



Thursday, June 24, 2021

Conventional Wisdom

Each spring, a rite of passage occurs in stadiums, auditoriums, and Zoom calls across the nation: The latest graduates cross the stage to begin a new phase of financial independence. As has always been the case for graduates, the class of 2021 will face an array of financial choices for the first time—simple decisions on saving and spending that may seem small in the moment but have financial repercussions that can extend far into the future.

Today's graduates also face a very different environment from their older siblings, cousins, parents, and grandparents. Instead of the anxious yet still carefree final months on campus, many students endured a more solitary experience from their dorm rooms or apartments—or their parents' basements. They will also enter a job market that is far from normal. The pandemic has altered the landscape for how and where work is done, and it's unclear how many of these changes will persist once the crisis has passed.

Even so, there will be no shortage of financial wisdom showered upon new grads from commencement speakers, proud parents, well-wishing relatives, and friends on social media. The advice they receive will likely include financial rules of thumb that have, in many cases, been passed down through generations, like a battered, leather-bound portfolio or briefcase.

Rules of thumb are simple frameworks to help us make complex decisions based on limited information and imperfect knowledge of the future. Some, like the widely used *rule of 72*, are rooted in math, while others are driven by behaviors. Either way, their value is that they don't have to provide perfect predictions to be useful. Instead, they serve to nudge us toward more successful behaviors and provide simple frameworks to consider the long-term consequences of everyday decisions.

Even if the current environment is very different from the past, there is always value in learning from people who have survived and thrived amid any number of challenges, shocks, and prior tectonic shifts in how we live and work. Many of the financial tips offered to graduates 50 years ago remain just as

true today—while others have likely changed.

Budget

What hasn't changed. The most fundamental driver of lifelong financial success is the ability to set and keep to a budget. You can only save or invest what you don't spend, and this simple truth forms the basis for perhaps the most famous financial axiom of all time: Pay yourself first.

This phrase, coined in a 1926 book on personal finance, titled *The Richest Man in Babylon*, has certainly stood the test of time and has been expanded over the years with additional parameters. The *80/20 rule*, for example, suggests spending 80 percent of take-home pay on needs and wants, with the remaining 20 percent aimed toward savings or debt reduction. This provides a useful, simple framework for the budget-savvy.

But after the initial shock subsides—Wait, you want me to reduce my paycheck by 20 percent?—the natural next question is what to do with that money. There is no shortage of competing and worthwhile priorities, including paying down college debt, saving for retirement, or building toward a down payment on a home. But the experienced advice-giver will have a ready answer: The rainy day fund. Conventional wisdom calls for three to six months of living expenses kept safe in a savings or money market account that may be just a little inconvenient to access, thereby reducing the temptation to raid the piggy bank.

This is sound advice indeed, and what's great about the second tip is that it requires knowledge of the first. After all, you can't plan for six months of living expenses until you actually know what those expenses are.

What may have changed. Fortunately, today there are many tools, apps, and services to simplify and automate the process of creating a budget. Instead of legal pads or spreadsheets, a smartphone app will scan accounts to track and categorize spending. Other apps will round purchase amounts up, turning spare change into gradual progress toward the rainy day fund. But as for the size of that fund, today's environment may call for a more customized approach to the standard six-month target.

Even before the pandemic, there was already a shift underway toward more flexible, independent work arrangements—the so-called *gig economy*. And all else being equal, gig workers probably need an even larger emergency fund for two reasons: to smooth out the more variable nature of their income and to protect against events (illness or even a flat tire) that prevent work. And as many experienced during the pandemic, unemployment benefits for gig workers are also less clear.

Workers in more traditional jobs may also need to adjust the six-month target to the current environment. A contemporary and clever twist on the six-month rule is to take the current unemployment rate (in percentage points) and keep that number of months' expenses in reserve, at a minimum. But with a recent unemployment rate of 6.1 percent, this takes us right back to where we started: a six-month target. Things may not be so different, after all.

Debt and Credit

What hasn't changed. As with budgeting, the most basic advice with respect to debt management is both simple and timeless: Live within your means. Whether drawn from a philosophical basis—such as the belief that money doesn't buy happiness—or from the practical recognition that debt reduces flexibility and limits future choices, debt management is a key to financial wellness.

