

# Why Retirement Is a Young Person's Issue

Why should someone in their 20s worry about retirement? Retirement is probably 40 years away, twice as long as you have been alive. There is plenty of time to save for the golden years.

That is the thought process of most young adults. Plus it is more fun hitting happy hour after work on Friday than investing in a mutual fund or stock that will probably fall in value anyway.

I get it. Does not mean I agree, but I understand how most people think.

However, I still urge young investors to save a little upon starting out in the work world.

U.S. News & World Report outlines, ["7 Ways Retirement Is a Young Person's Issue"](#). Well worth a read if you want added incentive to start saving for retirement today. As per usual, a few added thoughts from my side.

## **Social Security Reform**

There will be substantial changes in social security payouts in the near future.

Yes, politicians keep kicking the can down the road as implementing change will be political suicide. But at some point, changes must be made. Deferring eligibility until one's 70s, reduced payouts, thresholds based on wealth or income, etc. Whatever the actual mechanics, the bottom line will be less money in your pockets. Governments just do not have the money to continue financing retirees at current levels.

And this problem exists pretty much worldwide.

So be prepared for significantly less in government retirement pensions (but expect to continue to contributing to the pot!).

## **Debt**

I think this is a bit of a catch-22 issue.

Yes, it is a legitimate concern that impacts a growing number of retirees. And it will likely affect many young adults reading this post.

But the need for personal debt in retirement is probably caused by the fact that the person did not start saving until relatively late in life. If you start saving now, you will not require external debt to live as a retiree.

## **Longevity and Inequality**

With each passing decade, life expectancy in developed countries seems to increase.

Perhaps you can calculate annual savings, return, and expenditures up to and through retirement. But what happens if you expect to die at age 75 and find yourself living on into your 90s? Better to accumulate more than you require – to cover for unexpected costs, longer life, etc. – than to face a shortfall.

Also, as the old saying goes, make hay while the sun shines. You never know what will happen down the road. You get ill, lose your job, lose your spouse, etc. All these can impact your ability to save. So start as soon as possible and give yourself a buffer against unanticipated future shocks.

Given all the unforeseen events that can arise over the next 40 years, I suggest that [you can never save enough](#).

## **Bonus Thoughts!**

Not directly mentioned in the article, but worth considering:

## Detroit

Or a bunch of other cities, states, and countries.

They are bankrupt. Or will be bankrupt. That means [existing contracts will not be honoured](#). If you work for the bankrupt (or future bankrupt) entity, you [may not receive your contractual retirement benefits](#).

The same concern should apply even if you work for a private company. If you are part of a defined benefit plan, you want to be sure the plan is fully funded. Underfunded plans run the risk of non-payment should the company go insolvent. For company plans, I prefer defined contribution plans that are funded on an ongoing basis (and with a few other protections).

## Compound Returns

I have written about the [power of compound returns](#) previously.

It is an extremely important concept and a [huge advantage for young investors](#). The sooner you start to save, the higher your wealth will grow over time. So start saving, even if just a little, as soon as possible. It will be worth the sacrifice in the long run.

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# Buy Index, Not Actively Managed, Funds

Invest in passively managed index funds, not actively managed mutual funds.

A [constant theme of mine](#) for individual investors.

Today, a short video courtesy of The Motley Fool.

[http://www.youtube.com/watch?feature=player\\_embedded&v=wbiJAVU](http://www.youtube.com/watch?feature=player_embedded&v=wbiJAVU)  
EMAs

### **Keys to note in the video:**

0:20 – note the big discrepancy in expense ratios between the Spider Index Fund (9 basis points) versus the other funds. Every cent you pay in additional fees negatively impacts your performance. And your ability to reinvest your returns for [compound growth](#) in the future.

0:20 – note the correlation between expense ratios and performance. Look at the 5 year return. A strong correlation between [higher expense ratios and lower relative performance](#). That gets to my point about how [difficult it is for active investment managers to consistently outperform](#) their benchmarks over time. Smart investors stick with low cost index funds.

1:00 – the commentator discusses performance over the last month and three months. When considering investment alternatives, [ignore short-term results](#). Luck or external events can impact short-term performance. Focus on mid to long-term results when researching investment products. Given the number of new offerings out there, three year results may suffice. But if you can assess five and ten year data, much better.

