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The Essentials of Financial Planning for College Graduates

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Abstract

As graduation day approaches, many college students look forward to a time of independence when they can pursue their lifelong dreams and passions. Due to a lack of knowledge about personal finance, young adults are inadequately prepared to manage their money after they graduate from college. These individuals usually make many detrimental mistakes until they finally learn how to make good financial decisions; however, most never master this art. If college graduates have the correct knowledge and motivation for getting control of their finances, they can achieve financial security by making wise decisions from the start. College students need to understand various components of personal finance, including building good credit, avoiding debt, investing, real estate, and planning for retirement. All of these subjects will be covered from the perspective of a recent college graduate who, ready or not, has to make these financial decisions. This guide will provide insightful information that individuals need to know in order to be financially successful.

The Essentials of Financial Planning for College Graduates

Introduction

In today's society, many college students graduate from various universities with little more than a degree and fun memories. Unfortunately, the majority of them have not even thought about preparing for the future, but they are determined to achieve their dream of a big house and a nice car with little means of getting there. Financial planning is important for many reasons. Everyone has passions and dreams that they want to fulfill in life, and the majority of them require money. From feeding hungry children in Africa to sailing on a yacht in the Caribbean to going to college, all of these dreams require money, and a lot of it. Whereas most people end up giving up on their dreams, those who are diligent in managing their finances are able to accomplish them. This presents the case for financial planning early in life. Most college graduates would say that they desire financial security, so they will need to play an active role in managing their personal finances if they want to achieve this goal. There are many other reasons to be a diligent financial planner, but in a nutshell, college graduates need to plan for their financial future so that they can escape the miserable mediocrity of many Americans who lack financial savvy and accomplish all of the great things in life that they desire. The goals of this thesis are to identify common mistakes that students make when first starting out, to demonstrate the importance of avoiding these pitfalls, and to outline the essentials of financial planning for college graduates.

Common Financial Mistakes

Ignorance and Failure to Plan

High expectations after graduation. The majority of college juniors and seniors surveyed by Citigroup believe that they will have reached financial security within three years of graduation. When asked about salary, 59% of these students believe they will earn $30,000 or more the first year after they graduate, and 32% expect to make at least $40,000 (CitiGroup Press Release, 2007). In reality, most college students will graduate with thousands of dollars in student loans and credit card debt, not to mention the responsibilities of rent, food, and other necessary expenses. Although these college students are very optimistic about their futures, the same survey reported that less than half of these individuals think they have sufficient knowledge to manage their finances and credit responsibilities after graduation, and 69% of them admit they might have to ask their parents for some financial assistance (CitiGroup Press Release, 2007). Studies have shown that college graduates who overestimate their future income are more likely to be in debt than those with more reasonable lifestyle expectations (Norvilitis, 2006). Because of this, it cannot be stressed enough to start planning as early as possible in order to meet all current financial obligations as well as to plan for future dreams of financial independence.

Lack of financial education. One of the most important things to realize about personal finance is the need to actually set financial goals and make plans to achieve them. Since it is a lot easier to spend money rather than make it, the need for a budget is crucial. Unfortunately, few college graduates, or consumers in general, understand this simple concept, and it leaves them drowning in debt while crushing their dreams of achieving any type of financial security. According to a survey conducted by the Financial Services Authority, individuals between the ages of 18 and 40 are significantly

less financially capable than their elders, partly due to the increasing costs of education and retirement, as well as rapidly changing economic and social trends (Datamonitor, 2006). The survey also stated that approximately 70% of these individuals have made no plans for an unexpected drop in income, and 37% are making no plans for retirement.

A lot of these problems could be solved if people were informed and knowledgeable about financial issues, a subject that is unfortunately not emphasized enough in high schools or colleges. Specifically, the lack of financial knowledge that is typical among young college graduates causes them to overestimate their future income and be more tolerant of debt (Norvilitis, 2006). The good news is that this is one of the easiest problems to fix, if college graduates are willing to take a proactive role in managing their finances when they are first starting out. In fact, recent studies have shown that even though college students are not prepared to manage their own money after graduation, they are enthusiastic about learning how to become more responsible in this area. According to the Citigroup study of over 1,000 college juniors and seniors, 77% of upperclassmen are concerned with establishing good credit, 76% admit that they should do a better job of managing their spending, and 92% feel that financial education is very important (CitiGroup Press Release, 2007). This is a very good sign for today's college graduates; however, they must turn their eagerness into action, which is very possible with the right information and proper motivation.

