THE HIGH ACHIEVER'S GUIDE TO WEALTH

Written by the Financial Advisers of

PALISADES HUDSON FINANCIAL GROUP LLC

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Back in 2012, when Palisades Hudson Financial Group started writing its first book, company president Larry Elkin told the staff that we would rely on the principle "many hands make light work." That book would eventually become *Looking Ahead: Life, Family, Wealth and Business After 55.* I can attest that it was indeed the work of many hands, both in its original printing and in the revised second edition that we released in 2019.

The process of creating our second book involved different sets of hands, but certainly no fewer. The volume you are holding wouldn't exist without the intelligence, experience and skill of the authors who created it – 14 of them, besides me. Unlike many company-produced books, ours lists the authors of each chapter in pride of place. We want our readers to recognize each author's individual contributions. Like all our work at Palisades Hudson, this book reflects uniform dedication to the work, but also the unique perspectives of our staff members.

As an editor and an author, I am well aware that no book worth reading arrives in the world fully formed. I am deeply grateful for the efforts of Barbara Schechter, who copy edited this project. A retired copy editor at The Seattle Times, Barbara offered a thoughtful and much-appreciated fresh perspective on each chapter. Her feedback made all of them clearer and sharper. In addition to the two chapters he wrote, Larry Elkin also provided a technical edit that ensured our text was accurate and thorough throughout. While I know a great deal about what we do after 10 years at Palisades Hudson, Larry has been providing personal financial and tax counseling to clients since 1986. His expertise was invaluable in helping to clarify and polish many of our authors' explanations.

Getting our book to readers looking its best also required an expert touch. Najdan Mancic of Iskon Design, Inc. ensured that you would have a beautiful and smooth reading experience, whether you are holding a paperback or reading these words on your favorite e-book reader. I would also like to thank Ashley Bell, our designer for both editions of *Looking Ahead*, who contributed to the final design of this volume, including the concept for its cover. Administrative associate Lesley Oberstadt, whose many regular duties include arranging staff travel and managing our office phone lines, also assisted in creating the tables and graphics you will find in the pages that follow.

While you will not encounter every member of our staff by name in these pages, this book would not exist without the contributions of entire team. Linda Field Elkin, our director of marketing, has overseen the work of marketing manager Melissa DiNapoli and administrative associate Ashley Drayer to help this book find its audience. Linda is also our director of human resources, and she has had a direct hand in hiring every person who wrote the words you are about to read. Pascale Leon-Bocchino manages the financial and administrative sides of our business and ensures all the important behind-the-scenes work runs smoothly. Facilities manager Cristina Galante oversees our six offices across the country. Jeffrey Howard deploys and maintains our technical platforms and keeps us all productive, as our information technology manager.

In addition to our administrative staff, our client service team benefits from the skilled support of financial planning assistant Frank Disalvo and financial planning managers Stephen Grady III and Kirstie Ward. Kirstie also serves as the firm's chief compliance officer. And while our newest client service staff member, associate Victoria Romaniello, is too recent an addition to appear in these pages, we look forward to her joining us in our online newsletter (or maybe in a future volume).

It is the nature of business that not all colleagues stay forever. In the course of writing this book, we said goodbye to client service associates Jeremy Dym and Max Klein. While both Jeremy and Max have moved on to new professional opportunities, I am happy that my personal collaborations with them will live on in this book. We wish them the best.

My collaborators and I also must thank our partners, spouses, children, parents, roommates and all the other loved ones who support us in our work, whatever it may be. They allow us to give our best on the job, and give that work meaning at the end of the day. This book, like all our accomplishments, would not be possible without them.

Finally, but certainly not least, we thank our clients. Some are the young adult "high achievers" we wrote this book to help. Others are their parents, grandparents, aunts and uncles, or mentors. All of them have opened their homes and their families to our firm, and have entrusted us with the most personal aspects of not only their finances, but their lives. That trust means the world to us. Any wisdom we can share in this book was honed over years of working with high-achieving, intelligent and accomplished families and individuals. As in everything we do at Palisades Hudson, this book is for you.

—Amy Laburda,
editor

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CHAPTER 1

ANYONE CAN ACHIEVE WEALTH

Larry M. Elkin, CPA, CFP®

In entertainer Garrison Keillor's fictional town of Lake Wobegon, Minnesota, all the children are eternally above average. The humor works because the math doesn't.

When you add up all the wins and losses in Major League Baseball next year, they will balance out to a perfectly mediocre .500 winning percentage, just like last year and the year before that. Baseball does not award points for losing in extra innings, the way the National Hockey League gives credit to the team that loses in overtime. For every winner in baseball, there must be a loser. It is a zero-sum game.

When it comes to achieving success, however, life more closely resembles fictional Lake Wobegon than real-world baseball, because life is *not* a zero-sum game. Nobody must "lose" at life for someone else to win. Not everybody will be a winner, but practically anybody can be.