The commentator does not discuss, but when comparing investment options [be certain to do apples to apples](#). In this video, they compare the S&P 500 to a variety of funds. To ensure you are comparing similar risk-return profiles, you want to check to see what benchmark each actively managed fund uses. If it is the S&P 500, then comparisons are probably reasonable. But if the benchmark is something else, then it is

not fair to compare the fund to the S&P 500. In this case, the listed funds are primarily large cap U.S. equity funds, so S&P 500 is okay. But if a fund focussed on micro-cap technology stocks or Japanese equities, then using the S&P 500 as a benchmark is useless.

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## [Financial Tips for College Graduates](#)

U.S. News offers [10 financial tips for young adults](#).

Actually, financial advice for anyone starting out in the work world. Or even for those who have been working for awhile and now want to begin investing.

Good advice. A few comments from my side.

I shan't cover all the points, but do want to make a few observations.

### **Start Saving From Day One**

[Good investors save](#), invest, and grow their funds.

Enroll immediately in a plan where money is automatically deducted from your pay each period. Company plan, personal tax-deferred investment account, etc.

You did not have any income yesterday. Missing \$50 or \$100 per pay period will not be felt. But if you wait and get used to the extra cash in your chequing account, it will be more difficult to lose it later on.

### **Invest for the Long Term**

How you invest should, in large part, reflect your [phase in the life cycle](#).

Presumably you are young. With 40 plus years until you need to access your retirement funds. Starting out in the world, you hopefully are entering an accumulation stage of life.

With a [long time horizon](#), you can handle some volatility in your portfolio. That means you should consider relatively riskier assets when you are young.

No, not betting double zero on the casino roulette wheel. Nor even putting half your money in corn futures. This is speculation. I am talking [investment risk](#). Based on your [personal risk tolerance](#) and individual circumstances. For a typical young investor, that often means a well-diversified portfolio with an [emphasis on equities](#).

[Do not shun risk](#) at a young age. Risk can be an asset for young investors. Just make sure it is well considered, prudent investment risk.

As your time horizon decreases and your personal circumstances change, then you can slowly move to a lesser risk portfolio.

### **Maintain an Emergency Reserve**

Last in, First out (LIFO). An inventory term in accounting.

But also a reality for young employees who lack seniority within a company. If things go sour, new employees often suffer.

Start investing on day one. But also [start accumulating an emergency reserve](#) in case you suffer a loss of employment income. The amount should be based on various factors. A good benchmark is often 3 to 6 months of living expenses.

### **Don't Live Like a King**

Or queen. Or my nephew.

Yes, it is nice to finally get out of your parents' basement and begin earning real money. But live within, or even below, your means.

Try to keep life frugal and invest any spare cash. Take advantage of your youth and the [power of compound returns](#). Yes, you may enjoy that week in the Dominican Republic. But investing the money and watching its [compound growth](#) over time will allow for many more weeks vacation down the road.

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## Financial Advice for Younger Adults

The New York Times offers some [“Financial Tips for Younger People”](#).

Not bad financial advice for young investors. Worth a read.

Key points offered:

### **Those Under 40 Are Not Saving Money**

*With stagnant wages, a tough job market and heavy student debt, American under about age 40 have accrued less wealth than their parents did at the same age, even as the average wealth of Americans has doubled over the last quarter-century, according to a new study by the Urban Institute.*

You can substitute “American” for most nationalities.

With government deficits and heavy debt levels, ever

increasing tax rates, and high unemployment, the ability for individuals to save and create real wealth will get even tougher. That is why it is crucial to start saving as soon as possible. The earlier you begin to save, the less actual money you have to set aside (thanks to the [power of compound returns!](#)).

### **Develop a Saving Habit Today**

Individuals, especially younger ones, must see savings as a habit. They:

*... need to start saving – even if it's as little as \$10 a month, if money is tight – to get in the habit. With the uncertainty about the future of Social Security benefits, he said, "There's a high likelihood they're going to be personally accountable for their own retirements."*

### **Do Not Overspend on Homes or Cars**

Younger adults should:

*not to aim to buy a big, expensive house right away, because they are likely to move around before settling down. Ditto for fancy cars.*

I would differentiate between homes and vehicles.

Not buying too big a house now may save significantly on mortgage interest. Buy something reasonable, then pay down any debt as quickly as possible. In the early years, interest takes up the vast majority of mortgage payments. Take steps to reduce the principle and the overall cost of the house (purchase price plus mortgage interest) will be much lower.