Delaying Repayment of Student Loans

In general, employees with a college degree make more money than those who do not have one. As reported by College Board, students with associate's degrees make 29% more than those without, and students with bachelor's degrees make 62% more than

students who only graduated from high school (Garrett, 2007). For this reason, taking out a loan to pay for a college degree is not only necessary to fund one's education, but it is a wise investment. There has been a dramatic increase in the number of student loans issued in the past decade. The percentage of students with at least some student loans has risen from 49% to 66% in the past ten years, mostly due to the skyrocketing increase in the cost to attend college today (Garrett, 2007). While some students graduate having found ways to leave school debt-free, others graduate with student loans ranging from $1,000 to hundreds of thousands of dollars. The average is about $21,000. Fortunately, the interest on these loans is tax deductible; however, many students are placing less and less priority on paying back their student loans after graduation, letting them remain outstanding until their forties or even fifties (Pinto, 2006). This is disconcerting, as some private loans have variable interest rates that can reach 20%, though most fixed-rate student loans are under 10% (Gordon, 2007). Delaying the repayment of sometimes enormous amounts of student loan debt can prevent college graduates from achieving their financial goals as quickly as they would like, and the balance will only increase the longer they wait to pay off the debt. Though some have argued that paying off student loan debt should be one's last priority because of the tax savings, it seems wiser to pay down student loans as quickly as possible, in order to move forward without any past obligations haunting graduates in the future.

Accumulating Unnecessary Debt

Rise in consumer debt. There has been an enormous rise in the amount of consumer debt in America over the past several years. The annual rate of increase last year was 5.3% according to the Federal Reserve, amounting to a total of $2.5 trillion in

total outstanding consumer debt in the United States as of December, 2007 (Federal Reserve Data, 2008). A lack of self-control as well as a desire for instant gratification has landed millions of Americans in this much debt, and the total is growing larger every day. Debt of this magnitude did not exist before credit cards became so popular, which gave consumers the ability to spend money they did not yet have. One of the main things that make credit cards so attractive is that an individual is only required to make a minimum payment on his or her balance each month; however, high interest rates on credit cards only serve to add to the remaining balance, taking years to pay off. According to the Federal Reserve Board, in 2003, 76% of American families had at least one credit card, and 44% had recurring credit-card debt (Norvilitis, 2006). As of 2005, the average American had approximately $8,562 in credit card debt. This may not seem too bad, but for someone making the minimum payment each month, this debt will take twenty-nine years to be repaid after the average interest rate of 11.82% is factored in (Opdyke, 2006). This amounts to $8,016 extra in interest, almost as much as the original balance. In essence, this is no different than throwing money away, and it is something that a recent college graduate should not get involved in.

Facts about credit-card debt among college students. From the moment students graduate from high school, they are bombarded with mailings and advertisements for credit cards, tempting them to open an account to which they can charge everything that they need or want. In fact, in 2003, Nellie Mae conducted a study that showed that 83% of undergraduates have at least one credit card (Norvilitis, 2006). Even more surprising, 23% of students had a credit card before they even started college (Mansfield, 2007). Sallie Mae reported that half of undergraduate students accumulate more than $5,000 in

credit-card debt in college and one-third take on over $10,000 before they even graduate (PR Newswire, 2007). The average monthly balance carried on college students' credit cards is currently $2,169 according to Nellie Mae. Only 21% of students pay off their full balance each month, meaning that the remaining 79% either do not make their payments on time, or they only make the minimum payment on their debt (Mansfield, 2007). This will do nothing except create an unbearable burden of debt weighing down on college students the moment they receive their diplomas. In fact, financial experts estimate that about half of college students who graduate have an unmanageable amount of debt, and the payments will exceed 8% of their monthly income (Pinto, 2007). This amount of spending must be restrained if college graduates desire financial security in the future.

What does all of this debt mean? After the previous discussion, it is evident that not only college students, but Americans in general, have a spending problem. This means that if excessive spending habits continue, individuals will end up in a category with 2.06 million others each year in America: bankruptcy (Opdyke, 2006). Many people seem to have the perception that bankruptcy is only something for homeless people or those in extreme poverty, but it happens more often than most people believe, and it starts with financing unnecessary spending with unsecured debt. This represents a harsh reality that is contrasted with the lifestyle of wealth and financial independence that most college graduates desire for themselves. Any book on personal finance or money management will say that wealth is not determined by how much money one makes, but by how much money he or she spends. Individuals may not always have control over how much they make, but they can most definitely take control over where their money

goes after they get it. There is a big difference between the characteristics and money attitudes of those who are in debt and those who are experiencing financial security. Individuals who have large amounts of debt usually lack self-control as well as adequate financial knowledge. They desire instant gratification, and they make no attempt to save money (Norvilitis, 2006). On the other hand, individuals of great wealth realize the value of making wise financial decisions. They exercise self-control in these decisions, and they save their money, usually investing at least 20% of their annual income (Bach, 2002). The keys to financial success are being educated, getting control of one's spending, and eliminating unnecessary debt.

