

# YOUR FINANCIAL PATH



## COMMUNITY COLLEGE TO FUCK YOU MONEY

A textbook dedicated to helping  
community college students  
achieve financial security for life.



STEPHEN HEATH, CPA

## PREFACE

Dedicated to Lisa, Sophia, Luke, and

All my former community college professors and classmates, my current community college colleagues, and most importantly, my community college students

## PREFACE

|                       |  |
|-----------------------|--|
| Author                | Stephen Heath, <a href="mailto:heaths@smccd.edu">heaths@smccd.edu</a>    |
| Forward               | Dr. Frederick Gaines   |
| Executive Editor:     | Dan Salah  |
| Copy and Line Editor: | Tracey Leighton  |
| Associate Editors:    | Keaton Townley and Sophia Heath  |
| Cover Art:            | David Townley, Trever Jolin, Andre Morner “Boogie” and @illuminaries     |
| Resources             | ProfessorHeath.com for resources and information regarding this textbook |

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## My Background

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I hated high school and ended up dropping out my sophomore year. I would have been shocked if you told me then that I would later graduate from the University of California, Berkeley. I was arrested several times for drug-related issues in my late teens. I would have been shocked if you told me then that I would later testify in federal and state courts as an expert witness on accounting and finance-related issues. In my 20s I worked all sorts of blue-collar jobs, from mowing lawns to installing linoleum. I would have been shocked if you told me then that I would work as an accountant for 25 years and ultimately become an accounting teacher. I didn't have a dime to my name when I turned 30. I would have been shocked if you told me then I would retire from consulting a millionaire.

I am continuously told I can't write. My teenage kids ridicule me for my improper use of grammar in text messages, and I often have to ask my students how to spell certain words during lectures. If you were to ask me over the years if I was planning to write a book, I and everyone else I know would have been shocked.

I have walked the long path from high school dropout to reasonable financial success. I have learned a lot through my own experiences along that road. Looking back, I am certain that community college had the most influence on me in my transition. I received a formal education in business from the greatest public university in the world. I am recognized as a financial expert by the Federal Government, the State of California, and the American Institute of Certified Public Accountants. For the past 25 years, I have provided financial advice to clients. And finally, I have been teaching Personal Financial Planning and several related accounting courses at the College of San Mateo since 2015.

I have had countless conversations with my students about the costs and benefits of particular colleges, and I am constantly asked my thoughts on cryptocurrency and meme stocks. I have often found it frustrating that so many of my students make significant uninformed and poor financial decisions before they graduate that tend to lock them into a path far below their true potential. There are no personal financial planning textbooks targeted at low-income community college students that address these issues from their perspective. So, when the country went on lockdown to combat COVID-19, I began writing this book to address those issues. Along the way, I chose to turn down invitations to have this book published. I did so because I feel that if there is going to be a personal financial planning textbook directed at low-income college students, it should also be accessible to those students. And you don't get any more accessible than FREE. Let's be clear, the electronic version is free.

I'm a firm believer in "you get what you pay for," so I can't help but wonder what you must be thinking of my free book. You are probably thinking it can't be worth much. Well, maybe you should think of it this way instead: It could literally cost you a fortune to NOT read this book. And because of that, this book could be invaluable to you.

### A. High School

I attended a small private elementary school through the 8th grade and found the transition to a large high school totally overwhelming. To make matters worse, from the onset I was constantly harassed by a group of football players. They would relentlessly pick on me during lunch and after school on the way to the bus stop. To avoid the constant ridicule, I started hanging out with the "stoners," as most of them were juniors and seniors and looked rather intimidating to most people.

The harassment stopped but was replaced with a bigger set of problems. You don't hang out with the delinquents of the school without developing bad habits and attracting unneeded attention along the way. I got suspended for dealing drugs in the men's bathroom my freshman year, and by the time I was a sophomore, I was cutting classes

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by the day. I missed more than 160 classes my sophomore year and was therefore placed into continuation school. One day after school, I got into a huge fight that involved eight or nine students at the local liquor store. That fight pretty much ended my high school experience. In addition to getting suspended, I broke my nose and the bone over my right eye. I had teachers who said they drove past that fight after school and were too afraid to get out of their cars to stop it. By the time my so-called junior year rolled around, I had officially dropped out and was living in a two-bedroom apartment on the east side of San Jose with three other high school dropouts. I had absolutely no idea where I was headed or what I was doing. And most importantly, I was too young to listen to any sensible advice.