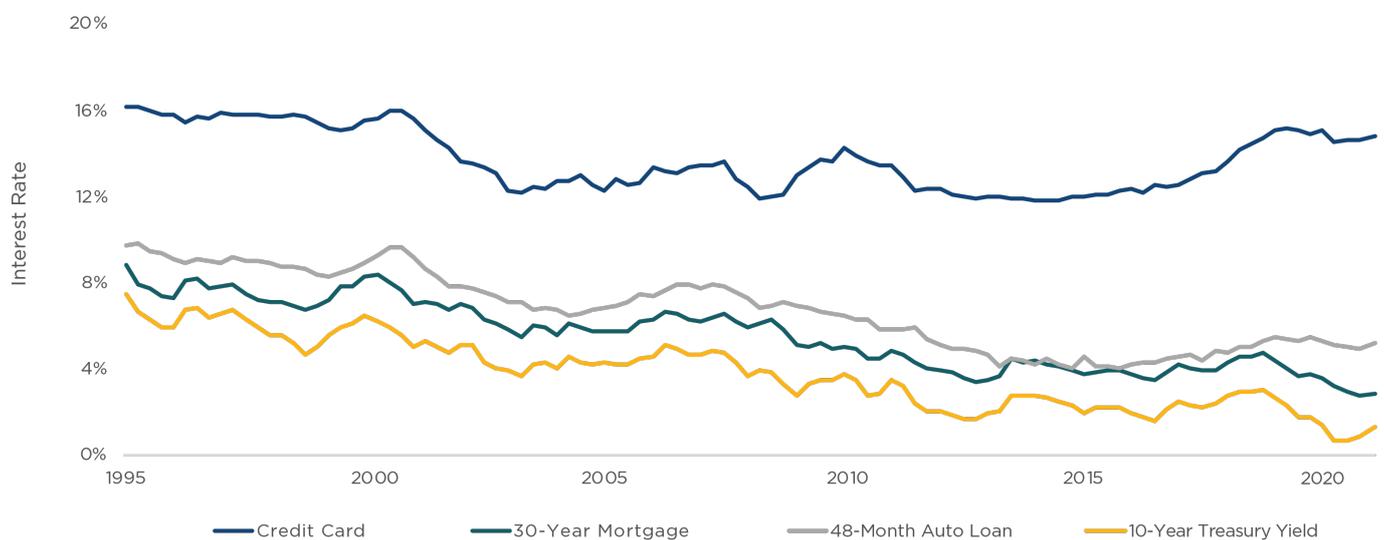
In addition to the stress that accompanies a high level of debt, debt carries tangible costs. Establishing a solid credit history and high credit scores can lead to far more attractive loan terms. For example, the difference in annual percentage rates (APR) for 30-year fixed-rate mortgage loans recently reported for borrowers with the highest (760 to 850) and lowest (620 to 639) Fair Issac Corporation (FICO) scores was 1.59 percent.[1] For a \$300,000 mortgage loan, this equates to a mortgage payment that is more than 20 percent (or \$265) higher each month and total interest costs more than \$95,000 greater over the life of the loan for those with the lowest credit scores.

Credit decisions can also influence career paths, both directly and indirectly. Increasingly, employers include credit checks as part of their preemployment background checks. Just as importantly, keeping debt levels under control can mean the difference between being forced to remain in an adequately paid but miserable job or one with limited potential for future growth versus having the flexibility to pursue opportunities that sometimes require a nonlinear path toward a more rewarding career.

What may have changed. For today’s graduates, there are two important factors that are different from those of prior generations: the prevalence of student loans and the historically low interest rate environment. Over the past decade, the amount of student loan debt outstanding has nearly doubled to \$1.7 trillion—an amount far above both credit card and auto loan balances.[2] A recent survey by the National Association of REALTORS® reported that nearly half of all homebuyers ages 22 to 30 years of age reported that student loans had delayed their purchase decisions.[3]

Another difference is the current interest rate environment. Over the past three decades, the overall level of interest rates (as measured by the benchmark 10-year U.S. Treasury yield) has steadily declined. As shown in Figure One, rates for consumer borrowers have generally followed suit, aside from credit cards, which have retained their steep premiums.