One may make an argument to invest in a large home now, given current popped housing bubbles in many locations. Over the long run, real estate has been a good investment. If you can



find a large home, at a reduced price, fine. But remember that your true cost will include interest on any assumed debt. So be cautious about overextending.

Vehicles are different as they are depreciating assets. We are not talking classic collectible cars, but vehicles you use for day to day use. You buy a new car and the second you drive off the lot it is worth substantially less. Vehicles are not investments.

A good rule of thumb is to invest in appreciating assets and minimize purchases of depreciating assets.

Spend money on items that will retain their value or increase in price. Spend as little as possible on wasting assets.

### **College is an Investment**

Another good piece of advice is:

*taking only as much college debt as they can reasonably expect as their first year's salary in their chosen field.*

I am not sure I agree with the ratio, but the point is valid.

Education, job training, etc., is an investment to help increase earnings during your lifetime. You must always consider the return on that investment before spending your money or taking on high debt levels.

A few other pieces of advice are offered in the article. So please give it a read.

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# 3 Ways Financial Advisors Mislead You

Probably way more than three ways personal financial advisors can mislead clients. But the article I want to link mentions three, so we will start there.

I agree with two of the three, but you can come to your own conclusions.

Okay, so what are these evil secrets financial advisors use to hurt clients?

Ramit Sethi writes about financial “experts” who offer advice that never actually works. [In his article](#), Mr. Sethi describes three “money secrets that the money pros won’t tell you.”

## **Secret #1: Cutting back on lattes almost never works**

I would have linked to the article just for this point alone. So, so, true.

“Latte” can be substituted for many other things advisors tell you to skip and invest the savings.

The issue is never saving \$3.00 per day by not buying the latte (and I would like to know where I can get a \$3.00 latte these days!). The issue is more fundamental. For most individuals, \$3.00 is not the tipping point to wealth creation. It is the reasoning behind the spending, as well as the other daily expenditures that occur.

If you can develop an ethos to save and invest, your daily caffeine high will not get in the way. But you need to develop a saving mentality. That usually requires a fundamental change in behaviour, not giving up one coffee a day.

Yes, I know the longest journey begins with a single footstep,

every penny helps, and so on. But I would rather focus on [positive techniques that aid in the investing](#) process. Tools that may still allow for your daily dose of joy.

## **Secret #2: As an individual investor, you're probably being ripped off**

Ripped off? Toi? Say it ain't so.

### 1. High fees

High fees? Where have we [heard that one](#) before?

As a small investor, use low cost index funds!

### 2. Commission-based financial advisors get fat fees recommending inappropriate funds

[Commission-based financial advisors](#) make their living from product sales. Does not make them bad people (or at least most of them), nor do I think that all of them recommend inappropriate funds. But that is how they pay their own bills, so be aware that a potential conflict of interest exists.

Same with [bank employees providing in-house products](#) to clients.

Always [know how your advisor is compensated](#) and apply a healthy degree of skepticism to recommended products. You do this when buying a car, television, etc. Financial products should be treated exactly the same.

And understand whether your [advisor will be a fiduciary](#) or not. An important distinction.

Also, those high priced mutual funds and structured products generally [do not outperform](#) passive investments or designated benchmarks. If someone tries to get you to invest in a product with high annual fees, demand to see [performance comparisons](#) to benchmarks and peers. Perhaps the fees are worthwhile. But

I doubt it.

In my opinion, [active portfolio management is not optimal](#) for smaller investors (and large ones for that matter). Put your money to work for you. Do not let it go into the pockets of the bank, fund company, brokerage house, or product salesman. [Minimize your costs](#) and you will maximize your long-term growth.

### 3. Unnecessary accounts

True, except for the part on using [target date funds](#).

Also, smaller investors should try and consolidate investment accounts with one bank or firm. The more assets in one place, the more leverage you may have when negotiating loans or other financial services. For example, many online brokerage houses offer reduced transaction fees if you maintain (say) \$50,000 in bankable assets with the institution. Often, this threshold applies to family assets (those who reside in same household).

If you are starting out and still live at home (or use your family address), you may be bundled in with your parents, thereby allowing you preferential fees. But you usually need to specifically request the linkage. So check the small print at your financial institution and see if you can reduce your costs.

Once you develop a substantial asset base, diversify between at least two banks. Partly for protection in case one bank fails. But mainly to play one against the other when negotiating for products and services. Banks live for new assets under management. The promise of new money coming in is a big motivator for flexibility.