One of the other dropouts I was living with became the neighborhood drug dealer, and you don't live with the neighborhood drug dealer without developing more bad habits. Unfortunately, I developed a serious meth habit. To say I was heading in the wrong direction would be an understatement. I was arrested again when I was 18 and was charged with possession, under the influence, and intent to sell methamphetamines. Faced with the possibility of serious jail time, I quit the habit, separated myself from most of my friends, moved near a beach in Santa Cruz, and obtained a decent attorney. By the grace of god, all the charges were ultimately dismissed and I was officially given a second chance. For the next several years, I meandered from place to place, worked several odd jobs, and even spent some time living in Australia. I worked at a fast food restaurant and gas station, washed big rig trucks, installed carpet and linoleum, mowed lawns and pulled weeds. Still, I had absolutely no idea what direction to head.

### B. College

When I returned from Australia, out of convenience, I went to work for a landscaper. He wanted me to take a horticulture class so I could become more familiar with what we were doing in the field. I had no interest in the job or taking the class but I still had no real direction, so I went along with the idea. The landscaper asked me to register for the course at Foothill College. I vividly remember walking around the Foothill campus intimidated by the students and faculty I would cross paths with on my way to the admissions office. By the time I got to the admissions office, I was too intimidated to go in, so I just left. I gave some lame excuse the following day to my boss as to why it was too late to register for courses, so he sent me to De Anza College with the same goal a few days later. I went to that campus and was equally intimidated by the school, the students, and the faculty, so I left without speaking to anyone. If it had not been for my boss forcing me to follow through with the idea at a THIRD community college, I never would have attended college.

I finally built up enough courage to enter the admissions office at San Jose City College (SJCC) a few weeks later. And a few months after that, at the age of 23, I was sitting in my first night of classes at community college. That first semester, I was placed into the lowest level general education courses SJCC had to offer. If there were classes that fell below the arithmetic and fundamental composition courses I was placed in, I guarantee I would have taken those instead. In fact, the classes I took that first semester were so rudimentary, they are not even offered at community colleges anymore. I started at the lowest possible educational level in the college because, as I previously mentioned, I had no high school diploma and had basically failed SJCC's placement exam a few weeks earlier.

I was scared to death heading into that first semester but a little excited about doing something to better myself. I took those first classes week by week and began to build a little confidence as the semester progressed. At some point during that first semester, I came to the realization that I was attending college to work towards a specific career. I also realized that landscaping and most other blue-collar jobs were not the set of careers I wanted to work towards. I decided that if I was going to go back to school, I should work toward something that sounded interesting and could lead to a more satisfying career than construction or landscaping. I was liking my math class at the time,

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so I decided that I would take an accounting course the following semester instead of that horticulture course. Unfortunately, since I started out in remedial math, I had to take a second math course before SJCC would allow me to take my first accounting course. So my second semester I took another math course and another English course. I earned an A in my math class and a C in my English class. I eventually got into the accounting class and did moderately well. I earned a B and, maybe more importantly, I was feeling like I was working toward a goal rather than just meandering.

My fourth semester I decided to take another accounting course, still at night. A conversation I had after class in that second accounting course changed the trajectory of my life. I could never have imagined what would happen after that.

After class one night, my professor asked me about my educational plans. I had not really thought it out, so I had no real good response. During that conversation, my professor encouraged me to consider transferring to the University of California, Berkeley. I laughed, and everyone I spoke to about that conversation also laughed. Cal was where all the smart kids went, and I really didn't view myself that way. Nonetheless, a few nights later, my professor provided me with the name of someone in Cal's Admissions department. He encouraged me to go to the campus to speak to that individual about transferring to Cal. I ended up visiting the Office of Admissions at Cal and they provided me with the list of courses I would need to take to be considered for admission.

With a clear plan and the motivation to work toward that plan, I started out on what would become the most transformational time in my life. I spent four life-changing years at SJCC. I built strong relationships with some of my instructors, with whom I continue to keep in touch. My biology instructor, Mark Newton, was the main architect and sounding board of my college essays. My accounting instructor, Mr. Wong, was dry as hell, but somehow inspired me to dream really freakin' big. And Spencer Shaw, my calculus teacher, was so good at what he did that he got me to believe I was capable of great things. That class remains the absolute favorite class I have ever taken. Mr. Shaw wrote my college recommendations for me. These instructors believed in me when I didn't even really believe in me.