A word about debt. At this point it is good to interject a few words about debt in order to prevent any misunderstandings on the topic. The past several paragraphs have discussed the growing problem of debt and why it should be avoided; however, it should be mentioned that not all debt is bad. Credit cards can actually be a great tool if managed properly. If used wisely, credit cards can help students improve their credit score. This can be beneficial when the time comes to buy a car or house because a higher credit score means lower interest rates on loans for these things. In fact, one of the primary principles of investing, especially when investing in real estate, is that leverage is essential to generating high returns. Leverage is simply using other people's money to make money, and it can lead to large profits. Taking on debt to buy a house, for example, can be good debt because an individual is able to build equity in his or her home, or lease it as income producing property. The objective for the previous discussion on debt is to demonstrate the danger of using credit cards to fund unnecessary wants and desires, not to discourage someone from taking on any debt at all.

Failure to Save

A common trend among recent college graduates is to spend everything that they earn as soon as their paychecks come in. This is usually the first time that these individuals have had large amounts of steady income, making them feel wealthy and empowered to buy new things. Many use it as an opportunity to buy a new wardrobe, go on a nice vacation, or purchase a new car (Masterson, 2006). In and of themselves, these things are all fine, but not if they cause someone to spend every last penny that they have. It is shocking that many people make no effort to save money for future use, especially those who are approaching retirement age and really need the extra savings. In fact, the average American works 90,000 hours in his or her lifetime, and by the age of 50 has only $10,000 in savings (Bach, 2002). These people are cheating themselves out of financial security by spending money on things that they most likely did not truly need in the first place. As will be discussed later in the investments section, saving money is the greatest way to achieve great wealth. It is the only way that people can let their money work for them, rather than having to work for their money. The power of compounding interest found in various investments can turn small amounts of savings into millions of dollars, but someone has to be willing to put this money aside without spending it if they want their finances to grow.

The Importance of Financial Planning

At this point, one may wonder why personal finance should even matter to college graduates. After knowing all of the things that people are doing wrong with their finances, some may believe that financial planning simply takes too much effort or they could never get it right. Too many people look at their own situation and they all reach

the same conclusion: they want to be rich, but they are not. And most people stop here. The key is that people want to be rich, and they can be, no matter how many financial mistakes they have made in the past. Life does not have to be, and is not meant to be, merely toiling through one meaningless job after another trying to make ends meet. Money is the cause of too many troubled minds, sleepless nights, failed marriages, and unfulfilled dreams. Since everyone has to have it, and it seems like there is never enough of it, why not master the art of financial planning and conquer the issue once and for all, so people can focus on more important things in life?

Financial planning is often a foreign concept to college students because in almost twenty years of education, they have not been provided with guidance in this area. While students learn about history, science, and math, often the practical issues in life, like how to manage finances, are not emphasized. Many parents have a hard time teaching their kids about finances because they are in financial trouble themselves. To the extent that parents have instructed their kids to "not spend all their money in one place" and "always keep some money in the bank," students must navigate the road of personal finance alone and learn along the way, usually after many mistakes. This could be avoided by learning how to financially plan for the future, a concept that seems overwhelming, but is not that hard.

The Essentials of Financial Planning

Principles of Investing

Introduction to investing. The benefits of smart investing cannot be emphasized enough. Investing in a variety of stocks, bonds, and other securities is the best way to acquiring massive amounts of wealth over time, and it is one of the primary ways that a college graduate should go about achieving financial security. Many college graduates

are skeptical of getting involved in the financial markets because they either think that they do not have enough money to start investing, or they do not believe they are smart enough to invest without losing all of their money. Simply observing the chaos on the floor of the New York Stock Exchange is enough to turn most people off to the thought of trying to compete with the financially skilled in such markets. Contrary to popular belief, a college graduate does not have to possess a major in finance to understand how the markets work or how to start investing. Warren Buffett, owner of Berkshire Hathaway and arguably the world's greatest investor states, "Success in investing doesn't correlate with I.Q. once you're above the level of 25. Once you have ordinary intelligence, what you need is the temperament to control the urges that get other people into trouble in investing" (Kiplinger, 2007, p.1). The goal of the investments section in this guide to financial planning is not to instruct someone how to beat the markets or even to promote the hottest tips circulating newspapers today. Rather, the goal is to teach college graduates the principles of smart investing for the stage of life that they are currently in, and to lift the veil of confusion from those who think bulls and bears are just animals and that blue chips are used in poker. For these reasons, financial instruments that are discussed below include short-term securities, bonds, stocks, and mutual funds. The resources that provide information on these securities and how to diversify risk in a portfolio are also covered.