Most of us can do at least one thing better than most other people can do it. We might be able to run faster or hit a ball farther. We might excel at music or pottery, at singing or acting, at mastering science or math, at fixing things that are broken, or at dreaming up new ways to fill a niche in a marketplace that nobody even noticed before. We might be great at playing the latest video game, or at knitting, or at fantasy football. A high achiever is anyone who excels at anything. There are people who make at least a perfectly good living, and sometimes quite a bit more than that, at every single thing I just mentioned. In fact, there is almost nothing a high achiever can achieve that cannot be done for monetary gain. Some people make money by winning hot-dog-eating contests.

Of course, an individual's exceptional abilities in one area does not mean the individual excels when it comes to acquiring, investing, spending or even giving away money. These are different skill sets. Even people who start and run successful businesses, or earn fortunes on a field or a stage, can struggle with managing their taxes, saving for old age, or raising well-adjusted and productive children rather than proverbial "trust fund babies." Those who do inherit large sums can be overwhelmed by requests from relatives or friends, pleas from charities and offers of advice — for payment or otherwise — on what to do with the new wealth.

This is where my colleagues and I come in. For over 25 years, we have worked with all sorts of individuals and families at all stages of wealth-building. We have helped newly graduated professionals launch their careers, inventors form startup companies and teenage performers sign their first deal. We have also helped newly affluent business executives arrange their personal finances, and "old money" families establish modern financial plans even when much of their wealth is held in structures that were created many decades ago.

Experience has taught us, and modern third-party research has affirmed, that "wealth" means different things to different people. To most Americans — in fact, to most people on Earth today — a million dollars is a considerable sum of money; the Federal Reserve reported in 2017 that the average U.S. household's net worth was

$692,100. This figure is skewed higher by the vast fortunes of people with names like Bezos, Buffett, Zuckerberg and Gates, along with a small number of other billionaires who are less famous. The median household net worth reported in that survey was just $97,300, which means half the reporting households had net equity below that figure when you subtract their debts from their assets. (The report covers a rolling three-year period from 2014 through 2016. Updated figures from a survey in the 2017-2019 period were due to be released in 2020 after this book went to press.)

Yet a separate survey by Charles Schwab & Co. released in 2019 said most Americans would not describe a $1 million net worth as enough to be considered wealthy. The survey put the figure the average respondent considered worthy of the label at nearly $2.3 million.

But is being "wealthy" really a function purely of how much money or other material wealth an individual or household has accumulated? The same Schwab survey that produced the $2.3 million figure reported 72% of respondents who said their personal definition of wealth depends more upon how a person lives his or her life, rather than on net worth.

I would rephrase it this way: Net worth, or at least the appearance of net worth, is how we judge whether *someone else* is wealthy. We look at the houses they buy, the cars they drive, the clothes and jewelry they wear, and the vacations they post on social media, and we make assumptions about their personal balance sheets. Ostentatious displays of wealth can be misleading, but they are easy to see. Most of us are inclined to take mental shortcuts much of the time, especially when we don't have more reliable information to guide us. The converse is also true. Many people who have substantial wealth choose to live and dress so modestly that even some of their closest acquaintances may have no idea how financially well-off they are.

When it comes to judging whether *we ourselves* are wealthy, we look at other factors. We ask ourselves questions such as: Are our physical needs met? Do we find our work fulfilling and pleasant? Do we have access to companionship when we want it and solitude when we need it? Are our families well-provided for, healthy and content? Are we engaged and respected in our community? Do we have a sense of security that our situation may not abruptly take a turn for the worse? The more of these questions we answer affirmatively, the more likely we are to consider ourselves "wealthy," regardless of the exact level of our bank balance. If we were to encounter someone who possesses only money but none of these other attributes, we would probably be inclined more toward pity than envy.

Of course, while money alone may not buy happiness, it can help — a lot. Many of the other characteristics that give rise to a feeling of personal wealth require at least a certain amount of material comfort or professional success to achieve. A study by Harvard Business School researchers and several collaborators, published in 2017, surveyed 4,000 millionaires from countries around the globe. On balance, they were pretty happy, as we might expect. Those who created their wealth from their own efforts reported somewhat more happiness than those who inherited their money. It took a lot of money — a net worth greater than $8 million or so — before individuals reported themselves being significantly happier than their fellow millionaires of more relatively modest means. Genuine financial security is not the only driver of wealth, but it is an important component of it.

"Wealth" is a subjective and relative concept. In January 1941, with America still struggling to emerge from the Great Depression and Europe and the Far East already immersed in war, President Franklin D. Roosevelt made his famous "Four Freedoms" speech. It was his eighth State of the Union address to a joint session of

Congress. In it, Roosevelt laid out a vision of what prosperity and security would mean in his place and time.

"In the future days, which we seek to make secure, we look forward to a world founded upon four essential human freedoms," Roosevelt declared. "The first is freedom of speech and expression everywhere in the world. The second is freedom of every person to worship God in his own way everywhere in the world. The third is freedom from want – which translated into world terms means economic understandings which will secure to every nation a healthy peace time life for its inhabitants everywhere in the world. The fourth is freedom from fear – which translated into world terms means a world-wide reduction of armaments to such a point and in such a thorough fashion that no nation will be in a position to commit an act of physical aggression against any neighbor anywhere in the world."

