

## 4.2: Analyzing Your Current Financial Situation

### Your Parents' Advice

Some students may have received advice from their parents or other adults ranging from how to ride a bike to which fork to use at a formal dinner. However, many parents are reluctant to talk to their children about financial management. And if you got financial advice, it might be wrong, as so much has changed since they had to make the important financial decisions you are currently facing. Julia Carpenter, in the Wall Street Journal article “Your Parents’ Financial Advice is (Kind of) Wrong,” points out what is right and wrong about your parents’ advice:

*The rules have changed...Americans entering the workforce in the decade since the financial crisis face a starkly different landscape than their parents did at the same age. They often have far higher student loan debt. Housing eats up a bigger chunk of each paycheck. And young households have lower incomes and fewer assets than previous generations did at the same ages (2019).*

Given these new conditions, Carpenter feels we need new rules. Below, I have listed these rules along with my commentary.

#### *Educational Debt is Not Necessarily Good Debt*

In 2018, the average starting salary of a college graduate was about \$60,000, while the average salary for a high school graduate was \$28,000. On average, students complete their undergraduate degrees in five years; however, at more than a third of U.S. colleges, only half of the students will earn their degree in eight years. Those who do not finish end up with debt but not with the higher income they were hoping for. Further, four in ten college graduates are in jobs which do not require a college degree (New York Federal Reserve Bank, 2018).

If you plan to go to graduate school, remember that if your starting salary after the degree equals the debt incur then it is probably a good investment. You want to be able to pay your living expenses and still have enough left over to pay off your loans in about ten years. If you think about it, “buying” an education after high school is really an investment and you should think about the kind of return you will be getting on that investment.

#### *Do Not Assume You Should Buy a Home*

Owning a house is still part of the American Dream, but it might not make financial sense for you. For example, you might work in a city with a hot housing market. You might not be able to afford a down payment, or you could wind up depleting your entire savings. On top of that, if you do not expect to stay in a city for more than three years, you will likely not get back all the transaction costs (fees, title insurance, etc.) of purchasing a house. Do not buy a house just because you think you should.

#### *The Best Place for Financial Growth*

You should compare your salary (or potential salary, based on the average for your field) to a city’s cost of living. Many people think it would be cool to live in New York City or San Francisco, but the cost of living is so high that your salary has to be proportionate. Otherwise, you can find yourself commuting an hour or more from the only affordable living accommodations in the area. Some cities like Chicago, Philadelphia, Austin, and Portland, although costly, have more affordable housing than San Francisco and good starting salaries. If, for example, you compare the salaries of high-tech workers and the cost of living in San Francisco to those in these cities, you will find you are financially better off living in the city with the lower cost of living. Cities around the U.S. are trying to attract tech companies and, although San Francisco had a higher percentage of high-tech jobs as a proportion of overall jobs, there are good high-tech jobs in the many cities.

As a result of the Pandemic, remote work has increased substantially. The U.S. Census Bureau recently released its annual 2021 American Community Survey a survey of household behavior (September, 2022). According to the Census Bureau, between 2019 and 2021, the number of people primarily working from home tripled from 5.7% (roughly 9 million people) to 17.9% (27.6 million people).

However, remote work is not evenly distributed around the country. In metropolitan areas, 19% of employees worked from home (with Washington, D.C. at 48% remote workers and Silicon Valley at 35% remote workers as outliers). Outside metro areas, only 9% of employees were working from home in 2021.

The opportunity for remote work is a factor to consider when seeking a position. It has its advantages, including working flexible hours and saving on commuting time. It also has its disadvantages, including the loss of comradery of office work and not being visible to your superior to take advantage of bonding and advice.

#### *Not All the Old Rules Are Dead*

Your parents might have followed this old rule: be frugal until you save up enough for the down payment on a house. Unfortunately, with student debt and the higher cost of housing, it does not work to do simple things like pack your own lunch or hold off on a vacation. It's part of the American Dream that couples rent for a while, save up for a house, and then, when they are ready to have children, buy a house in a good school district. If they cannot do this, they might feel a sense of disappointment or failure. However, that should not cause you to throw up your hands and not work on saving for your future. There are still important goals for you to save for. First, although young people tend to live in cities, there are almost always suburbs that are more affordable.

Under the **gravity model of real estate**, the center of gravity is downtown where there are a lot of jobs. Then, unless there are physical constraints such as mountains or a coastline, housing construction proceeds over the years in concentric rings around center city. In general, the closer the housing is to the center, the more expensive it is. Housing that is farther out is then cheaper, but it could entail a longer commute. However, in many cities, young people are creating a new trend of moving into affordable suburban housing, and others have started looking for a job in smaller cities with good salaries and a reasonable cost of living.