The power of compounding. The power of compound interest is what makes investing so profitable. The principle behind compounding is the simple fact that an individual not only earns interest on their initial investment, but they are paid interest on their interest. The advantage that college graduates have over older individuals is that

they have a lot of time to let their interest compound before retirement, which can literally be a million dollar difference from someone who doesn't start investing until their thirties. This is why it is so important to start investing early, to take advantage of this benefit. To illustrate, a twenty-two year old who starts investing $2,500 a year, only $210 a month, at a 10% annual rate will have about $1.5 million dollars by the time they reach the age of 65. Comparatively, someone who starts investing the same amount at the same rate, but waits until the age of 30 will only accumulate about $700,000 by retirement at 65, not even half of what the 22 year old will accumulate. This is due to the loss of interest in early years that cannot be recouped by the thirty year old who started investing eight years later. Therefore, college graduates have no time to waste and they should begin to invest as soon as possible. Just imagine the amount of money that could be accumulated by someone who is diligent in investing a set percentage of 15-20% of their income each month, especially if they start as soon as they graduate from college. This wise individual will not only be financially secure within a few years after graduation, but they will be a millionaire in no time.

Investing for the short-term. Many people do not want to keep all of their savings in a long-term investment that they cannot liquidate quickly; however, they do not want their money hidden under a mattress either. As a result, some money should be invested in short-term securities which can be liquidated relatively quickly, should the need arise. Many people keep their savings in regular savings accounts, but the interest rates for these rarely exceed 1% (Bankrate.com, 2008). This is not generally enough to even cover inflation, which has averaged 3% per year over the past century and eats away at investors' returns (BLS, 2008). For this reason, a smart college graduate will open a

money market account which is currently averaging returns of 3.8% per year, with a high of 5.1% (Bankrate.com, 2008). The numbers vary over time, but money markets usually return a percentage point or two higher than the national inflation rate. There are nearly 15,000 financial institutions that offer money market accounts today, each with various regulations regarding minimum balances and monthly withdrawal limitations. The initial investment required to open a money market account can range from $0 to $15,000; and while some institutions only allow a few withdrawals and transfers each month, others have unlimited free checking (Bankrate.com, 2008). Some money market accounts have greater benefits than others; therefore, the best way to go about opening one is to research a variety of banks and financial institutions to determine the best rates and features. Another option for short-term investments are CDs, or Certificates of Deposit. These are similar to savings accounts except that CDs offer a fixed interest rate for a specific amount of time, and investors are not permitted to make withdrawals without a penalty. They currently have interest rates ranging from 3 to 5%, depending on the time until maturity and the total amount invested (Bankrate.com, 2008). Another short-term instrument is the government Treasury bill, called the T-bill, which is fully insured and backed by the United States government. T-bills are debt securities issued by the federal government rather than banks, and instead of paying interest, they are issued at a discount and redeemed at full-price (Bach, 2002). The interest earned from treasuries is exempt from state and local taxes, another benefit of this investment (Gitman, 2004). Out of all of the short-term investment options, money market accounts are probably the most practical for college graduates because they provide competitive interest rates and the most liquidity. All of the short-term securities discussed above can have higher interest

rates and lower account fees if they are acquired through an online bank, as these companies have less overhead cost and are able to provide a more attractive offer (Opdyke, 2006). These are just a few ways that college graduates can earn money on their savings without tying it up in long term investments.

Bonds. The main reason for a college graduate to invest in bonds is to balance out the risk of stocks that are in an investment portfolio. These fixed income securities are less risky than stocks, which also means that they do not usually provide as high of a return (Opdyke, 2006). Bonds are a form of debt sold by corporations or the U.S. government. They are purchased at par value and pay a certain rate of interest each year that is determined at the time of purchase. The average annual return on long-term corporate bonds since 1926 is 6.2%, while the return for government bonds is 5.8% (Gitman, 2004). When evaluating bonds to purchase, a cautious investor will only buy the ones with high credit ratings issued by Standard & Poor's or Moody's credit-rating agencies. The ratings range from Triple A to "junk" bonds, which are any bonds less than a Triple B minus (Kansas, 2005). The risk of bond investing is less than investing in stocks; however, they can become risky if interest rates become volatile or if the credit rating is lowered. Nevertheless, bonds are a more conservative alternative for those who are wary of putting all of their money into stocks.