### **Secret #3: Getting a tax refund is a good thing**

I see the point. People take positive wealth accumulation steps with the refunds, but would (foolishly) spend it

otherwise (probably on lattes).

But I do not agree. That is why I like individuals to contribute to their tax-deferred investment accounts as early in the year as possible, then have their [source deductions reduced](#) to reflect the tax-deductible contribution.

First, the interest foregone is small at today's rates. Fine. But when rates were 10% or more (not that long ago), that \$3000 refund lost interest becomes much more significant.

Second, there is the whole [time value of money](#) thing. A dollar today is worth more than a dollar tomorrow. If you are not getting a return on your cash (as is the case with tax refunds), you want the money in your jeans (to start earning a return) as fast as possible.

Third, and perhaps most important, is the [stronger compounding](#).

You contribute \$3000 annually for 20 years, earning a return of 8% each year. You make the contributions at year end, reflecting your tax refund. At the end of 20 years, you have \$137,286. Or you decide to make the contributions at the start of each year and not wait for a tax refund. After 20 years, your capital would be \$148,269. By investing at the beginning of each year, you would accrue \$10,983 more than by waiting until year end. Or in easy to understand terms, 3,661 lattes at today's prices.

Yes, I agree that psychologically it may be easier to wait for a tax refund, then invest it or pay down debt.

But from a pure finance perspective, get the money owed to you back in your pocket as fast as possible. Then put it to work immediately. The extra wealth that you will accumulate over the long-term is worth it.

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# A Good Investor Always Saves

I am not a fan of Jim Cramer. Simply because he plays to the cameras. And I hate the theatrics.

But he talks about a time when he was doing poorly in life. And he makes a great point that should apply to all investors. So we shall give him a listen.

## **Good Investors Always Save**

According to Jim Cramer, good investors must:

*Save. Whatever you can – whenever you can. But always save.*

I agree this is pivotal for successful long term wealth accumulation.

*Quite simply, a good investor always saves – period.*

Learn to become disciplined and consistent in saving. Even if only a little each period.

It may take a few months to adjust to having less disposable income, but you do adjust. If your rent goes up \$100 per month, you adjust. You have to. Pretend your rent, car loan, utilities, etc., went up and put the difference into your investment account, rather than your landlord's.

## **How to Save**

Take advantage of automatic deductions from pay cheques to make direct deposits into investment accounts. If you are able to use tax-deferred accounts, so much the better.

Sign up for [dividend reinvestment plans \(DRIPs\)](#) where available. Over time, you must watch the tax liability on income earned but not received. But starting out, there should be no issues.

Note that you can invest directly in some public company shares using DRIPs or Direct Stock Purchase Plans (DSPPs). Also, if employed by a public company, there may be Employee Stock Purchase Plans (ESPPs) available. All of these provide the opportunity to periodically invest small amounts while saving on costs.

While I prefer exchange traded funds (ETFs) in general, consider open-ended, low-cost, [no-load index mutual funds](#) when beginning to invest. Why?

Most ETFs have [transaction fees when you buy or sell](#). There are a few no-transaction fee ETFs out there, but most ETFs charge brokerage fees. Even if you only pay \$9.99 per transaction, that is 10% on a \$100 purchase. If you wish to invest in ETFs (because they are cheaper than mutual funds, allow intraday trading, etc.), I recommend you accrue your periodic deposits, then purchase an ETF once you reach a critical mass (say \$1000).

[Mutual funds tend to be more expensive](#) than comparable ETFs. However, when starting out, you may choose to pay more in annual expense ratios to avoid transaction fees. If you stick with no-load funds you will not pay any fees when buying or selling (but watch for potential charges or penalties if you sell a no-load fund within a certain period from purchase date). At this stage of life, do not even consider any mutual fund with loads.

If you look for low-cost index mutual funds, annual expense ratios may not be too insane. They will be higher than the same ETF though. But in the first few years of saving, the tradeoff between higher annual costs versus paying transaction

fees on ETFs may be worthwhile.

Often the initial investment index mutual funds is relatively low, \$500 or \$1000. This may take a few months to build to with minimal savings. But for many of these funds, once you have met the initial minimum you can usually make additional purchases for extremely small amounts, such as \$50 to \$100. This helps the wealth accumulation process.

