A Road Map to Financial Security for Young Adults

The path to financial security may be more difficult for those starting out and working toward independence today than it has been for others in the past. Unemployment among those under age 24 is 16.4%, double the national unemployment rate. Additionally, more than a third of the nation's $870 billion in outstanding student loan debt is held by borrowers younger than 30 years old.

Yet financial security may be more attainable than many young adults realize, even in weak job markets and times of high college costs. Stuart Ritter, a T. Rowe Price senior financial planner, says that with the right expectations and a bit of planning, young adults can get their finances on the right track.

"Young investors can accomplish a lot in just three to five years," he says. "Financial security is not necessarily a 20-year endeavor, and thinking of it as such can only facilitate excuses to neglect working toward it.

"Young adults today may have a comparatively tougher road ahead of them, but small steps can lead to big results over time."

The Essentials

Mr. Ritter lists four primary financial priorities for those starting out:

- Saving 15% of their salary for retirement
- Obtaining the right insurance—both health and renters or homeowners insurance
- Paying off high-interest debt such as credit cards
- Building an emergency fund to cover three to six months worth of living expenses

As for student loans, Mr. Ritter advises, "Don't pay them off any sooner than required. And any extra money should be applied to these goals."

He also emphasizes that young adults should work toward these goals simultaneously and that there are consequences to completely ignoring one to focus on another.

Working Toward Financial Security

How Much Do Young Adults Need to Save?

This chart shows how a recent college graduate with a starting annual salary of $35,000 could save for financial security. In this example, she would save 15% of her salary toward retirement by splitting her contributions between a Roth individual retirement account (IRA) and her employer's 401(k) plan. Assuming her employer matches half of her contributions up to 6%, she contributes enough (6%) to receive the full match (3%), bringing her total 401(k) contributions to 9%. The remaining 6% is directed toward the more beneficial retirement vehicle for long-term investors, the Roth IRA. Within three years, she builds an emergency fund covering three months of living expenses. Her initial student loan balance of $25,000 carries a 7% interest rate; she pays it off in 10 years. As she builds a financial cushion over time, she may have more disposable income to direct toward secondary goals, such as saving for the down payment on a house, a new car, or going back to school.

Monthly salary and expenses	First year out of college	Six years out of college	10 years out of college
Salary	$2,917	$3,381	$3,920
Income taxes	$547	$634	$735
Retirement savings			
401(k) contributions to receive match: 6%	$175	$203	$235
Roth IRA contributions: 6%	$175	$203	$235
Emergency fund contributions—totaling at least $5,700 in 3 years	$160	$0	$0
Insurance			
Health insurance	$100	$116	$134
Renters insurance	$20	$23	$27
Student loan—pay off $25,000 in loans with 7% interest in 10 years	$290	$290	$0
Total expenses toward financial security	**$920**	**$835**	**$631**
Disposable income	$1,450	$1,912	$2,553
Disposable income as a percentage of gross salary	50%	57%	65%
Disposable income as a percentage of net salary after taxes	**61%**	**70%**	**80%**

The salary and insurance expenses are increased 3% each year for inflation. The federal income tax rate is 15% and local taxes are 3.75%. Assuming a 7% annualized return, retirement account balances combined would have grown to $43,069 after six years and $87,526 after 10 years, even though the investor never made more than $46,000 per year by that time.

This example is for illustrative purposes only and does not represent the performance of any particular investment.

"Consider what can be done realistically to put a bit of money toward each goal and hopefully accomplish more over time," Mr. Ritter says.

For example, even with an employer's matching contribution, it may be difficult to save 15% of annual salary toward retirement right away. But young adults should start by contributing enough to receive their employer's match, and then increase their contribution rate by two percentage points each year until they reach the 15% target.

> "The biggest obstacle for those starting out is not financial, but psychological: They have to make a significant mental shift to right-size their expectations and perhaps their level of patience."

Saving for retirement and having the right insurance may be lifelong endeavors, but paying off high-interest debt and building an emergency fund might be accomplished within a number of years. As shorter-term goals are met, more money can be allocated to the longer-term goals.

Even with today's tough job market, Mr. Ritter emphasizes that if young adults have an income stream, they should try to work toward these goals, even if their contributions are small and come from a part-time position or low-paying job. Avoiding the essentials now only makes it financially harder later.

Time as an Ally

Young adults also can begin to take a few small steps toward their long-term goals that can put them in a much better position to remain financially secure in the future.

"Once you begin to earn income, time can be a significant ally when it comes to saving for retirement," says Judith Ward, a T. Rowe Price senior financial planner.

She suggests young adults consider investing in a Roth IRA (individual retirement account) for retirement. While investors cannot deduct their contributions to a Roth IRA, their earnings can grow tax-deferred and withdrawals are usually tax-free under certain conditions.

Additionally, young investors may be in a higher tax bracket after retirement than they are now, making tax-free withdrawals more valuable.

When considering what may be an appropriate asset allocation, stocks have tended to offer relatively stronger returns over long time periods, making them particularly well suited for young retirement investors.

Because they may be investing small amounts at a time, young investors should consider a fund that offers asset allocation and diversification in one easy step, such as a fund of funds.

For more information on Roth IRAs and young adults planning for retirement, T. Rowe Price offers videos at youtube.com/troweprricegroup.

Biggest Hurdle

The biggest obstacle for those starting out is not financial, but psychological: They have to make a significant mental shift to right-size their expectations and perhaps their level of patience.

"Until they graduate college or high school, young adults have had their lives divided into four-month blocks," Mr. Ritter says. "Their goals were oriented toward what they wanted to accomplish that semester or school year, from kindergarten onward. And the things they planned for came to fruition in several months.

"Now all of the sudden, they have to plan for 3-, 5-, 10-, and even 40-year periods. They have to develop patience and foresight on a new scale."

Additionally, many try to replicate, in just a few years, the lifestyle it took their parents a lifetime to achieve. They may be used to having a high-speed Internet connection, cable TV, smartphones, annual vacations, one car per driver, many gadgets of convenience, and so on.

But Mr. Ritter cautions, "It is easy to think, 'I deserve this. I worked hard, and now I am done living like that.' But preparing for tomorrow's needs may mean delaying purchases or considering lower-cost items. They can get the things they want, but it is not an overnight process."

Mr. Ritter also cautions young adults from benchmarking themselves against their friends and others in their situation, as these comparisons can lead to impulse purchases on short-term items such as clothes and vacations. This renders such higher-priority items as a house down payment more difficult to attain.

Secondary Goals

Once young adults are on track to meet these four goals, they can start focusing on saving money for their secondary goals, Mr. Ritter notes, such as a house or car down payment, vacation, or perhaps going back to school for a graduate degree.

He suggests young adults make a list of each secondary goal, when they want it, and how much it will cost when they purchase it and then figure out how much they will have to save each month to buy what they want.

If they find that they will have to save an unrealistic sum of money to reach these goals, they may have to "want less or want it later," Mr. Ritter says.

He also suggests they examine how they are actually spending their money each month and consider if what they are buying actually reflects their priorities.