The stock market. Perhaps the most popular and profitable tool of investing, stocks have historically provided larger returns than any other type of investment, averaging 12.2% since 1926 for large companies, and 16.9% for riskier, small-cap firms (Gitman, 2004). The riskiness of stock investing is what makes the returns so great, which is why some regard the action as gambling. The good news for college graduates

is that they are able to tolerate the increased risk of stock investing, because they have plenty of time to ride out the highs and lows of the stock market. The key to success is making wise, knowledgeable decisions when investing in stocks, and behaving as an owner in that company. Too many investors dart in and out of different stocks as a result of "hot tips", which, not to be mistaken, can make quite a large sum; but someone who wants a consistent, sustained increase of wealth from the stock market should set goals and stick to them. For college graduates who want to participate in the stock market, rather than investing in individual stocks, mutual funds are a good alternative, which will be discussed shortly. Also, they should hire a financial advisor to manage their assets, someone who has experience dealing with the markets and who gets paid to research sound investments. There are a multitude of financial service firms in the country, each with their own perks, as well as disadvantages. These institutions either charge a flat fee for managing an individual's assets, a commission for transactions they carryout for their clients, or a percentage of the assets they manage, usually ranging from 1% to 2.5% (Bach, 2002).

Brokerage firms are financial institutions that execute buy and sell transactions for investors. They also provide services such as investment research, gathering market information, and issuing periodic statements of account activity (Gitman, 2004). Every year, Smart Money researchers survey the best brokerage firms by analyzing how easy it is to trade, customer service, website tools and research. Last year, they found the best premium brokers were E*Trade and Fidelity, and the best discount brokers were Scottrade and TradeKing (Parmar, 2007). Full service brokers were Merrill Lynch and Edward Jones. When it comes down to it, college graduates must do their homework on

whomever they decide to manage their assets and choose the best broker for their own situation.

Mutual funds. Mutual funds are ideal for new investors because of their ability to provide diversification in a portfolio as well as the high returns of the stock market. Mutual funds are essentially pools of money that are managed by individuals who invest in a wide variety of stocks and charge fund owners fees for these services. These fees come from "loads," which are commissions charged when shares of a mutual fund are purchased. Sometimes these fees can be reduced or eliminated by either purchasing a "no-load" mutual fund, which does not require commissions to be paid or a "low-load" fund, which only charges 2% to 3% (Gitman, 2004). Mutual funds have become increasingly popular over the years, currently managing about $7.5 trillion in assets as of 2004. Now one out of every two households in America owns shares in a mutual fund (Gitman, 2004).

There are many different types of mutual funds from which an investor can purchase shares, including actively managed funds, index funds, target date funds, exchange traded funds, bond funds, and sector funds. Actively managed funds are more expensive but history has shown that they rarely beat the major index funds, so college graduates would be better suited investing in index funds (Ferri, 2007). While many individuals believe that an actively managed fund will give them greater returns, eight out of ten neither equal nor outperform their matching index (Masterson, 2006). Various index funds track a certain stock index, like the Standard & Poor's 500 largest companies, the Dow Jones Industrial Average of thirty large stocks from various sectors in the market, the Wilshire 5000 most commonly traded stocks, and the Russell 2000

small-cap companies. Index funds are also cheaper and require less supervision than actively managed funds, which is perfect for college graduates who do not have extra time to constantly monitor their investments. The average annual fees for index funds range from .1% to .35% while they are usually greater than 1% for actively managed funds (Goldberg, 2007). Another type of mutual fund that is becoming popular among those saving for retirement is the target date fund. These funds require little follow-up, and their purpose is to manage risk by gradually diversifying away from stocks and into more bonds over time with a specific "target" date of retirement (Wherry, 2007).

Exchange traded funds, often referred to as ETFs, are similar to mutual funds which trade like stocks on the American Stock Exchange. In 2006, ETFs that tracked the AMEX index received a return of 15.3% (Fisher, 2007). A benefit of the ETF is the ability to buy and sell these shares throughout the trading day, resulting in greater precision in tracking the indexes (Opdyke, 2006).

Mutual funds also invest in various types of bonds, and are appropriately named bond funds. Certain bond funds, similar to stock index funds, track a certain index. A popular index on which some bond funds are based is the Lehman Brothers Aggregate Bond Index, which tracks the entire bond market (Kansas, 2005).

The final type of mutual fund to be discussed is the sector fund. Sector funds only invest in a particular industry or sector of the market. Many individuals like focusing their investments on specific sectors in the market because sometimes the most attractive returns come from these smaller sectors (Gitman, 2004).

