What is a 401k and how does it work:

A 401(k) is a feature of a qualified profit-sharing plan that allows employees to contribute a portion of their wages to individual accounts.

- Elective salary deferrals are excluded from the employee's taxable income (except for designated Roth deferrals).
- Employers can contribute to employees' accounts.
- Distributions, including earnings, are includible in taxable income at retirement (except for qualified distributions of designated Roth accounts).

Benefits of 401k plans:

- Employer Matching Contributions - Many employers offer what is called a "matching contribution." That means the employer will match the dollars you contributed to the 401(k), usually up to a certain amount. For instance, if your employer offers a 5 percent match, it means they will contribute the same amount to your account that you do, up to 5 percent of your salary.

- Tax-advantaged savings plans can permit both pre-tax and after-tax contributions. Each contribution type offers different tax advantages. Pre-tax contributions include salary deferrals that are tax deferred until distribution.

- Compound interest - Compound interest is a powerful tool for building wealth. When savings are invested, they earn interest - or earnings. These earnings then earn their own earnings. Thanks to compound interest, the earnings on 401(k) contributions can "snowball" drastically over time.

- Convenient payroll deductions make enrollment easier and more likely to occur. Contributions are automatically deducted from participant's paycheck based on election of percentage of compensation.

- Dollar-Cost Averaging (DCA) – DCA involves the investment of a fixed dollar amount at regular intervals over a long period of time. 401(k) participants employ this strategy – whether they know it or not – by making regular salary deferrals by payroll deduction. These contributions buy a different number of investment shares each payroll. When shares are more expensive, they buy fewer. When they're cheaper, they buy more. DCA makes it easy for 401(k) participants to participate in the long-term gains of an investment.

The Power of Compound Interest:

Published in 1994 by USAA, it shows how much money you'll accumulate over time if you invest $250 a month starting at different ages. It assumes an eight percent average annual investment return.

If you start at age:

25: You'll accumulate $878,570 by age 65

35: You'll accumulate $375,073 by age 65

45: You'll accumulate $148,236 by age 65

In short, the longer you wait to start saving and investing, the more you'll miss out on compound interest.

Consider the following example and the chart below. Chris and Jennifer both invest $100 a month at a 5% annual compound rate of return. Chris begins investing at age 25, putting away $100 every month until 65 and Jennifer begins saving $100 a month at age 35.
An extra 10 years of saving means that Chris has about $162,000 in his retirement plan, while Jennifer has $89,000 by the time she is 65. Chris's balance is nearly double Jennifer's, and he contributed only $12,000 more of his own money.

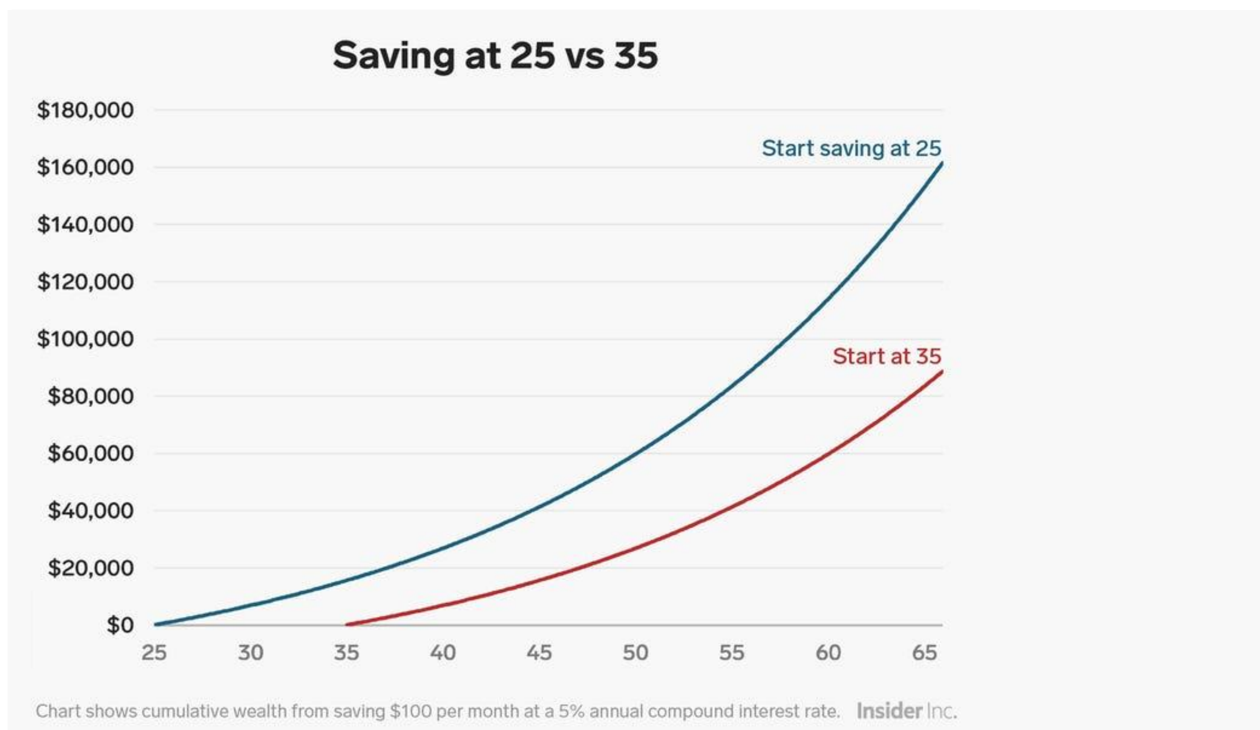

Chart shows cumulative wealth from saving $100 per month at a 5% annual compound interest rate.

Business Insider/Andy Kiersz