

Financial Planning in Your 20s and 30s

Overview

What you need to know about financial planning in your 20s and 30s.

- Strategies for financial planning
- Setting goals
- Developing a plan
- Tips for staying on track
- Insurance
- Saving for your wants and dreams
- Getting help

Financial planning is different at different stages of life. Older people are often focused on planning for a comfortable retirement, while younger people often want to plan for multiple situations: immediate goals, like a car or vacation; foreseeable future events like children's educations and home ownership; and later goals, like retirement. To ensure that you reach all your goals, it's important to start early and follow a financial plan. In this article, you'll find the information you need to get started on planning your financial future.

Strategies for financial planning

Everyone -- even someone without a lot of money -- needs at least some level of financial planning. Financial planning is about creating a roadmap that will help you get where you want to go. It's about setting realistic goals and targets and then figuring out the best way to reach them.

At this stage in life, your financial plan should involve three core strategies:

1. Managing debt to achieve freedom and flexibility
2. Saving for financial security in the immediate future
3. Investing for long-term future growth

You may shift your focus from one strategy to another depending on your current financial situation. For instance, in general, if you have credit card debt, you should focus on paying that down before you do anything else. However, if you don't have any emergency savings or haven't started saving anything for retirement, it may be wise to work on saving some money while you pay down your debts. Then, once your credit card debt is paid off, you can start saving and investing more money. It is important to make a good plan and start following it.

Setting goals

In setting up your financial targets, your first step is to prioritize the goals according to importance. Some experts advise assigning three categories: needs, wants, and dreams.

- *Needs* are the nonnegotiable, inescapable basics: your monthly bills, such as rent, mortgage, and utilities; an emergency fund; and existing debt, such as student loans and credit cards. This category also includes maintaining appropriate insurance, saving for children's education, and your own retirement.

- *Wants* are goals that are important but that don't need to be taken care of by a set time: a vacation, a car, or a home purchase or improvement.
- *Dreams* are the frosting on the cake, a little further off in time: a vacation home, a boat, or early retirement.

You may find it helpful to take a piece of paper, divide it into three columns, and make a list for each category. This will help you get a better overall picture of your financial situation so that you can start putting together a plan to meet your goals. Use your lists to come up with a few financial goals. Your goals might include paying off credit card debt, paying down student loans, building an emergency fund, and saving for a down payment on a house. Don't forget to include short-term goals, too, such as saving for a vacation or making an extra mortgage payment.

Developing a plan

Now that you have a clear idea of where you want to go, you can begin to figure out how to get there. As a younger person, you're in a great position to succeed in reaching your financial goals. You have lots of time to save and invest for your future, but you'll only be successful if you develop a concrete plan.

Financial plans are easier to make than they are to follow. It's tempting to ignore a budget or your long-term goals when there's something you really want or need right now. But if you develop a financial plan that's realistic and easy to follow, you'll be more likely to stick with it.

The "needs" category is the first one to address in your financial plan. The first 60 percent of your pay will probably go toward essentials like food, housing, clothing, and taxes. Once you take care of these basics, you can focus on the three steps outlined below: managing debt, accumulating savings, and investing for the future.

I. Managing your existing debt

Reducing, or, even better, eliminating your unsecured debt should be a priority in any financial plan. Paying off your debt is even more important than setting aside savings because debt typically grows at a rate that far outstrips the growth rate of savings.

- *Get your credit cards under control.* Try to pay the full balance on each of your credit cards each month. If you can't do that, focus on never missing a payment and paying more than the minimum balance each month. You should also work toward paying off your highest interest cards first because those are costing you the most every month. Even if you can only afford to pay a little more than the minimum balance, you'll still be making a big difference in how long it will take you to pay off the total debt.

- *Consider consolidating your student loans, if you haven't already.* It'll be easier to pay all your student loans each month if they're consolidated into just one loan. You might also take this opportunity to switch to a repayment plan that leaves you with more cash each month. To get an idea of what your monthly payments would be if you consolidate, use the online calculator at the U.S. Department of Education's Web site at www.loanconsolidation.ed.gov, or call the Department's Federal Direct Loan Consolidation Center at 800-557-7392.
- *Pay bills right away.* To avoid late fees, open mail as soon as it arrives. Even better, pay your bills online. Most companies will allow you to set up automatic payments or receive e-mail reminders so that you'll never miss a deadline again.
- *Be patient.* Depending on how much debt you have, paying it off can take a long time. Try to remember that every single dollar you put toward getting out of debt is making a difference in your total financial picture right now and in the future.

