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.

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 lon-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 of 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 $1,119,00 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.

Easy Ways to Mess Up Retirement

Many readers are a long ways away from retirement.

Messing up on retirement is not yet on one's radar.

But it should be.

And the sooner you realize how people mess up retirement, the easier it is to avoid problems.

Consumer Reports outlines "7 Easy Ways to Mess Up Retirement".

Good points. Ones that are relatively easy to avoid if you

know they exist.

1. Not Having a Plan

You fail to plan, you plan to fail.

Different financial professionals recommend varying ways to plan. But all agree that you need to plan. If you meet one that says you do not need to plan, run do not walk.

I believe that creating an Investment Policy Statement is a great way to plan.

An Investment Policy Statement incorporates your unique investor profile. That is, your current financial situation, investment objectives, financial constraints, investing time horizon, phase in your life-cycle, and personal risk tolerance.

From this, you can then develop a comprehensive investment strategy that meets your needs and and unique personal situation.

2. Not Having Alternative Plans

The Investment Policy Statement cannot be a one and done document.

As life changes over time, the Investment Policy Statement must be reviewed and updated.

You win $5 million in a lottery? That completely changes your retirement planning.

You get convicted of drunk driving and lose your $100,000 a year job? That also impacts your retirement planning.

And it is not just you. Governments can change tax rates, devalue the currency, adjust access to social welfare programs, etc. Your company can introduce stock option plans, reduce the company pension scheme, go bankrupt, etc. The

economy can experience inflation, high unemployment, high gas prices, etc. Investment markets can change significantly over time.

There are so many variables that can impact your life. Many which you cannot control.

You need to monitor and amend your Investment Policy Statement as required. An annual review at minimum. Also, anytime there is a material change in your life.

If a change in strategy is warranted, then make those changes.

3. Not Knowing What You've Got

You should prepare a comprehensive balance sheet as part of evaluating your investor profile in the Investment Policy Statement.

Make sure it is comprehensive.

Many people forget things.

A typical omission is a home you own. Investors do not forget that they own the house, but they do often forget to include it when calculating their current asset allocation. Make sure you include yours as part of your real estate allocation.

4. Underfunding Accounts

I do not think that you can save enough each year.

Studies consistently show that [individuals do not save enough for retirement].

I strongly believe that most national governments will substantially reduce benefits in their social welfare programs. This may be due to clawbacks, higher thresholds, increased entitlement ages, etc. High government debt levels may also result in higher tax rates attaching to withdrawals from private pensions.

I also think there may be problems for individuals who are part of defined benefit corporate pension plans. Many of these are not fully funded.

> *Of the 341 companies in the S&P 500 index with defined benefit pension plans, 97 percent are underfunded, according to a Credit Suisse analysis. Despite generous contributions last year, Credit Suisse estimated the plans' liabilities at $458 billion at the end of 2011, an 86 percent increase from a year earlier.*

Others rely on very optimistic returns to justify their funding levels.

> *The median expected rate of return on pension-plan assets at companies in the S&P 500 has dropped from 9.1% a decade ago to a still-high 7.8%*
>
> *Among major public-employee pension plans, the median assumed return is 8%*

Is that realistic given recent rates of return on cash, fixed income, and equities?

> *Consider a corporate plan projecting a long-term average annual rate of return of 8% and holding 50% stocks and 50% bonds.*
>
> *With the Barclays Capital U.S. Aggregate bond index yielding around 2.2%, a 50% allocation to bonds contributes 1.1% annually to the portfolio's overall return. Stocks have to make up the remaining 6.9% for the entire portfolio to hit the 8% target.*
>
> *If stocks gain 10% annually, a 50% allocation to them will provide 5% of return, not the 6.9% needed. For this hypothetical portfolio to return 8%, stocks need to gain an average of 13.8%. That would be nice—and unlikely. Over the*

past 10 and 20 years, respectively, the Dow Jones U.S. Total Stock Market Index has returned 3.9% and 8% annually.

The probability of meeting these assumed rates of return is low. That means more funding problems for these pensions. And potentially payment issues for fund participants.

Try to maximize contributions to personal pension plans, then save through non-registered investment accounts. It is not wise to rely solely on your government and company pensions.

The sooner you begin to contribute, the less money you will have to invest over time.

5. Wimping Out On Risk

Many investors, especially young investors, are too cautious in their risk levels.

I am not telling you to take your savings, run to Las Vegas, and put it all on black 26 at the roulette table.

But investors should understand the relationship between risk and expected return. Then take an less emotional approach to investing.

I do not think individuals need to become investment experts. But it is helpful to spend a little time learning about the investment process. It will definitely help in your planning and investing for retirement.