If having wealth is about having choices, achieving wealth is about making sound choices that bring you to that point.

An analysis by Max Roser published in 2019 on the website "Our World in Data" shows that even as Roosevelt spoke, the world was in the midst of a global explosion of economic growth that began with the Industrial Revolution and continued through the 20th century and into the 21st, lifting hundreds of millions of people out of physical poverty. The spread of freedom of expression has been a mixed bag at best, however. As for Roosevelt's pledge of global disarmament as a cornerstone of freedom from fear, we are probably further away from that position than ever. But most of us would agree that the world is, on balance, far wealthier now than was the case 80 years ago. We eat better and dress better. Virtually nobody would want to trade today's health care, communication or transportation options for what was available to Roosevelt's audience.

Psychologist Abraham Maslow provided a seminal definition of well-being in his 1943 paper "A Theory of Human Motivation." Maslow posited that there is a hierarchy of needs, beginning with physical needs, then security, then emotional, then the esteem of others, and finally that of "self-actualization," which I would call the achievement of one's own satisfaction and self-esteem. If you possess all of these things, you might consider yourself wealthy.

Another widely shared view of wealth, and one to which I subscribe, is that wealth gives us choices. You can choose (at least to a degree) how much to work, as well as how to work. Joseph P. Kennedy founded the family fortune that enabled multiple generations of his descendants to dedicate their careers to political, nonprofit or philanthropic endeavors they found personally or socially rewarding even if not especially remunerative. Warren Buffett told Fortune magazine in 1986 (when his fortune was a fraction of what it later became, but still measured in billions) that he viewed the perfect amount to leave his children as being "enough money so that they would feel they could do anything, but not so much that they could do nothing." Buffett is still alive and working in his late 80s as I write this, and his children – in their 60s – ended up dedicating most of their work to philanthropy, using funds seeded by their family's wealth but giving themselves a mission and purpose independent of their father's business career.

If having wealth is about having choices, achieving wealth is about making sound choices that bring you to that point. Most people who reach their own definition of wealth do not arrive there by accident. They make choices in a strategic manner, guided by their own priorities about which goals are most important to them, and about the timeline in which they want to achieve those goals. When we set out to write this book, my colleagues and I wanted to offer guidance and share our experience with people primarily in their 20s, 30s and 40s — the decades in which most schooling is finished and we make the decisions that direct our professional careers and personal finances for many years to come. Should we buy or lease a car, and if we buy, how much borrowing is appropriate? When is it time to consider purchasing, rather than renting a home? How much money should we dedicate to paying down debt, building an emergency fund, and saving for our own retirement or our children's education? How should money best be directed toward those goals? What devices can we use to mitigate the friction of taxes in trying to reach our other financial goals?

We will answer these questions and many others in the chapters that follow. Or, rather, we will provide you with the information and perspective to answer these questions yourself, or with the help of a professional adviser if your situation warrants. There simply is not a single universal answer to any of these questions. It comes down to goals and priorities that are just as personal as the definition of wealth itself. Our views on these issues may be more broadly informed than most because of our extensive professional experience, but that does not make them better or more important than yours; quite the opposite is true. As professionals in our daily work and as authors of this book, our goal is to share our knowledge and experiences so you can apply them to your own situation. You already are, or expect to become, a high achiever in your field. Now let's make sure your achievements translate into real and durable wealth, however you define it.

CHAPTER 2

SPENDING VS. SAVING VS. DEBT REPAYMENT

Thomas Walsh, CFP®

Financial planning is not a one-time event. It is the process of meeting your goals through the proper management of your finances. This process should give direction and meaning to your financial decisions and allow you to understand how each decision affects all areas of your financial life. In the big picture, this sounds reasonable. But many people struggle with translating this broad idea into concrete action that allows them to reach their personal goals. How do you determine how much to spend and how much to save?

In a perfect world, you would start adulthood with a list of specific financial goals for each stage of your life, along with the precise level of savings required to meet each goal. You could then form a plan that would let you achieve those goals, one by one, and carry it out. But real life is more dynamic and complex. Your perspective, priorities and circumstances will change over the course of your lifetime. That does not mean you can't take steps early on to establish a strong foundation to help you navigate life's uncertainty, even as your goals change and grow. Learning to balance spending, saving and paying down any debt you have accrued will help you pursue your financial goals, no matter what they are.

SPENDING

When balancing spending, saving and paying down debt, spending has an unfair advantage for many of us. That's because it offers immediate gratification. Spending money is not inherently bad, of course. But the fact that it often feels good in the moment means you should be careful and approach spending with a plan in order to maintain balance.

The best way to do so thoughtfully is to create and maintain a budget. While Chapter 3 covers budgeting in more detail, an important consideration is that you budget with specific goals in mind. Those goals will likely involve plans to save and pay down debt, but those are means, not ends in themselves. Are you saving for a down payment on a home or a comfortable retirement? Are you paying down debt so that you can have more flexibility in your career or take more vacations? Your goals will be specific to you. But associating saving and paying down debt with positive goals, rather than just with the vague feeling that they are responsible things to do, will provide more motivation. That, in turn, is likely to help you stick to your budget.

