A 20-year-old could need to save $7 million for retirement

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Centre College student Bryce Rowland works on homework in a hammock in front of the Campus Center, Tuesday, April 1, 2014, in Danville, Ky. (AP Photo/The Advocate-Messenger, Clay Jackson)

For young people just getting their careers off the ground, saving for retirement can often feel like an exercise in futility.

There are bills to pay, debt to be tackled, apartments to rent, and social lives to be had. It's baffling to imagine putting a piece of our precious paycheck in an account that's designed to keep us from touching it until we're old and gray. That money, we tell ourselves, would be far more useful in our pockets.

That line of thinking is precisely why people like David Marotta, president of Marotta Wealth Management in Charlottesville, Va., stay in business.

In a recent blog post, Marotta offers a sobering example of just how little buying power the cash us 20-somethings earn today will have when we're ready to retire:

Someone retiring now in 2014 with $1 million at age 65 can safely withdraw $43,600 a year. However, [because of inflation], today's 20-year-olds will need over $7 million to have that same lifestyle when they retire. In 1970, they would only have needed $166,000 in retirement to have a similar purchasing power for the rest of their life.

[For this calculation, Marotta assumes an average inflation rate over the next 45 years of 4.5%.]

To get close to saving $7 million, a 25-year-old with a starting salary of $50,000 would need to save about 14.65% of their salary throughout their career (see Marotta's math here).

To be fair, Marotta's estimate is conservative — the U.S. inflation rate is currently at 1.5% and hasn't been close to 4.5% since 2008 — but not outlandish. Marotta and other experts say it's too risky to assume inflation will remain as low as it has been for the long-term. The average inflation rate since the 1960s is just above 4.5%.

"Using current year inflation rates for long term planning is like using last year's U.S. stock returns (33%) for long term averages," he says. "Economics classes have to memorize long-term interest rates for planning purposes which average over 4% (4.5% to 4.1%). I don't think I'd want to use any rates outside of that range for ... long-term retirement planning."

If we use the 10-year average for inflation, however, which has hovered around 3%, a 20-something would need to need to save about $4 million to have as much buying power as someone retiring with $1 million today. (Not exactly chump change but...*phew*.)

Like any form of financial planning, predicting future savings and earnings requires as much math skill as it does crystal ball reading. In other words, it's not an exact science, so try not to freak out too much.

Whether or not you'll need the equivalent of $1 million today in your golden years is going to depend on a lot of factors — including your lifespan, expected lifetime earnings, and your standard of living.

But Marotta's central message here is inescapable: "Inflation is almost guaranteed and it is the risk that has the biggest effect on people saving for retirement," he says. "And yet, it's the one most young people overlook."

Time is on your side

The average Gen Yer (defined in this case as workers 23 to 35) today saves about 6% of their pay and has a little less than $20,000 invested in a retirement fund, according to data compiled by Fidelity for Yahoo Finance.

By comparison, savers aged 36-64 put away more than 8% of their income and have saved nearly $90,000

The good news is that 6% for a 25-year-old with 40 solid working years ahead of them is probably just as — if not more — valuable than 8% for a 55-year-old a decade away from retirement.

"The money you earn when you're young is more important than the money you earn when you're older," Marotta says. "Even saving $100 a month or $10 a month or something ridiculously low is the right place to start."

Let's use a fictional saver, Jennifer, as an example. She's 22 years old earning $3,000 a month and decides to save 5% of her (pre-taxed) salary in a 401(k). She gets a 5% match from her employer, so she's putting away a total of $300 a month ($150 with each bi-weekly paycheck). If she puts that cash into an index fund earning 6% a year — even if she never gets a single raise or promotion — she will have saved **$753,849** by age 65. (Run your own savings estimation using Bankrate.com's savings calculator.)

Now, let's say Jennifer decides to wait to start saving for retirement until she's managed to work her way up and feels more financially stable. By age 35, she's been promoted twice and has doubled her income to $6,000 a month. She uses the same savings strategy (5% of her own cash plus a 5% employer match for a total of $600 a month).

She's saving twice as much as she would have at age 20, but by the time she's 65, she will have saved only **$317,843** (using the same investments as in the example above). Those 13 years of procrastination cost her *more than $436,000*. Why? The interest she's earned on her investments have had less time to compound. When it comes to retirement savings, time is literally money.

She still has time to make up for her losses, sure, but it will require cutting more of her spending later in life — not an easy task if she has a family and a mortgage to worry about.

“A lot of young people are very proud that they don’t spend more than they make, but the problem is they spend 100% of what they make,” Marotta says. “You get all the power of compounding interest when you’re in your 20s and it really does make a difference.”

Beating inflation

Seven million (or even $4 million) sounds like an impossible feat, but your personal retirement goal might be quite different. Financial planners and free tools online tools can help find your target, but both options have their drawbacks — planners cost money and online tools can be confusing to navigate.

If you really want to set yourself up for a healthy retirement, focus instead on one simple goal: beating inflation. No matter how much you save, so long as your return on investment is higher than the rate of inflation, no one can say you’re not a winner. (The current inflation rate is around 1.5%.)

If you’ve got $1,000 in cash, your first impulse might be to throw it in a savings account or a CD. But because savings rates are so devastatingly low now (0.06% on average — yikes), that’s not the wisest approach.

Your best bet is to invest in a 401(k) or open an individual retirement account (IRA) on your own. Both options give you access to low-cost investments that won’t require much upkeep. We’re fans of “set it and forget it” options like target date funds, which are cheap, reliable and adjust your investments as you age with little work on your part.

You might even find out that you’re already enrolled in a 401(k) plan and never knew it. More than 25% of employers offer auto-enrollment for 401(k)s today, and Gen Y workers are the most likely group to take advantage, according to Fidelity. By auto-enrolling, your employer will funnel 3% or 4% of your pre-tax income into a plan.

But if you want to really see your savings grow, you’ll have to eventually take the wheel.

"The problem is that many young [workers] don’t do anything after they’ve been auto-enrolled,” says Jeff Munn, vice president of Benefits Policy Development for Fidelity. “They’ve got a good start but if that’s all they do, they’re not going to get to where they want to go."

If you’re auto-enrolled — or even if you’ve actively set your contribution rate — make sure you’re at least saving enough to capture any matching contribution from your employer. Three or 4% is a nice starting point, but 10% or even 15% would be better. Baby steps can help you get there. Consider signing up for automatic increases of 1% to 3% a year. Gradually work your way up to double-digits. By the time you get there, you might be surprised how easy it is to adjust.

Ask your human resource manager if they offer Roth 401(k) options. Just 10% of Gen Y workers take advantage of Roths, which differ from traditional 401(k)s significantly. With a Roth, you contribute funds and pay taxes upfront rather than paying taxes on withdrawals in retirement. For a young worker who’s likely in a lower tax bracket than he will be in retirement, a Roth can help save a boatload on taxes later.

There are endless ways to strategize your retirement savings, and if you're approaching your goals correctly, it can be smart to seek advice from a certified financial planner at least once a year.

Regardless of whether you get help from an expert, saving for retirement is definitely the kind of "to-do" that should be at the top of your list. Maybe you'll never hit $7 million or even $1 million in savings, but the point is to make a goal, save for it, and hope for the best. Chances are you will be far better off than had you done nothing at all.

"It can be difficult to make the decision to save for the future," Munn says. "But people who do that earlier set themselves up much better for success."