Stepping Up the Savings in Your 30s

Sometimes it may feel like it was just yesterday that you started your first job. Shortly after, you probably opened your first retirement account and wondered how it would ever grow to anything significant.

But time flies by and those early dollars and cents, steadily contributed over the years, are adding up. But are you regularly reviewing your investments to make sure you are staying on track?

There are many different options for retirement savings. What you choose depends on personal choices – such as your comfort level with risk, when you plan to retire, how you want to diversify your investments and more. By this point, you're probably somewhat familiar with details of 401(k) plans and/or Individual Retirement Accounts (IRAs), but each has important differences for you to consider.

For example, consider the following scenarios:

Elena is 35 years old and has been contributing to her retirement accounts for about 10 years. She has worked at small and early stage companies that haven't offered employer-sponsored 401(k) or other retirement plans. For this reason, she opened her own traditional IRA shortly after starting her first job.

About five years ago, a friend who is an accountant told her about Roth IRAs, so she opened an account and began contributing to that, as well. She now wants to reevaluate her situation and determine if any changes in her strategy should be made.

ELENA
35 years old

Traditional IRA vs. Roth IRA

Let's look at the most significant difference between a traditional IRA and a Roth IRA. Contributions to traditional IRAs are often tax- deductible in the year they are made, effectively earning you a bit of a tax break. Those contributions and earnings grow tax-deferred over time, but money in a traditional IRA will be taxed as ordinary income when it is withdrawn from the account.

Roth IRAs offer a different tax advantage. Your contributions are made with after-tax dollars, but then grow tax-free over time. Generally speaking, withdrawals from a Roth IRA are not taxed, as long as you take the money out after the account is open for five years and you are 59½ or have met other criteria.

Each Option Fits Different Needs

As investment accounts, these two IRAs function very similarly. Funds in these accounts can be invested in stocks, bonds, mutual funds, Exchange Traded Funds (ETFs), and sometimes, alternative investments, as well.

Since paying taxes is required no matter what type of account you choose, tax implications are often the biggest consideration in evaluating whether to invest in a traditional or Roth IRA.

If Elena is in a 24% tax bracket right now but expects to be in a lower tax bracket in retirement (due to lower projected income), it may make sense to invest in her traditional IRA now, so she is subject to the lower income tax rate when she takes money out. But, if she thinks her tax bracket will be higher in retirement, she may consider using a Roth IRA now because contributions are made after tax at the lower, current tax bracket, and then generally tax free when she withdraws funds in retirement. There are often many other considerations, and you should always consult your tax advisor to select an IRA that is right for your situation.

Timing for Withdrawal

Both traditional and Roth IRAs are tax advantaged retirement accounts. With either type of account though, there can be penalties if certain withdrawals are made prior to age 59½. With a traditional IRA, Elena would not be able to withdraw funds penalty-free until she reaches the age of 59½ (with mandatory required minimum distributions, or RMDs, beginning at age 72*), unless a qualified expense or exception applies.

Generally, funds withdrawn before 59½ incur a 10% early withdrawal penalty, in addition to ordinary income tax due. For Roth IRAs, withdrawals of contributions are tax-free and penalty-free at any time, while earnings are subject to an early withdrawal penalty if taken before 59½. During the lifetime of the Roth IRA owner, there is no mandatory RMD age for a Roth account – which can make these vehicles ideal for wealth transfer.

* With the SECURE Act signed into law in December 2019, the RMD age increased from 70½ to 72, effective January 1, 2020. If you turned 70 ½ on or before December 31, 2019, you are required to begin or continue taking RMDs since you turned 70½ before the SECURE Act went into effect.

Discuss Investment Strategies with Your Tax Advisor

With IRAs there is a lot of flexibility for the type of investments and risk profiles you choose.
Elena can opt to invest in primarily bonds and blue-chip stocks, which could keep her potential growth rather stable but may limit the returns she will be able to achieve. Or, she may invest in growth stocks that might have more volatility but have more potential to achieve higher, long-term growth.

She can also choose a strategy with more risk for one account and a more conservative strategy for the other. Elena should always research her options and consult an advisor to determine the right strategy for her.

Lastly, many account structures offer options called Target Date Funds. These are often mutual fund accounts that change their investment profile over a period of time.

For example, if Elena plans to retire in the year 2055, her investment mix will start out aggressive but will be automatically rebalanced by the fund advisor over time so that as she reaches retirement age, her investment mix will become more and more conservative. This may provide some protection from market fluctuations as Elena approaches retirement.

> *“Whatever stage of the savings journey you are in, Millennium Trust is here to help you stay on the path to retirement readiness, and we look forward to working with you every step of the way.”*

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