Goal-setting can also help you weigh your various expenses and realistically measure how much they mean to you. If you find you are overspending and need to cut back, evaluating the importance of various expense categories can help you prioritize and identify areas where cutting back will cause less discomfort. Conversely, identifying areas that mean a lot to you can help you enjoy spending on nonessential items even more. When you determine the items or experiences you value most, you can make sure your spending is going toward what really matters.

A key component to effective budgeting is determining where your spending is now, if you do not already know. Gather your last few credit card and bank statements, add up your monthly income after tax and subtract your monthly purchases. If you don't have a surplus of cash at the end of the month, you are spending too much and it is time to cut back. Regardless of your financial goals, the most important reason to budget is to maintain control of your spending and avoid new debt. The key is to never spend beyond your means.

QUICK NOTES

Determining if you have a cash surplus

- ☑ Gather credit card and bank statements for the past few months
- ☑ Subtract monthly purchases from total after-tax income
- ☑ If you have no extra cash at all, or the total is negative, look for optional spending to cut (remember that big-ticket items will make more of a difference)

If you want or need to cut back on spending, it is important to take a big-picture look at your budget. While it can help to eliminate little things like your daily trip to Starbucks or eating lunch out, the greatest impact will come from bigger ticket items. If you feel saving is difficult, consider giving up or postponing big discretionary spending, if any. Do you want to take that big international vacation in the next few years or save for a down payment on a house? That said, not everyone has such major discretionary spending to cut. In that case, turn your attention to your fixed monthly expenses. Can you reduce the cost of your internet package? Give up cable or cut some streaming services? You might consider renting a cheaper apartment when your lease is up, trading in your car for one with a lower monthly payment or exploring alternatives to your gym membership. Balancing spending and saving is ultimately an exercise in priorities and trade-offs. The sooner you start, the easier this process will be.

If you haven't done so, open a credit card and bank account as soon as possible. As income and expenses increase, financial situations grow more complicated and mistakes can have a larger impact. Mastering account management while your situation is relatively simple will set you up for success. A credit card can also help you to build your credit score. (For more on credit cards and credit, see Chapter 3.) If you are just starting out, take time to shop around and read the fine print before you commit to a particular credit card or bank, and make sure you are comfortable with all the terms and conditions. It is also important to know yourself. A credit card can help build your credit and provide flexibility in an emergency while you build your savings, but if you are prone to spend too much, be sure you set up roadblocks to impulsive behavior. For instance, don't routinely carry your credit card with you.

If you are part of a couple, don't stop with only your own financial goals and expenditures. Couples should create joint goals and assign responsibilities to improve spending habits. There is no right answer when it comes to how couples manage savings and spending. Some want to share everything, while others keep separate accounts. Some share their assets with a prenuptial agreement in place. (For more on blending finances and prenuptial agreements, see Chapter 11.) Be open to finding what works for you as a couple, even if it doesn't mirror your perception of how a couple "should" handle their money. Regardless of how you divide your finances and financial chores, the most important point to remember is open communication.

SAVING

At the most basic level, savings are the excess of cash inflows over cash outflows after taxes. In other words, savings are any post-tax income that you don't spend right away. But effective saving isn't an end in itself — it's a way to pursue your financial goals.

Determining your ideal level of savings can be more complicated than it first appears. The percentage of income to set aside depends not only on your goals and preferences, but also on factors like the stability of your job, your budget's flexibility, and the cost of living and tax burden in your locale. You may encounter the rule of thumb that you should try to save between 10% and 20% of your gross (or pretax) income. If you can save 10% for retirement and 10% for other long-term goals, you are doing well. But a rule of thumb is only a broad suggestion; it may not be practical, or even best, for everyone. To find your right level, you will have look at your goals, the practical constraints of your situation and your debt-repayment priorities, among other factors.

Once you determine how much you want to save, the next step is to set up a plan. A proactive approach will help you make sure your savings don't accidentally become spending by the end of the month. You may have heard the advice to "pay yourself first." The idea behind this is to set aside money earmarked for savings right away, rather than putting any "leftover" money toward your goals at the end of the month or pay period. In other words, make savings a priority, not simply the destination for any money you didn't happen to spend. Transferring your money immediately after you get it to a savings or investment account can remove the temptation to overspend.

One strategy many people find helpful is automation. Most banks will let you set up an automatic transfer on a regular basis, so you don't need to rely on your own memory to fund a savings or investment account. Employer-based retirement plans often allow you to go one step further and set up automatic payroll deductions, so the money never reaches your checking account in the first place. Automating contributions is a hugely helpful tool for ensuring you meet your retirement saving goals each year. Many people find that when money is automatically deposited into a retirement account, they do not miss it. This is also the principle behind services that "round up" purchases and automatically transfer the difference to a linked savings account.

Emergency Funds

Your very first savings goal should be an emergency fund. Also sometimes called a "rainy day" fund, an emergency fund is meant to cover unforeseen expenses, which means you will need to dip into it from time to time. If you don't already have savings built up, an emergency fund should also be your first order of business. And if you do have a fund, be sure to prioritize replenishing it after you withdraw funds to deal with an emergency.

