OnTrack

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COMPOUNDING — The Magic Ingredient

If you're looking for a little magic to help you build a retirement fund for your future, look no further than this simple concept: compounding. Compounding is essentially the magic ingredient that can help your savings grow over time. Combined with your plan contributions, compounded investment earnings can help you achieve your retirement savings goal.

Money Making More Money

What is compounding? Basically, it's money making money. And investing for retirement through your employer's retirement savings plan lets you take advantage of it.

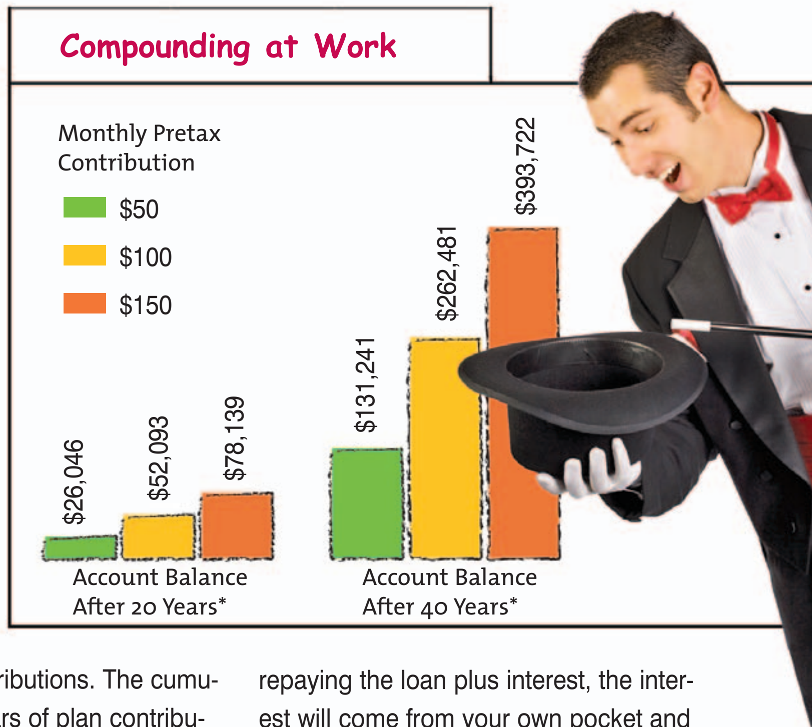
Here's how compounding works:

- The money you contribute to your plan is invested.
- Your plan investments earn income.
- Those earnings are reinvested in your account. Now you're earning income on a larger pool of money — your contributions *plus* your earnings.
- Every time you increase the amount you have invested, you increase the potential benefit of compounding.

While investment returns are not guaranteed, a program of steady investing gives your savings the potential to grow through compounding.

Behind the Magic

Time is a big part of the magic. The longer your money is invested, the more you potentially benefit from compounding. So the key to making the most of compounding is to begin participating in your plan as early as possible and keep making regular contributions. The cumulative result after years of plan contributions and earnings may be the nest egg you'll need to see you through your retirement years.



Don't Break the Spell

Your regular, uninterrupted contributions should compound over time and help build up your retirement savings. However, you'll lose some of the benefits of compounding if you borrow from your plan. (Some employer plans do not permit loans.) When you take a loan, that money won't be available for investment in your plan. Even though you will be repaying the loan plus interest, the interest will come from your own pocket and you will lose out on potential growth opportunities while the loan money is not invested in your plan account.

Also be sure to keep your savings invested if you change jobs. Compounding can only work its magic if you give it time.

* Amounts shown are before taxes. Distributions of pretax contributions and earnings on those contributions will be subject to income tax.

These are hypothetical results involving a retirement plan participant making the same monthly pretax contribution for the specified time periods and earning a 7% average annual total return, compounded monthly. These results are not representative of any specific investment. Your investment returns will differ, and your contribution amount is not likely to remain the same over an extended period. Source: NPI

WHERE DO *You* Draw the Line?

You're probably going to need a lot of money to pay your expenses when you're retired. So, why would you want to put your retirement savings into investments that have the potential to lose money?

Why even consider taking that risk? The answer is — for the potential returns. The big question for retirement investors is where to draw the line between risk and potential returns.

Check the Risk Scale

In general, the more risky an investment is, the higher its potential return. Each major asset class — stocks, bonds, and cash equivalents — has its own risk/return characteristics. Money market and other cash equivalent investments, for example, present little risk of losing money. However, they typically deliver relatively modest returns that may barely keep pace with the rate of inflation.

Stocks are at the other end of the scale. Riskier than both bonds and cash equivalent investments, stocks have traditionally delivered better long-term returns than either of the other two asset classes. Over the long term, stock returns have also outpaced the annual inflation rate. That's an important consideration given that inflation can substantially reduce your future buying power. (Of course, past stock market performance doesn't guarantee future results.)

Consider the Question

If stocks have the *potential* to deliver the best results, why not invest all of your retirement savings in stocks? Because that approach is *too* risky for most investors. Your investment strategy should be designed to help you reach your retirement goal with a manageable level of risk. And much will depend on your tolerance for risk and how long you have to invest.

Find Your Comfort Level

Risk tolerance is the ability to accept the possibility that your investments will lose money in exchange for the possibility that they could earn higher returns. Ask yourself:

- Could you weather a 10% decline in the value of your plan account without much worry?
- Would a 10% to 15% decline in the stock market force you to delay retirement or postpone other major goals?

Answering questions like these will help you determine whether you're a conservative, moderate, or aggressive investor.

Factor In Your Time Frame

The general thinking is that if you have many years until retirement, you can afford to invest a greater percentage of your portfolio in stocks. That's because you have time for your investments to recover from any downturns in the stock market. But if retirement is getting close, you may want to reduce your risk by shifting more of your money into less volatile investments, such as bonds and cash equivalents. That way, a dip in the stock market won't dramatically deflate your savings right when you're going to need to begin drawing on them.

