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The Roth IRA Path to Millions

Teenagers being teenagers, it is rarely easy to get them thinking further into the future than the upcoming weekend. But with the summer job season for high school and college students in full swing, now is a good time to teach your children, grandchildren, nieces and nephews a valuable lesson about the benefits of putting money aside in a Roth IRA.

While the notion of retirement probably seems unfathomable to a teenager, the idea of investing in a Roth IRA and becoming a millionaire—or better yet a multi-millionaire—may compel them to put down their smartphone aside and pay attention. There are two primary reasons why a Roth IRA is a great starter investment for teenagers and young adults: Taxes and the power of compound growth.

A child who is only working for the summer or just starting his or her professional career will likely be in one of the lowest tax brackets. Therefore, she may be better served paying taxes on her income now in return for tax-free growth in a Roth IRA over the course of several decades.

Even a relatively modest annual contribution of \$1,000 starting at age 15 could grow to over \$417,000 by age 70, assuming an average annual return of 6%. Bump those annual contributions up to \$5,500 (the maximum currently allowed for investors age 49 and younger) and those savings could grow to more than \$2.3 million by age 70.

The table below illustrates what a great starter investment a Roth IRA can be. We set up several different scenarios for the purpose of this table. All of them assume a 6% average annual return. The only difference between these scenarios is the amount contributed per year, which increases five increments from \$1,000 to \$5,500 from age 15 to age 70. As you might expect, the larger the contribution and the longer the time horizon, the larger the account grows. With larger initial (and subsequent) investments, you accrue even larger balances.

Roth IRA Results May Improve with Age

Age	Annual Contribution Amount					Increasing Contributions
	\$1,000/year	\$2,000/year	\$3,000/year	\$4,000/year	\$5,500/year	
15	\$1,000	\$2,000	\$3,000	\$4,000	\$5,500	\$1,000
30	\$24,673	\$49,345	\$74,018	\$98,690	\$135,699	\$33,126
60	\$225,508	\$451,016	\$676,524	\$902,032	\$1,240,295	\$567,960
70	\$417,822	\$835,645	\$1,253,467	\$1,671,289	\$2,298,023	\$1,093,974

Note: Table assumes a steady 6% average annual return.

We also developed another scenario that attempts to show a conservative, natural progression a young person might follow as he or she ages and gains employment (see the "Increasing Contributions" column). It starts by assuming a first summer job at age 15 where they invest \$1,000 a year until they graduate from college and get settled into a career. At that point (age 25), they bump their annual contributions up to \$2,000. In their 30s, they will be well established (hopefully) and able to again bump their contribution up to \$3,000 at age 30, to \$4,000 at age 35, and \$5,500 at age 40. The table assumes they continue to contribute \$5,500 per year through age 70.

Those who follow this hypothetical progressive contribution strategy could end up with more

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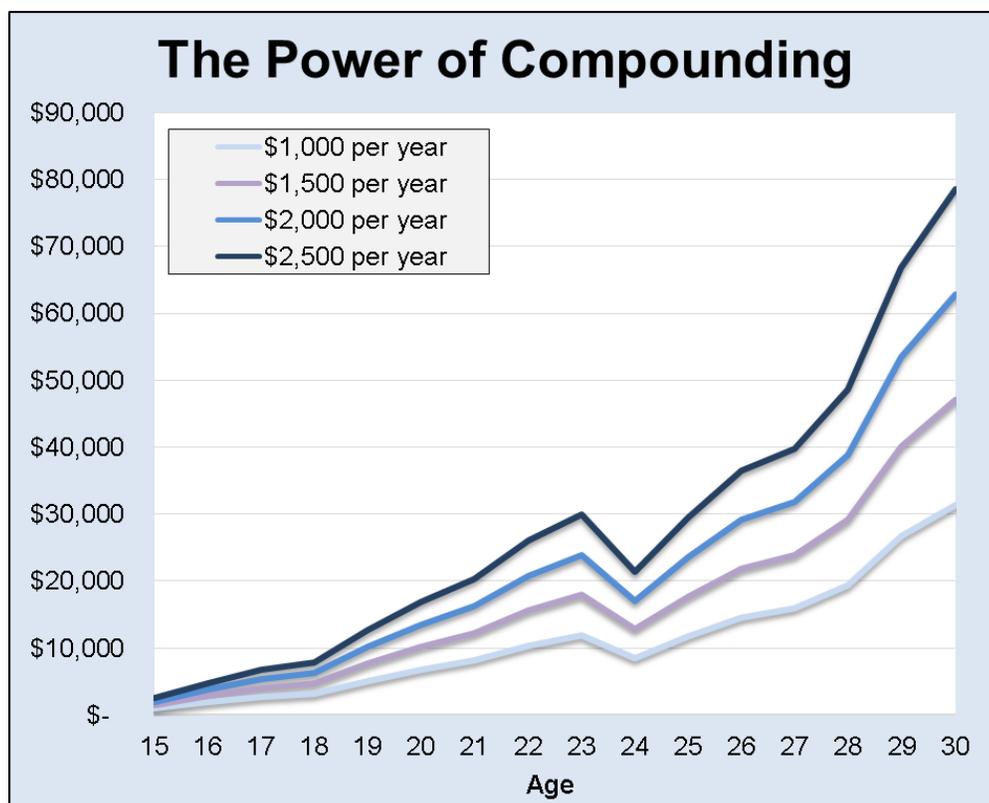
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money at age 70 (\$1,093,974) than those who contribute \$2,000 per year from age 15 on but never increase their contributions (\$835,645).

