

September 2011

Five Decisions That Will Shape Your Financial Future

Overview: Personal finance and investments are among the most complicated topics facing young adults. Following is advice for young adults in the key areas of saving money, paying off debt, purchasing a home, buying insurance and investing.

1. Saving

One of the first decisions most young adults need to make as they are entering the work force is how much to save. It is hard to give a specific answer, but it is important to save as much as you can, as early as you can, which is illustrated by this example.

Imagine the year is 2051 and Mary-Kate and Ashley are 65 years old. Starting at age 20, Ashley started saving \$2,000 per year in an IRA. After 20 years of contributions, she stopped making new contributions. Her investments returned 7 percent per year, and the account is not taxed until the funds are withdrawn.

Mary-Kate, on the other hand, did not start saving until age 40, and she saved \$2,000 per year in her IRA for 25 years. She made her last contribution in 2051. She also earned a 7 percent return on her investments. Mary-Kate saved for five more years than Ashley, but she started saving much later. Who ended up with more money? Ashley wound up with \$476,151 while Mary-Kate's ending balance was \$135,353.

Let's make a change to this example to emphasize the importance of saving early. What if Mary-Kate is the next Warren Buffett? Let's say she earned 14 percent while Ashley still earned 7 percent. Mary-Kate's ending balance of \$414,665 still fell short of Ashley's \$476,151 despite Mary-Kate earning more than twice as much as Ashley on her investments.

Deciding Between a Roth and Traditional 401(k)

Young savers may also need to decide between a Roth 401(k) and a traditional 401(k) when saving in their company retirement plans. A Roth 401(k) allows you to contribute to your 401(k) plan with after-tax dollars and grow your money tax-free. When you retire, withdrawals from a Roth 401(k) are not taxed.

A traditional 401(k) allows you to contribute to your 401(k) plan with pre-tax dollars, and your money will grow tax-free. However, when you retire, withdrawals from a traditional 401(k) will be taxed. The key to this decision is your tax bracket now versus your tax bracket in retirement. If you expect to be taxed at a higher rate in retirement, you should save to the Roth 401(k). If you expect to be taxed at a lower rate in retirement, you should save to the traditional 401(k). If, like most people,

you aren't certain what your tax bracket will be when you retire, it likely makes sense to "diversify" the tax treatment of your retirement savings by splitting your savings between a traditional and a Roth 401(k).

2. Paying off debt

Making smart decisions about debt can be more important than making smart investing decisions. Debt is one area where diversification is not your friend. Let's look at an example. How many months does it take to pay off a debt of \$10,000 by making \$200 monthly payments? What is the total cost? Of course, an important piece of information has been left out: the interest rate. This table shows the answer to these questions, depending on the interest rate.

Interest Rate	Months	Total Cost
3%	53	\$10,600
5%	56	\$11,200
15%	78	\$15,600
18%	93	\$18,600

As you can see, the interest rate is vital when it comes to making debt decisions. Diversifying your sources of debt is not a good idea. To the furthest extent possible, it is best to consolidate your debts to the lowest interest rate.

Another important decision with respect to debt is whether to save or pay down debt. Below are some general guidelines that aren't applicable to every situation but are good rules of thumb for making this decision. When deciding which debt to pay down first, you should start by paying off the debt with the highest interest rate and work your way down to your debt with the lowest interest rate.

Order of saving versus paying down debt:

- ▲ Save in your 401(k) to get the maximum employer match. This is the closest thing to "free money," and you are leaving money on the table if you fail to save enough to get the match.
- ▲ Pay down credit cards. Generally, credit card debt has the highest interest rate.
- ▲ Pay down other non-deductible loans. A car loan would be an example of a non-deductible loan.
- ▲ Max out savings to tax-deferred accounts.
- ▲ Pay down deductible loans. Mortgages or student loans are examples of deductible loans. It may make sense to wait before paying down a student loan, as you may be eligible for a student loan forgiveness program. Teachers often are eligible for such programs.
- ▲ Save to a taxable account.

3. Purchasing a home

Should I purchase a home?

Purchasing a home is a decision that should not be taken lightly. In fact, making a poor decision with respect to a home purchase can drastically alter your financial future. Research has found that most people should not buy their first home until they are in their mid-30s.¹ Two of the main reasons for waiting to purchase a home are a lack of diversification and a lack of mobility. When people are younger, they have relatively little in financial assets. When you purchase a home before you've built other savings, your total financial asset portfolio is highly undiversified. The other main reason is that by purchasing a home, you've tied yourself to some extent to your current community.

This can limit your future job opportunities to your current city. While you may not see this “cost” come out of your checking account, it is what is called an opportunity cost, which is the cost of a forgone alternative.

Tips for purchasing a home

The best advice for buying a home: be prepared. First, save for a down payment. You generally need 20 percent down to avoid the additional cost of private mortgage insurance. The next step is to find out how much you can comfortably afford. You can get prequalified for a mortgage at your local bank or mortgage broker. Of course, just because you’ve qualified for a certain amount doesn’t mean you need to buy a house for that entire amount. It is likely best to buy a house for an amount less than your qualified amount. The last step is to familiarize yourself with the different mortgage options. There are many different options to choose from, and the landscape can be confusing. You will need to decide between a fixed or variable rate, the term of the mortgage, and other options.

4. Insurance

Making decisions with respect to insurance can be complicated and often depend on your specific circumstances. The best insurance lesson is that you want to insure against catastrophic losses, regardless of the probability. For example, it might be highly unlikely that you will die in the next year, but if you have a spouse and children who depend on your income, the financial impact of your death would be profound. If this situation applies to you, it would appear you have a clear need for life insurance.

On the other hand, it may be likely that your smartphone will break in the next two years, but even if it does, replacing it won’t make a huge impact on your financial life. Further, extended warranties tend to be expensive, making this a situation in which you would not want to purchase insurance.

5. Investing

There are generally two schools of investing: active and passive. Active investors attempt to outperform the market by identifying underpriced securities or by timing the market. Passive investors simply accept market returns. Active mutual funds generally have higher expenses than passive mutual funds. Simply because of fees and expenses, the average actively managed dollar must outperform the average passively managed dollar. What’s more, academic research has shown it is quite difficult to identify which active managers will outperform the market.

The most important action you can take with respect to your investments is to diversify and not own concentrated positions in individual stocks. Mutual funds are the least expensive way for investors to own a diversified portfolio. Among mutual funds, index funds or asset class funds are generally low in cost and highly diversified in terms of number of stocks.

Conclusion

The financial choices facing young adults as they start their careers can be confusing. But by educating yourself, you will give yourself the best chance of making the right decisions.

¹ Rui Yao and Harold H. Zhang, **Optimal Life-Cycle Asset Allocation With Housing as Collateral**. Working paper, November 2005.