Outside of housing, you will need to save for a number of things. You should have an emergency fund of, ideally, at least six months' salary in case you lose your job and begin contributing to your retirement as early as possible. If you intend to have children and expect them to attend college, you should begin putting aside money for their college expenses. Put these savings into an account where the money will compound to a significant amount by the time you need it. Having these savings will reduce your financial anxiety and improve your well-being.

### Ten Rules for Financial Freedom

In 2019, Susan Hube wrote for the financial journal Barron's saying:

*The true measure of financial success isn't how much money you make—it's how much you keep. That's a function of how well you're able to save money, protect it, and invest it over the long term. Sadly, most Americans are lousy at this(Hube, 2019).*

Two-thirds of Americans would have trouble coming up with \$1,000 cash (not credit) to pay for an unexpected medical bill or emergency. Even more disturbing, seventy-five percent are not saving enough or investing correctly for their future retirement requirements. While there are a number of external factors that exacerbate this problem—stagnant salaries, expensive healthcare and education and rising housing costs—there is a deeper issue: a lack of financial literacy.

Parents are reluctant to talk to their children about money, and high schools and colleges lack financial literacy courses. Individuals are increasingly left on their own to decide how much to save and where to invest their savings. To help, Hube laid out ten rules for financial freedom that I present here, along with my commentary.

#### *Set goals.*

The first step is to set goals: short-term, medium-term, and long-term. For example, a short-term goal could be to save up six-months' salary as an emergency fund. A medium-term goal might be to save up for a down payment on a house. Finally, a long-term goal would be to save for retirement.

The sooner you set your goals, the sooner you will begin trying to achieve them. Goals motivate us, and when you have your goals to think about, you will likely squirrel away the extra cash.

#### *Know what you have got and what you need.*

Always keep this question in mind: "Do I need this thing or do I just want it?" It is hard to resist something you really want, like a new pair of shoes or a new kind of tool. However, you should it is not a good idea to buy something just because it gives you a jolt of pleasure.

For example, my neighbor had a garage sale recently. Since my wife helped organize the sale, we got a preview on what was being sold. I saw three electric guitars, and I really wanted one. Luckily, my wife said, "You already have a guitar. You don't need

another one!" I must admit, it was hard to distract myself from that guitar, but the next day, I knew she was right.

Look at your monthly after-tax income (disposable income), and add up all your expenses for the month. If your expenses exceed your income or if you are not saving any money monthly, you have to cut expenses. Finally, if you are buying things that you do not need or do not use (such as a gym membership or a particular streaming service), drop it and bank the money.

*Save systematically.*

Pay into your savings, the same way you pay your electric bill: monthly and automatically. Assuming you have joined a credit union for your banking needs, (See Chapter 10, Banks and Financial Institutions.) arrange for automatic bill payment and have a specific amount transferred into your savings account every month. Ideally, you will be saving 10% of your disposable income each month. However, this is impossible to do in your first or second job. Start out with 5% of your take-home pay and slowly ramp it up to 10%.

Begin saving early to take advantage of the compounding of interest. In simple terms, this means if you put \$1,000 in a savings account, and in year one you earn 10% interest, this means you will have \$1,100 at the end of the first year. If you leave the \$1,100 in the account and continue to earn 10% interest, you will not only earn interest on the original principle of \$1,000 but you will also earn interest on your year one interest. Thus, at the end of year two, you will have \$1,210 in your account.

There are websites such as [www.bankrate.com](http://www.bankrate.com) that give you compound interest calculators to estimate the value of your principle over time, but the Rule of Seventy can also calculate your money's growth. Take the number 70 and divide into it the interest you earn. Assuming compounding of interest, the result is the number of years it will take for your money to double. Using our example above, if you are earning 10% per year your money will double in seven years. (A 10% return is not an unrealistic goal. As you will see in Chapter 15, The Vanguard Group has shown that, going back to 1926, a mutual fund containing a very broad portfolio of U.S. stocks (i.e., the stocks in the S&P 500 Index) has earned 10% per year).

*Invest in your retirement plan.*

If your employer provides a retirement plan, for example, a 401(k), and matches your contribution to it, always contribute the maximum your employer will match. If you really think about this, you are earning 100% return on your money; the employer is doubling the money you contribute. You should even give up your lunch or other non-essential expenditures to contribute the maximum.

