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Time Can Be a Strong Ally in Saving for Retirement

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Father Time doesn't always have a good reputation, particularly when it comes to birthdays. But when it comes to saving for retirement, time might be one of your strongest allies. Why? When time teams up with the growth potential of compounding, the results can be powerful.

Time and money can work together

The premise behind compounding is fairly simple. Your retirement plan contributions are deducted from your paycheck and invested either in the options you select or in your plan's default investments. Your contribution dollars may earn returns from those investments, then those returns may earn returns themselves--and so on. That's compounding.

Compounding in action

To see the process at work, consider the following hypothetical example: Say you invest \$1,000 and earn a return of 7%--or \$70--in one year. You now have \$1,070 in your account. In year two, that \$1,070 earns another 7%, and this time the amount earned is \$74.90, bringing the total value of your account to \$1,144.90. Over time, if your account continues to earn positive returns, the process can gather steam and add up.

Now consider how compounding might work in your retirement plan. Say \$120 is automatically deducted from your paycheck and contributed to your plan account on a biweekly basis. Assuming you earn a 7% rate of return each year, after 10 years, you would have invested \$31,200 and your account would be worth \$45,100. That's not too bad. If you kept investing the same amount, after 20 years, you'd have invested \$62,400 and your account would be worth \$135,835. And after just 10 more years--for a total investment time horizon of 30 years and a total invested amount of \$93,600--you'd have \$318,381. That's the power of compounding at work.

Keep in mind that these examples are hypothetical, for illustrative purposes only, and do not represent the performance of any actual investment. Returns will change from year to year, and are not guaranteed. You may also lose money in your retirement plan investments. But that's why when you're saving for retirement, it's important to stay focused on long-term results.

Also, these examples do not take into account plan fees, which will impact total returns, and taxes. When you withdraw money from your traditional (i.e., non-Roth) retirement plan account, you will have to pay taxes on your withdrawals at then-current rates. Early withdrawals before age 59½ (age 55 for certain distributions from employer plans) may be subject to a 10% penalty tax, unless an exception applies. Nonqualified withdrawals from a Roth account may also be subject to regular income and penalty taxes (on the earnings only--you receive your Roth contributions tax free).

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