Managing Your Money When You're Starting Out

6-step action guide for teens and young adults

Written by the Editors of *Kiplinger's Personal Finance*

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Your Road to Financial Wellness Starts Now

6 STEPS YOU CAN TAKE TODAY

This is an exciting time for new beginnings. You may be headed off to college soon, starting your first summer job, or even launching a permanent career.

It's also a time when you'll be asked to make some big financial decisions. You might have to figure out how to pay for college—or repay education loans. Your new employer might offer you a retirement plan that requires you to choose among investments you've never heard of before. Or, you may wonder how you can get started with saving for that vacation abroad and your first car or home.

It can all seem complicated and a bit intimidating. But navigating life's finances is not as difficult as you might think. For instance, saving even small amounts can pay off big over time. And for investing newbies, there are simple funds that do the hard work for you.

Establishing some good financial habits early on will also put you in a solid position to reach your near- and long-term goals. And this action guide can help. It outlines six financial steps you can take now to build a sound financial foundation:

- Start saving and watch your balance grow.
- File your first tax return.
- Be smart about student loans.
- Start off right with credit and debt.
- Open a Roth IRA.
- Become an investor.

Now let's take a closer look at the six steps.

STEP 1: Start saving and watch your balance grow

Maybe you're not earning a big paycheck at your after-school job or on that first step of the career ladder after college. Nevertheless, you have a huge savings advantage—time. That along with "compound interest" can turn even small savings deposits into big balances.

GROW YOUR SAVINGS

When you deposit money in a savings account, the bank will pay you interest on the cash. That interest is added to your balance on a daily, monthly, quarterly or yearly basis. Then the bank pays you interest on this bigger balance, which again is added to your account. And so on. You're earning interest on your interest, and that's called compound interest.

Albert Einstein reportedly called compound interest the "eighth wonder of the world." It doesn't take a genius to see why.

Say you deposit $100 in a savings account paying 3% annual interest. The interest compounds daily, so the interest you earn is added each day to your balance. If you continue to contribute $100 a month, by the end of 10 years your balance would be $14,129. And $2,029 of that is the interest you earned just by keeping your money in the account.

SHOP FOR THE BEST TERMS

Look for a bank or credit union that pays the highest annual percentage yield. The APY is the interest rate you will earn on your money if you leave it in the account for a year and let the interest compound. Online banks and credit unions often offer the highest APYs. (If you're younger than 18, you generally will need an adult to be a co-owner of your savings account).

Not sure where your money goes? Free budgeting apps, such as Mint.com and Wally.me, can help track your spending and identify dollars you could put toward savings.

Look for interest that compounds daily, rather than quarterly or annually, so your money grows faster.

And don't overlook fees. Some banks charge a monthly maintenance fee of $4 to $8 if your balance falls below, say, $300 or $500. Some institutions waive this fee for minors. Others don't require a minimum balance or charge a fee.

TAKE-AWAY ACTION STEPS

- **See how much your money can grow** by using the Compound Interest Calculator at **Investor.gov**.
- **Find the highest rates** offered by banks and credit unions at **Bankrate.com** or **Depositaccounts.com**.

STEP 2: File your first tax return

Your age, filing status, income and whether you're a dependent are just some factors that determine whether you must file a tax return. To find out if you need to file, use the IRS tool at **www.IRS.gov/help/ita/do-i-need-to-file-a-tax-return**. For most young people, though, their first job is followed by their first tax return. Young single workers in 2020 must file a return if their annual earnings are $12,400 or more.

Even if you don't have to file, do so anyway to get a refund of the income taxes taken out of your paycheck. (Consider putting some or all of your refund into a retirement account or a savings account you can tap for emergencies.)

WHEN TO FILE

The tax season kicks off each January, with tax returns usually due by April 15. To file, you'll need your Social Security number and your W-2. The W-2 is a form employers must send out by the end of January to employees and states the wages they earned and the amount of taxes withheld for the previous year.

WHAT'S FICA?

FICA is a big shock to workers getting their first paychecks. The Federal Insurance Contributions Act tax automatically reduces your paycheck by 7.65% to fund Social Security and Medicare. Your employer kicks in an equal amount. If you make $30,000 a year, for example, your annual share of FICA is $2,295.

Need help from an expert? **The IRS's Volunteer Income Tax Assistance (VITA) provides free tax preparation for taxpayers with low- to moderate-incomes. Find the nearest VITA site at IRS.treasury.gov/freetaxprep.**

HOW TO FILE

Tax software can help you fill out your Form 1040 individual tax return by fixing math errors and alerting you to tax breaks. For example, college grads may be able to deduct up to $2,500 in student loan interest they've paid during the year. The IRS Free File program (at **IRS.gov**) makes tax software available for free to most taxpayers. Free File prepares federal returns and, in some cases, state returns, too. The returns are electronically filed, which speeds up the timing of your refund. Also for speed and safety, have the IRS directly deposit your refund into your bank account.