Building an emergency fund offers a few notable benefits. First, it promotes financial stability. Without such a fund, you might need to borrow at high interest rates to cover an unexpected expense. An emergency fund allows you to avoid the extra expense of carrying a credit card balance or other debt to meet an unanticipated financial need. Emergency funds can also combat frivolous spending. Keeping that money in a separate account can reduce the temptation to spend the funds on something inessential.

Finally, an emergency fund can reduce stress and increase your confidence that you can handle the unexpected events that will inevitably crop up.

The exact amount you should save in your emergency fund will depend on your circumstances. You will likely encounter the rule of thumb that you should save three to six months of expenses. If you are married and both partners work, or if you are single but have multiple sources of income, three months may be a sufficient buffer. If you provide the sole income for your household, six months may be more prudent. Of course, every situation is different. When determining how much to save, try to understand how the various components of your financial life interact so you can better predict the impact different emergency scenarios might have. Consider the following questions: How secure is your job? Are you salaried or are your paychecks irregular? Do you have someone to cover the bills if you are out of work, such as a partner or family member? You should also factor in your own comfort, to some degree. Overfunding an emergency savings account involves an opportunity cost, in that you are tying up money that can't be used for other goals. But if it makes you sleep better at night, sometimes forgoing financial optimization is OK.

Your expenses will also be particular to you. Note that when you calculate your three-to-six-month figure, you should differentiate between critical and discretionary expenses. Critical ones such as housing, food, health care (including insurance), utilities, transportation and debt payments are relatively fixed. You will need to keep covering these bills indefinitely, so include them in your calculations. You do not need to include discretionary expenses that could be eliminated in case of a major financial emergency like job loss. These might include entertainment, eating out, nonessential shopping, vacations and long-term savings goals that you can pause until your situation improves. Take a detailed look at your spending, as well as your broader circumstances, to determine your savings target.

If six months, or even three months, of expenses looks daunting, remember that saving something is better than nothing. While an emergency fund is to help cover a temporary loss of income, many emergencies have a fixed duration, such as a major car or home repair. A 2019 study published in the journal SSRN found that shortfalls of $2,500 or less are much more common than larger shortfalls. If you can set aside even $25 a week, or $50 from a biweekly paycheck, you could save $2,600 in two years, which would help defray or cover many smaller emergencies. Even a small emergency fund puts you ahead of many Americans. A 2018 survey from the Federal Reserve found that nearly four in 10 did not have enough saved to handle an unforeseen expense of $400.

QUICK NOTES

Benefits of an emergency fund

- ☑ Promotes financial stability
- ☑ Avoid credit card or other high-interest debt
- ☑ Combat frivolous spending
- ☑ Reduce financial stress overall

An emergency fund should be reserved for true emergencies, ones that are sudden and unexpected, giving you little or no time to prepare. Common financial emergencies include unanticipated job loss, major medical problems, and home or car repairs. Create your own set of definitions or possible scenarios and consider writing them down. The clearer you are with yourself about how you plan to use the fund, the easier it will be to determine how much you should save. Being specific and having your own set of instructions also can help you avoid tapping into your fund for nonemergency purposes. Once you get in the habit of dipping into the fund for other reasons, it can be hard to stop. A weekend trip with your friends is not an emergency. Wanting a new car or new home appliance is usually not an emergency (though replacing older versions might be, depending on the circumstances). Don't dip into your emergency fund casually with the idea that you will replenish the money later. You never know when a true emergency will occur or how severe it will be.

Also bear in mind that an expense should not be considered an emergency just because it does not occur regularly. If the expense is something you can foresee, prepare for it by building funds into your regular budget. Say you anticipate your car will last about three more years and that it will cost approximately $9,000 to replace. If you ignore this future expense and wait until your car breaks down completely, it could become a true emergency. Instead, arrange your budget so that you can start setting aside $3,000 per year. Even if you do not set aside the full amount or your car fails sooner than expected, any amount you have saved will help you avoid raiding your emergency fund in a panic the day your car dies. If you can minimize the sudden need for cash occurring from irregular expenses, you will be better prepared to handle a true emergency.

Your emergency savings should be easy to access, so keep them somewhere you won't pay a fee to withdraw funds or lose value from selling at an inopportune time. Keep the emergency fund in cash, or other safe and liquid short-term investments. For example, while a two-year certificate of deposit is very safe, it is not very liquid. You may need the money before the two-year term ends, in which case you will incur early-surrender charges. On the other hand, you should keep your fund separate from your general checking account. For most people, a regular savings account or a money market account insured by the Federal Deposit Insurance Corporation is the best choice. These options will let you earn a bit of interest while giving you easy access to the funds. The yield on such accounts is low, but the purpose of an emergency fund is not to generate income or have a good rate of return; it is to protect you and provide cash in an emergency.

