What are we Telling our Children about Investment?

or, Investing in a Boring Old Pension in Your 20's or 30's

Last month I penned an article called "What Are We Teaching Our Children About Investment". This article focused primarily on online trading platforms, day trading and how easy it is now for anyone to do this, and how easy it is to lose a lot of money.

Near the end of that article, I briefly mentioned the contrast with 'boring' pensions or long-term investments, also suggesting that it is up to all of us who care, especially as parents, to point out the dangers and occasionally steer our children towards the 'healthy' fresh produce aisle.

Well, being someone who does care, I'd like to welcome you to Strategic Expat's fresh produce aisle.

It's a short illustration of how much extra a pension can be worth if that person starts to save earlier in life.

It is effective, regardless of your nationality and the currency you work in. The fundamentals are the same and your government may also have some schemes set up to encourage pension contributions from an early age, which may offer some opportunities, even for expats.

Why Small Investments Now Matter Later On

In our 20s and 30s most of us tend to be carefree, and maybe as we enter our 30's and 40s we have reached the stage of having kids and a mortgage, so pension planning is taking a back seat. But you should know that you're missing out on tens of thousands in retirement income.

Regular monthly contributions to your pension build up over time. Compound interest and consistent investment returns do the hard work for you, helping your pension pot to grow.

But how does this actually work?

For example, let's suppose you have a total of US$100,000 to pay into your pension throughout your life. Compound returns on investments mean that US$100,000 could mean a comfortable retirement nest egg, or one that may not see you through your retirement in full.

So, how can the same amount invested have such a different outcome?

It's all about time.

Drip-feeding your $100,000 in over the course of 30 years means each payment you make has the opportunity to grow over longer periods of time.

Paying in $100,000 when you're only a decade away from retirement means that same investment won't have the same opportunity for growth to accrue.

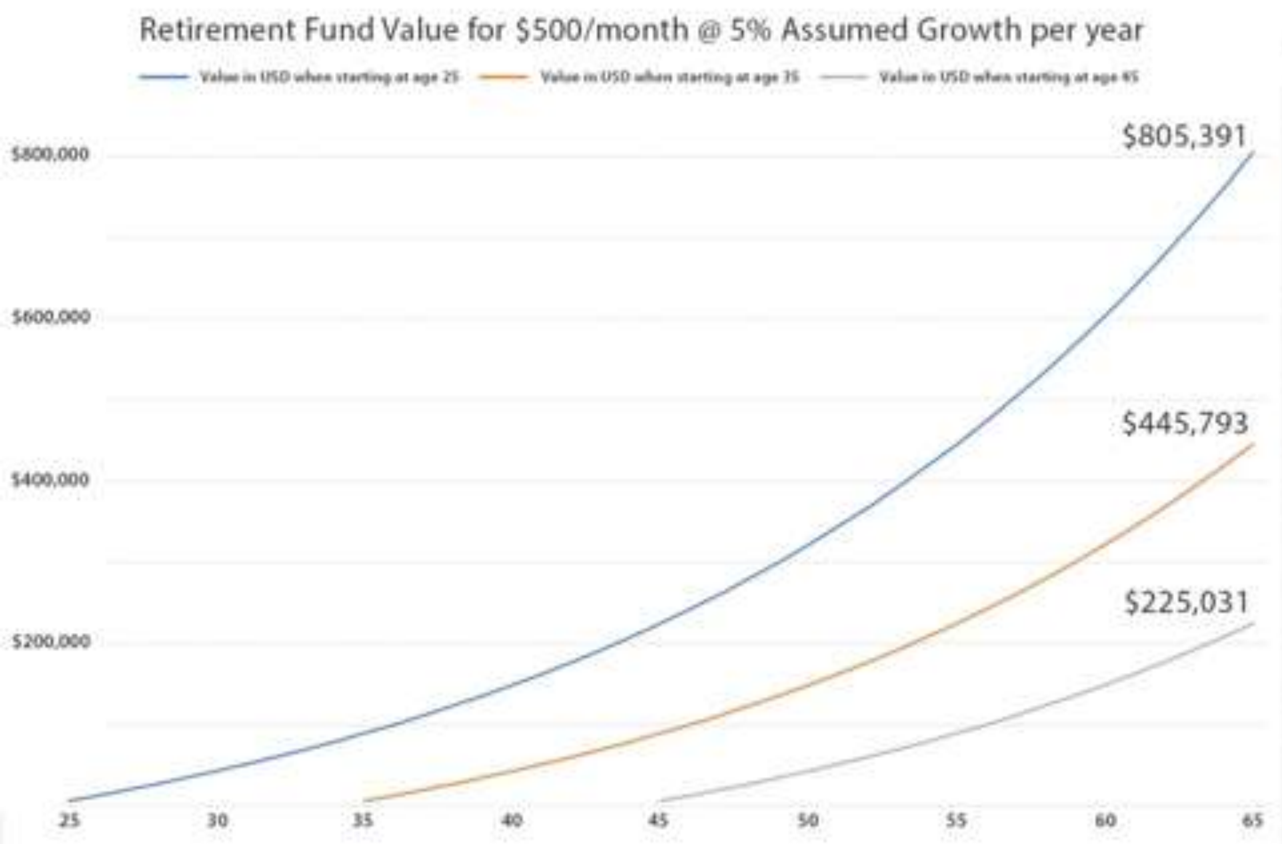
Of course, the best thing to do would be to put the $100,000 in when you're in your 20s, so the whole lot has more than thirty years to grow, but I know how unrealistic that is for most people.

