What Type of Retirement Account Is Right for You?

Here at Axos Invest, we're kind of obsessed with planning for retirement – and with good reason. There are stats in every corner of the internet telling us how woefully underprepared Americans are for retirement. (See here and here, if you're interested)

However, it turns out that Millennials (born between 1981-1996), are more committed to preparing for the future than other demographic age groups. A study compiled by Pew Research Center[i] found that Millennials tend to have more in retirement savings plans than Gen-Xers did at the same age.

While this is heartening news, it's never too late to start saving for retirement. Whether you're totally new to the idea of retirement plans or already saving, let's review the different types of programs so you can figure out which one is right for you.

Employer-sponsored retirement accounts

If you're lucky enough to have access to an employer-sponsored retirement plan, you should definitely consider participating and starting as early as possible.

401(k)

A 401(k) is a tax-advantaged employer-sponsored retirement plan. According to the American Benefits Council[ii], out of the 656,241 defined contribution retirement plans in the United States, 560,241 are 401(k)-type plans. Over 100 million Americans participate in defined contribution plans, making them the predominate retirement savings vehicle.

These programs offer many potential benefits. They're tax-advantaged because your contributions usually come out of your gross (pre-tax) income, which reduces your taxable income, and in some cases, might even lower your tax bracket. Your employer might also match up to a certain percentage of your contributions, which some people call "free money." And finally, your savings grow tax-deferred in a 401(k) plan, which means your money compounds as long as it stays in the plan.

Pension

Pensions, or defined-benefit schemes, are like rhinoceroses. They exist, but it's unlikely you'll ever see one outside of a museum, unless you're a state or local employee. Back in olden times (like up until the 1980s), defined-benefit pension plans were the norm. Your parents or grandparents expected to put their 25-30 years with the same company, then retire with a fancy clock and a steady stream of checks. Today, however, only 26% of civilian workers, including 86% of state and local government employees[iii] have access to one of these plans.

Individual retirement accounts (IRA)

If you don't have access to an employer-sponsored retirement plan, don't worry, you have other options to explore, including individual retirement accounts (IRAs). Almost anyone can open an IRA if they have taxable income. You can also open an IRA as a second retirement account if you're super ambitious and want to take advantage of time and compound returns. You have two types of IRA to consider: traditional and Roth.

Roth vs. traditional

IRAs offer tax advantages similar to those included in 401(k) plans. In a traditional IRA, you make pre-tax contributions that grow tax deferred. Your contributions to a Roth IRA are from your net income and aren't deductible. However, when you begin to draw on your account (after you reach 59½ years) you don't pay tax on your withdrawals.

Retirement plans for the self-employed

You still have retirement plan options[iv] if you're self-employed or a business owner. You can open an IRA, a Simplified Employee Pension (SEP), or Savings Incentive Match Plan for Employees (SIMPLE IRA Plan). You can also open a one-participant or solo 401(k).

Just a note on these tax-advantaged plans: we don't offer tax advice here at Axos Invest, so check in with your accountant or tax professional for tax-specific questions and advice.

One more option to consider

You don't have to use a specific retirement savings plan to prepare for your future. You can also open a personal investment portfolio. Depending on your knowledge and interest, you could consider a variety of options including robo-advisors (Managed Portfolios) and Self-Directed Trading. If you're more comfortable talking to a financial advisor, you can also investigate that route.

Personal investment portfolios don't offer the tax advantages as some retirement plans, but you can implement a strategy to take advantage of potential long-term returns and compound interest. They're an option to consider when planning for retirement.

Benefits of choosing a retirement account over savings

You can (and should) stash money into savings accounts, but this isn't necessarily the best option for maximizing potential returns on your money. While investing is inherently risky – after all there are no guarantees in investing – your money has more potential to grow in a retirement plan or investment portfolio. Historically, investments have a higher long-term return[v] than most savings accounts. You can read more about this in our blog about how investing can beat inflation.

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[i] https://www.pewtrusts.org/en/trust/archive/fall-2018/actually-millennials-are-planning-for-retirement

[ii] https://www.americanbenefitscouncil.org/pub/e613e1b6-f57b-1368-c1fb-966598903769

[iii] https://www.bls.gov/ncs/ebs/factsheet/defined-benefit-frozen-plans.htm#:~:text=In%202019%2C%2026%20percent%20of,formula%2C%20such%20as%20a%20pension.
[iv] https://www.irs.gov/retirement-plans/retirement-plans-for-self-employed-people
[v] https://www.berkshirehathaway.com/letters/2018ltr.pdf