TAKE-AWAY ACTION STEPS

- **Track your refund** by using "Where's My Refund?" at **IRS.gov**.
- **A big refund** means you're having too much in taxes withheld. Put more money in your paycheck by updating your **W-4 form** with your employer.

STEP 3: Be smart about student loans

Prepare for sticker shock. The average cost of college, including tuition, fees, and room and board, is approaching $50,000 a year at a private college and more than $21,000 a year for an in-state public school. And the price of some schools on many students' list of "dream colleges" exceed $60,000 or even $70,000 a year.

Fortunately, most families don't pay the full sticker price—thanks to financial aid. Still, tuition and fees keep rising, and many students are meeting these higher costs by borrowing. Student loan debt has more than doubled in the past 10 years to $1.48 trillion today, reports the Federal Reserve Bank of New York.

Borrowers with bachelor's degrees are starting their careers with an average of $28,500 in student loan debt, according to the College Board. Student debt is even causing some grads to postpone marriage, home ownership, or starting a business.

But you don't have to let education loans derail your future. Here are tips to keep debt in control:

Choose your school wisely. You can get a good education without going to the most expensive college in your field. The most affordable four-year school for you could be a public institution in your home state—and you may be able to save money by living at home. Or you can attend a less expensive community college for the first two years and transfer to a four-year institution to finish your degree.

You don't have to rule out all elite private schools. Some are affordable because of generous aid packages.

To find out what you might pay to attend specific colleges, check out the net price calculator on the school's website. Based on information you plug in, the calculator will estimate what you likely will pay after scholarships and grants are subtracted.

Keep debt manageable. A good rule of thumb is not to borrow more than your projected first-year salary. This will keep monthly payments affordable and allow you to

erase your debt within 10 years, the standard repayment term on federal loans.

For example, entry-level computer programmers earn on average $51,200, according to Payscale.com. Graduates in that field could more comfortably manage $50,000 in loans than a first-year elementary school teacher earning an average of $39,000.

Will your aid package go the distance? Check to see if your financial aid award is likely to shrink in future years. Look up the school on Collegenavigator.gov and click on financial aid. Compare the average awards for first-year students with those for all undergraduates.

If you're going to graduate school, the federal government offers grad PLUS loans that can cover up to the full cost of attendance, assuming you pass a credit check. But just because you can borrow that much, doesn't mean you should. Better to follow the rule of not borrowing more than you will earn the first year out of grad school.

When borrowing, take advantage of federal loans first. These generally offer more favorable terms and repayment plans than private loans. And to qualify for a private loan, you might need an established credit record or a co-signer who agrees to repay the debt if you don't.

WHEN IT'S TIME TO REPAY LOANS

Uncle Sam offers a variety of repayment plans. Several are income-driven plans that will base monthly payments on what income you have left after paying for necessities. The government also offers loan forgiveness programs. The Public Service Loan Forgiveness Program, for example, is for full-time workers at a government agency or certain types of nonprofits. Loan balances are erased after these workers make 10 years' worth of on-time payments under one of the income-driven plans.

If you have trouble making payments on your federal loans, you can request a deferment or forbearance. This will allow you to temporarily stop payments or lower the amount of your payment for a period. If you can't keep up with private loans, contact the lender to learn about your options.

TAKE-AWAY ACTION STEPS

- **Search for scholarships and grants** at free websites such as **Fastweb.com** and **bigfuture.collegeboard.org**. Never pay to search or apply for scholarships and grants.
- **Find out more about federal loans,** repayment plans, and loan forgiveness at **Studentaid.ed.gov**.

STEP 4: Start off right with credit and debt

You can't get a loan or credit card without a credit history. This is an ongoing, digital record of the amount of debt you have and whether you pay your bills on time.

Once you establish a credit record, it will follow you throughout your life. A landlord might want to check your credit report before renting to you. Banks and car dealerships will review your credit report before lending to you (and charge you higher interest if your history is poor). Even an employer might check your report before offering you a job.

When just starting out, here are ways to build a good credit history and keep it that way.

ESTABLISH YOUR CREDIT RECORD

Many young adults get their first experience with credit by becoming an authorized user on a parent's credit card. (You typically must be at least 18 to open a credit card in your own name, but authorized users can be younger).

Another option is to apply for a secured credit card. You make a deposit with a card issuer, say, $250, which usually matches your credit limit. If you don't pay your bill, the issuer can dip into the deposit. After a year of on-time payments, you can ask to be upgraded to a traditional credit card—and get your deposit back.