2. Saving for financial security

Financial advisers recommend that everyone set up an emergency fund to help with an unforeseeable financial disaster, such as job loss, illness, an unexpected tax bill, or anything else that could pull the rug out from under you. Experts recommend that people save enough to cover at least three months' worth of expenses.

You can set an emergency savings goal by looking at your fixed monthly expenses, such as rent and health insurance, and other necessary expenses, such as utilities, food, and gas. Multiply this figure by three and you'll know how much you need to save. Don't feel overwhelmed by your savings goal -- you don't have to build an emergency fund overnight. Just keep adding to it as often as you can.

You may not be able to set aside this money all at once, especially if you're focused on paying off debt first. But building an emergency account should be your next goal, and remember that even small contributions to a savings account will add up. Put your emergency savings into a low-risk, accessible account such as a savings account, short-term CDs, or a money market account. Once you have at least a three-month stash set aside, forget about it; it's only there in case of emergency and shouldn't be used for anything else.

3. Saving and investing for long-term goals

Retirement savings should be your next priority, followed by saving for college if you have children. It's estimated that while a comfortable retirement now requires \$1 million in savings, when today's 20- to 30-year-olds retire, that cost will be at least \$2 million -- an amount that may seem unreachable but is probably within your grasp if you start planning for it today. As a rule of thumb,

many advisers recommend that those in their 20s and 30s save at least 10 percent of their income, increasing to 15 percent in their 40s.

Here are some investment options for retirement savings:

- *A traditional IRA* is a personal savings account that gives you tax advantages for saving for retirement. Contributions to a traditional IRA may be tax deductible, either in whole or in part. In 2006 and 2007, you can make contributions to a traditional IRA of up to whichever amount is smaller: (a) your taxable compensation for the year, or (b) \$4,000. In 2008, the \$4,000 limit will be \$5,000. You can withdraw or use your traditional IRA assets at any time, but those withdrawals will be treated as income for tax purposes. If you make withdrawals before age 59½, you may be subject to an additional 10 percent penalty tax unless there are special circumstances, such as death or disability, certain higher education expenses, or a qualifying first-time home purchase.
- *A Roth IRA* operates somewhat in reverse compared to a traditional IRA. Unlike a traditional IRA, contributions to a Roth IRA are not tax deductible. However, while distributions (including earnings) from a traditional IRA may be included in income, with a Roth IRA, if you satisfy certain requirements, the distributions (including earnings on your contributions) are not included in income and are potentially tax free if you meet certain requirements. A Roth IRA is generally available only if your adjusted gross income is less than \$160,000 for joint filers or \$110,000 for single filers. Also, if you contribute only to a Roth IRA, your contribution limits are generally the same as for a traditional IRA; for high incomes, however, contribution limits are gradually reduced. The amount you can contribute each year to a Roth IRA may also be limited if you contribute to both a Roth IRA and a traditional IRA. Investors in Roth IRAs can withdraw funds without penalty for some expenses: a first-time home purchase, college tuition, high medical expenses, and health insurance premiums if you're unemployed.
- *A 401(k) retirement plan (or a 403(b), if your employer is a government entity or tax-exempt organization)* is a tax-advantaged savings arrangement through an employer. With a 401(k) plan, money is deducted from your pay and put into a retirement account before income taxes are taken out of it, thus reducing your taxable income and the amount of income tax you'll need to pay. If your company matches part of your 401(k) contributions, try to set aside at least the percentage of pay that your employer matches. That way, you'll get more bang for each buck taken out of your pay. Many 401(k) plans allow employees to borrow against their plan account for a first home or for educational expenses.
- *Mutual funds* are a common vehicle for saving for retirement. With a mutual fund, you buy shares in a fund managed by an investment firm, which in turn buys stock, bonds, and other investments. The value of your shares rises and falls depending on the success of the firm's investments. While mutual funds lack the

tax advantages of IRAs and 401(k)s -- your deposits to the account are from your taxable income, and, in most cases, the earnings in your account will be taxed -- mutual funds typically offer better returns (although with more risk) than standard bank savings accounts.

It's a good idea to check with a financial or tax adviser to see if you're eligible for a particular type of IRA and to get help in choosing the best investment vehicles for your particular situation.