Also, these small subsequent purchase thresholds lend themselves well to [dollar cost averaging](#). An excellent tool to build wealth slowly, while reducing some of the volatility impact on your holdings. So this is another advantage of no-load mutual funds over ETFs in your early years.

But we still want to keep costs down in the long run. Over time you can sell your mutual fund and replace it with a less expensive ETF. But wait until you have adequate capital for this to make sense.

One final thought – remember our previous discussions on the [power of compound returns](#). The sooner you start to save, the less you actually have to save over time to reach the same result. Similarly, the more you save now, the much greater it will grow over time. [Look at Nicole and Matt](#) to see what I mean.

Even a little saved consistently when you are young will grow significantly by retirement. As Lao Tzu supposedly said, “A journey of a thousand miles begins with a single step.”

So take even a small step today and start on your path to amassing wealth.

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# Will You Need to Work Until 70?

I continually stress that people need to save for retirement.

The sooner you start the better. And the easier it is grow wealth through [compound returns](#). But regardless if you are 20, 30, 40, or 50, you need to begin saving now and prudently invest for your later years.

If not, you may just find yourself greeting customers as they enter your local Walmart.

## **You Will Have Plenty of Competition for a Walmart Job**

An incentive to start seriously investing comes courtesy of the [Employee Benefit Research Institute](#) (EBRI).

*For about one-third of working-age households (those between ages 30 and 59 in 2007), working until age 70 won't enough to provide adequate income in retirement.*

*EBRI's Retirement Security Projection Model indicates that nearly 64% households aged 50–59 in 2007 would be “ready” for retirement at age 70, compared with 52% those households if they were to retire at age 65.*

So 36% of U.S. households will work until age 70 and still not have enough money saved to retire properly. And that percent falls to about 50% if you wish to retire at age 65. Scary stuff.

## **Do Not Count On Government**

Most governments are in [heavy debt](#). Will they have enough money to pay current levels of social security benefits to retirees? I have my doubts. I fully expect benefit payout to

seniors to decrease in the future. [We are seeing this already.](#)

In fact, many governments have already gone, or may go, bankrupt. This means that if you are counting on a pension from government employment (police, fire, etc.), it may not be what you expect. [Look at California](#) and its ever increasing number of bankrupt municipalities. When these situations are restructured, will the various pension agreements (that are a huge part of the fiscal crises) survive intact?

Also, governments need to raise additional revenues to pay interest on debt and general cost overruns. Expect taxes to continue to rise, which will further erode your savings.

[Consider Spain](#). Value Added Tax of 21% (so almost every purchase you make, you pay 21% to the government), cuts in benefits, indirect taxes on energy, etc. All these impact your life if you are a Spaniard. And someday [Greece](#) and [Italy](#) may actually implement real austerity measures.

Okay, but that is Spain (and maybe Italy and Greece). Yes, but look at where you live. There are very few places not in financial distress. It is simply a matter of degrees. The fact that no one is seriously addressing their financial problems suggests more Spains are on the way.

Do not count on the status quo when planning for your future retirement needs.

### **Save Early, Save Often**

I understand that finding available cash to start saving may be a real challenge. But sacrificing a little today may be a lot easier than competing with all those other seniors for a spot greeting people at Walmart.

Improve your cash flow, maximize contributions to tax deferred accounts, and start seriously saving for retirement today. If you do, you may lessen the odds of asking me if I “want to

supersize that” down the road.

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## Planning to Start Investing?

Just starting to invest?

Perhaps you just graduated from school, got your first real job, and now want to start saving money and building wealth.

Or maybe you are older but personal issues precluded you from beginning to seriously invest for future retirement. Student debt, home mortgages, and children, are just a few things that greatly impact the ability to invest for individuals in their late 20s and 30s. But now you have decided to focus on wealth accumulation.

Regardless of where you are in the life cycle, today some good tips for those beginning to invest.

The Wall Street Journal offers [four simple recommendations to new investors](#). I have covered them myself, but they do bear repeating.

### **Start Early**

The sooner you start investing, the better your long term wealth accumulation. This is due to the [power of compound returns](#).

*“A study by Maria Bruno, a financial planner with Vanguard Group, illustrates why: No matter how conservative or aggressive the hypothetical portfolio, projected median portfolio balances at age 65 are significantly higher for investors who started saving at an early age than for investors who began saving at older ages.”*

It is incredible how beginning to [invest early in life has such an impact on capital growth](#) over time. If you are in your 20s, this is great news. Hopefully it will spur you to sacrifice a little now when money is tight, because the long-term benefit is so high.