We also created another scenario that may be more realistic, particularly when we're talking about real markets and real teenagers (see chart below). First off, few teenagers are going to be able to earn \$4,000 in a summer (though they might be able to hit that number or higher if they work during the school year as well), and even if they do, they may not be willing or able to invest all of it.

It's also clear that markets don't compound in a straight line. They go up and they go down. Therefore, in the chart below we have assumed that our hypothetical teenager is not only stashing away more modest sums in his or her early years, but also that returns from the market mimic those of the past 15 years (using total returns from a hypothetical investment in the S&P 500 index over that period).

As you can see, the power of compounding relatively small sums of cash annually is a highly effective means to save money over a 15-year period, even if your investment suffers significant losses during that time. Take a look at the V-shape formed by the lines between ages 23 and 26 on the chart, which represents the S&P 500's 37% decline in 2008 and subsequent rebound in 2009 and 2010. In this example, each investment recovered from its losses and continued to grow through a combination of a couple of years of positive returns and steady annual contributions.



Note: Based on annual total returns of the S&P 500 index from 2000 through 2015.
Source: Morningstar.

Roth IRAs Are More Flexible than Traditional IRAs

The idea of tying up savings in an IRA may not appeal to a teenager or a young adult who may need to access savings to pay for a new car, a wedding or a down payment on a first home. With a Roth IRA, however, the rules do provide some flexibility.

Contributions to a Roth can be removed penalty-free at any time. (Of course, that defeats the purpose of saving in a Roth IRA, but the ability to access cash in a pinch may be a selling point to your teenager.) In addition, a Roth owner can withdraw up to \$10,000 in earnings on contributions after five years for a qualified first-time home purchase. Earnings can also be taken tax-free after five years for disability, death or once the account owner reaches age 59½. Keep in mind, however, that non-qualified withdrawals on earnings taken for any reason prior to five years are subject to a 10% early withdrawal penalty and are taxed as ordinary income.

Getting Started

The scenarios described above clearly demonstrate the benefits of investing in a Roth IRA starting at an early age. Nevertheless, the question remains: How do you impel a teenager to plan ahead and start saving?

Our suggestion is to lend a helping hand (or dollar, in this case). Assuming you can afford to match the summer earnings of your child, grandchild, niece or nephew, do it. Let them keep their hard-earned money, but open a Roth IRA in their name and contribute the money yourself. Remember, the child may earn \$1,000, but taxes will reduce take-home pay. But that shouldn't keep you from contributing a full \$1,000 into a Roth IRA (note that contribution amounts cannot exceed the account holder's earned income for the year). If you think it will teach some fiscal responsibility or cannot contribute the full amount yourself, consider making a deal with your teen to match a portion of her earnings as long as she contributes to her Roth IRA as well.

Finally, there is the issue of fund minimums. Vanguard has \$3,000 minimums for a majority of its funds. If that amount is out of reach, one option would be to start your child in Vanguard's STAR fund or one of its Target Retirement funds of funds for just \$1,000 (as their investment grows, they may want to consider moving out of these starter options). Or, if you have a personal representative at Vanguard or any other fund family, see if they will waive the minimum for your child or grandchild. If these firms are smart, they will see this as a way to grab a potential long-term client at an early age. Fidelity has wised up to this fact and has no required minimums for Roth IRA accounts.

Helping the teenagers and young adults in your life start on the road to a comfortable retirement may be one of the best gifts you can give them. Along the way, you will also be teaching them fiscal responsibility and the importance of long-term financial planning from an early age. If your child or grandchild has plans to work this summer or already has started working, we urge you to steer them towards a Roth IRA.

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