If you have children, you may be wondering about the best way to save for college. There are a number of different college savings accounts or plans you can take advantage of. It's important to do some research into these types of plans because they may affect your child's ability to get financial aid when applying to college.

- *529 college savings plans* are tax-advantaged education savings plans operated by a state or educational institution. Investment gains are income tax deferred, and there is no federal income tax on withdrawals for qualified educational expenses. Control of the 529 account stays in the hands of the donor -- you -- and not the student, so you decide when to make withdrawals. Most plans even allow the donor to reclaim the account (though subject to tax and a 10 percent penalty). For more information about 529 plans, go to www.savingforcollege.com.
- *Coverdell Education Savings Accounts (ESAs)* operate like Roth IRAs. You make an annual nondeductible contribution to this account, and earnings grow tax-free. When it's time for college, withdrawals from the account will be tax-free as well if used for eligible expenses. Total annual contributions to an ESA are limited to \$2,000 per child, but if you want to save more, you can set up other college savings accounts as well, such as a 529 plan. Funds in a Coverdell account can be applied to higher education and even certain early education (K-12) costs. The rules governing Coverdell accounts are complicated, so it's a good idea to consult with your tax or financial adviser to get the greatest tax advantages from your education savings plan.

Though it's important to put some money away for your children's education, be sure to give first priority to paying down your debts and setting up an adequate retirement fund for yourself. When the time comes for college, your children may well qualify for financial aid and will be able to take out student loans, probably with relatively favorable terms. But if you forego your own retirement saving, you won't have similar options. It's great to be able to support your children through their college years, but not so great if that means they'll have to support you further down the road.

Diversifying your investments

It's important to be sure your investments are diversified. This means that you shouldn't put all your eggs in one basket. Instead, spread your money out among several different

- investment tools (stocks, bonds, CDs)
- markets (not just the U.S., but international stock markets as well)
- industries (some stocks in consumer goods, some in technology)
- portfolio management styles (from conservative to risky investment philosophies)

For each of your investment goals, be sure that your total investment picture is diversified. For instance, look at all the financial assets that are in place for retirement -- your 401(k), IRA, and bank and mutual fund accounts -- and be sure that, when looked at as a whole, your retirement savings are scattered among varied types of investments. That way, a downturn in one market or investment tool won't destroy your savings.

You'll also want to think about diversifying the amount of risk within each investment choice. Younger people can generally invest more aggressively than their parents because they have more time to weather the inevitable ups and downs of the financial markets.

If you aren't sure how best to diversify your investments or how much risk you can handle, consider talking with a financial planner. The program that sent you this article may be able to help you find a financial planner in your community.

Tips for staying on track

A financial plan only works if you stick to it. The following tips can help you stay on track:

- *Make it automatic.* When it comes to saving, "out of sight, out of mind" is a good rule to follow. If money that's earmarked for savings goes directly from your paycheck into an account that's not easily accessible, it'll be much harder to spend it. So have your paycheck deposited electronically and have your bank automatically move some of your pay into savings. Also consider having some of your pay transferred electronically into your IRA or other retirement or investment account. And to make sure your bills are paid on time, you might arrange for electronic bill payment. (Many creditors and vendors even offer discounts for electronic payments.)
- *Make the most of your employer's help.* Maximize your savings by signing up for tax-advantaged plans at work. These may range from 401(k) retirement plans to flexible savings accounts for child care and health care reimbursement accounts.

These benefits, especially 401(k) plans, can help you save a significant amount of money, so be sure to contribute as much as appropriate.

- *Put it in writing.* Keep a list of your goals and a written plan that you can refer to. This will help you stay focused.
- *Consider setting up separate savings accounts for specific goals.* Most people do have separate college savings vehicles (for instance, a Coverdell Education Savings Account) and retirement accounts (401(k), IRAs). But you might also consider having separate savings accounts for goals such as a vacation, car, or down payment on a house. That way, you'll be able to see the progress you're making toward each goal. You may find it helpful to set up savings accounts that aren't linked to your main checking account. This will make it harder to access your savings. And to get an idea of what it will take to reach each goal, go to www.bankrate.com, which has an online savings calculator: You plug in the cost of what you're saving for, the years you've got available to save, and the estimated interest rate on your savings, and the calculator will tell you how much you'll need to deposit each month.
- *Put "found money" into savings.* "Found money" might be a bonus, the amount of a raise, or monetary gifts you receive. Don't treat these windfalls as an invitation to spend. Treat them as an invitation to save. Whenever you get a raise, increase your 401(k) contributions. Put at least half of your bonus or any cash gifts into savings.
- *Protect against future debt.* Once you've figured out what to save for and how to reach those financial goals, you'll need to keep yourself on track to get where you want to go. That means controlling your spending to avoid being sidetracked by additional unnecessary debt. Prepare a budget, or spending plan, as some people prefer to call it, so you know where your money is going. Track all of your spending for two weeks. Then, look back through your spending and see whether your actual spending reflects your financial priorities. If you're like most people, you'll find lots of places where you could cut back.