Figure One: Average Consumer Interest Rates (1995 to 2021)



Source: Federal Reserve Bank of St. Louis (FRED)

In the short term, low rates represent a boon to those early in their careers, as they reduce the monthly maintenance cost of debt. And unlike savers later in their careers, the opportunity cost of low interest rates on savings or money market balances is typically low. The risk is that low debt service costs lead to overextension, particularly if borrowers make decisions on how much of their car, house, or even graduate school degree they can afford based solely on the current, historically low monthly

payment. Although we don't know what interest rates will look like a decade from now, they're unlikely to be significantly lower.

Homeownership

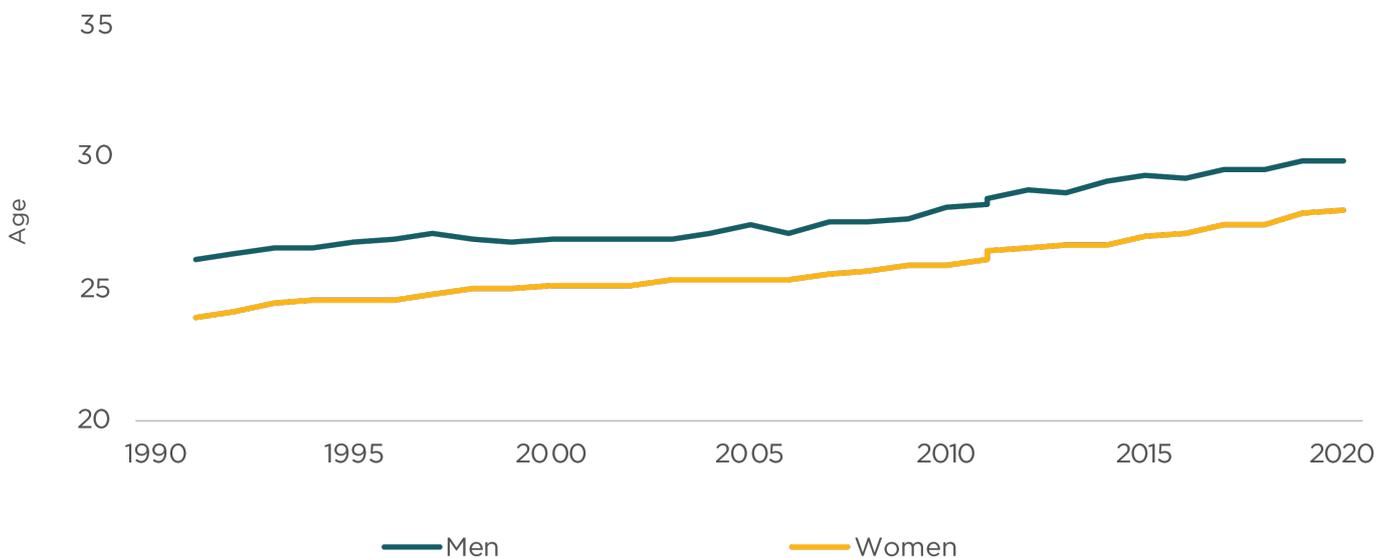
What hasn't changed. When we think of debt, the natural next topic is homeownership and the classic bit of financial advice that forms the very cornerstone of the American dream: Save 20 percent toward a down payment and buy your first house as soon as you can.

The fundamental financial case for homeownership has not changed. Owners build equity in an asset that they can use, enjoy, and improve with sweat equity, in addition to the potential tax benefits. Although real estate prices are notoriously local in nature, since 1987, the average annual increase in the Case-Shiller U.S. National Home Price Index has been greater than 4 percent with lower volatility than many other types of assets.[4] This is in addition to the less-tangible, nonfinancial benefits such as a greater ability to personalize a home to the owner's needs, the notion of putting down roots, establishing a stable home base for raising a family, and enjoying a greater sense of community.

What may have changed. Even with mortgage rates at historically low levels, soaring home prices have pushed home affordability out of reach for many potential buyers. Not surprisingly, the median age of first-time homebuyers has increased to 33, which is four years older than it was in 1987.[5]

One contributor to this delay may be that people are forming households later in life than previous generations. Dual incomes can be important for many first-time buyers, and one recent study reported that more than 70 percent of homebuyers were either married or unmarried couples.[6] But, as shown in Figure Two below, the median age at marriage has increased dramatically over the past three decades, reaching more than 30 for men and 28 for women in 2020, an increase of more than four years since 1990.

Figure Two: Estimated Median Age at First Marriage



Sources: U.S. Census Bureau, Annual Social and Economic Supplements, 1947-2020. Estimates include same-sex marriages after 2019.