Now if you are in your 40s, it is all right to groan a bit at this realization. But what is past is prologue. You did not save in your 20s and we cannot turn back the clock.

On the positive side, not too many people do begin saving in their 20s and early 30s. Not the best approach, but the common one among adults. So if you have yet to start seriously saving, you have plenty of company.

Today is the first day of the rest of your life. Or, as another old saying goes, the longest journey begins with but a single footstep.

The power of compound returns works at any age. The sooner you start investing, the better the results. But you need to make that first step and then continue onwards.

Starting at 25 is better than 35, but so too is starting at 45 better than starting at 46. Additionally, life expectancy today may be between the ages of 80 and 85. Even at 45, you have ample time to allow your wealth to accumulate over time. But every day delayed negatively impacts wealth building.

So assess your financial situation today. See where you can make some modifications in spending and come up with money to invest.

## **Save Often**

*“Ms. Bruno found that the amount of money someone ended up with at retirement was more influenced by how much money was saved than by how that money was invested.”*

How often and how much you save is more important than what you invest in.

Obviously, this refers to a well-diversified portfolio of assets and not investing everything in the next Apple. Nor placing all your money in a term-deposit or savings account.

But the point still stands. Timing and amount are more crucial to long-term wealth accumulation than the individual assets invested in.

### **Invest Early and Often**

*“The two levers an investor can directly control—savings time horizon and savings rate—will generally provide a higher probability of success, rather than relying on the possibility for higher portfolio returns.”*

I wanted to highlight this statement.

Asset growth over time is a function of three variables. The rate of net return, time horizon, and invested capital.

If you are 25 years of age and invest \$4000 annually for 40 years earning 8% per year, your ending capital is about \$1,119,000. If you wait until 35 to begin, you will have to contribute \$9150 annually at 5% to reach your goal. Perhaps that is doable. But if you wait until age 45, you will need to find \$22,650 annually to reach \$1,119,000. Perhaps not so doable.

Within limits, you can control when you begin investing and how much you invest over time.

However, your actual investment returns are out of your control. It is difficult to consistently identify individual assets that will outperform the market. That is why active asset management does not normally beat a passive approach.

You can control your asset allocation and that does affect your portfolio's risk-return profile. For example, by adding higher risk (with higher expected returns) assets to your portfolio. But asset allocation and adding assets with greater return potential can only go so far.

In our above example, say you waited until age 55 to start saving. At the 8% return, you would need to invest \$71,500 annually over 10 years to reach \$1,119,000 by age 65. Not very likely.

Even projecting higher annual returns may not help that much. Say you manage 16% per annum, you will still need to invest about \$45,500 annually to hit \$1,119,000. Or you get 24% (triple our original figure which means a lot of added risk), you still must contribute \$28,500 each year. A fair bit of free money to find beneath the sofa cushions.

Focus on the two controllable factors (timing and amount) as they are more important to long run success than relying on riskier investments to provide higher returns.

## **Invest Frugally**

*"Investment costs are another, often overlooked variable that investors can typically control and that can have a big impact on a portfolio's longterm performance."*

Often-overlooked variable? Well not if you [read this blog!](#)

Transaction costs, commissions, management fees, operating costs, and taxes eat away at your gross returns and greatly damage your long-term growth. Every dollar that you pay to someone else – fund manager, brokerage house, tax agency – is one less dollar that will compound over time on your behalf.

Put your money to work for you. Minimize your costs to the greatest practical extent possible.

## Divide and Conquer

Okay, you want to start investing, but you have debts and other needs that also must be met.

*“Mr. Ritter suggests young adults tackle these major goals simultaneously. “Put a bit of money toward each goal,” he says, “and work toward being able to do more over time.” “Once one goal is reached—for example, after debt has been paid off—you can redirect money toward another goal, such as building an emergency fund. And once that is fully funded, with around six months of living expenses, you can save more toward retirement. Even if your contributions are small and come from a parttime or lowpaying job, Mr. Ritter says, they will pay big dividends in years to come. Remember, it’s the little steps that count.”*

I agree with this approach to some extent. It gets you on the investing path. It promotes a consistent and disciplined investing style, which is important for long-term success.

Also, investing a little is better than nothing. And, as your debts are paid off, you can indeed reallocate your cash and invest more over time.

Finally, I like the psychological impact that comes from seeing your investments actually grow. Even if you still have student loans outstanding, it is reassuring to see your investment account growing every month.