I also made lifelong friends at SJCC with guys who were looking to do more than just go through the motions of community college. Jose Licea and Jeff Madrid became my partners in crime. What a great time in life that was. I worked a full-time job and took more than a full load of classes most semesters but still had time for plenty of fun. By the time I entered that final year, I was an expert student. I learned through my years there that grit and understanding the syllabus has more to do with educational success than natural ability – a lesson I have leaned on over the years.

I completed every class I needed to take and submitted my application to Cal at the end of my 1995 Fall semester. Since I was done with community college at that point I packed my bags and headed back to Australia for the Spring 1996 semester. I was living in a friend's garage in Australia at that point and my dad called to inform me that he received a letter from Cal. He opened it while I was on the phone and his exact words were "Holy shit Stephen, you got in." I transferred to Cal and entered their business program in the Fall of 1996. At the time, it was the number one undergraduate business program in the country.

My time at Cal wasn't without issue. My initial thought about Cal, "that's where all the smart people go," was accurate. I was surrounded by so many amazingly smart students. I was average at best in the classroom compared to everyone else. But I grinded my way through it and, at the same time, there were professors at Cal who took the time to guide me through the process, Steve Etter, who we all called "Etter" was most instrumental. He took the time to pull me aside after many classes to make sure I understood the material and was engaged with the content. He allowed me to work on my own cases studies and also taught me Put Options and Call Options as it related to

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dating. Then there was Clancy Houghton, my favorite accounting instructor. I remember him constantly talking about how he and his wife would save and invest every dollar he made while working at his firm, while many of his colleagues would buy lavish cars and go on wild vacations. Well, he retired wealthy and was able to teach a class here and there at Cal while his counterparts worked themselves to death late into their lives. And like SJCC, I made even more lifelong friends: Dave Martin and Knut Westby, whom I still speak to regularly. Those two guys were also community college students who transferred to Cal and have their own unique stories.

I graduated from Cal with a Bachelor of Science in Business Administration and landed a job at Arthur Andersen, the biggest and most respected public accounting firm in the country at the time. Landing that first job was clearly the result of the opportunities presented to me at Cal. I happened to meet one of the Bay Area recruiters at an on-campus recruiting event. I attended the event for the free food with no little understanding that it would lead to an internship my Junior year summer which would then lead to a full-time offer upon graduation.

### C. Accounting Career

I worked for a few years within Arthur Andersen's tax practice in San Francisco. I worked on engagements related to Francis Ford Coppola's winery and the Fairmont Hotel chain. In the end, tax wasn't for me. I therefore transferred into PriceWaterhouseCoopers' (PwC) Advisory Services division in Los Angeles, where I valued large hotel chains. It was at PwC where I was exposed to Litigation Consulting, a service line and career I did not know existed when I was in college. I left PwC to move back to the Bay Area and to work for a small firm that specialized in Litigation Consulting. I enjoyed a 25-year career in "accounting." Primarily, I valued private companies and intellectual property in the context of commercial litigation, both in the United States and abroad. I have testified in federal and state courts and participated in various international arbitrations regarding accounting and valuation issues. I'm now a Certified Public Accountant (CPA), Accredited in Business Valuation (ABV) and a Certified Financial Forensic Analyst (CFF).

During my career, I worked on large engagements here in the Bay Area, New York, Washington, Miami, Chicago, Los Angeles, Paris, Brussels, and the Hague to name a few. I was asked to value the artwork associated with Snoop Dogg's first album cover. I was asked to opine on the value of Rebelution's trademark name in relation to the artist known as Pitbull's use of that trademark. I participated in a multibillion-dollar valuation of EMI Music. I valued a winery business in Lithuania and a uranium mine in Mongolia. I worked on the plaintiff's side of three litigations that each resulted in over a billion dollars in damages and royalties. One of those cases is still the single biggest jury verdict ever awarded in the state of Oregon. I also worked on international arbitration cases against the governments of Lithuania, Mongolia, Venezuela, and Mexico.

Just before I started teaching full-time at CSM, I was a director at the Berkeley Research Group in their intellectual property group.

### D. Teaching

To say that community college had a profound impact on the trajectory of my life would be an absolute understatement of the value I received from my time at community college. I enjoyed an incredible career. My wife and I were able to purchase a home on the Peninsula here in the Bay Area. We have our retirement accounts fully funded, with additional investment accounts with sizable amounts in them. And we have saved enough to send both of our kids to college. During much of this time, my wife was able to stay home with the kids for most of their formative years.

