership because we've all seen what can happen to those who use a big house as a means of accumulating wealth.

Many of the expenses that we incur from day-to-day seem quite manageable in isolation. However, by viewing current expenditures in terms of long-term opportunity costs it becomes evident that a dollar here and a dollar there, spent today, can have a significant impact over time.

2. You have been afforded the power of time, so don't waste it.

Many young people fail to realize the power of time and the advantage they have due to a long time horizon. Albert Einstein is believed to have once said that of all the forces in the universe, none is as powerful as compounding interest. Whether or not he actually said it, I agree with the statement wholeheartedly.

Consider a twenty five year old and a forty five year old; both with a desire to retire at age sixty five. Let's assume that both are able to earn four percent above the rate of inflation on their investments. The older investor with a 20 year time horizon will need to save more than three times as much annually to reach the same goal as the younger investor who is afforded a 40 year time horizon. I will concede that a forty five year-old is often able to save more than someone twenty years their junior because of their place in the workforce, but this still does not undermine the power of a long time horizon.

3. 59 ½ will be here before you know it.

In talking with my colleagues and clients, I'm consistently reminded of just how fast time passes. Without realizing this, young people forgo the opportunity to fund a traditional IRA, Roth IRA, or 401k because they can't fathom putting money into an account and not touching it until at least age 59 ½ without incurring a penalty. First, I always remind them that penalties on early withdrawals are only assessed on the growth of the account, not the contributions. Second, tax-deferred growth, especially for those who are young is a gift from the IRS that needs to be taken full advantage of. When your investment earnings aren't being eroded by taxes year after year, they have the ability to compound more quickly over time.

4. Good investing should be boring.
Young people like talking about which stock they are buying today. Today's hot stock is different than yesterday's, and tomorrow's will be different than today's. They want to make investing exciting, constantly mining for that one stock pick that skyrockets and makes them rich. In most cases when that doesn't happen right away, it's on to the next idea. This is fine if someone is looking for a hobby, but it is not how wealth is built. Wealth is built over time, by putting money away consistently and sticking to a well thought out, often boring strategy. Young people tend to have an aversion to things that are boring. However, a little bit of boredom in the portfolio is likely to go a long way for those who have more than 40 years to accumulate assets.

When it comes to investing for young people, two things are paramount. The first is saving money consistently and the second is diversification, both of which can be painstakingly boring.

5. Live below your means.
This is one of the simplest, yet most powerful concepts in personal finance. I like to think back to college and realize just how little I was able to live on. This is not to say that I envy the days of eating frozen dinners, but it is a constant reminder of how it is possible to live inexpensively and still be quite comfortable. If there is $3,000 of net monthly income, act like there is $2,500. When that $3,000 gets bumped up to $4,000, pretend it didn't happen and save the balance. I'm not suggesting living like a pauper, but with a little restraint this simple concept becomes very powerful.

In closing, I want to stress that my goal in writing this is not to project myself as the poster child of personal finance for my generation, but rather to share with my peers how simple taking control of your own financial situation can be. Nobody is going to do it for us. The employer and government funded retirement benefits that have been there for previous generations won't be there for us. The retirement funding gap that we are facing is enormous, particularly with the lifestyles that many of us have become accustomed to. However, with a bit of education, a lot of hard work and a commitment to self-discipline that gap can be filled.

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The Economic and Market Environment

In Sum: The global economy has begun to recover from the 2008-2009 Great Recession. Continued strengthening depends upon: 1) success in addressing unfunded liabilities the world over, 2) progress at peacefully reducing political repression of the Middle East/North Africa (MENA) citizenry and, 3) an orderly unwinding of the Federal Reserve Board's (Fed) Quantitative Easing program.

Geo-political: The big news for 2011 has been the changing landscape of the political dynamic across much of MENA. The economic importance of this region, given its vast oil reserves, is clear. The linchpins of future developments appear to hinge on what happens in Libya and Iran. A recent Sigma blog, guest written by long time friend of the firm and Middle East expert Haleh Vaziri, PhD, is insightful. She wrote, "Some dominoes wobble but do not easily fall: Declarations about revolution's inevitability and the domino effect are tempting. Yet inevitability is hindsight's gift. The MENA's tyrants may ultimately fall, but questions about when and how persist. The dictators' willingness to leave and the instruments they use to maintain power vary from one country to the next. Tunisia's and Egypt's presidents chose to leave, realizing they could not prevail without resort to devastating force to crush popular discontent. Iran's and Libya's rulers have not hesitated to unleash their armies on demonstrators." A heartened Libya and/or Iran will not be constructive to world order.

Economic: A year ago leading economists were predicting further deterioration of economic fundamentals. Sigma suggested that natural economic forces (sustained employment, pent up demand) would result in economic improvement and invested accordingly and this proved accurate. Presently, the direction of monetary and fiscal policy (discussed below) will influence consumer and business confidence and determine the near term direction of the economy.

Monetary: "Quantitative Easing (QE)," or printing money, is one of the tools that the Fed deployed to combat the financial crisis. This alarmed monetarists because of inflation concerns. Hence, deliberations about when to terminate the program have dominated recent Fed governors meetings. End QE prematurely – the economy relapses: Too long – more inflation!

Fiscal Policy: The Fiscal Fight: In one corner, President Obama, suggesting a multi-year prescription of tax hikes and spending cuts. In the other is Congressman Paul Ryan, proffering spending cuts and revenue-neutral tax reform. At this juncture, it is difficult to predict which ideology will prevail. But, it appears that a prospective victory for fiscal rectitude may be at hand. It would have been far worse to have both major political parties continue to ignore this problem, leading to a major crisis of confidence that would rattle capital markets and the economy (see Greece).

Equity markets: The triple threat of violence in the Middle East, the Japanese earthquake/tsunami, and the politics of the budget debate failed to unnerve financial markets. In fact, the first three months of 2011 saw broad based single digit increases in equity prices. We maintain our cautious optimism about the long term outlook for equities.

Fixed income markets: Interest rates have trended moderately higher during the past twelve months as economic growth resumed and investors began to concern themselves with higher inflation (either real or perceived). Continued increases are anticipated.

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