Holding aside these financial aspects, the current reality is that homeownership may not be right for everyone. Today's workers are far more mobile than they were in prior generations. A 2019

Department of Labor study reported that workers held 5.7 jobs on average from ages 18 to 24 and an additional 4.5 jobs from 25 to 34. However, it is important to note that this study only included individuals born between 1957 and 1964 and therefore may underrepresent the degree of mobility in today's younger workforce. And the 2020 pandemic may have only accelerated this trend. Another recent survey conducted by Harris Poll exclusively for *Fast Company* showed that the majority (52 percent) of U.S. workers are considering a job change in 2021, and as many as 44 percent have plans to do so.

Considering the up-front costs of buying a home, another common rule of thumb is that buyers should plan to remain in their homes for at least five to seven years just to break even. Unless the home's location could support four to six job changes, on average, during that period, renting could be more attractive than buying.

Even so, delayed homeownership doesn't eliminate the need to save for the eventuality of buying a home, and the key is to begin to accumulate equity elsewhere. Home prices (and, therefore, down payments) are likely to increase over time, and without accumulating liquid savings that can grow at a similar rate, a purchase five or ten years hence becomes that much more difficult.

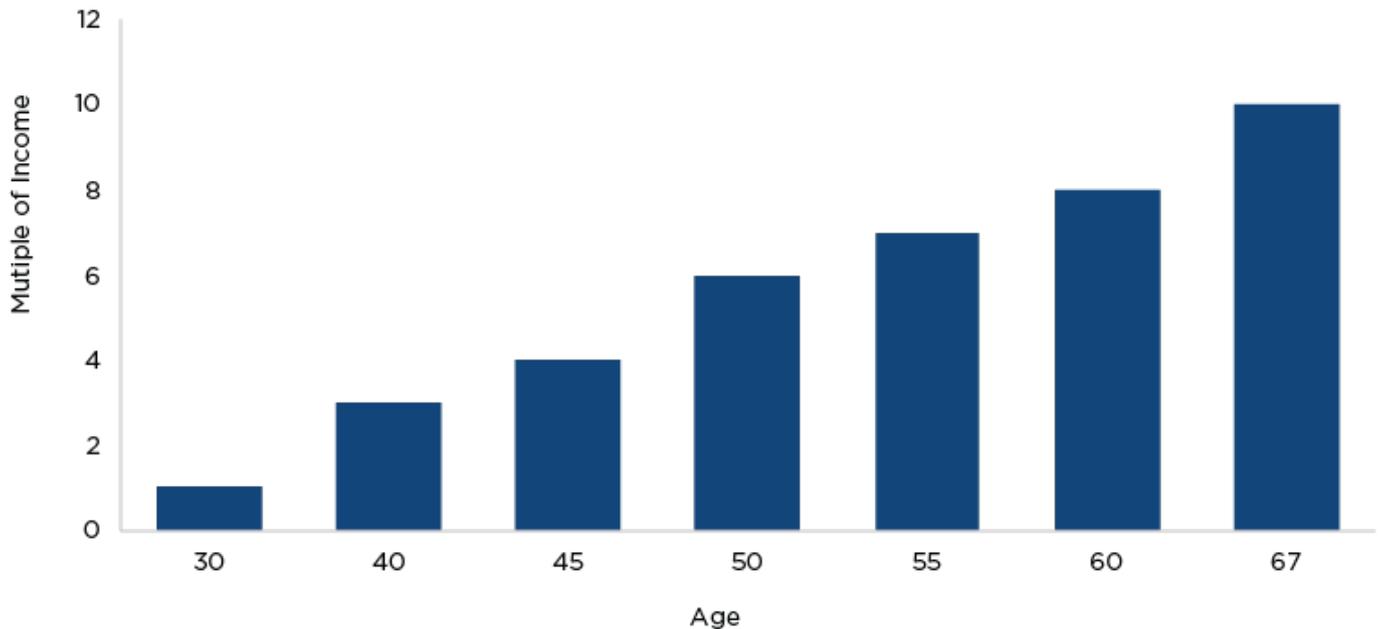
Investing for Retirement

What hasn't changed. Saving and investing for retirement have long been fertile grounds for financial wisdom. And for good reason. For those in their early 20s, retirement is maybe 40 or 50 years away. With such a long period before the payoff is realized, it's even more difficult to make sacrifices today.