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I continue to independently consult on accounting, finance, and valuation issues. I currently charge clients \$450 per hour for my time. However, in 2015 I decided that I wanted to teach accounting at community college because of the profound impact community college and the professors I encountered while I was there had on my life. I was lucky to have been able to join CSM's Accounting Department. I spend most of my time at CSM echoing the things I learned from Messieurs Wong, Shaw, Newton, Etter, and Houghton, along with all my own personal tricks.

If I were to identify the major inflection points between my teenage years and now, they would be as follows:

- I luckily avoided getting into credit card debt.
- I developed the habits of a good student when I was at community college, and willed my way to success in the classroom,
- While at community college I focused only on getting into a school that would provide big upside opportunities to me after graduation rather than worrying about what I was going to do after I graduated,
- I invested in my education, and therefore passed on the lowest cost options available, and instead chose to attend the University of California at Berkeley,
- I took full advantage of the on-campus recruiting events beginning my Junior year,
- I learned how to manage my budget rather than allowing my budget to manage me when I entered the workforce,
- I began investing my money the minute I got my small amount of credit card debt paid down and my budget squared away,
- I purchased a small condo and then sold it to move into the home I live in today, and
- I further invested in my career and earning potential by obtaining a deeper set of skills within my profession.

## The Book Title

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The title of this book gets a lot of attention for obvious reasons. Most of my colleagues and friends believe the name is too abrasive and will prevent me from reaching certain audiences. However, my students love the title. Ultimately I went with the title to increase interest and possibly spark a twentysomething's attention.

A PhD economist that we all referred to as the Godfather first told me about Fuck You Money. I have crossed paths with a number of characters through the years. Toward the top of that list is Dr. Jose Alberro, with whom I worked at Berkeley Research Group. Young associates in the office called him "The Godfather" or "El Jefe" because he was a large, loud, and intimidating guy, with an equally large personality and a ton of credentials next to his name. He is a U.S. citizen, Mexican citizen, and French citizen, and therefore speaks three languages. He holds a PhD in Economics from the University of Chicago. He was the founding CEO and president of Pemex Gas, a large Mexican gas and liquids company, and served as Pemex's chief representative during NAFTA negotiations. He has consulted for the International Monetary Fund, the World Bank, the United Nations Development Programme, and the Economic Commission for Latin America and the Caribbean.

"The Godfather" also taught at universities in the United States, the United Kingdom, and Mexico. His research and analyses have been widely published, including in the GAR Guide to Damages in International Arbitration, the ICSID Review, the Journal of Damages in International Arbitration, and the International Arbitration Law Review. He has recently been named one of the world's leading expert witnesses and thought leaders by *Who's Who Legal*. Financier Worldwide has recognized him as an exceptional expert and "power player" in the field of international arbitration.



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Most at the firm at my level and below were deathly afraid of the guy. By happenstance, he and I began working together quite a bit. Even though I was also super intimidated by the guy, I really enjoyed working with him on his cases. Turns out, he is hilarious, amazingly authentic, REALLY nice, and has the ABSOLUTE best stories.

He and I were involved in an international arbitration case in Europe between an Italian winemaker and the Lithuanian government. At some point during that trial and over a cigar and a beer, he asked me if I had ever heard of Fuck You Money. The simple answer to that question was no. Turns out the phrase and concept is very much folklore. And when you catch on to what it means, it will make you smile.

I spend a lot of time with our football team at CSM talking about budgeting, saving and investing, and compound interest. It's hard to keep those guys interested, so I do my best to package otherwise less-than-thrilling concepts into entertaining stories. When I'm with a new team for the first time, I always preface my discussions of compound interest with the question, "Does anyone know what Fuck You Money means?"

Certainly, none of them do. But usually by the time we complete Chapter 1 of this book, most of the players know exactly what I'm talking about. If you have \$3,000,000 in an investment account that earns eight percent a year, you would make \$240,000 ( $\$3,000,000 \times 8\%$ ). If your investments were making \$240,000 a year and your boss asked you to work over the weekend, what would you say? I'll give you a hint, think of the name of this book.

So, how do we get from community college to Fuck You Money? That is what this book sets out to uncover.

## **The Forward by Dr. Frederick L. Gaines**

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I met Professor Stephen Heath several years ago and was immediately impressed with his passion for his profession as an accountant, his intense desire to give all students an opportunity to pursue a career in accounting, and his motivation to reach out to the least likely to pursue a career in accounting. He has been able to reach African-American, Latino, Polynesian and poor White students at the College of San Mateo who have been intimidated by and less likely to pursue a career in accounting. He has made accounting a non-threatening and cool occupation for Gen Z to pursue.