Mutual funds are the perfect investment for a recent college graduate because they provide exposure to the market as a whole (compared to individual stock investing in

only a few companies), they require a smaller initial investment than stocks, and they often provide larger returns than the investors who try to beat the markets.

Diversification. After discussing what kinds of investments that college graduates should buy, it is important to address how much of each kind they should be holding based on their age. Jeff Opdyke (2006) says, "The academics who study Wall Street have shown that more than 90% of a portfolio's long term success depends not on what you own but how you allocate your money" (page 126). Diversification is basically including a number of different types of investments in a portfolio in order to control risk and return. A common calculation for appropriate diversification in a portfolio subtracts an individual's age from 110 and the resulting number represents the percentage of stocks that should be held, with the remainder invested in bonds (Bach, 2002). Thus someone who has just graduated from college in their early twenties should have about 90% of their money invested in stocks and only 10% in bonds. As these individuals get older, they should decrease the percentage of stocks and increase the percentage of bonds. The reason for this is that younger individuals have more time until retirement to endure the volatility of the stock market.

Preparing for Retirement

Many college graduates feel that they do not need to worry about retirement until they are in their forties and fifties; however, young people should start planning for this as soon as possible. A common trend among employees is that they do not take advantage of the retirement plans offered at their jobs or the matching contributions that their employers often provide. For those who have actually taken the initiative to open a retirement account with their employer, a common mistake is for them to not diversify

their money appropriately. According to a study done in 2003 by the Employee Benefit Research Institute, of their retirement savings, 38% of young people in their twenties invested no money in stocks, and 22% had only 50% in stocks (Kansas, 2005). As stated earlier, since college graduates should be investing for the long term, they should take on some riskier investments in order to grow their wealth at a faster rate. College graduates need to be diligent in taking advantage of the retirement plans offered by their employers and take an active part in determining how their money is to be invested.

Benefits of the 401(k). There are various names for retirement plans depending on which industry an employee works in, but for the sake of discussion the 401(k) will be of primary focus. 401(k)s are defined as employee sponsored salary deferral plans that allow employees to contribute a portion of their gross(pre-tax) salary to a savings plan (Kansas, 2005). These employee options are tax deferred retirement accounts provided by many employers that allow employees to contribute a limited amount of their gross income in order to save it for retirement. Most allow employees to choose among several investment options. The most significant benefit of the 401(k) is that many employers match a percentage of the employee's contribution, sometimes even doubling what the employee gives. The typical matching contribution is $.25 or $1 of every dollar that the employee invests (Opdyke, 2006). This is free money! A wise college graduate would be making a mistake not to take advantage of this benefit; however, as of 2004, only 72.6% of employees participated in a 401(k), down from 76.9% in 2001 (Marshall, 2004). As of 2006, individuals could contribute up to $15,000 of their gross salary to their 401(k)s. This number will increase $500 every year starting in 2007 in order to keep up with inflation (Opdyke, 2006). If possible, individuals should contribute the maximum

amount, and they should have it deducted automatically from their paychecks, eliminating the possibility of spending it.

Roth IRAs. Some companies do not provide matching programs, and in this case an individual should consider opening a Roth IRA. Roth IRAs have dramatically increased in popularity over the past few years. Roth IRAs are perfect for college graduates because they have many potential benefits over a regular IRA. The contributions to Roth IRAs are made with after-tax dollars, so when an individual makes withdrawals after retirement, they do not have to pay taxes on their initial investment or any interest earned. Those with regular 401(k)s have to pay taxes on all of the money they withdraw after retirement. The Roth IRA is beneficial because most college graduates are in lower tax brackets now than they will be in forty years, so they are saving money by paying the taxes on the contributions rather than the withdrawals. Also, the Roth IRA has no minimum withdrawal requirements or age limits, which makes it the only retirement account with these benefits (Adelman, 2005). A recent development is the approval of the Roth 401(k) in 2006. This option combines the benefits of the 401(k) and the Roth IRA but only 20% of eligible 401(k) plans currently have them (Jones, 2006). The main point is that it is better to pay taxes now so that retirement withdrawals will not have to be taxed, which is only provided by Roth retirement plans.

How to manage a retirement account. Employees have a variety of investment options in their retirement accounts, depending on what their employer offers. They can choose from stock and bond funds, variable annuities, guaranteed investment certificates, and sometimes individual stocks (Kansas, 2005). As a result of employees not managing

their 401(k) plans effectively, many companies have hired financial advisers to manage them, which has tremendously helped the uninformed investor.