You'll likely qualify for a traditional credit card if you can demonstrate an ability to make payments, by proving you have a job, for example. To build a positive history with your card, pay your bills by the due date and try to keep the balance to less than 20% to 30% of the credit limit. The lower your balances each month, the better for your credit score. Lenders and other creditors use this score to decide whether to extend credit to you and under what terms.

Or, if you want to avoid credit cards, consider a credit-builder loan through a community bank or credit union. The amount you borrow is deposited in an account, and you make scheduled payments on the loan that are reported to the credit reporting companies. Once you've repaid the loan, the money is returned to you.

Repaying auto and student loans on time can also help you build a good credit history.

LEARN TO MANAGE DEBT

Credit cards are a quick way to get into debt trouble if you're not careful. It's best not to charge more than you can afford to pay off in full each month. And avoid paying only the minimum amount due because accruing interest will cause your balance to balloon. In this case, compound interest works against you: charging you interest on the interest you owe.

To keep on top of bills, sign up for email or text alerts from your card issuer on when your payment is due. Make sure you pay bills on time. Credit card late fees run as high as $28 for the first late payment, and up to $39 if you're late again within six months. The card issuer might also bump up your interest rate.

CHECK IN FREQUENTLY

Once you establish a credit record, it's a good idea to annually review what the reports say about you. Errors happen. A report might list a debt that's not yours or mistakenly claim you're behind in payments. This can damage your credit score.

You can order a free copy of your report every 12 months from each of the three major credit reporting companies at **AnnualCreditReport.com**. Learn how to dispute errors on the companies' websites at Equifax.com, TransUnion.com and Experian.com.

KNOW YOUR NUMBER

Information in credit reports is used to produce a credit score. What's that? It's a three-digit number designed to predict the likelihood that you'll repay your debts. Standard credit scores from FICO and VantageScore, for example, range from 300 to 850. The higher the score, the more likely you will be to be offered loans and to receive lower interest rates.

Your bank or credit card company may provide your score to you for free. FICO offers a free tool to estimate your score at **MYFICO.com/free-credit-score-range-estimator**. And some personal finance sites such as CreditKarma.com, NerdWallet.com and Bankrate.com, offer free VantageScores (although some might also pitch products to you).

Be wary of websites that advertise free credit scores but ask for your credit card number. This is a sign that they'll likely charge you for something else.

TAKE-AWAY ACTION STEP

- **Find out how credit scoring works** by reviewing the Federal Trade Commission's Credit Scores consumer page at **FTC.gov**.

STEP 5: Open a Roth IRA

A Roth IRA is a powerful tool for young workers to get a jumpstart on saving for retirement and other goals.

You contribute money into the Roth after you've paid taxes on it. Your money then can be invested in stocks, bonds, mutual funds, and more. Your withdrawals in retirement will be tax-free—a big bonus for savers.

Say, at age 25 you start saving $2,500 a year in a Roth and you earn 7% annually on your investments. By age 67, you would have contributed $107,500, but your account balance would have grown to nearly $662,802. And you won't owe taxes on any of it!

FOLLOW THE ROTH RULES

As long as you have earnings from a job, you may be eligible to open a Roth. However, you'll likely need to have an adult open a custodial Roth for you if you're under 18. The most you can contribute is the amount of wages from your job for the year, but no more than $6,000 in 2020 for those under age 50.

The Roth has other restrictions. For instance, you must own the Roth for five years and be at least 59½ to qualify for tax-free withdrawals. Pull money out earlier, and you will owe income taxes on the earnings and possibly a 10% penalty.

Yet a Roth has more flexibility than other types of retirement accounts. You can withdraw your contributions (but not your earnings) at any time without taxes or a penalty.

In addition, you can withdraw earnings without penalty to pay for qualified college expenses, although you'll still owe income taxes on that money. And once you've owned the Roth for five years, you can withdraw up to $10,000 to buy your first home without owing taxes or penalties on the earnings.

TAKE-AWAY ACTION STEP

- **A Roth isn't the only type of IRA.** With a traditional IRA, you might be able to deduct some or all of your contributions on your tax return. You'll pay taxes on the withdrawals, though. See which type of IRA is right for you by using the IRA Selector Tool at **TIAA.org**.

STEP 6: Become an investor

To reach your financial goals, you'll need more than a savings account. You'll need to become an investor.

Young investors who are saving for retirement or other long-term goals should consider stocks — which are shares of ownership in companies. Stocks go up and down, but over time they are likely to outperform bonds or other investments.

The easiest way to begin investing is with mutual funds and exchange-traded funds. But remember: As with other investments, you can lose money in funds.

Be aware, too, that funds and ETFs charge fees that lower your return. The average expense ratio (an annual percentage deducted from your account) for US diversified stock funds is 0.37% for an ETF and 1.08% for a mutual fund, according to Morningstar. Look for funds that charge this average or less.

