



Economic Toolbox

Small Change Equals Big Money

Balance sheets are very revealing. Beyond the basics of percent equity and the current ratio, the balance sheet reveals the personality and management style of the owner. There are stories of struggle, of triumph and of defeat on the balance sheet. And importantly, what's not on the balance sheet can tell as much as what is on the balance sheet. Sadly, most farm balance sheets show that farmers are woefully unprepared for the day they have been looking forward to for much of their lives - retirement.

Most farmers believe that when it's time to retire they simply sell the farm and live in prosperity from the equity they have built up over years of struggle. To depend on this sole means of retirement is very risky and in many instances, foolish. Suppose the children don't want or can't manage the farm, or the person you sold the farm to files for bankruptcy, or you can't sell the farm because there's better to be had elsewhere, or the debt and taxes you need to pay eat up all your planned retirement equity.

Depending on social security payments for retirement can hold false promise as well. According to Dr. David Kohl, professor of Agricultural Finance at Virginia Polytechnic Institute and State University, 46 percent of the general public rely on social security to cover retirement living costs. For farms, the figure drops to only 8 percent. This is due to the fact that most farmers operated their businesses in a way to reduce the taxes they were required to pay into the system. The money is just not there for them to take out when they retire.

All of these reasons and more are why farmers need to have investments outside the farm business that they can count on for retirement. David Kohl says farmers should aim towards putting 25 percent of their annual net excess earnings into outside

investments. The idea is to have enough money saved by retirement that one can live off the earnings of that retirement fund, indefinitely. Retirement and estate planning for farms ranges from simple to complex. Vehicles such as IRA's (Individual Retirement Accounts), SEP's (Simplified Employee Pensions), Keough Plans, 401k' s and others allow individuals and business owners and employees to accumulate savings on a tax deferred basis . The examples that follow are simplified to show why starting early is important and how outside investments can be put to work for you.

The Rule of 72

The rule of 72 is an old investors rule that tells you how long (approximately) it will take money in your savings or investment account to double due to the effect of compound interest. To compute how long it will take money to double, divide 72 by your interest rate. For example, if your bank is paying you 3 percent interest, 72 divided by 3 percent interest is 24 years. Put one dollar in your savings account today and in 24 years you will have \$2, after 48 years you will have \$4. Not much incentive for saving at 3 percent interest, is there.

Now take a look at Table 1. Compare what happens to your savings at different interest rates. At 3 percent \$1,000 grows to \$,8000 in 48 years. At 6 percent interest, \$1,000 grows to \$16,000. And, at 12% percent, your same \$1,000 grows to \$256,000.

The relationship between interest rates and the value of your investment over time is exponential. This is how small change can turn into big money if given enough time. Savvy investors, even those investing for their own retirement, can justify spending a lot of time trying to get high yields on their investments. For fun, use the rule of 72 on 18% percent interest for 48 years (hint your money doubles every 4 years for 12 doubles). The answer will tell you why credit card companies keep sending you all those applications.

The Real World

Most people were not savvy enough to put a thousand or two away in a savings fund

when they were 18 and let it grow to retirement 48 years later. They find themselves 30, 40 or 50 years old with little if any retirement savings. Fortunately, they have one thing they didn't have when they were 18, earning power. The problem is, the more you earn, the more you spend so that there seems to be little income left over for savings. The remarkable part about starting and maintaining a retirement program is that it takes only a few dollars a day and the commitment to pay yourself first. Table 2 shows the effect of adding \$1,000 every year to a retirement fund. With a constant rate of return of 12%, your retirement fund could grow to almost \$120,000 in only 24 years for every \$1,000 saved each year. With \$2,000 invested per year, your savings would increase to \$240,000 in 24 years. \$3,000 a year would get you \$360,000. Once people begin to realize that every dollar they invest turns into big money down the road, they develop an attitude towards saving.

Getting Started

Simply getting started is the largest stumbling block in developing a retirement and savings plan. Start slowly with your investment plan while you are a beginner. Savings plans can be started with as little as \$25 per month investment. Attend seminars, subscribe to financial management magazines and get referrals from others for investment advisors that will work for your retirement fund, not just theirs. Beware of life insurance policies sold as retirement plans. The younger you are the easier it is to get that nest egg growing. If you are one of those people who is learning these lessons later in life, there is still plenty of time to get the next generation started on the right foot.

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