In general, build your emergency fund before you pursue other long-term savings goals. One major exception is if your employer matches contributions to your 401(k) or other retirement plan. In this case, try to build your emergency fund and your retirement plan at the same time. You want to secure the "free money" of the employer match in the 401(k) for as long as possible. If you're worried about job security or work in a particularly volatile industry, though, focus more on the emergency fund to the extent you have to choose between the two. And you will need an emergency fund even if you are dealing with debt; don't tap your emergency savings for routine debt payments or let eagerness to pay off debt keep you from building this form of savings.

Long-Term Savings Goals

Once you have a robust emergency fund, you can begin to think about how you want to invest your savings for long-term goals. As my colleague Ben Sullivan explains in Chapter 5, investing is key to making sure the money you save doesn't lose value to inflation over time. Beyond that, investing early is a great way to effectively pursue big financial goals. Yes, it involves risk. But as a young adult, time is on your side. If you were already setting aside a certain amount of savings for your emergency fund, you can now repurpose it toward other long-term goals such as retirement, future educational expenses, or big-ticket purchases like a home or a car. You may also want to save for periodic, nonemergency expenses such as routine health care or home upkeep.

One key to successfully saving for long-term goals is to avoid "lifestyle creep." In most cases, you can expect your income to rise as you grow more experienced and gain responsibility in your career. You may also experience a financial change when you blend finances with a higher-earning partner, or if you receive a lump sum as a lifetime gift or bequest. In any of these circumstances, try to maintain the same standard of living to the extent that you can. This will allow you to increase your contributions to retirement accounts and other long-term savings goals without substantially altering your spending habits.

What if you have debt? There is no one right answer to whether you should concentrate on paying off your debt first, or paying down debt while simultaneously building your savings. The right strategy will depend on your circumstances. For instance, paying off outstanding credit card balances before implementing a savings plan can be a good strategy, in part because credit card debt often carries a high interest rate. In contrast, if you are paying down federally subsidized student loans, which typically offer a low interest rate, a more balanced approach may make sense. That balance can shift even further if you have access to an employer match in a 401(k) or other workplace retirement plan; the benefits of securing the match contributions will typically offset the opportunity cost of not paying off your debt faster. If you are enrolled in an income-based repayment plan for federal student loans, reducing your take-home pay through payroll contributions to a retirement plan may even lower your monthly minimum payment amount. The rule of thumb is to prioritize saving over debt repayment when your anticipated investment return is materially higher than the interest you will pay on the debt. (And then, of course, be sure to invest that money, not spend it.)

DEBT REPAYMENT

Debt is a major problem in the United States, especially among young adults. In late 2019, the Federal Reserve reported that American households owed a collective $14 trillion. There is some good news; while young adults hold much of the more than $1.5 trillion in collective student loan debt, the U.S. Census Bureau's biennial American Housing Survey found in 2017 that millennials carried less credit card debt, on average, than their Gen X counterparts. But the average millennial respondent still carried a balance of $2,662.

Debt can create a vicious cycle, because compound interest can make the problem progressively worse if you cannot or choose not to deal with your debt aggressively. Not only is it costing you money, but debt can be a major roadblock to meeting your long-term financial goals. That said, debt can often trigger feelings of shame or appear to be an insurmountable problem. As much as you can, try to keep your debt in perspective and remember that you can take concrete steps toward paying it down.

Paying down debt from the highest interest rate to the lowest is wise. Compounding means you will pay much more on higher interest debt over time.

It is especially important to be honest and as objective as you can if you are dealing with outstanding debt as a couple. If only one partner is in debt, you should both express clear expectations as to who is responsible for repayment, and how. Ideally, the debt-free partner will agree to some short-term sacrifices to help the other one for the good of their overall financial health. However, do not shy away from discussing future debt, too. If one of you is struggling with impulsive spending or other discretionary forms of debt-building behavior, consider jointly tracking your spending to gauge the problem areas. Budgeting together and talking about finances regularly are also key. However you decide to approach the process, couples should work as a team to pay off unproductive debt and avoid it going forward.

As a financial adviser, I typically recommend organizing existing debt by interest rate when you formulate a payment plan. You will want to pay down the debt in order of highest interest rate to lowest. This is because compounding means you will pay much more on higher interest debt over time. Credit card debt in particular can be difficult to dig out from, so you will likely want to knock this out before moving to other debts, such as your student loans. (I will discuss prioritizing types of debt more fully in this chapter.) You should also prioritize paying down existing debt, if you can, before taking on a new mortgage or other ongoing financial commitments.

Becoming entirely debt-free has obvious advantages; you no longer accrue interest you will have to pay back, and you can devote money previously budgeted for debt to other priorities. But decreasing your debt has advantages even before you pay it off. For instance, when you apply for a mortgage or auto loan, lenders often consider your debt to income ratio. This figure is all of your monthly debt payments collectively divided by your gross income and is used to evaluate whether you can responsibly take on more debt. (For more details, see Chapter 8.) As a rule of thumb, your annual payments on all outstanding debt should not exceed 36% of your adjusted gross income (gross income minus specific federal tax deductions).

Types Of Debt

Not every sort of debt is created equal when it comes to your overall financial health. While being entirely debt-free has its advantages, you may hear financial professionals discuss “good” debt and “bad” debt. The reality is slightly more nuanced, but this distinction does spring from a real difference.