UNDERSTAND MUTUAL FUNDS AND ETFS

A single mutual fund may own stock in hundreds of companies or bonds issued by the government or corporations. The idea is that if some stocks or bonds fall in value, others in the fund may go up—limiting the fund's losses and damage to your account balance.

Some mutual funds are "actively managed." That means the fund's portfolio manager analyzes securities and decides when to buy or sell them with the aim of beating the market.

Index funds are simpler and "passively managed." They buy securities similar to those in a benchmark like the S&P 500 index, for example. Their goal is to match the index's performance.

You can buy or sell fund shares only once a day. Some funds have no minimum initial investment requirement. Others may require you to invest $250 or $2,500 or more to get started.

Exchange-traded funds share features with both index funds and stocks. An ETF buys stocks, bonds, and other securities, usually mimicking the holdings of a specific index. And just like stocks, ETFs can be bought and sold throughout the day on a stock exchange. The minimum investment in an ETF is the cost of one share. This makes ETFs ideal for beginners without deep pockets.

CONSIDER A TARGET DATE FUND

Target date mutual funds are for people who prefer to put their investments on autopilot. You select a single fund whose name contains the year you expect to retire, say, Retirement 2060. The fund makes all the investment decisions for you. It invests aggressively when you're young and gradually becomes more conservative as your retirement approaches. A target date fund, which invests in multiple other funds, is designed to be the only investment you need in your retirement portfolio.

GET DEPENDABLE ADVICE

With investing, you don't need to go it alone. You can find a financial adviser who caters to younger clients at **XYPlanningNetwork.com**. Bonus: These advisers are "fiduciaries," meaning they must put your interests first.

But an adviser can be expensive when you're just starting out. Instead, a tech-driven "robo adviser" such as Betterment, Wealthfront, and Schwab Intelligent Portfolios, may fit the bill.

You start by answering a few questions online about your age, income, and goals. Within seconds, the robo adviser's program suggests a portfolio of usually low-cost ETFs that it can also manage for you. Annual management fees often run 0.25% of the value of your investments—a fraction of what a human adviser charges. (You'll also pay annual fees on the funds you invest in).

TAKE-AWAY ACTION STEP

- **Compare fees** on more than 30,000 funds and their impact on your investment over time with the Fund Analyzer tool at **FINRA.org**.

THE BENEFITS OF WORK

Beyond a paycheck, many employers offer valuable benefits. Here are some you'll likely encounter:

Retirement plan. This is usually a 401(k), or 403(b) for public employees. With these plans, money is deducted from your paycheck before taxes are paid and invested in your account. Employers often match workers' contributions, so make sure you contribute enough to get the full match—which is free money!

Health insurance. Employers often offer more than one plan, which vary in price and in which doctors you can see.

Health savings account. Many employers pair high-deductible health insurance with a health savings account. HSAs have a triple tax-break: Contributions aren't taxed, the money grows tax-deferred, and it can be used tax-free for eligible medical expenses.

Disability insurance. One-in-four 20-year-olds will become disabled before reaching retirement age, reports the Social Security Administration. Disability insurance will pay a percentage of your salary to you if you can no longer work.

Flexible spending account. This tax-free account lets you put aside up to $2,750 in 2020 to pay for out-of-pocket health costs. You generally must use the money within a certain period, or lose it.

PREPARE FOR FINANCIAL SUCCESS

Now that you've learned about building strong money habits, you'll be better prepared to meet your future goals.

ABOUT WHEN I'M 65

How we live and thrive in retirement is changing dramatically in the 21st century. ***When I'm 65*** is a groundbreaking documentary, produced by Detroit Public Television, and community engagement program that examines the choices all Americans must make today to plan for a financially secure and fulfilling future.

> *"When I'm 65 offers jargon-free explanations and can-do action plans for all ages—Millennials, Gen Xers and Baby Boomers alike."*
>
> *–Don Blandin, CEO and President of Investor Protection Trust*

Watch the documentary and find upcoming workshops and conferences at **www.WI65.org**, **facebook.com/WI65project**, or **twitter.com/WI65project**.

Investor Protection Trust

THE INVESTOR PROTECTION TRUST (IPT) is a nonprofit organization devoted to investor education. More than half of all Americans are now invested in the securities markets, making investor education and protection vitally important. Since 1993, the Investor Protection Trust has worked with the states and at the national level to provide independent, objective investor education.

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Investor Protection Institute

THE INVESTOR PROTECTION INSTITUTE (IPI) is an independent nonprofit organization that advances investor protection by conducting and supporting unbiased research and groundbreaking education programs. IPI carries out its mission through investor education, protection, and research programs delivered at the national and grassroots levels in collaboration with state securities regulators and other strategic partners. IPI is dedicated to providing innovative investor-protection programs that will make a meaningful difference in the financial lives of Americans in all walks of life and at all levels of sophistication about financial matters.

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