An Example that Shows the Consequences of Waiting to Invest Until Later in Life

The easiest way to show you how regular payments grow faster over time is with some facts and figures in picture form.

In this example, we are assuming a retirement age of 65, a regular monthly contribution of $500 and an annual growth rate of 5%.

Graph: Starting to pay into a pension later in life can greatly reduce your future retirement income.



If you paid in $500 a month for 40 years from the age of 25, after annual growth of 5% your pension pot would be $805,391.

But if you start paying in when you're 35, that drops to $445,793.

The difference in contributions, if you start when you're 25 versus 35, is $60,000 ($6,000 contributions a year). And yet, the difference in the final pot is $359,998! To put it another way, missing the first 120 monthly contributions means you lose out on six times that amount at retirement!

This clearly shows the huge impact that compound growth has on regular contributions over time.

* I have also thrown in an example of starting to make contributions at the age of 45. This once again indicates the consequences of delaying pension contributions. However, even if you are starting later in life all is not lost, there's just a bit of catching up to do.

$500 May Seem a Lot

However, I am realistic in that many people in their 20s might think that $500 a month feels too much to pay into a fund you can't touch for another forty years or so.

But with a better understanding of the benefits of starting early (even if it's something like $250 per month, not $500) and a little bit of focus on managing your monthly budget to make these contributions easier (without going to the extremes of not enjoying life in your 20s and 30s), you can benefit from a much more comfortable retirement many years down the road.

The final things to consider are:

1. Do not opt out of any workplace pension scheme

Many expats, working for large international companies have access to life insurance, healthcare policies and retirement plans provided by employers. When we are young, we pay very little attention to these benefits. After all, we are not likely to fall seriously ill so young, and retirement seems light-years away. It is easy to simply consider these employer benefits as worthless trinkets, but often, company retirement plans offer a contribution from the employer, contingent on an employee contribution. Embrace the chance to start retirement planning early!

2. Think carefully about windfalls

Unfortunately, it’s a fact of life that our 30s and 40s is the time when we’re most likely to start receiving windfalls in the form of inheritance.

When you’re faced with a cash lump sum in your bank account that you hadn’t planned on receiving, it’s tempting to get spend-happy.

However, make sure you think about your future as well as your present and consider putting away some of your windfall into your pension. Doing this will give you a significant boost for your retirement.