This could also be a good time to work with a competent financial planner. Someone that can assist you in making more rational investment decisions. Yes, it will cost a little today. But the returns may be well worth the price.

6. Ignoring Fees

Expand this to cover all investment costs – transaction costs, mutual fund sales charges, portfolio management fees,

administrative and operating expenses, and income taxes.

I would also factor in financial planner support. Either commission based or fee only planners.

Lower costs equals stronger performance.

However, do not sacrifice service and portfolio performance just to find the cheapest options.

7. Depending on Home Equity

Traditionally, the family home was a key source of retirement capital.

At some point, the home owners would sell their house, “trade down” to lower cost accommodation, and live in part off the cash proceeds.

That system worked well for many years. But as we have seen over the last decade, it is not a guaranteed strategy.

Maybe housing prices will rebound. I think over the mid to long run that they will, on average, strengthen. Now may be a good time to buy if you are looking for long-term appreciation.

But it is not a given. There will be fluctuations over time based on general economic conditions, government legislation, etc. There will also be differences between real estate markets, as well as within specific sectors.

I stated above that we cannot be certain that government and corporate pension plans will provide the same benefits in future as they do today.

I think prudence should also apply with the future realizable value of your home. Do not plan to live off your home proceeds. If real estate bounces back, great. If not, you will be prepared.

Conclusion

As I like to say, hope for the best but expect the worst.

Plan for your future.

Start saving today.

Invest in low cost diversified products, such as index funds, that meet your investment goals.

Do not rely on governments, company pensions, or home, to provide for your retirement.

If you are going to err, better that it be on the side of caution.

I would much rather see clients complain to me that they saved way too much by the time they retired. Instead of seeing them struggle to live in retirement because they did not save enough.

Recession Babies?

Younger investors should be willing to take on the most investment risk.

This is due to the classic risk-return tradeoff from Investing 101. The greater the risk assumed, the higher the expected return over time.

However, young investors today are shying away from risk in their portfolios.

Why is this the case?

Is it because young investors were “recession babies”?

Recession Babies

A good term, possibly coined by Bill Finnegan in this Wall Street Journal article.

> *“We had Depression babies,” says Bill Finnegan, a senior managing director with MFS Investment Management, a Boston-based asset manager. “Now I think we have recession babies.”*

Given the tough economic conditions and volatile markets over the last decade plus, many young investors have no memory of bull markets and strong economic growth. All they see is high unemployment, a tough job market, and high student loans. Maybe their parents are out of work. Perhaps these young investors still live at home due to a lack of money.

Fully understandable that these “recession babies” are risk averse.

And for any aged investor, I normally recommend maintaining a 3 to 6 month emergency reserve in cash to protect against tough times and unforeseen circumstances.

Better to Earn Little in Safety, Than Nothing at All

Recent market history reinforces this low risk approach. As the article states,

> *A 27-year-old who started investing right out of college has seen a 0.5% annualized gain from a Standard & Poor’s 500-stock index mutual fund—less than the 1.85% returns of an ultrasafe money-market fund.*

As a result of poor equity market returns, young investors have moved into very low risk assets.

> *According to a June MFS survey, investors in their 20s held*

> *30% of their non-401(k) portfolios in cash—four percentage points higher than the average for all investors. The survey found that 40% of investors in their 20s agreed with the statement: "I will never feel comfortable investing in the stock market."*
>
> *An October MFS survey showed that young investors held 33% in cash, six points higher than the overall average, while 52% agreed that they would never feel comfortable investing in stocks.*

So in mid to late 2011, young investors had 33% of their capital in cash equivalents. A much, much higher percentage allocation than any standard asset allocation model would recommend for investors in their 20s.

And roughly 50% of young investors "will never feel comfortable investing in stocks." This compares with an average of 29% for all investors polled. A marked variance.

But is this Wise?

No.

A hard one to explain, especially given the equity market returns over the last few years.

Modern portfolio theory is based in large part on the relationship between risk and expected return. Under the Capital Asset Pricing Model, expected return is a function of risk. Yes, there are times when it is not perfect but I think the principles hold.

I shall not get into the theory – the linked Investopedia article does a good job – but it should be intuitive to anyone reading this. When faced with two scenarios, you will require a higher return for the riskier venture.

Consider Nicole and Matt

For example, my niece and nephew come to me needing a $10,000 loan each.

Nicole will spend the money on a car to get to and from her new job. She has borrowed money from me before and always paid off her debt in full and on time. Further, she will use the car as signed collateral on the loan.

Matt, on the other hand, is like most Matts. He just lost his last job as a landscaper (who knew that sod did not go in grass side down?) and plans to use the money to finance a trip to Ibiza. His repayment history has been poor and the only collateral he has is a broken down ski-doo.