Employers often have 401(k) plans where they will match your contribution up to 4% of your gross salary. These plans have taken the place of the traditional guaranteed pensions and have shifted the burden of managing each worker's retirement fund from the employer to the worker. However, if you put your retirement contributions in a mutual fund of all stocks with a good manager such as Vanguard, you can earn the 10% annually. The value of a 401(k) plan is that the money you contribute and the money your employer matches are tax-deferred (but not tax-free). That is, you are not taxed on these contributions nor on the annual return (presumably 10% annually) until you withdraw money for your retirement. If your employer does not offer a retirement plan or if you are self-employed, you can create either an Individual Retirement Account (IRA) or a Roth Individual Retirement Account (Roth IRA) and still earn the same returns. As of 2019, you can contribute up to a maximum of \$19,000 into a 401(k) and \$6,000 or \$7,000 into a Roth IRA.

*Invest for growth.*

Until you are within a couple of years of retirement, you should invest your retirement funds and other extra income for growth, which means investing in stocks. Although stock prices have more volatility than bonds, they return double what bonds do over time. You will need to be able to stomach that volatility in order to get the higher return. In Wall Street terms, a bull market is a market in which prices are going higher, while a bear market is a market in which prices are going lower. This archaic language comes from the fact that a bear hits downward with its paws while a bull goes upward with its horns. See Chapters 14 and 15 for more detail on the joys and risks of investing in the stock market.

*Avoid bad debt.*

Debt used for investing in something, such as a house, your education, or your car is good debt. Credit cards are bad debt—debt for consumption purposes. If you buy something with a credit card, pay it off at the end of month. Credit cards charge anywhere from 9% to 25% per month, depending on your credit score. If you pay only the minimum each month, you can end up paying double the original amount you borrowed. If you really need to pay for something on a credit card, such as car repairs or a new computer for school or work, use the credit card that charges the lowest interest rate and then use another credit card for your other purchase and pay it off every month.

*Do not overpay for anything.*

Do not overpay on fees or commissions for investing in stocks and do not overpay on your taxes. I talk about each of these issues in the chapters on investing and on taxes. Financial advisers usually charge 1% of your assets annually to tell you what stocks to buy. None of the actively managed portfolios or mutual funds has consistently exceeded the return on the S&P 500. Index funds or Exchange Traded Funds will hold all the stocks in the S&P 500 or similar indexes and will charge less than ¼% of your assets annually and still return 10% per year on average. Furthermore, do not overpay on other big purchases, such as televisions and appliances. Shop around.

*Protect yourself.*

The ideal goal is to build up a fund worth six months' expenses. This is a very difficult goal to accomplish, so when you are young try to save at least one month's rent for starters. Why do all the experts pick six months as the ideal amount in this emergency fund? This is because it takes about six months to find a new job if you are laid off. You can go on your job search without falling apart emotionally. Also, buy renters insurance (It's very cheap) and, if you own a house, a decent house policy with a reasonably low deductible.

You may have an accident and be unable to work. Many employers pay for a minimum amount of disability insurance that will pay you 60% of your salary if you are disabled long term. If you own a home and have a family, you should consider buying some long-term disability insurance as a supplement to your employer's. It is pretty inexpensive. As to life insurance, do not buy a whole life policy. Whole life insurance is a rip-off. If your life is financially complicated with a house and family, buy term life insurance. It is much cheaper than whole life insurance.

*Keep your investing simple.*

As I said above, keep your investments simple. Do not chase fads, such as cryptocurrency or 3D printing companies. Invest in an Index Fund that has the S&P 500 stocks in it, and you will pay low fees and earn on average 10% per year. Also, a mutual fund with the S&P 500 stocks in it will have Google, Apple, Facebook, and any other significant stock worth holding, so you can still ride the high-tech wave with your mutual fund.

*Seek unbiased advice.*

I strongly advise you to go to Vanguard and invest in one of their index funds. Vanguard is owned by the customers who invest in its mutual funds, so it is essentially a non-profit. There are no stockholders, so they can keep their fees low. Jack Bogle, the founder of Vanguard, invented Index Funds (passively managed funds that track a stock market index like the S&P 500) because he saw that actively managed mutual funds were not beating the S&P 500 returns and were charging a fee of 1% of assets.

Finally, do not buy individual stocks from a stockbroker, and do not buy mutual funds that charge you a commission to get into them. You cannot pick the consistent winner stocks and the brokers who charge you a commission to get into a fund often sell you the investment that gains them the highest commission, not the investment that fits your needs.

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