

## Investing Is Not Just for Adults

(Interstellar Investor – Full Article)

By Jonathan Guymon

“Three in four millennials say the ‘prospect of speaking to a financial advisor has stopped them from investing.’ In other words, they don’t want to have to talk to anyone about their money, and that’s partly because they seem to fear looking stupid or revealing how little they know about investing” (Palmer, 2014, para. 3). But it is important to realize that while the financial industry can be very confusing with all its jargon and lingo, it is not really as complicated as we are often led to believe.

While understanding all of the nuances of the investment world would certainly be helpful, it is not essential to building a worthwhile retirement account. Sendhil Mullainathan (2015), a professor of economics at Harvard, explains how the cost of not doing anything affected him personally, “The biggest lesson, I realized, was one that faces me all of the time: The biggest cost of fear is paralysis. It is easy to make a mistake in choosing investments. But in an effort to avoid an error, I had been making an even bigger error. As I procrastinated, my money was uninvested and earning zero returns. That, surely, is not the path to a happy retirement” (para. 34-36).



There are several main reasons why we allow ourselves to procrastinate investing for retirement. We might not see the importance of investing for retirement while they are still young, or we might feel overwhelmed by the amount of information and advice investing carries with it. Overcoming these obstacles and investing early in life could earn today’s youth millions of dollars.

### Why invest for retirement?

Too many Americans are not preparing for a retirement that will inevitably come. Choosing to ignore the future will force many to continue working throughout their retirement. And, young adults, those who are probably least likely to think about retirement, are at the best stage of life to begin investing for retirement, and likely to gain the most benefit from planning ahead.

- Among Americans ages 50 and older who currently have jobs, 82% expect to work in some form during retirement, according to a poll by the Associated Press-NORC Center for Public Affairs Research (Benz, Sedensky, Thompson, & Agiesta, 2013).

- Excluding pensions and homes, 39% of survey respondents said they have \$100,000 or less saved for retirement. Nearly one-quarter have less than \$10,000 (Benz, et al., 2013).
- According to the EBRI, only 40% of American workers took part in their employer's retirement savings plan last year (Carlson, 2013).

These statistics sound scary, but the only thing that will save any of us from a similar fate is investing. Because of inflation, things will cost a lot more by the time any millennials plan on retiring. We need a weapon to fight against these overwhelming odds, and that weapon is compound interest.

According to the U.S. Securities and Exchange Commission (2011), "Compound interest is a key aspect of investing. With compound interest, you earn interest on the money you save and on the interest that money earns. Over time, even a small amount of savings can add up to big money and help you achieve your financial goals" (para. 5).

Because time is such an important part of making compound interest successful, the sooner we start investing the better. Young adults are able to take advantage of the power of compound interest because of the increased amount of time on their side. Charles Ellis (2005) describes why this principle is essential for retirement. He explains that, "successful investing can be almost easy," but "by the time we 'get it,' it may be too late to use the lesson because the powers of compounding need time" (pg. 1).

"A 25-year-old, for example, who makes \$40,000 and contributes 10 percent of his salary to a 401(k) plan annually will amass \$3.9 million by the time he retires at age 67. That figure assumes a 50 percent employer contribution match, a 5 percent estimated salary increase rate annually and an 8 percent investment rate of return. Using all the same parameters, that same person would have \$2.5 million—or \$1.4 million less—if he had started saving at age 30." (Schwartz, 2014, para. 5-6) Investing now rather than later can literally earn millions of dollars.

## **How to invest**

When most people think of investing, they likely think of stocks and bonds. Stocks are "a type of investment that signifies ownership in a company. The value of a stock changes throughout the day. If the price goes up, the value of your investment increases; if the price falls, the value decreases" (Folger, 2015, para 6). If we were to "buy" a company's stock, we are really just purchasing a percentage of ownership of that company.

The most important thing to remember when buying a stock in a company is that regardless of how high or low the stock price goes, we will only make or lose money when we sell the purchased stock. If, for example, we bought one stock in a company for \$5 and the price went up to \$9, we haven't made any money yet. If we chose to sell our one stock for the \$9, we would earn the difference between the purchasing price of \$5 and selling price of \$9. In this case we would have earned \$4.