Most advisers and commentators who talk about “good” debt mean low-interest debt that can help you increase your net worth in the long run. “Bad” debt is high-interest debt used to pay for discretionary or nonessential purchases. Some financial planners also advise favoring secured debt over unsecured debt. Secured debts, such as mortgages or auto loans, involve collateral. There is nothing inherently better about one sort of loan or the other, but lenders typically offer lower rates for secured loans. Some debts fall between “good” and “bad,” while others start good and go bad as circumstances change. Still others don’t fit this paradigm at all. For instance, medical debt is unusual in that it typically bears no interest and is not something you voluntarily choose to take on.

The most common form of so-called bad debt is consumer debt, which is any form of debt used to purchase consumable items or personal items that depreciate. This includes credit card debt, as well as personal loans used for discretionary purposes such as vacations or high-end electronics. In general, you should avoid this type of debt as much as possible and pay it off quickly if you can. Credit card debt is subject to high interest rates and unfavorable contract terms. Many credit cards set annual percentage rates (APRs) between 15% and 18%, with even higher rates for borrowers with bad credit. Compounding means that carrying a balance can make even a small debt grow more quickly than you might expect.

Whether auto loans are considered good debt or bad depends, in part, on whom you ask. Since cars depreciate, it is usually better to buy them outright if you can. On the other hand, auto loans have characteristics that set them apart from other forms of consumer debt. Because the car itself is collateral, auto financing rates are usually low enough to make these loans less burdensome than credit card debt. Like mortgages, they can often be refinanced or renegotiated if necessary. In addition, in many parts of the country a car is a necessity to get to work, supporting your ability to earn an income. As long as you avoid going underwater — meaning that you owe more than the car is worth — you can always sell or trade in the car if payments become too burdensome. This is why it is important not to buy more car than you need, especially if you are financing your purchase. For more on financing a car, see Chapter 6.

A mortgage is the traditional example of so-called good debt. Many mortgages offer interest rates well below what you could earn through investing in a diversified portfolio, which means you may be in less of a hurry to pay it down. Mortgages are also designed to be paid back over years, rather than month to month. You can typically refinance to change the loan term or the interest rate, which offers other advantages. And while the housing crisis of the late 2000s was a vivid reminder that property does not appreciate in all circumstances, in most cases your home will gain value over the course of a 30-year mortgage. (For more on mortgages, see Chapter 8.) Small-business loans are also usually considered good debt. While starting a small business involves risk, securing a loan will mean creating a comprehensive business plan, making it unlikely you will take out this sort of loan carelessly. If you approach this debt prudently and methodically, a loan to get your business underway can ultimately prove a net positive for your financial outlook.

Educational debt may be either good or bad, depending on the circumstances. Loans to attend an accredited university are generally considered positive, especially if you take out an amount consistent with your expected ability to repay based on your future career. Student loans with oversized balances relative to future earning power, loans for a degree you did not finish or loans to attend a disreputable institution are more likely to become bad debt. It is also worth differentiating between federally subsidized student loans and private student loans. Loans from the government often have a low interest rate and mechanisms to help you handle payments. Private loans bear higher interest rates and lack many of these benefits. If you have both, it will often make sense to prioritize paying off private loans first. A particular hazard of student loans of either type is that they generally cannot be discharged in bankruptcy. For more information on student loans, see Chapter 4.

Debt is a reality for most people who own a home or a car, or who pay for their own or their children's education. But making sure you avoid unnecessary debt, especially consumer debt, as much as possible and that you approach secured debt in a thoughtful way can give you a better chance of staying on top of your repayment plan.

Paying Down Your Debt

When balancing saving and debt repayment, you should never neglect minimum payment amounts on any of your debt. The question is what you will do with available cash beyond that baseline. The overall goal when you decide to pay down your debt is to pay more than the minimum required. You want to not only pay off the interest each month, but slowly work down the principal balance as well. In general, it is best to focus on one debt at a time. Chip away at the principal payment by payment.

When you design a repayment plan, consider one that will naturally gain momentum the longer you stick with it. Two popular strategies are the "debt avalanche" and the "debt snowball" (described below). Both approaches have pros and cons. The debt avalanche strategy leads to paying less interest overall, but the debt snowball method can offer the encouragement to stick with your plan by overcoming common psychological barriers that hinder repayment. Researchers have found the debt snowball method works better for many people by keeping their motivation strong. Whichever method you choose, however, paying down one debt at a time has clear advantages. A study published in 2016 in the Journal of Consumer Research found that borrowers who concentrated on repaying one debt at a time repaid their overall debt 15% faster than borrowers who dispersed extra payments across accounts. Both the snowball and avalanche methods have their merits and, when implemented effectively, equally result in a clean financial slate.