The gold standard retirement savings rule of thumb is to save 15 percent of pre-tax income, including any employer contributions. For those who are able, this sets an excellent trajectory that can dramatically increase the likelihood of retirement success. But with the competing priorities already discussed—student loans, credit card payments, and building a rainy day fund—it can be difficult for many new graduates to hit this target right out of the gate. But all is not lost. Experienced advice-givers have a few more go-to tidbits to pass along:

- Maximize the match. Even if you can't hit the 15 percent target, do everything you can to maximize your employer's contributions, even if this means slowing down your progress toward other savings or debt reduction goals.
- Set yourself on autopilot. Many 401(k) and 403(b) plans offer automatic escalation features that increase paycheck deferrals by, for example, 1 percent each year—a level hardly noticeable for most people.
- Check progress regularly. Even if your goal is still several decades away, set milestones and checkpoints to measure and celebrate success. This can take the form of retirement planning sessions with a qualified retirement plan advisor. If this kind of service isn't available, even simple measuring guidelines can make progress feel much more tangible and attainable. Figure Three shows one such benchmark based on target retirement balances by age.
- Look, but don't touch. Given the job-switching behaviors already discussed, younger workers will face the temptation to take a distribution instead of a rollover when leaving a job. Such premature distributions are a common mistake that should be avoided whenever possible. What seems like a small sum of money can have massive implications on long-term success, particularly after early withdrawal penalties.

Figure Three: Retirement Balance Benchmarks as a Multiple of Income



Source: Fidelity Investments

What may have changed. Given workforce trends already discussed, one piece of advice many of us may have once received is becoming less and less applicable: Find a good company, build your career there, and retire with a comfortable pension. Today, it's estimated that only 15 percent of private-sector workers have access to a traditional pension plan, according to U.S. Bureau of Labor Statistics.

Another common, but outdated, rule of thumb for retirement investing is the *rule of 100*—investors should subtract their age from 100 to set the percentage of their portfolio to hold in stocks. Over the past two decades, the industry has invested massive resources in studying the best approach to asset allocation over a retirement saver's career. The rule of 100 may leave retirement savers underexposed to equities both at the beginning of their career and toward the end, when their accumulated balance must support several decades of spending.

A more modern approach is, once again, to take advantage of automation. Many retirement plans today offer age-based target date funds or other solutions that offer diversified portfolios with set-it-and-forget-it convenience. In addition to eliminating the need for manual adjustments, these solutions may also reduce investors' temptations to make changes in response to short-term bouts of volatility.

Finally, most retirement plans today offer a Roth option—the ability to save after-tax dollars today and receive qualified distributions tax-free in retirement. Although everyone's tax situation (and view around future taxes) is different, a simple rule of thumb is that if your current tax rate is lower than you expect in retirement, you should direct at least some retirement savings toward Roth. If nothing else, the ability to choose between taxable and nontaxable buckets can be a powerful planning tool.

Those in the position to offer financial advice to those just setting out can make a huge impact—assuming, of course, that the advice is heard, understood, and relevant to the current environment.

Ambitious young readers of *Fortune* magazine's 1956 article, "Twenty Minutes to a Career ... Or Not," were advised to consider the standard 20-minute job interview as an event that would settle their careers for life and that they should consider a job offer in terms of a lifetime career. Simply

considering the number of bankruptcies, corporate mergers, and acquisitions since then, it is unlikely that many of the class of '56 retired from their first jobs.

The best advice is always good advice that is actually followed. And more often than not, it's the stories of our own struggles and mistakes that have the greatest impact. No matter our level of success, there are always things that we would have done a little differently—and these are likely the most impactful lessons to pass along to the next generation.

[1] Fair Isaac Corporation, Home Purchase Center, May 17, 2021

[2] Student Loans Owned and Securitized, Outstanding, retrieved from FRED, Federal Reserve Bank of St. Louis

[3] National Association of REALTORS®, 2021 NAR Home Buyer and Seller Generational Trends

[4] S&P/Case-Shiller U.S. National Home Price Index, retrieved from FRED, Federal Reserve Bank of St. Louis.

[5] Pickert, Reade, "Young Homebuyers Are Vanishing from the U.S.," *Bloomberg*, 2019

[6] 2021 Home Buyers and Sellers Generational Trends Report, National Association of REALTORS® Research Group, 2021

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