Bonds are fundamentally different than stocks. Stocks represent partial ownership of a company, while bonds represent a company's debt to us. "Bonds are issued by companies, municipalities, states and federal governments to finance a variety of projects." (Folger, 2015, para. 2) If a bond was purchased from one of these entities, we are essentially lending our money to them. If we bought a bond from our local town, for example, we would earn money on the interest being paid back to us by the town.

Stocks and bonds are traded in a virtual marketplace known as the stock market. Groups of stocks are tracked in indices such as the Dow Jones Industrial Average, S&P 500, or NASDAQ Composite Index. There are actually many different indices out there that track the average price growth or decline of a group of stocks.

While this is fundamental knowledge, understanding these terms and how they work will not usually translate into investing habits. The reason for this is probably the unending amount of different stocks and bonds. How does someone that doesn't study finance know what to invest in? The good news is that there are other options that allow anyone to start investing for retirement.

## **Retirement Savings Plans**

The terms 401(k) and Roth IRA are also familiar to many people. Often people say that they are investing in their 401(k) or IRA. Really they are investing in stocks, bonds, or mutual funds that are protected in some way from taxes. 401(k) and Roth IRAs are simply tax shelters for retirement funds. Once either of these accounts is opened, stocks, bonds, or mutual funds can be placed under tax protection. Automatic deposits can even be set up for both of these retirement plans.

- 401(k)
  - "A savings plan in which employees can elect to have their employer contribute a portion of his or her wages to the plan on a pretax basis. Generally, the funds are not subject to income tax withholding at the time of deferral, but are usually taxed upon withdrawal. The contributions are not reflected on your Form 1040 since they were not included in the taxable wages on your Form W-2. However, they are included as wages subject to withholding for social security and Medicare taxes" (Mullen, 2014, para. 20).
  - Sometimes an employer will match the money put in up to a certain amount. In this case, always at least meet the company match amount. This is free money employers are willing to give away if we are just willing to start investing for retirement.
- Roth IRAs
  - With a Roth IRA, "you make contributions with money you've already paid taxes on (after-tax) and your money may potentially grow tax-free, with tax-free

withdrawals in retirement, provided that certain conditions are met” (Fidelity, 2016, para. 2).

- A Roth IRA can be set up through a financial advisor or brokerage firm even without an existing 401(k) retirement plan.

## **Mutual Funds**

Folger (2015, para 5) describes a mutual fund as, “an investment that is made up of a pool of funds collected from lots of investors to invest in securities including stocks, bonds and money market instruments.” This means that giving money to a mutual fund allows investors to put the decision making in the hands of a fund manager. This manager can then use his or her knowledge to diversify the type of investments they put our money in. “Diversification is a risk management technique that mixes a variety of investments within one portfolio (a portfolio is a combination of stocks, bonds, and cash savings). The goals of diversification is to balance riskier investments with safer investments to limit overall risk.” (Folger, 2015, para. 8) Investing through a mutual fund allows us to lower risk and raise potential return without having to understand everything about finance. They are great options for many investors and some can offer very high returns.