This provocatively titled book is packed with the most potent and clearly explained behaviors that will transform financial destinies and shape attitudes toward money, investing, building, and managing wealth. I will be making this book required reading for my Black Leadership Theory course because I truly believe that the ability to gain, maintain, grow, and pass on wealth are some of the most critical issues facing African/African-American people today. I truly believe that this is a part of Professor Heath's mission – to speak the language of a new generation while introducing them to the vital knowledge and practices they will have to employ in order to thrive and prosper in the 21st Century!

Dr. Frederick L. Gaines  
Chair of Ethnic Studies  
College of San Mateo

# CHAPTER 1: Saving, Investing, and Budgeting

## 1.1 The Power of Saving, Investing, and Compound Interest

## 1.2 Create a Budget to Save Money and Avoid Overspending

## 1.3 Learning How to Control Costs

## 1.4 Really Important to Maximize Earned Income

## 1.1 The Power of Saving, Investing, and Compound Interest

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You most likely won't get rich by working hard, although that will help. You probably won't get rich by saving your money and hiding it under your bed. You probably aren't going to get rich overnight. Your employer isn't going to give you an extravagant salary just because she likes you, and Congress won't send you a stimulus check big enough for a down payment on a house. Odds are you won't invest in the ground floor of any up-and-coming company that goes public and makes you millions. I suppose all of these things could happen, but are you really willing to put your financial freedom in the hands of chance?

It would be nice if I could show you some safe, easy, low-risk, get-rich-quick tricks, or say that one day things are going to just work out for you financially. Or better yet, show you how to pick that great stock that will make you millions. Unfortunately, there are no such tricks and anyone who says there are, probably doesn't know what they're talking about – or worse – is possibly lying to take advantage of you.

The fact is you are on your own. The good news is that there are simple, safe, and tried-and-true ways to move from nothing to financial independence, generational wealth, or any other financial goal. The bad news is that it takes time, sacrifice, and plenty of action. The fact that it takes time, sacrifice and action is why so few people are successful at it. Most people want to believe there is some magical way to get rich that they have not yet discovered. I imagine they look for these things to avoid having to do the hard work.

Here is the truth, though: Accumulating financial wealth is a slow and steady game. If you want to get rich, build generational wealth, or become financially independent, then you should plan to travel the long, boring road that the rest of us average everyday people have been traveling. That road requires you to do ALL the things in the figure below:

### FIGURE 1: Slow and Steady Steps to Financial Independence and Generational Wealth

- Become a saver rather than a spender.
- Invest your money to take advantage of compound interest.
- Diversify your investments rather than putting all your eggs in one basket.
- MOST IMPORTANTLY, YOU SHOULD: ‘
  - 1) DO THESE THINGS, DON'T JUST THINK ABOUT IT.
  - 2) START NOW AND MAKE IT A LIFELONG HABIT.



Budgeting your money is the tool that will allow you to begin doing these things. However, diving straight into budgeting isn't the most exciting thing to begin talking about. We need to go more in-depth about why the long, boring road is so important. We will discuss how to invest your money and how to diversify your investments in later chapters. Regardless, the entire process begins with understanding why we want to save and invest, so that is where we will begin.

### A. Start Investing Your Money as Soon as Possible

Any financial planning textbook will tell you to save AND invest your money, and to do it as soon as possible. The real key here is to *act* early in life to take full advantage of *compound interest* later in life. In very simple terms, compound interest is both the interest accumulated on the principal (or the original amount invested) *and* on the interest earned from previous years. For example, let's assume you have \$1,000 and you place it into an investment that earns an eight percent return every year. After the first year, you would have \$1,080 (the original \$1,000 plus the \$80 in interest you earned in year one ( $\$1,000 \times 1.08$ )). Then, in the second year, your \$1,080 grows to \$1,166 ( $\$1,080 \times 1.08$ ), and so on.

