

# THE EDUCATED INVESTOR

## A DAY LATE AND A DOLLAR SHORT

As most investors know, the individual retirement account (IRA) is a personal savings plan that allows investors to set aside money for retirement in a tax-advantaged account. Most investors also know the value of an IRA (even if they don't actually have one). What many investors don't realize, however, is the importance of timely annual contributions. IRAs that are funded early each year will accumulate substantially more assets than IRAs that are funded later.

### IRA Rules in a Nutshell

Money can be added to a traditional IRA for each year that a worker earns income and has not yet reached age 70 1/2. As of 2007, the maximum that can be added to an IRA each year is \$4,000. In future years, the contribution limit will rise periodically to account for inflation.

For any given year, contributions to an IRA can be made anytime between January 1<sup>st</sup> of that year until April 15<sup>th</sup> of the following year (when tax returns are due). That is,

for any year, there is a 15-month window in which funds can be added to an IRA account.

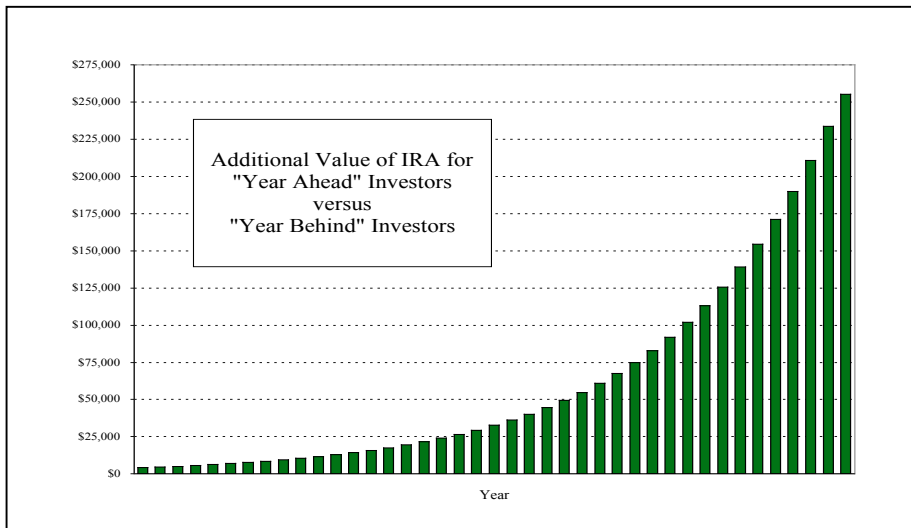
### IRAs in Practice

While investors are permitted to add funds to their IRA beginning on January 1<sup>st</sup> of each year, many people postpone contributions as long as possible, often until January of the following year (or even to April). Yes, they make a contribution eventually, but they are always behind. These investors would be well served to try to get ahead of the game and make their IRA contribution at the beginning of each year, rather than the end. We can see the benefits of early investing using a simple example.

### IRA Example

Consider two IRA investors. Both contribute to an IRA every year during a 40-year working career. Both contribute a fixed \$4,000 every year. Both deposit the funds in January.

One investor makes his first IRA contribution starting in January of



### Company Contact

P.O. Box 569  
Johnson City, TN 37605

ed@rollinscapital.com  
www.rollinscapital.com

423-676-9030  
fax: 815-301-9056

Edward S. Rollins  
MD CFP CFA

### Company Profile

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his first working year. He then makes subsequent deposits in January of each succeeding year. The second investor also makes his IRA deposit in January, but waits until January of the following year to begin. That is, he makes the contribution for his first work year in January of the second. He then makes the contribution for his second year in January of the third, and so forth until January of his 41<sup>st</sup> year when he makes a final deposit for his last (40<sup>th</sup>) year of work.

the same investment return. However, one came out \$250,000 ahead of the other. The difference is that the first worker invested at the beginning of each year, rather than the end.

#### **A Day Late and Dollar Short**

For this example, we held annual IRA contributions fixed at \$4,000. In fact, IRA contribution limits are designed to rise periodically to keep up with inflation. If we project IRA contributions to increase at the rate of 3% inflation, the investment

consistent contributions *at the beginning of the year* rather than the end, lead to significantly better investment results. This principle applies to any savings account: Roth IRAs, employer retirement plans (like a 401k), college savings plans, etc. It also applies whether an investor makes maximum contributions or only what they can afford. The crucial point isn't how much or how well funds are invested, merely *when*.

The remedy to this situation is simple: Make savings contributions as early each year as possible. For those currently funding an IRA account, but caught in the "year-behind" mode, the trick is to switch to the "year ahead" plan. Bite the bullet and make a double contribution: One deposit for year just past and another for the upcoming year. After that, future deposits can be added each January, but now for the year ahead rather than the year behind.

For readers interested in more detailed information on this topic, or other investment topics and strategies, please feel free to visit our website at [www.rollinscapital.com](http://www.rollinscapital.com), or call or drop me an email.

Edward S. Rollins MD CFP CFA

## The crucial point isn't how much or how well funds are invested, merely *when*

If we assume both investors earn a 10.5% investment return, they will both amass a tidy nest egg. However, the first investor will come out well ahead of the second. Each year, the second investor falls steadily farther behind the first (see graph) until, by the end of the 40 years, the first investor will have accumulated roughly \$250,000 more than the second.

The difference isn't that the first worker saved more than the second. Both wrote a check for \$4,000 in January and deposited it into the IRA account. Both workers invested annually for 40 years. Both earned

difference between the first and second worker increases to nearly \$400,000.

Similarly, if a worker and spouse both contribute to their IRAs, for a total of \$8,000 per year, the shortfall doubles to \$500,000! This isn't just a day late and a dollar short, this is a year late and *half a million* dollars short.

#### **General Principle**

This example centers on maximum annual contributions to a traditional IRA, but it is the general principle that is important, not the particulars. The general principle is that timely,