QUICK NOTES

Avalanche	Snowball
PROS	**PROS**
► Pay less interest overall ► Become totally debt-free faster	► Overcomes common psychological barriers that can hinder repayment ► Quickly dealing with fewer outstanding balances
CONS	**CONS**
► Requires discipline and patience ► More loans to keep track of over time	► Pay more interest overall ► You may be in debt longer overall

In the debt avalanche method, you will prioritize your debts by interest rate, from highest to lowest. You will concentrate on tackling the highest interest rate first, while making minimum maintenance payments on any other debts. In the debt snowball method, you will also concentrate on paying off one debt at a time. But instead of ranking them by interest rate, you will rank them by the outstanding balance, from lowest to highest. The idea is that you get a positive psychological bump from successfully tackling an outstanding debt, no matter its size. Paying off small loans first gives you early wins and fewer overall loans to think about. This generates greater momentum as you turn toward larger, more burdensome debts.

Of course, certain types of debt should be top priority, regardless of interest rate or balance. For instance, payment of back taxes owed to the Internal Revenue Service should almost always be the first priority, regardless of balance or interest rate. You could face fines, or even jail time, if you fail to pay; short of that, the IRS can impose liens to make sure Uncle Sam gets his due.

Stay mindful, too, of any early repayment penalties. Some mortgages include provisions that trigger fees if you pay off too much of your loan early. Early-repayment penalties are rarer on other types of loans, though some auto or personal loans also include them. Student loan lenders are not allowed to penalize borrowers who eliminate their debt early.

When considering which types of debt to pay down first, you should also pay attention to any associated tax benefits. For example, up to $2,500 of qualified student loan interest can be deducted against your taxable income per year (subject to an income phase-out), effectively reducing the actual interest paid on the loans. Mortgage interest is also deductible on loans up to $750,000, or up to $1 million if you purchased your home on or before Dec. 15, 2017. When you are ranking debt by interest rate, you may want to adjust that rate to reflect any associated tax benefits the debt offers.

Once you have satisfied your first debt in full, don't abandon the minimum maintenance payment you included in your monthly budget. Continue to earmark that amount for debt payment and apply it to the second debt on your list, so you are paying down even more of that debt's principal each month. Repeat this pattern and watch as the old minimums for the paid-off debt act to compound the rate at which you pay off your remaining debt. Treating the former minimum payments as if they never went away protects you from spending your extra income elsewhere, while helping you to build the momentum you need to become debt-free.

Depending on the types of debt you carry, you may find their sheer number and policy details overwhelming. In this case, debt consolidation may help. Assuming your outstanding debt hasn't drastically lowered your credit score (see Chapter 3), it's not uncommon for your bank to provide a loan so you can consolidate your credit card debt. Depending on your credit score, the interest rate on the bank loan often will be lower than your credit cards' APR. If you have several student loans, you may also want to consolidate these; see Chapter 4 for more on consolidating educational loans.

If you are close to paying off credit card debt but need a small boost, you may want to apply for a credit card offering a promotional balance transfer with a 0% interest rate. This method is best for those with a decent credit score and the ability to pay off their transferred balance quickly, since promotional offers tend to cover a relatively short time span before reverting to a high rate. Know yourself, however. If you feel that a fresh credit card could be too much temptation, avoid this method of consolidation.

Don't discount the possibility of negotiating directly with your debt issuers if you need to. If they suspect you are at high risk of default, or if you are contemplating the possibility of bankruptcy, issuers will often negotiate an interest rate or structure a repayment plan to avoid a total loss.

When paying down your debt, or trying to minimize future debt, the key is to be honest about your habits and inclinations. For many people, the inability to systematically pay down debt is much more a psychological issue than a financial one. Those who tend to max out their credit cards are prone to do the same once debts are repaid. It truly takes a shift in how you view debt to break the cycle of poor spending habits. You can find many success stories from individuals who paid off large amounts of debt, each using a different strategy, and many of them emphasize a change in perspective as much as a change in budget. It is important you look within and face your debt fears so you can begin to understand what caused you to get into that hole as well as what will get you out of it. Similarly, picking the debt avalanche repayment method does you no good if you get frustrated and give up paying more than the minimum after a few months because it doesn't feel like you are making progress. What may seem like the most effective strategy on paper may be unsuccessful in practice if psychological limitations keep you from sticking with a plan. Find the strategy that you can live with both financially and psychologically, then follow it.

Knowing yourself can also help you find a balance between long-term saving and debt repayment. For some people, the allure of becoming debt-free is a highly motivating factor; for others, the idea of saving enough for a down payment or an early retirement makes saving the more emotionally satisfying way forward. While there are certain steps you should take either way — keeping up with minimum payments or building an emergency fund, for instance — working with your natural inclinations rather than against them may help you stick to your plan, which is more important than pursuing perfect optimization.

Your financial awareness will likely grow sharper over time through experience. As you try to balance spending, saving and debt repayment, it is almost certain you will make some choices that are less than perfect. Everyone does – even financial professionals. While you are still gaining experience, though, you will benefit from turning elsewhere for advice. You can do your own research, ask a trusted mentor or consider a consultation with a professional financial planner. Picking up this book is, in itself, a great start. While experience will help you when it comes, attending to your financial well-being shouldn't wait. An imperfect plan is much better than no plan at all, and the best time to act is always now.