It is often desirable to rebalance the allocation of different investments in a retirement account about once a year. This practice is only to ensure that the diversification of securities in the account still matches up with investment goals set at the beginning. By rebalancing their retirement accounts annually, individuals are able to make any adjustments to the amount of risk in their plan relative to their current stage of life. Other than these few tips, managing a retirement plan is not extremely difficult; all it takes is the initiative to set up a 401(k) or IRA and make regular contributions, something that a smart college graduate will do as soon as possible.

Real Estate

Nothing has recently made more headlines than the situation involving real estate and the subprime crisis. During the past several years, imprudent lenders have offered mortgages to people with little or no down payments, poor credit history, and sometimes to borrowers who did not even have a job. Also at fault, many irresponsible home buyers obtained mortgages that they are unable to afford. Many of these sub-prime mortgages are fixed at a certain rate for a short period, but then reset to higher interest rates. These individuals find they can no longer afford the payments and many are foreclosing their homes (Lucchetti, 2007). The lesson to be learned from this crisis in the economy is that before someone purchases a house, they need to determine a monthly payment they can afford and they need to be able to pay a sufficient down payment. This section on real estate will address whether a college graduate should rent or buy a home, and how individuals can start investing in real estate.

Leasing a Home

For the majority of college graduates, renting an apartment or house makes the most sense for at least the first couple of years after graduation. Most people do not have enough money to buy a house right away, and this would probably be unwise until they are settled in a certain area and plan to stay there for an extended period of time (Opdyke, 2006). By renting, college graduates do not have to worry about carrying mortgage debt, paying for repairs or maintenance, and they have the flexibility to relocate without the hassle of having to sell their residence. Financial advisors say that college graduates should plan on paying about 35% of their take-home pay for their rental payments (Brown, 2007). The downside to renting is that the money paid each month is gone after it is paid, while mortgage payments can help homeowners to build equity for themselves. Purchasing a home is one of the greatest investments someone can make, because property values generally appreciate over time (though some home values have fallen considerably given the current sub-prime crisis). According to Dave Kansas, until college graduates are somewhat settled in one place for more than five years, they should continue to rent their personal residence (Kansas, 2005).

Buying a Home

Requirements for obtaining a mortgage. If they are able to afford it, college graduates should buy a home in order to build equity for themselves rather than filling the pockets of someone else. Some of the benefits of owning a home include potential increased value over time, tax deductible mortgage interest, and personal equity that can be used for a loan or line of credit. There are some disadvantages to buying a home, including closing costs, brokerage fees, and certain risks that either the home will not

easily be resold, or that it could perhaps decline in value. Currently, the average American house costs $250,000, and interest rates are 4.95% on a fifteen year mortgage and 5.47% on a thirty year mortgage (Bankrate.com, 2008). There are many ways of determining if a house is affordable or not, including two ratios that mortgage lenders will look at when determining whether to sell someone a mortgage or not. The front-end ratio is the total monthly mortgage payment divided by the individual's monthly gross income. The general rule is that principal, interest, taxes, and insurance (PITI for short) cannot account for more than 29% of an individual's gross income. Therefore, someone making $50,000 a year could afford a mortgage payment of about $1,200 per month. The second ratio, called the back-end ratio, is the total monthly debt divided by an individual's gross monthly income. The industry usually requires that the mortgage payment as well as all other monthly debt not exceed 41% of monthly gross income (Opdyke, 2006). Another factor in obtaining a mortgage is having a good credit score; otherwise an individual with poor credit may have to pay a larger down payment and a higher interest rate, or they may not qualify at all. As discussed earlier, the importance of building good credit and minimization of unsecured debt is essential for a time such as this.

Always make a down payment. Some lenders will sell mortgages without requiring a down payment, but this is a mistake on their part as well as the borrower's. An appropriate down payment is between 10-20% of the purchase price of the home. It is important that a person does not acquire a mortgage that they cannot afford. Many lenders offer attractive interest rates on an adjustable rate mortgage; however, these rates can reset to higher interest rates after a few years, and homeowners often cannot afford

their higher mortgage payments. The major lesson learned from the turmoil currently taking place in the housing markets is that individuals must make sure they can provide a sufficient down payment from the beginning and that they can afford the monthly payments.