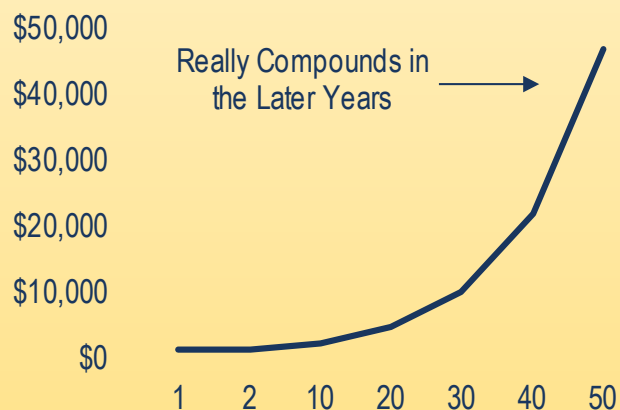
**FIGURE 2: Compound Interest Example**

| Year | Beginning Balance | 8% Interest | Ending Balance |
|------|-------------------|-------------|----------------|
| 1    | \$1,000           | \$80        | \$1,080        |
| 2    | \$1,080           | \$86        | \$1,166        |

Albert Einstein said, "Compound interest is the eighth wonder of the world. He who understands it, earns it. He who doesn't, pays it." In other words, start now. Over time, the more interest you earn, the more your interest *earns interest*. The table below gives you a better idea of how compound interest affects a measly \$1,000 over 50 years.

**FIGURE 3: Compound Interest in Later Years**

| Year | Beg. Balance | Amount Saved | 8% Interest | Ending Balance |
|------|--------------|--------------|-------------|----------------|
| 1    | \$0          | \$1,000      | \$80        | \$1,080        |
| 2    | \$1,080      | \$0          | \$86        | \$1,166        |
| 10   | \$1,999      | \$0          | \$160       | \$2,159        |
| 20   | \$4,316      | \$0          | \$345       | \$4,661        |
| 30   | \$9,317      | \$0          | \$745       | \$10,063       |
| 40   | \$20,115     | \$0          | \$1,609     | \$21,725       |
| 50   | \$43,427     | \$0          | \$3,474     | \$46,902       |



Impressive, right? You earn \$80 in interest in the first year, but by Year 50, without doing anything but waiting, you earn \$3,474 in interest. Likewise, you turned that \$1,000 into \$46,902. To put it simply, the longer you give your money a chance to compound, the more you will have in the end. As you can see from the graph above, the compounding in the later years is much greater than in the earlier years. This is why everyone says to start investing early. The sooner you get started, the longer your money is compounding, and the more you will have later in life.

If you were to put your \$1,000 into that investment when you were 20 years old, by the time you turn 70, you would have \$46,902. On the other hand, if you put \$1,000 into that investment at age 50, you'd be 100 years old, or more likely dead, before your money grew to \$46,902. I'm not saying you won't live to be 100, but you get what I'm saying...the sooner you start investing, the better.

## B. Save and Invest as Often as Possible

Now, let's also assume you save \$1,000 in every year rather than just the first year.

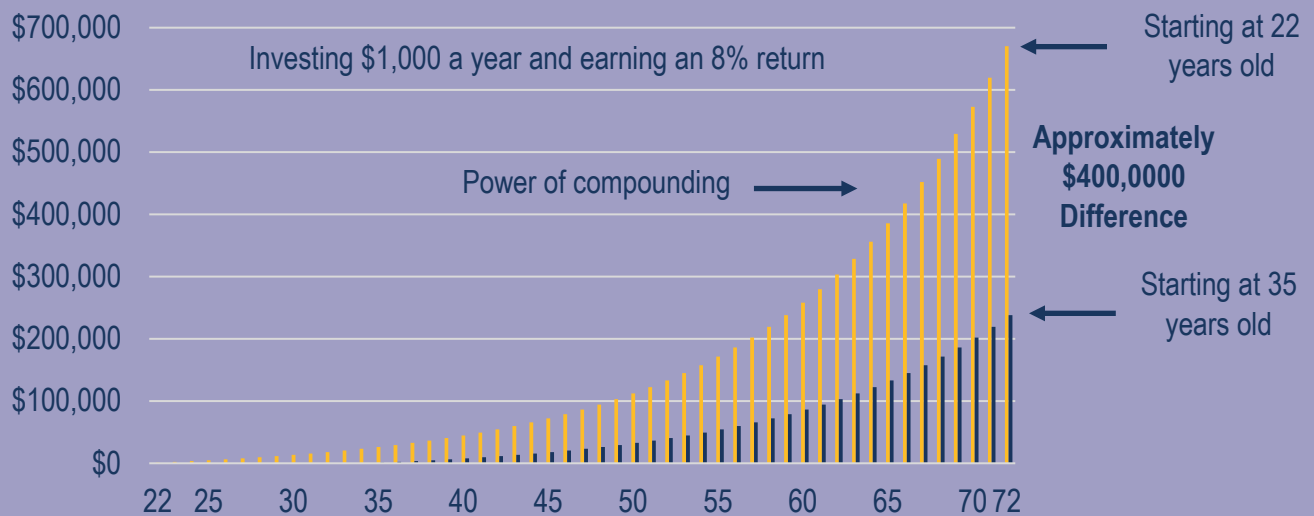
**FIGURE 4: Compound Interest and Saving Consistently Over Several Years**

