New Deals for New Dollars

Cheaper stock prices are boon for young investors saving for retirement

By Nathan Becker, MarketWatch
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ST. LOUIS (MarketWatch) -- The bear market is providing a unique stock-buying opportunity for a small slice of the workforce. Young people just starting out in their careers have a chance to contribute to new 401(k) accounts that haven't been hit with the steep losses that older investors have suffered.

Moreover, workers in their 20s have several decades before they retire -- time enough to recover from even a prolonged stretch of poor returns.

"At these lows, and assuming that you're a long-term investor, you have one of these historic moments in time that few of us ever get to see," said Rick Meigs, president of 401khelpcenter.com. "If it was me, I'd be pouring every dollar I could into the plan into a high-quality stock mutual fund."

In 2008, the Dow Jones Industrial Average declined 34% -- a 12-month slide unseen since the Great Depression. According to investment researcher Morningstar Inc, the average U.S. diversified stock mutual-fund -- typically the cornerstone of a 401(k) -- tumbled almost 40%.

Andrew Sellers, a 25-year-old operations specialist with Kansas City-based Cerner Corp., graduated with his MBA in May 2008 and began work at Cerner that July. He said he contributes as much possible to his newly-minted 401(k) plan.

"As soon as the market started tanking, I said, 'Wow, now's a really awesome time to buy -- I'm going put as much into my 401k as I can,'" he said. "If I can just cut down on my spending wants and desires now, it's a big payoff in the future."

Meigs added: "It's like walking into a retailer and you've got a nice plasma TV up there, and six months ago you'd have had to pay 100% of retail, and today you get to pick it up at a 40% or 50% discount," he said. "That's a pretty good deal, and it's the identical piece of merchandise."

Power of compounding

Aaron Skloff, president of Skloff Financial Group, said that on top of a potential for big gains on stocks' recovery, employers' offer to match contributions to a worker's plan is like getting free money.

Even if your employer contributes even $1 for every $4 you put in, your contribution rate bumps up by 25% -- at no cost to you, Skloff noted. Some employers will match contributions dollar for dollar up to a certain percentage, doubling the amount you have to invest.

Plus, that's more money you have to compound over time. Indeed, the biggest advantage young people have in funding a 401(k) account is the power of compound interest, Skloff said. Investment earnings built up over the course of a working lifetime will bolster retirement.

And the sooner you start, the better.

"The person who starts later is generally so disadvantaged that, despite significantly higher contribution of dollars, it can't make up for the historical power of compounding," Skloff said.

Meigs offered a scenario of the "magic of compounding": Suppose two workers start at the same company with the same salary. One begins contributing to a retirement plan at 20 years old and stops when he turns 28, then never contributes another dime until retiring at age 65. The other delays contributing until he's 28 and stops once he reaches 65.

Because of the effects of compounding, the worker who began contributing at 20 will end up with more money at retirement, even though the other worker contributed for almost 30 more years (assuming they both received the same returns and made the same periodic contributions).

The biggest hurdle, Meigs said, is convincing young people they should contribute as early as possible and set aside some money that would otherwise go to leisure and entertainment. Only about 12% of 401(k) participants are in their 20s, according to the Employee Benefit Research Institute.

"Retirement's just so far out," Meigs said. "It's just not on [their] radar screen."

Sellers, the new 401(k) saver, agreed that 20-somethings don't put as much thought into retirement investing as they should.

"We haven't really had tough times -- our generation doesn't quite understand yet that we need to save and invest," he said. "A lot of people have been living beyond their means, and this is kind of a wakeup."

Young workers should take into account their needs to live comfortably and then contribute as much as they can to their retirement plan, even if it doesn't seem worth it now, Skloff said.

In 2009, the maximum possible 401(k) contribution is $16,500, though that applies only to higher paid employees. Some companies also put a limit on the percentage of your salary that can be contributed into a 401(k), not including the employer match.

At the least, Skloff said workers should contribute up to the point that their employer will match -- typically as much as 6% of your pre-tax salary. Even if it doesn't seem like a good idea now, it will pay benefits in the future.

"Eat your vegetables," he said. "They may not taste good going down, but at the end of the day, you know it's good for you."