Now would you expect that I would charge each the same interest rate? Especially bearing in mind that they are my niece and nephew, so naturally I like neither.

No, I would desire a higher return to take a chance on the deadbeat, Matt. The probability is much higher that I will have difficulty collecting the debt from him versus Nicole.

You would do exactly the same.

In any aspect of life, the greater the risk you must assume, the greater the return you want.

This Holds For Investments

This risk-return relationship has held over time in the capital markets.

Cash pays less interest than investment grade bonds. And investment grade bonds pay less than riskier speculative (i.e., junk) bonds.

And the relationship between low risk cash, higher risk bonds, and highest risk (of the three asset classes) equities also holds over the long run.

If you take a quick look at the linked chart you will easily see that over the long run, higher risk assets (small and large company stocks) outperformed moderate risk assets (government bonds) which in turn outperformed risk-free assets (Treasury bills).

But note that in many short periods (1930s, 1970s, etc.) riskier assets underperformed the risk-free asset. So during shorter terms, risky assets may not always outperform. A crucial point to always bear in mind.

Perhaps an argument can be made as to whether this long-term risk-return tradeoff will continue. Even I have some concerns due primarily to demographic shifts (a topic for another day). But I think the majority of experienced investors do see the risk-return relationship holding into the future.

The Key is Youth

In the short term risky assets may underperform. But over the long run, the tradeoff works.

How does that impact investors?

The key to utilizing the risk-return relationship is the investment time horizon.

The longer the investment time frame, the more likely that the risk-return tradeoff will hold true. Investors with long time horizons can ride out short term volatility and still prosper.

If you are 30 years of age with a 40 year investment horizon, you can invest in riskier assets knowing that the long term trend is positive. But if you are 65 and only have a few years before needing your capital to live on, you cannot afford to be caught up in a shorter term bear market.

My Advice to Young and Middle Age Investors?

The 50% of young adults who “will never feel comfortable

investing in stocks" need to reassess that viewpoint. Equities are not to be feared. And for the younger investor, stocks have proven to be the best of friends over time.

For most young and middle age investors, a 33% asset allocation to cash is probably excessive. I suspect a large portion of cash could easily be allocated to equities.

As for the exact asset allocation, creating a comprehensive Investor Profile will help determine the correct mix for each person. Part of this reflects an investor's time horizon, personal risk tolerance, and phase in one's life cycle.

Investors must take a more rational approach to their risk aversion. Take a long term perspective and tune out the short term hysteria and unpleasantness. Young and middle age investors have the time to ride out the periodic ups and downs. Use time to your advantage.

The phase in one's life cycle plays a significant role in the asset allocation of common stock. Make certain you understand where you are in life. Then take an investment approach that takes advantage of your personal situation.

One comment that I may expand on in a subsequent post. When I refer to risky assets, I refer to them in a traditional investment sense. Shorting stocks, playing the futures' markets, writing naked call options, are all high risk investment tactics. But I would never recommend their use by non-expert investors even though I believe high risk assets outperform lower risk assets over time. The potential exposure is great enough that a short term negative movement could cause irreparable harm.

And be aware that even within traditional investments, there may be different risk-return profiles within asset subclasses.

Use some common sense when investing to reduce portfolio risk. Focus on mutual and exchange traded funds (bearing in mind

that risk-return can also fluctuate within these groups). Employ proper investment techniques including adequate diversification, long term buy and hold strategies, and dollar cost averaging to create strong portfolios.

Risk-Averse Young Investors

Just watched an excellent little video.

Excellent for two reasons.

One, it agreed with some of my recent comments on asset allocations.

Two, I have better hair than the Bank of America representative. A rare feat these days.

The commentary is that younger investors, those in the accumulation phase, are actually more conservative than older investors. The video argues that this is a strategic error and that younger investors should increase their portfolio risk to attain better long-term returns.

A valid point. One that I have made previously in discussions on life cycle phases.

I agree that debt repayment should be a priority. Interest on most non-investment related debt is non-deductible for tax purposes. So the interest expense is even more onerous.

I also agree that investors should maintain emergency cash reserves.

My only quibble with the video is that equities are not necessary for every young investor. Logically, and based on

historic data, younger investors should invest in common shares. But if you are extremely risk adverse, do not feel pressured to acquire shares. You may not get the best possible portfolio returns, but you will be able to sleep at night.

Most corporate savings or investment programs are beneficial for employees. But before committing, review your company’s plan and make sure that it is a good thing for you.

Remember that everyone is different. While the video comments make sense in general terms, you need to evaluate in terms of your own investor profile.