| Year | Beginning Balance | Amount Saved per Year | 8% Interest | Ending Balance |
|------|-------------------|-----------------------|-------------|----------------|
| 1    | \$0               | \$1,000               | \$80        | \$1,080        |
| 2    | \$1,080           | \$1,000               | \$166       | \$2,246        |
| 10   | \$13,487          | \$1,000               | \$1,159     | \$15,645       |
| 20   | \$44,762          | \$1,000               | \$3,661     | \$49,423       |
| 30   | \$112,283         | \$1,000               | \$9,063     | \$122,346      |
| 40   | \$258,057         | \$1,000               | \$20,725    | \$279,781      |
| 50   | \$572,770         | \$1,000               | \$45,902    | \$619,671      |

In this instance, you would have significantly more money in 50 years. In fact, in Year 50 you would have \$619,671 rather than \$46,902. So it makes sense to not only save early but to save AND invest often.

I'll say it again. Start saving and investing *now and often*.

Let's look at the negative effects of beginning to save later in life again. Look at the next two graphs (Figure 5 and Figure 6). Figure 5 relates to an example where, between the ages of 22 and 72, you have saved and invested \$1,000 a year, earning an eight percent return on your investments. The second graph assumes that you start later in life and only saved and invested \$1,000 a year between ages 35 and 70. The only difference is that you start at age 35 rather than 22.

**FIGURE 5: Negative Impact of Beginning to Save and Invest Later in Life**

Based on these data, you will earn approximately \$400,000 *less* by waiting 13 years. Think about it for a second. You save \$1,000 a year beginning at age 22 rather than 35, and you have an extra \$400,000 by the time you are 70. While \$1,000 a year at 22 may seem like a lot, it isn't *that* much money. And, personally, I would rather have that extra \$400,000 at 70 than save the \$13,000 (\$1,000 a year from 22 to 35). Compounding, saving consistently, and starting early are the most powerful tools you have in accumulating wealth. It's that simple.

### C. Saving and Investing More Obviously Means You Earn More

Here is another scenario. You are earning \$55,000 a year at age 24. At that point, you save 10 percent of your income each year. Then, every subsequent year, you save an additional \$2,750 (due to a raise, employer retirement matching, etc.). By 28, you will be saving \$16,500 a year. And, of course, you're also earning that eight percent interest.

Here's how that scenario would look:

**FIGURE 6: Compound Interest and Saving at Least \$16,500 Per Year by the Time you Turn 28**

| Year | Beginning Balance | Amount Saved Per Year | 8% Interest | Ending Balance |
|------|-------------------|-----------------------|-------------|----------------|
| 24   | \$0               | \$5,500               | \$440       | \$5,940        |
| 25   | \$5,940           | \$8,250               | \$1,135     | \$15,325       |
| 26   | \$15,325          | \$11,000              | \$2,106     | \$28,431       |
| 27   | \$28,431          | \$13,750              | \$3,374     | \$45,556       |
| 28   | \$45,556          | \$16,500              | \$4,964     | \$67,020       |
| 29   | \$67,020          | \$16,500              | \$6,682     | \$90,202       |
| 30   | \$90,202          | \$16,500              | \$8,536     | \$115,238      |
| 40   | \$452,889         | \$16,500              | \$37,551    | \$506,941      |
| 50   | \$1,235,905       | \$16,500              | \$100,192   | \$1,352,597    |
| 60   | \$2,926,376       | \$16,500              | \$235,430   | \$3,178,307    |
| 70   | \$6,072,368       | \$16,500              | \$487,109   | \$6,575,978    |

This example really demonstrates the benefits of early life financial planning. It combines the power of investing early and often with the benefits of having more money to invest early in life. I started with nothing other than a college degree and some student loan debt. However, I learned these lessons in college and graduated with a decent job that allowed me to save and invest very early after graduating. Due to early life financial planning, I live very comfortably.

I understand that the formulas behind compound interest are complicated and I realize that not everyone knows how (or wants) to use Excel or some financial calculator. Many personal financial planning textbooks will devote a good amount of time to teaching you how to do the calculations with great precision. However, that is not the point of this lesson. The point is you need to save and invest, and the sooner you do that, the more you have later in life.at the end.

