What's a 401(k) and Why Should I Care?

Few young workers take heed of need to start saving now

You have a college degree, an iPhone, a great job and killer abs. But if you're in your early 20s, your most valuable asset is time.

Because you're more than 30 years from retirement, investments in a 401(k) or other retirement savings plan have decades to grow and compound. Even small contributions will grow dramatically.

If your employer matches part of your savings, your investments will compound even more.

This message doesn't seem to be getting through to a lot of young workers. A new survey by Hewitt Associates found that only 31% of workers ages 18 to 25 who are eligible for a 401(k) participate in their company's plan.

That compares with 63% of workers 26 to 41 and 72% of baby boomers, Hewitt said.

Among Generation Y workers who participate in a 401(k) plan, the average contribution is 5.6% of pay. Companies typically require workers to save at least 6% to earn a full company match, so a lot of young workers are leaving money on the table.

Despite the low savings rate, nearly 90% of Generation Y workers believe they will be able to maintain their standard of living in retirement. Only 69% of baby boomers think they'll be able to maintain their standard of living when they stop working.

Younger workers' optimism about their retirement security reflects some worrisome assumptions:

Nearly 65% of Generation Y workers say they expect to receive a monthly pension payment when they retire.

The reality: Traditional pensions are disappearing faster than your father's hairline.

In January, IBM announced that it will freeze its pension plan, the latest in a series of big companies to put their pension plans on ice.

More than 80% of Generation Y workers said they plan to support themselves in retirement with savings they'll put away later.

The reality: When you shrink your time horizon, you weaken the awesome power of compound interest. That means you have to save more - a lot more - and take bigger risks with your money.

Here's an example from Choose to Save, a public education program. Suppose you want to save $100,000. If you have 20 years, you can reach your goal by saving $3,272 a year and earning a 4% annual return. Shorten your time frame to 10 years, and you'll have to save $6,559 a year and earn 8% annually to achieve the same goal.

To get the higher return, you'll have to use riskier investments, increasing the chance you'll lose money in a market downturn.

Barriers to saving

To be fair, young workers have a lot of competing demands on their paychecks. The average indebted college graduate has more than $17,000 in student loans, according to an analysis by the Center for Economic and Policy Research. Many are also paying off credit card debts and car loans.

Nearly 80% of Generation Y workers said day-to-day needs interfere with their ability to save.

"Some of these are very legitimate demands" on finances, says Lori Lucas, director of participant research at Hewitt.

But 61% of young workers also cited "lifestyle purchases" as an impediment to saving. Those purchases include "the iPhone, the big-screen TV - things that aren't required for day-to-day living but allow people to keep up with the Joneses," Lucas says.

The success of automatic enrollment suggests that many workers can find room in their budget to save. With that system, workers are automatically enrolled in their employers' 401(k), and must opt out if they don't want to contribute. About 90% of workers who are automatically enrolled stay in the plan, Lucas says.

Getting involved

While automatic enrollment is a great way to start your retirement savings, it's only a first step.

Many companies with automatic enrollment plans initially invest workers' contributions in stable value funds or other low-risk investments. Unless you reallocate your investments, you'll earn sub par returns.

One way to sort through the confusion is to invest your contributions in a target retirement fund.

Target funds invest your money primarily in stocks when you're young, and shift to more conservative investments as you approach retirement.

Target funds work best when they're the only fund in your 401(k) plan, because they're designed to be all-in-one portfolios.

Questions for Discussion *(Type your responses; 25 words each)*

1. Answer the question that was posed in the article's title … "What's a 401(k) and why should I care?"
2. Why is it a good idea to contribute to a 401(k) if your employer offers one? Why is it good to contribute more than 6% of your earnings to your 401(k)?
3. Why is it a good idea to start investing for retirement in your 20s? Provide two examples from the article to back up your response.
4. If it's such a good idea then why DON'T many young people save money? Again, try to provide a couple examples from the article.