Insurance

Insurance is essential to your financial plan. You probably already carry some required insurance, such as auto or homeowner's insurance. But there are other types of insurance that protect against the risk of huge expenses down the road if something unexpected happens.

- *Health insurance* should be at the top of your list, to cover any physical and mental health needs that may come up. If health insurance is a benefit offered through work, carefully evaluate your choices to find the plan that best suits your needs.
- *Life insurance* is important if someone depends on you financially. It protects your family from the loss of your income if you were to die. Look for term life

insurance, which is quite inexpensive at your age, and buy enough coverage to pay for funeral expenses and your family's living expenses for three to five years.

- *Disability insurance* provides coverage if you become disabled during your working years. Look for a policy that provides 60 or 70 percent of your income, and also compare policies to see how each defines a disability.

Other types of insurance to consider, depending on your circumstances, are the following:

- *Renter's insurance.* Your landlord's insurance policy covers the structure of your home, but it does not cover your possessions. Could you afford replacing your material goods if they were stolen or destroyed? If not, you need renter's insurance.
- *Personal liability, or "umbrella" insurance.* If you have any "excess liability," you might consider getting umbrella insurance to protect your net worth in case you were ever sued. For example, if you have a swimming pool on your property, you might add additional liability coverage to your homeowner's or renter's insurance policy.
- *Particular risks* can also be covered by insurance, such as a "personal articles" or scheduled personal property policy to supplement your regular homeowner's or renter's insurance. If you have any particularly valuable or important belongings, such as expensive electronics, collectibles, musical instruments, or jewelry, are you comfortable living with the risk of losing them? Or would you rather transfer that risk to an insurance company? This type of coverage isn't typically very expensive, so you might want to check with your insurer to see if it's worthwhile for you.

Saving for your wants and dreams

There's more to life than the necessities, and you should remember that in your financial planning. It's important to plan for the things that bring you contentment, happiness, and fun -- whether it's the computer set up of your dreams, a beautiful wedding, or a much-needed vacation. Set aside money for these goals, just as you're setting it aside for necessities like retirement. Otherwise, you'll be tempted to put these expenses on your credit card or take on other forms of debt.

The trick is to be intentional about saving for what you want. In your 20s and 30s, it's likely that you're not able to set aside money every month for everything -- retirement, college, home improvements. It's okay to cut back in some areas occasionally, to focus on others. For example, if you're planning a vacation, figure out how much it'll cost, and cut back on your college savings program for the amount of time it will take you to save for the vacation. Just be sure to set a date for yourself to get back to your regular savings program.

Getting help

It's not easy to sift through all the financial choices before you, nor is it easy to stick with a financial plan. But there are lots of resources and help available to get you started on the right financial track and motivated to stay on it.

Your employee assistance program (EAP) or work-life program may offer financial resources, including articles like this one; referrals to financial planners; or financial coaching. If you're not sure how to contact your program, ask a human resources representative.

If debt is a special concern, a credit counselor can help you work out a payment plan that you can live with. Contact the National Foundation for Credit Counseling (800-388-2227 or www.nfcc.org) and the Association of Independent Consumer Credit Counseling Agencies (800-450-1794 or www.aiccca.org) for lists of agencies affiliated with these trade organizations. By dealing with a member of one of these groups, you'll know that the agency has agreed to be bound by certain fee limits and professional standards.

If you'd like to meet with a financial planner, you can find one through the membership organization Financial Planning Association at www.fpanet.org, (800-282-7526 or 303-759-4900). The program that sent you this article may also be able to help you find a financial planner.

Financial planning -- and sticking to a plan -- may seem daunting, but it's important to start when you're young. The sooner you start, the more time your money has to grow. Even if you can only afford to set aside a little bit at a time at first, you'll still be having a huge impact on your future, and your family's.

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