So I like this approach.

That said, I tend to see debt as a negative investment. And I prefer to invest my capital where I get the most return for my money.

Say I have \$1,000 in cash on hand, owe \$5000 on my Visa at 18% per annum, and want to invest monthly in a balanced fund expected to return about 6% annually. Now does it really make

sense to split that \$1,000 50-50 between my Visa and the investment fund? No. At an 18% non-deductible interest rate, I want to get rid of that balance as quickly as possible. So while I agree with the recommendation (especially getting people started on the investment process), you do need to assess your own situation.

While I think you should start saving and investing as soon as possible (and then consistently investing over time), you also need to be aware of your debts and the interest payable on them. If the interest payable on debt exceeds what you can earn on your capital, you may want to pay off your debt first.

And make certain you factor in the tax consequences. Interest payable on debt is often non-deductible for tax purposes while interest income, dividends received, and capital gains are usually taxed to some extent. So ensure when you do your calculations you consider the after-tax amounts, not the gross.

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## Money Lessons From One's Twenties

If only. If only I knew then what I know now. Or at least what I think I know now.

A concept anyone over the age of thirty understands very well. Okay, maybe forty.

“If only I had this wealth management advice when I was twenty, rather than learning painful lessons for the next decade or two.”



That is the tale of one woman in today's discussion.

## **Learning About Money In One's Twenties**

[S.L. Bathgate](#) seems like the typical young adult. Someone I can relate to.

*Looking back on my twenties, I realized that I spent my money mainly because I wanted to feel richer than I actually was. This single desire was probably the most fundamental problem I had with money during my twenties, and admittedly, it is one that I still struggle with today.*

*I got my first office job in my early twenties, complete with a paltry, yet steady, salary. Suddenly, I was hungry to experience the full spectrum that life had to offer, and all too eager to ignore the wide disparity between my means and aspirations. It was still a time when everything in the world seemed novel, and by virtue of its novelty, was mandatory to experience. Bottomless mimosa brunches? Buying that \$200 used guitar on a whim? Impromptu road trips? Yes, yes and yes.*

*I knew I shouldn't have been spending my money so liberally, but for the first time, it felt like a relief to just have the nice things that always seemed missing from my life. Somehow, it seemed perfectly fine to drop at least \$200 a month on sushi dinners, to purchase designer handbags, to drink endless rounds of American craft beers, and to have and to hold each new Apple product in my hands.*

I do not know of too many people who did not follow this path. Present company included.

I remember when I first moved to the Cayman Islands. An acquaintance there said that you will live your first year like a rock star. And he was right, although I never could get the long, flowing hair looking quite right.

Many of my fellow ex-pats lived a few more years like rock

stars. Making great money, living beach-front, out for dinner every night, and travelling the world on vacation.

Not the way to live if you want to accumulate wealth and retire comfortably. But after living like a pauper through school, once you start earning a little cash you want to enjoy it and make up for lost time. I know I did.

### **At Thirty, The Party Stops**

After enjoying her twenties, Ms. Bathgate reaches thirty to find her financial situation less than stellar.

*It was clear that I had refused to live within my means, and I needed to do something to change my situation. On one too many occasions, I had ransacked my short-lived savings to pay off mounting credit card bills. I still had an array of credit cards I had accumulated during my early twenties while playing the balance transfer game. And my credit score had taken a sizeable hit.*

Fortunately, Ms. Bathgate came to her senses and sorted out her financial problems. Sadly, many individuals do not correct their errors at 30, nor even 40 or 50. And with each passing month, rectifying the problem becomes harder and harder.

Why?

### **The Power of Compound Returns**

The longer one delays saving, the greater the capital required to catch up over time.

Consider a previous [lesson on compound returns](#). Nicole starts investing \$300 per month at age 25 and stops investing at age 40. Her total capital invested over 15 years is only \$54,000.

Her twin brother Matt enjoyed his 20s and 30s a little too much. Matt only begins to save at age 40. To catch Nicole's

wealth level at age 70, Matt must invest \$700 per month from age 40 to age 70. His total capital invested over 30 years is \$252,000.

Matt needs to come up with almost five times the disposable income to end up with the same wealth as Nicole when both reach age 70. Not an easy proposition.

The [power of compound returns](#) is a big incentive to start saving early in life.

### **Her Plan Going Forward**

Ms. Bathgate is planning on changing her (long-term) fortunes.

