Planning for retirement

By starting to save early and building short-term savings, even while paying off student loans and handling other expenses, you'll be making an investment in a secure retirement and creating peace of mind.

Investment horizon

Your investment horizon is extremely important. This is the length of time in years that you will invest before you begin to use the money. For example, if you invest in your retirement for 25 years, your investment horizon is 25 years. Investment horizon is also called your time horizon.

Your investment horizon is also influenced by your retirement duration—the period of time over which you expect to use your retirement savings. For example, if you retire in 25 years and live for another 30 years, your investment horizon is 25 years, but you need to live off of your retirement investment for an additional 30 years, so your retirement duration is 30 years.

As a rule, the longer your investment horizon, the more aggressive you can afford to be as an investor because you have more time to recover from declines in asset prices that inevitably occur.

Compounding interest

Compounding interest along with your investment horizon can be powerful forces to help you achieve your retirement goals. Compounding occurs when the money you have saved earns interest, which is added to the principal amount of money that you already have in savings, and then that new total starts earning interest. With contributions and compounding interest over 40 years, you could save a substantial amount of money for retirement. Get help calculating your needed savings by using the retirement calculator.

Investment risk tolerance

Having a basic understanding of investment risk can help you to make wise asset allocation decisions. Risk tolerance is a measure of your willingness to accept investment risk in exchange for higher potential returns. For example, if you're an aggressive investor, you're likely willing to accept the risk of losing some of your investment capital. This means you will see a negative rate of return or partial loss of your initial investment in exchange for earning higher potential returns.

A conservative investor is less willing to accept risk, even in exchange for higher potential returns. Preserving the original amount invested is a top priority for conservative investors.

Retirement account options

There are a number of specially designed accounts to create retirement savings, and many of these accounts allow you to deposit money directly from your paycheck before taxes are taken out.

The following are specialized accounts that allow the account holder to invest in securities within certain tax code restrictions:

401(k)

Contributions to a 401(k) plan are taken out of your paycheck before taxes, so your pre-tax dollars make up your 401(k) plan. If you contribute, your employers may match up to a certain percentage of your salary toward your 401(k). Early withdrawals generally will be subject to taxes and a penalty. Rates of return vary on these plans depending on how the plan is invested. You can search for a 401(k) calculator online to see how monthly payroll contributions add up over your lifetime.

IRA

An Individual Retirement Account (IRA) is a tax-deferred retirement fund on which you will not pay taxes until you withdraw your funds. Withdrawals are taxed at regular income tax rates, not at the lower capital gains rates. If you qualify, some or all of your current IRA contribution may be tax deductible.

Roth IRA

This differs from a traditional IRA because it provides no tax deduction up front on current contributions. Instead, it offers total exemption from federal taxes when you cash out to pay for retirement or a first home. A Roth IRA can also be used for certain other expenses such as education or unreimbursed medical expenses without paying a penalty—any earnings that are withdrawn, however, are subject to income taxes unless you are over age 59½. Roth IRAs have tighter income restrictions than traditional IRAs. Taxpayers who participate in corporate retirement plans and don't qualify for deductible contributions to the traditional IRA can often take advantage of a Roth IRA.

SEP plan

A simplified employee pension (SEP) plan is a special kind of Keogh-individual retirement account. SEPs were created so that small businesses could set up retirement plans that were easier to administer than normal pension plans. Both employees and the employer can contribute to an SEP.

Mutual funds and securities

A mutual fund combines, or pools, investors' money and then uses that money to buy securities. Some mutual funds are actively managed by professionals, and some track the returns of an index such as the S&P, Dow Jones, or NASDAQ. Pay close attention to a mutual fund's prospectus, which provides its investment objective(s) and various fees.

Various types of securities are discussed below. You should consult a professional financial advisor or brokerage for advice and more in-depth research.

Bonds

Known as "fixed-income" securities because the amount of income the bond generates each year is "fixed," or set, when the bond is initially sold, bonds are issued by the government or by corporations instead of banks. Bonds have different risks depending on whether you are investing in U.S. Treasuries, corporate bonds or junk bonds.

Stocks

Stocks are a way for individuals to own parts of a business. A share of stock represents a proportional share of ownership in a company. As the value of the company changes, the value of the share in that company rises and falls. Weigh your risk tolerance to determine if stocks are the right investment vehicle for you and what type of stock best fits your investment style and time horizon. There are many types of stocks to choose from, including: value stocks, growth stocks, income stocks and foreign stocks.

Because the value of securities fluctuates with the market, the balance in your account will also fluctuate, whether you invest in mutual funds or securities, which may include gains or the loss of your initial investment.

Capital gains

A capital gain is the profit realized on the sale of an asset that was purchased at a lower price. The most common capital gains are realized from the sale of stocks, bonds, precious metals and property. Short-term capital gains and long-term capital gains have different tax attributes.

- Short-term capital gains are gains that are realized when an asset is sold within 1 year of the purchase of the asset. Currently, these gains are taxed at the owner's income tax rate.
- Long-term capital gains are gains realized when an asset is sold more than 1 year from its purchase date.

Disclaimer: This information is provided for informational purposes only and should not be construed as financial or investment advice. Consult a professional regarding your specific situation.

401(k) Savings Calculator

Estimate your 401(k) savings with this Banknote.com tool.

Retirement Planner

Find retirement planning resources from the Social Security Administration.