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Advice to Young Adults

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Phase I: Do No Harm

Strive mightily to stay out of debt. For most individuals, the initial working years provide an opportunity to learn about living within their means, paying bills on time, and staying out of financial trouble. How do you know you are succeeding? If you do not pile up credit-card debt and incur big auto loans, then you're probably on the right track.

Debt presents a big challenge for people in their 20s. Nationally, about two in three (65 percent) college seniors who graduated from public and private nonprofit colleges in 2017 had student loan debt. These borrowers owed an average of $28,650.[1]

This debt can cause financial stress. New York's Alliance Bernstein Investments surveyed college graduates between ages 21 and 35. Among those who graduated with debt, 42% said they were living paycheck to paycheck, versus 24% of those who graduated debt-free.[2]

Credit cards and auto financing cause more serious problems. After graduation, credit-card balances can easily balloon, as young adults struggle to live on their paychecks. Tack on a car loan or lease and you could be looking at big trouble.

With any luck, your post-college financial struggles will ease as you approach age 30. The achievement of higher employment earnings and formation of families can create a stronger financial foundation. At this age, many people look to buy their first home and start seriously saving for retirement.

The median age of first-time home buyers is 31, according to the National Association of Realtors, based in Chicago[3]. Similarly, surveys by the Investment Company Institute in Washington suggest people typically start investing in mutual funds in their late 20s or early 30s. These first investments are often made through 401(k) or similar employer-sponsored retirement plans.

To reach your late 20s or early 30s in reasonable shape so that you can buy a home and increase your retirement saving, you should:

- Focus on your career. Your primary source of wealth will most likely be employment compensation. Continue to invest in your ability to earn more money.
- Don't expect to live like your parents. It took them 25 or 30 years in the work force to achieve their current standard of living. If you're eating out as often as they do or taking equally extravagant vacations, you're probably spending too much.

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[1] The Project on Student Debt, https://ticas.org/posd/home, accessed 06.03.19.
[2] Alliance Bernstein, Graduating with Debt- The biggest Threat to You Americans' Financial Well-Being, 2006.
[3] Economist Outlook Blog, http://economistsoutlook.blogs.realtor.org, accessed 06.03.19

- Drive a basic, safe and reliable car. The high cost of financing, maintaining, insuring and depreciation on a fancy car should be saved for a down payment on a home.
- Handle credit cards with care. Use a debit card, partly because you may get cash back on purchases. Using a debit card also makes you a more careful spender, because you know the money is coming straight out of your checking account. If you prefer to use a credit card because you earn frequent-flier miles or some other award, then every time you use your card, subtract the sum from your checking-account balance. That way, when the monthly credit-card bill arrives, you know you will have enough to pay off the entire bill.
- Don't necessarily rush to pay off student loans if the interest rate is low and the interest payments are tax-deductible. Instead, increase the contributions to your employer's retirement plan to get the full matching contribution and then earmark the rest for a house down payment.

Phase II: Save for Retirement

You should set an intermediate term goal of accumulating retirement savings equal to two-and-a-half times your annual compensation. Once you hit that milestone, the financial wind will be at your back. The power of compounding investment returns should help you reach your retirement-savings goal.

You can initially estimate your goal and then refine it as new information becomes available. Looking ahead to retirement, you might estimate that -- in addition to Social Security -- you will need $45,000 a year from your portfolio in today’s dollars. To generate that $45,000, you will need $1 million in financial assets, calculated in today's dollars. This example uses a 4.5% annual portfolio-withdrawal rate in retirement.

Once you reach a certain level of assets, most of your savings should come from investment returns. The breakthrough occurs at around 2.5 times income. Let's say your salary has reached $100,000, you have amassed $250,000 in savings, you save 15% of your pretax income each year, and your investments earn 6.0% a year. Over the next 12 months, your $250,000 portfolio could grow by $30,000 to $280,000. Your monthly savings would account for $15,000 of that growth. The other $15,000 could come from investment gains ($250,000 times 6.0%). In other words, you have reached the crossover point, where the biggest driver of your portfolio's growth could become investment earnings, not the actual dollars you save.

You should, however, keep saving money. That sacrifice will be handsomely rewarded, as your portfolio really starts to grow. Using the assumptions above, your portfolio could grow from $250,000 to near $645,400 in 10 years. Part of this gain would be lost to inflation. However, inflation should also drive up your salary, allowing you to save more money.

That still leaves the initial goal of accumulating 2.5 times income, which can take 12 to 15 years. The earlier you start the better. If you're close to 2.5 times pay by your early 40s, you're probably in pretty good shape.

As you strive to amass that sum, your top priority should be funding your employer's 401(k) plan. In addition to the initial tax deduction and continuing tax deferral, you will likely receive a matching employer contribution, which will help speed your portfolio's progress.

If you can, save outside your employer's retirement plan, by funding a Roth IRA. You will not receive an initial tax deduction, but you will enjoy tax-free growth. A Roth also offers flexibility because you can withdraw your contributions, but not the account's investment earnings, without a tax obligation or

penalty. The tax treatment of a distribution of Roth IRA earnings will depend on whether or not the distribution meets qualified distribution requirements.

Summary

Avoid debt, start saving while you are young and invest wisely. Young investors should have an equity orientation in their portfolio with broad diversification. Over the long-term, the equity market has rewarded investors for assuming uncertainty about the timing and magnitude of returns.

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