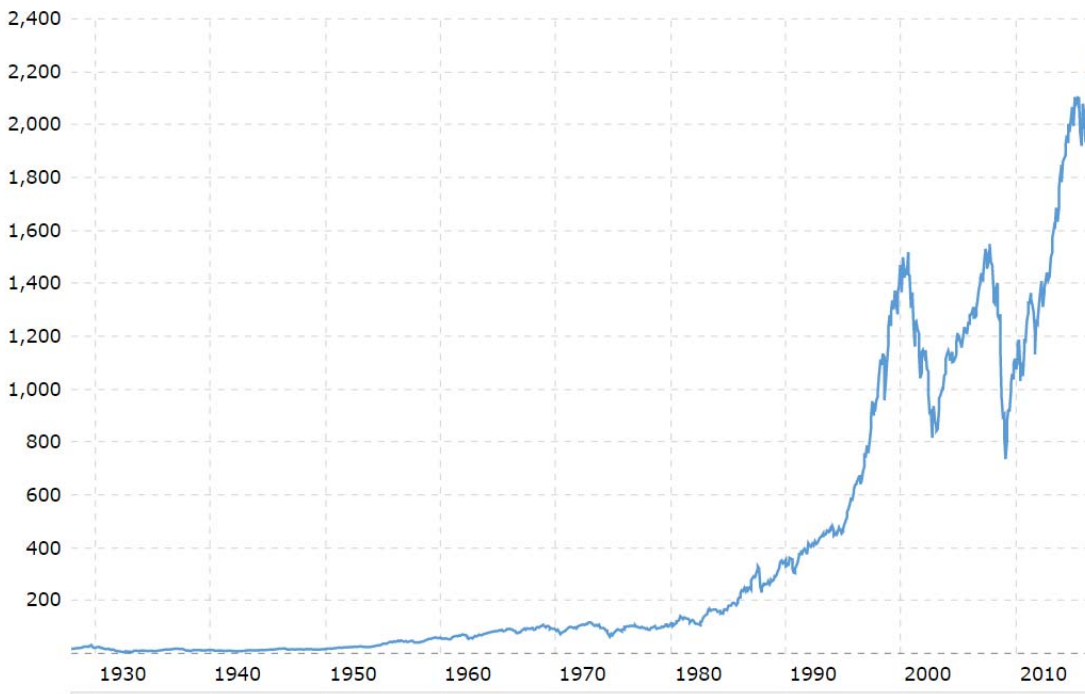
There is a problem however, because many fund managers still make mistakes. “In 2012, 66.08 percent of all domestic equity mutual funds underperformed when matched against the S&P 1500. In 2011 a swollen 84.07 percent were laggards, while in 2010 ‘only’ 57.63 did worse than the averages. The S&P 1500 includes the value of 90 percent of all exchange traded stocks” (Finger, 2013, para. 1). This means that most fund managers struggle to beat the average growth of stocks found in indices. This is most likely because of fees and taxes associated with most mutual funds.

## **Index Funds**

Index funds were created to take advantage of this phenomenon. “An index fund is one designed to reproduce the behavior of a chosen market index. Its attraction to investors is that the only risk associated with investment in an index fund is market risk.” (Meade & Salkin, 1989, pg. 871) Index funds generally have much lower fees, which means more money going toward compounding interest. They also are very diverse, because they are investing in every stock covered in an index.

The S&P 500 for example, has had up and down swings in average stock price, but overall the trend has been upward. If someone started investing in an S&P 500 index fund in 1970 and didn’t sell until 2015 they would have a total return of over 2000%. That means that a 20 years old started investing in 1970 and decided to retire in 2015 at age 65, they would have taken advantage of those massive gains. The most important variable again is time, and the gain will be greater the more time one has to invest.

Figure 1. S&P 500 Historical Performance 1950-2016. (Macrotrends, 2016).



Not all index funds are created equal however, and research should be done to better understand the fees associated with each. “Although all of these funds hold the same securities in virtually identical percentages, they have substantial differences in fees and returns that investors should find economically significant. For example, the difference in annual return between the best performing and worst performing S&P 500 index fund is 2.09 percent per year” (Elton, Gruber, & Busse, 2004, p. 261).

Anyone can get started investing for their future today. The first step is to open an investment account, either through your employer or on your own. A great option is a Roth IRA, which can be opened through online broker services, mutual fund companies, or a local bank. These accounts can even be set up to take a percentage of each paycheck. Any combination of mutual funds or index funds can be added to a Roth IRA investment account with varying returns and fees. Individuals should ask a certified financial advisor for advice on which funds will work best.

It truly is possible to invest now for retirement no matter how old someone is. Investing is not just for adults, and young adults everywhere can start investing today. Our main weapons are compounding interest and time. With those tools combined, there is no reason for us to not retire comfortably. We don’t have to major in finance to start investing. Remember the council of Senhil Mullainathan (2015), that if our money remains unvested, we are not earning anything for retirement. “That, surely, is not the path to a happy retirement” (para. 36).

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