BusinessWeek

WHAT'S YOUR STORY IDEA February 12, 2009, 12:01AM EST

Advice for Young Investors

It's a bewildering time to begin saving and investing. *BusinessWeek* asked financial advisers for words of wisdom for the young investor

By Ben Steverman

Two 22-year-olds are just starting their careers and beginning to save and invest. One devotes half his salary to quickly paying off student loans, with the goal of saving money to travel the world. The other dabbles in stocks, while planning to buy a home. Which one is starting out on the right foot? Neither? Both?

Learning to invest is hard enough. Now try doing it during the worst recession in a generation and the biggest financial crisis in a lifetime. If you're a young person with money to invest, however, you can consider yourself lucky. You have income at a time when the jobless rate is rising rapidly. If you're just starting out, you avoided—so far—huge losses of the sort that drastically changed the retirement plans of many baby boomer parents.

NO EASY ANSWERS

But the current environment naturally leaves a beginner confused about how to invest. The tough housing market means real estate looks cheap, but it's also an unreliable investment. After the financial market's problems of the past year, the same can be said for stocks, bonds, and other investments. Are they a bargain or a dangerous trap? At the same time, the financial crisis and widespread layoffs seem to argue for playing it safe. But how much cash can really fit into your piggybank or under your mattress?

BusinessWeek asked experienced financial advisers for some advice to young investors. Experts don't always agree, but all agreed on one piece of wisdom: There is no easy answer. The right investing plan depends on your personality and your short-term and long-term goals, advisers say. Consider the two young investors mentioned above. On the surface, they're similar, but they're going about saving and investing very differently.

Alex Engelman is 22 and works at a market strategy consulting firm near Burlington, Vt. He distrusts the stock market and he doesn't plan to buy a home anytime soon. "I'm all about mobility in my twenties," he says. Instead, Engelman plows half of his income toward one goal—paying off student loans that once totaled more than $20,000. "I don't want debt hanging over my shoulder," he says. When the loans are paid off—before the end of the year—he'll start saving cash so he can pack up and travel.

Robin Jordan, also 22, works in marketing at a retirement planning firm in Santa Barbara, Calif. He doesn't plan to move away anytime soon, and is seriously considering buying real estate. "The rent I'm paying right now to live in downtown Santa Barbara is more than the monthly payment on my parents' mortgage in northern California," he says. "I look at home ownership more as an investment than as a lifelong commitment," he adds. Meanwhile, Jordan is also starting to dabble in stock investing—setting aside 20% to 30% of his savings to buy individual stocks and another 50% for broad index funds. He's trying to diversify his portfolio, but has noticed that's hard to do because many funds require minimum contributions.

Both young men may be pursuing plans that are perfect for their particular circumstances. There are, however,

some general principles of investing and saving that it pays to be aware of. Advisers offer these tips:

1. Cash, cash, cash. Both Engelman and Jordan said they're not yet saving much cash from month to month. However, nearly every financial planner will tell clients the first priority is an emergency cash fund. Before you can invest for the long term, you need enough to cover your current needs, they say. It's important not just if you lose your job, but for covering any eventuality from a major car repair or moving expenses to a pet's—or your own—surgery. For years, many clients resisted this advice, says Leisa Brown Aiken of Timothy Financial Counsel in Chicago. They preferred to be making money in the stock market or spending more on a future or existing home. Now that stocks and home prices have been pummeled, there's been "a big sea change" in attitudes, Aiken says.

The insecurity of many jobs these days also prompts more saving. "People are getting wise: You've got to have money in the bank," says Robert Timineri of Total Return Advisory in Oroville, Calif. The goal is keeping the cash handy so you can get it in an emergency. Many online banks pay out relatively generous interest rates on savings accounts.

But how much to save? A bare minimum starting point is one month of expenses, but ideally a fund should cover three to six months of expenses. Timineri used to advise each adult should have ready access to $10,000 in cash, but, because of the bad economy, he has boosted that to $15,000 to $20,000.

2. Enough insurance? One other base that needs to be covered before serious investing starts is insurance. Robert Oliver of Oliver Financial Planning in Ann Arbor, Mich., says most young people don't have enough disability insurance, which covers living expenses in case you're injured and can't work. "As younger people, your main asset is yourself, your ability to earn over a lifetime," Oliver says. A disability puts that in jeopardy, but the basic disability insurance offered by employers is rarely adequate, he says.

3. Should you buy a home? This might look like a great time to buy real estate. Home prices are falling, mortgage rates are low, and Congress is debating rich incentives for first-time homebuyers as part of the pending economic stimulus package.

But there are problems: Credit standards are tighter and it's harder to get a mortgage by putting only 5% or 10% down, a practice that was common a couple years ago. Also, if your job situation is tenuous, this might not be a good time to take on a heavy debt load. Using your emergency cash fund for your down payment defeats the purpose of such funds. Plus, you'll probably need that cash once you move in. "Owning a home is expensive," says Paula Hogan of Hogan Financial Management in Milwaukee. Maintenance on average costs 1% of the value of the home each year. "That can take a new homeowner by surprise," she says. The housing bubble misled many Americans about real estate investing. Taking into account maintenance and the long history of home values in the U.S., the annual return on a home might be only 1%, says Kristopher Johnson of Timothy Financial Counsel in Wheaton, Ill. A home purchase might be the right choice, but it's often a decision made for nonfinancial reasons. "I view my home as an expense," Johnson says. "I need a place to live."

