The Wall Street Journal

How Millennials Can Maximize Savings for Retirement

Set aside 10% for a 401(k) or similar fund. Build an emergency fund. Cut student debt. Buy disability insurance.

By Anne Tergesen

Nov. 15, 2018

Retirement may be decades away for people in their 20s and 30s, but rarely has it been more important—or more difficult—to establish habits that lead to long-term financial success.

Thanks to the financial crisis, millennials are behind where their parents stood at similar ages, said Alicia Munnell, director of Boston College's Center for Retirement Research. People between 25 and 35, for example, have less wealth compared to their income and millennial men have lower earnings as a percentage of median national pay than their baby boomer and Gen X counterparts did at those ages.

With higher debt and longer life expectancies, millennials also have less margin for error when it comes to saving for the future. In an era in which Social Security is underfunded and old-fashioned pension plans are falling by the wayside, they are also likely to bear a greater share of the responsibility for creating their own retirement security than prior generations.

Here are some steps financial pros say to take in your 20s and 30s to prepare for financial success in your 50s and beyond:

The Two Rules of Savings

Financial planner Sheryl Garrett recommends two rules of thumb to get into the habit of saving for the future. The first is to put 10% of pay per year, including any matching contribution from an employer, into a tax-advantaged 401(k)-type plan.

That means that if an employer has a 3% match, the individual should save 7% of their income.

The second is to save an additional 5% in an emergency fund to serve as a buffer in the event of an unexpected expense or decline in income. Such a move may prevent a raid on retirement savings to cover expenses. Once the balance covers three to six months of expenses, the 5% can be put toward another goal, such as a down payment on a house or debt repayment, Ms. Garrett said.

Someone who consistently saves 10% of pay for 40 years should have enough—combined with Social Security—to maintain their pre-retirement living standard without a significant risk of going broke over the following 30 years, she says. (That assumes the person withdraws 4% from savings in the first year of retirement and adjusts that amount annually to keep pace with inflation, a formula that has held up over every 30-year retirement from 1926 on for an investor with 60% in large-company stocks and 40% in intermediate-term U.S. bonds.)

But people who start saving 10 years after they've begun working and save for 30—rather than 40—years would have to set aside 20% annually to reach the same goal, according to Ms. Garrett.

Savings and student debt

While people with student loans often struggle to save at all, they shouldn't give up on the notion altogether. There are some basic ways anyone can free up cash for saving, including: tracking expenses to look for spending cuts and considering ways to boost income, such as freelance work or taking on a roommate.

People with student loans may also benefit from refinancing their debt. When you refinance, you swap federal or private student loans for a private loan with a lower interest rate. Online lenders including Social Finance Inc., known as SoFi, and First Republic Bank frequently offer attractive deals to those with healthy credit scores, among other factors, said Daniel Wrenne, a financial adviser in Lexington, Ky.

Borrowers who refinance their federal loans should weigh any interest-rate reduction against the benefits they'll lose, including the flexibility to suspend their payments if they become unemployed.

A second option for reducing payments is open only to those with federal loans. The default option for repaying these loans is a "standard" plan, which requires the borrower to make fixed monthly payments for up to 10 years. This often minimizes the interest the borrower will pay over the life of the loan, in comparison to other payment plans, but maximizes monthly payments.

Some borrowers—particularly those who are cash-strapped—may benefit instead from an income-driven repayment plan. These generally cap student-loan repayments at 10% to 15% of a borrower's annual discretionary income—an amount that is determined by a formula that includes the borrower's income and family size, among other factors.

Income-driven repayment plans also offer the possibility of loan forgiveness after a set number of years of on-time repayments—from 10 to 25 years, depending on the plan and the borrower's profession. (Those who work full time for 10 years for the government or certain types of nonprofit groups may be eligible to have their remaining balance forgiven tax-free after 10 years of payments. Others will pay income tax on any debt that is canceled—which can amount to as much as one-third or more of the forgiven amount.)

Borrowers who can benefit the most from these plans generally have debt in excess of their income, says Mr. Wrenne. To see what payments would be under the various repayment options, borrowers can plug their loan information into the U.S. Education Department's online Repayment Estimator.
The goal, of course, should be to plow savings from better student loan management into a 401(k) in order to secure at least an employer's full matching contribution. The latter, said Mr. Wrenne, "is free money."

Protect yourself

Aside from amassing an emergency fund, millennials should buy disability insurance to cover as much of their income as they can afford to protect. Doing so will also help shield their savings from depletion.

With these policies, individuals pay monthly premiums in return for coverage of a set portion of their income in the event they become disabled and are unable to work. To collect, you have to meet your policy's definition of being disabled and the benefits will last until you either return to work or for the policy's stated term.

"You are your number one asset. What would you do if you become disabled and cannot do your job?" said Ms. Garrett, founder of the Garrett Planning Network of 250 planners who charge an hourly fee for financial advice. "You don't want to be 40 years old and asking your parents for a loan. For one thing, what will that do to their finances?"

The coverage isn't cheap, but Ms. Garrett says it's important for couples who cannot get by on a single income and for single individuals who don't have a partner to rely on. She said a 25-year-old who buys directly from an insurance company might pay $50 to $100 a month to protect $5,000 of monthly income, depending on factors including age and job duties.

It's generally cheaper to obtain coverage from an employer or any professional association you are a member of, said Alan Moore, co-founder of the XY Planning Network of 750 advisers who specialize in younger clients, often with incomes of $60,000 or more.

Many employers offer free short-term disability coverage for up to 90 days as part of a benefits package. Some also provide long-term coverage, or allow employees to buy it at a discounted rate. These policies typically pay 50% to 70% of a disabled employee's salary for three to four years, Mr. Moore says. (If the employer pays the premiums, the benefits are taxable. If the employee pays, they are generally tax-free.)

One way to reduce premiums is to buy a policy that pays if you are unable to do your job for two years and then continues only if you are unable to work at all, said Mr. Moore.

Ms. Garrett says millennials also often overlook the need to do basic estate planning. At the least, she said, appoint trusted individuals to make medical and financial decisions in the event you are unable to do so.