*I've come up with some new goals for my thirties. I am going to contribute at least 10 percent of my salary towards my retirement. I am going to chip away at my student loan debt until it is paid off or forgiven, whichever one comes first. I am going to embrace the very simple concept that I must spend less than I earn.*

A decent strategy. As is said, the first step is acknowledging you have a problem. Many do not.

I wish her the best of luck.

But if I was advising Ms. Bathgate, I think she could have improved her stated plan with a few simple amendments.

We will [look at my suggestions](#) next time.

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# A Formidable Investing Foe

There are many variables that make successful investing a challenge.

And one of your biggest foes may just be you.

What do I mean by this?

## **Are You Your Own Worst Investment Enemy?**

In my last post, [Mutual Funds Lag Their Benchmarks](#), I linked to a Wall Street Journal article, [It's Not Your Fault Your Fund Can't Keep Up](#).

According to the article, you are also at fault as to why your portfolio lags its benchmark.

*The average equity-fund investor saw annual returns of only 3.49% in the 20 years through 2011, according to the latest analysis from Dalbar. Compare that with the average 7.81% annual return of the S&P 500.*

*For the average investor, that's more than half the possible returns left on the table.*

That is significant in both relative and absolute terms.

If you started with \$100,000, made no additional investments, and earned 3.49%, over 20 years your capital would grow to \$198,595. But had you earned 7.81% annually, that \$100,000 would become \$449,967. A lot of money to leave on the table.

Why the discrepancy?

*The reason is most investors fail to hold mutual-fund investments for long enough, and instead try to time their investments. But they tend to enter the market after it has risen, Mr. Harvey says. So they are likely buying at a higher*

*price. They also are apt to leave the market after it has dropped, therefore selling at a lower price.*

*The result: investments that will massively underperform against their benchmarks.*

A lot of this is due to [emotional investing](#) based on lack of investment expertise. Individuals wait too long before buying – they want to see a clear upward trend first – and/or miss the price peaks. A good example of this would be [investment bubbles](#).

Even many knowledgeable investors can get caught up in the hype. It is not easy or popular to take contrarian stances. Better to get it wrong like everyone else, than to get it wrong while everyone else is correct. The [herd mentality](#) is quite common in the investment world.

Also, it is extremely difficult to time market or stock movements. Or identify the best individual investments. Even if you manage to stay unemotional. That is why professional money managers typically underperform their portfolio benchmarks. And why the [“best” investment analysts](#) seem to change from year to year.

### **What to Do?**

*investors looking to close the gap should be buying mutual funds, whether they be stock or bond funds, for the long term. Don't be tempted to bail when performance is poor because, over time, that has been shown to be a losing strategy.*

*And don't try to chase performance by getting into funds that have performed well recently. This is the equivalent of buying high and selling low—the exact opposite of what investors should be doing.*

You know me.

### If You Cannot Beat Them, Join Them

If you [cannot beat the market](#), try to match it as closely as possible. That means [passive investing](#) in open ended index mutual and exchange traded funds (ETFs). Keep [costs low](#) and [replicate the benchmark](#) as best you can. Actively invest under [only a few scenarios](#).

### ETFs Over Mutual Funds

As for the article's comment on ETFs over mutual funds, I generally agree.

I prefer ETFs for their [potential trading](#) and [cost advantages](#). But there are a wide variety of cost effective mutual funds out there. Many are extremely popular with investors. I still think they have a place in one's portfolio. So long as you focus on cost and net performance.

Also, as the popularity of ETFs grow, so do the number of ETFs offered. Not all are cost-effective or simple structures that replicate clear benchmarks. Be careful if considering investing in such things as [leveraged ETFs](#), [actively managed ETFs](#), [life-cycle ETFs](#), [alternative asset ETFs](#), and [ETF wraps](#).

### Buy and Hold

Identify solid investments and invest for the long-term.

I like the [buy and hold approach](#) for funds, although not so much for individual [non-diversified assets](#). The buy and hold promotes investment discipline and [works well for most investors](#) in shifting markets.

Note that you still need to [periodically review](#) your holdings and [rebalance as necessary](#).

### Dollar Cost Average

I also like a [dollar cost averaging](#) approach.

By investing a fixed amount on a periodic basis, you buy relatively more shares when the asset is cheap and less shares when the price is high. That smooths your purchase stream and provides some protection over time against volatile markets.