4. How secure is your job? The U.S. unemployment rate is inching higher every month, with thousands of layoffs announced each week in a range of industries. "At this point, I don't think anyone's job is secure," says Jorie Johnson of Financial Futures in Manasquan, N.J. Even teachers are facing layoffs. "Anyone who feels too comfortable is doing themselves a disservice."

The security of your job matters because it affects how much risk you should feel free to take in your investing

portfolio and how much cash you should hold. One oft-repeated guideline, says Aiken: "Is your earnings stream more like a bond or a stock?" Though the financial crisis put these distinctions to a test, bonds are supposed to be reliable, while stocks can be volatile and unpredictable. A person or couple with jobs that fit in the bond category can afford to take on more risk in their investments.

5. How much risk can you handle? If you're saving for the long term, you probably have time to ride out market turbulence and, in 30 or 40 years, rack up some nice gains even from risky investments. That's how it's supposed to work in the abstract, anyway. In reality, the ups and downs of the market can leave you anxious and cause you to bail out of investments too early. "Some can't take the heat," Kris Johnson says.

Thus, the amount you should invest in, for example, risky stocks is driven partly by your personality, Jorie Johnson says. Lately, investors have gotten a taste of just how bad conditions can get. "The last six months have been a good test of risk tolerance," Oliver says. If you can't sleep at night when your nest egg loses 40% of its value, a more conservative portfolio—for example, more bonds and less stocks—may help. Engelman, for example, admits equity investing doesn't fit his personality. To him, he says, "There's something intrinsically unreliable about it."

6. Equities are risky. Equities, or stocks, do better than most other investments over the long term. The problem is that equities sometimes go through long periods—the 1930s, the 1970s, the past decade—when values barely budge and even fall substantially. That has sparked debate over how appropriate it is to risk retirement funds in the stock market, and, if so, what portion of a portfolio should consist of these risky assets.

Any amount of money you need soon, i.e., in the next five or ten years, should not be in stocks, advisers say. Even a decade is too short of a period for some conservative investors.

Young people have an advantage here because they have longer until retirement. Jordan says he doesn't mind betting on stocks because "while I'm young, I still have time to recover those losses." For young people in their twenties, 50% or more of a 401(k) or other retirement plan could go into equities. But, says Aiken: "The key is not time period, but the resiliency of their ability to earn income." Young people have decades to earn back money lost in bad years like 2008.

The classic antidote to the riskiness of equities is bonds. However, that didn't work last year. Funds based on U.S. Treasuries—safe government debt—saw outsize gains, while corporate bond funds registered huge losses. "A lot of people got caught by surprise," Jorie Johnson said. Bonds may return to their calmer behavior eventually, but in the meantime bank certificates of deposits and inflation-protected Treasuries, or TIPS, are other safe alternatives.

7. Get started. Retirement can feel like a long time from now, but money invested now can compound year after year. "Compounding is a very powerful thing," Oliver says. "Even if it's just a small amount, time is your biggest ally." Also, young investors can learn and even make mistakes while the stakes are still low, Hogan says. Almost all experts advise clients to take full advantage of an employer that matches retirement contributions. Doing otherwise is leaving money on the table. Jorie Johnson advises saving 10% of your income no matter what. Get started now, because while your income may rise in the future, so will your responsibilities and spending, she says.

8. Do everything. "It's important to do everything," Jorie Johnson says. This means you've got to juggle it all, financially: pay down debt while saving for both short-term and long-term needs. "You have to make sure that

every month you're putting money aside for each goal," she adds. Without that balanced approach, you're likely to focus on one goal—like buying a house—and never meet the others—like setting up an emergency fund or saving for retirement.

9. Be flexible. Timineri, who advocates setting aside a larger-than-usual cash reserve, says the financial crisis and stock market collapse have changed the rules for investors. "I don't have the faith that I used to have [in the financial system]," he says. For now, he's allocating a maximum of only 50% of portfolios to stocks, and telling clients to wait before making any major moves. "No one thinks this is going to be over in a couple months," he says. In other words, this may not be the time to set up a financial plan that you stick with for life. A little caution and flexibility may be warranted for the time being.

10. Can you save and invest too much? It's rare that young people can set aside too much money for the future, advisers say. More often, clients need to be reminded of the risks of saving too little. "If you don't save [a certain] amount, you're never going to be able to stop working," Aiken tells clients. "That often motivates them."

But how do you balance your present happiness with future needs? Bob Smrekar of Wade Financial Group in Minneapolis says some clients save very aggressively, living a lean lifestyle because they want to retire by age 55. "If that's what their goals are and that's what they want to do, more power to them," he says. Other of his clients prefer to travel while they're young and healthy, even if they're well aware that expensive trips may delay their retirement.

Obviously, advisers say, it makes sense to spend now on college or graduate school. Even if it delays the start of your retirement investing, another educational degree could add substantially to your income over a lifetime. "Your life today is just as important as your life in retirement," Oliver says. "But the difference is you're not going to have some earned income in retirement. It's all about that trade-off."

With each paycheck, young investors must weigh a variety of goals, for the present and into the future, against each other. It's a balancing act made even more difficult by these unstable times.

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