Manage Your Risk

The lesson is simple: You and only you can draw the line between risk and potential return. Decide how much investment risk you can *comfortably* handle to reach your goal of a financially secure retirement — then choose your investments accordingly.

David and Julianne, two hypothetical investors, are investing their plan money based on their tolerance for risk and their investment time frame.

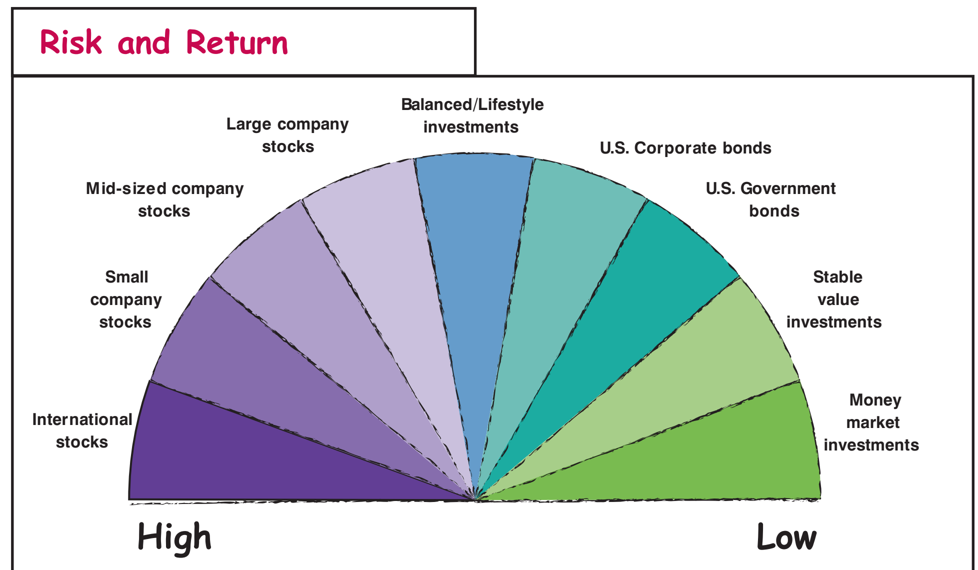
David

David, just five years out of college, contributes 5% of his salary to his company's retirement savings plan. He's willing to take on a higher than average level of risk to help his money grow. David allocates the bulk of his plan assets to stock funds and the rest to bond funds. He believes that his portfolio can recover from any temporary downturns in the stock market and continue to grow.

Julianne

Julianne is three years away from retiring and no longer wants to take a lot of risk with her retirement savings. She knows there might not be enough time for her investments to recover fully if they experience a losing quarter or two. She has gradually reduced the amount she has allocated to stocks and moved the money into bonds and cash investments, which are more stable. Still, Julianne is keeping a portion of her portfolio invested in stocks for their growth potential and their protection against inflation.

Your retirement plan might not offer selections in all of these investment categories.



Can't Save ANOTHER CENT?

Feel like you're stretched to the max financially? If you do, you're not alone. A growing number of Americans are spending more and saving less than ever before. In fact, a recent survey* found that 35% of workers reported that they had less than $10,000 in total savings and investments, while 13% had between $10,000 and $24,999 saved.

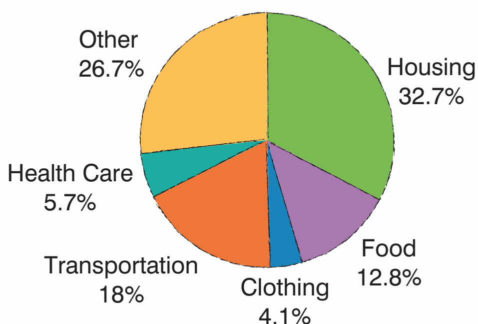
Following the Money

Unless employees find a way to save more during their working years, they could come up short at retirement time. If you could be doing a better job of saving in your employer's plan, figuring out where your money *goes* is a good first step in freeing up more money to sock away.

Here are some government statistics on how Americans are spending their money. How do your own spending patterns compare?

Spending on the Basics

Housing, food, and clothing account for almost half of the typical American household budget.** Transportation expenses and spending on health care also account for a significant share of the typical household budget.



Spending on the "Must Haves"

More and more items that were once regarded as luxuries are now considered necessities. This expanding universe of "things" Americans can't live without is adding to the strain on wallets — and making it harder to save.

% of adults rating item as a necessity***

	2006	1996
Microwave oven	68%	32%
Home computer	51%	26%
Home air conditioning	70%	51%
Auto air conditioning	59%	41%
Cable or satellite TV	33%	17%

Finding Savings

The good news is that you *can* make changes if you're serious about saving more for your retirement. While you may not have a lot of flexibility when it comes to some of your expenses, you still can find ways to save on other things.

If you don't already have one, create a budget. It can be a great help in identifying areas of potential savings. Reconsider what are — and are not — "necessities" and limit your use of credit to buy only those items you really need. Who knows, it may not take you long to find enough savings to boost your retirement plan contributions. And that's a step in the right direction.

* *The Retirement System in Transition: The 2007 Retirement Confidence Survey*, by Ruth Helman, Mathew Greenwald & Associates; Jack VanDerhei, Temple University and EBRI Fellow; and Craig Copeland, EBRI. EBRI Issue Brief No. 304, April 2007.

** *Consumer Expenditures in 2005*, U.S. Department of Labor, U.S. Bureau of Labor Statistics, 2007.

*** *Luxury or Necessity? Things We Can't Live Without: The List Has Grown in the Past Decade*, Pew Research Center, 2006.

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