Types of mortgages. There are two main types of mortgages: fixed and adjustable rate. Fixed rate mortgages require the same payment every month until the loan is repaid. Adjustable rate mortgages usually have "teaser rates" initially which are lower than the interest rate charged on a fixed rate loan. After the reset date, which usually occurs after the first few years, the interest rate increases or decreases depending on economic conditions and a variety of other factors (Brueggeman, 2008). If an individual plans to live in their house for a long period of time, or if interest rates are highly uncertain, he or she should get a fixed rate loan. If someone only plans to live in a house for five years or less, or if interest rates are expected to fall, they would be wise to consider an adjustable rate mortgage. Adjustable rate mortgages do carry risk though, as there is the possibility that interest rates increase or decrease dramatically, which will be reflected in their mortgage payments. As far as length is concerned, typical mortgages are amortized over fifteen or thirty years. Even though the 30-year mortgage is most common, individuals should consider paying down their mortgage sooner. Given the average house price of $250,000 at current interest rates, this house will end up costing $353,518 with a 15-year mortgage and $505,378 with a 30-year mortgage, a $151,860 difference! (Opdyke, 2006). Having a shorter mortgage will allow individuals to build equity quicker and save a lot of money in interest. There are, however, many benefits to having a 30-year mortgage, including lower monthly payments and large tax advantages. When deciding to buy a

home, many factors determine which type of mortgage to purchase; therefore, an individual must research current interest rates and other economic conditions that affect their own situation.

Investing in Real Estate

Buying real estate as income producing property can be a wise investment move that a college graduate should consider including in his or her portfolio. One of the main reasons that real estate can provide such large returns is because investors can use leverage to increase their profits. Leverage is using someone else's money to make money, which can be accomplished by obtaining a loan to build or buy a house, selling that house, and using the proceeds to pay off the loan. Many college graduates cannot afford to invest in rental property immediately, but they can still put money into real estate by investing in Real Estate Investment Trusts (REITs). REITs pay dividends and trade like stocks, and in 2004, they were the best-performing mutual funds sector in the U.S., providing a 32% return (Kansas, 2005). They act like mutual funds in that they pool investors' money and invest it in real estate, something that the average college graduate might not be able to do right away. With the recent downturn of the housing market, REITs are not performing as high as normal, but it will only be a matter of time until the markets stabilize. In fact, now might be the best time to get into real estate, because prices are low and the market might be expected to return to normal by the end of 2008.

Resources

There is a myriad of resources which can help the recent college graduate find personal finance solutions to their own specific needs and monetary situations. Virtually any question about finance can be answered at one of these places. Here are a few internet resources that provide a variety of information that will equip new investors, retirement planners, and homebuyers:

- Bankrate (www.bankrate.com) provides a comprehensive look at national interest rates for savings accounts, money markets, mortgage loans, bonds, and almost every kind of long and short-term security. An individual can quickly and easily find up-to-date interest rate quotes in their own city and state and compare them to find the best one. They can also find local rates at local banks or brokers in their area.
- Citi Bank (www.citi.com) has a Young Professionals website that is an excellent source for providing articles and guidance on every principle discussed in this thesis. They also have a separate website called Citi Credit-ED, specifically designed to help college students and other young people learn how to budget properly, use credit wisely, and improve their credit scores. Their calculators for real estate can help a potential homebuyer determine the amount they can afford to pay for a mortgage, the tax implications of selling their house, whether to refinance at a new interest rate or prepay the mortgage, and how much closing costs will be. They also have retirement information and tools to help individuals prepare for the future.

- Kiplinger (www.kiplinger.com) covers all areas of personal finance and gives practical knowledge about the basics for individuals starting out. It also provides some beneficial research for new investors in the mutual fund center, and provides tips on how to choose the best online broker.
- Yahoo! Finance (www.finance.yahoo.com) is a great website for someone who wants to track stock performance, manage his or her portfolio, or research the history of almost any company. It also has articles from popular news sources like CNN Money, CNBC, The Street, and Investor's Business Daily, as well as many "how-to" guides for those who have little experience with finance.
- Morningstar (Morningstar.com) is similar to Yahoo! Finance, but it is popular for providing exceptional research and information on mutual funds and ETFs, which as previously mentioned are ideal for college graduates. They are also famous for their rankings of the best mutual funds for various investors and their different investment goals.
- WSJ.com (www.wsj.com) is the online version of the Wall Street Journal, which is the most popular resource for international business and financial news. Some parts of this website do require a subscription, but all of the economic data and market performance data is available to anyone who accesses the website.

Any college graduate who spends some time on these websites will be able to learn valuable lessons about personal finance as well as gain access to insightful market and economic research that will help them make solid financial decisions.

Conclusion

Financial security is clearly an attainable goal for the individual who takes a disciplined approach to spending, saving, and investing. By following the basic principles described in this thesis, college graduates can embark on their career with confidence that they have the knowledge and ability to manage their own money in such a way that they can avoid many of the mistakes made by those who have gone before them. By first educating themselves and then acting on that knowledge, today's college graduates have the potential to fulfill their dreams and passions because they have made wise decisions from the start.

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