The Future Value Calculator at [www.calculator.net](https://www.calculator.net/future-value-calculator.html) (<https://www.calculator.net/future-value-calculator.html>) is a straightforward utility for beginners. To help you learn how to use this online calculator, I am providing the inputs to the calculator and the corresponding result. The inputs and results for saving \$1,000 at the beginning of every year for 10 years while earning an eight percent return are as follows:

**FIGURE 7: Calculator Inputs and Future Value Result**

- Number of Periods = 10
- Starting Amount = \$0
- Interest Rate = 8%
- Periodic Deposit = \$1,000
- Payment Made = Beginning of the Year
- Future Value Result = \$15,645.49 (The amount in the table above at year 10)

<https://www.calculator.net/future-value-calculator.html>

Have you ever heard an older person say, “A penny saved is a penny earned”? Well, I hate to admit it, but they’re right. The truth is, just because you have money does not mean you should spend it. Marketing teams get paid a lot of money to persuade consumers to buy the newest upgraded product. Don’t be a victim of advertising or impulse shopping. It’s an easy concept to save (or to pay yourself first) before buying that new pair of shoes or going out to eat every other night. If you don’t need it, don’t buy it.

Most financial advisors will tell you to begin by saving five to 10 percent of your earned income in early adulthood. Of course, you will want to move up to the 15 percent range as soon as possible. One commonly employed approach involves saving the entire portion of any new raise you get. For instance, if you have been saving 10 percent of your earned income and your employer decides to give you a five percent raise in the following year, it is wisest to slide the entire five percent raise directly into savings. This way, you would reach that 15 percent goal without sacrificing (or even lowering) your overall standard of living.

Saving isn’t everything, however. Accumulating wealth requires investment. If you simply leave your cash in your savings account, you are going to lose money due to inflation. Assume you have \$100,000 in savings and the inflation rate is 3%. If you don’t invest your \$100,000, it will still be \$100,000 the following year, and then the year after and so forth. However, because of inflation, everything will be more expensive next year and your \$100,000 will buy you less. So, saving without investing won’t get you very far. You must do both, and again, the sooner the better.

## **1.2 Create a Budget to Save Money and Avoid Overspending**

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It’s great to understand the benefits of investing, but there’s more you need to know. Budgeting is an integral part of saving. A budget is a written plan that allows you to track your money as it comes in and goes out. It can help you establish your priorities (like saving your money) and help you live within your means (avoiding credit card debt). Creating a budget is the first step to saving, in that it tracks, estimates, and adjusts your income and expenses over time. Budgeting also compares projected income to your estimated expenses.

I started using a budget after college so I could figure out how to pay for living expenses. I mapped out my major expenses and compared them to my monthly income. I was living in San Francisco and earning \$36,000 a year. For the first few years, I was living paycheck to paycheck. By budgeting, I figured out how and where to cut corners on expenses and pay off the credit card debt I had accumulated in college. After I had paid down my credit card debt, I began aggressively saving for retirement.

Over the years, as my income began to increase, the next order of business was to buy a house, which required a new budget structure to calculate what I could afford on down payment and property tax. Now that I own a house, my focus has been saving for my kids' college tuition, and again, my retirement.

Budgeting is a lot like going to the gym. It's easy to implement and adjust, but if you start skipping days, you'll skip *more* days. And if you're like me, the more days you skip, the more weight you gain. Benefitting from a budget requires consistency and discipline as well. Before long, you will notice measurable differences.

Websites such as [www.mint.com](http://www.mint.com), [www.kiplinger.com](http://www.kiplinger.com), and [www.betterbudgeting.org/](http://www.betterbudgeting.org/) can help you establish a budgeting template that works for you. You can also do a quick search for household budget worksheets online, and there is no shortage of helpful videos on [www.youtube.com](http://www.youtube.com). I prefer to create a monthly budget because it allows me to measure how I will be doing by the end of the year.

An effective budgeting plan starts by including all income sources such as wages (net of payroll deductions), student loans, financial aid, family support, and any other sources of income. Review your paystubs, online banking statements, and any other documents that report income. Sometimes you will receive annual bonuses or tax refunds. If you create a monthly budget for the entire calendar year, you can account for those one-time payments like financial aid checks and stimulus packages.

Next, you will focus on monthly expenses. You will need to include housing costs, tuition, other related school expenses, food, utilities, transportation, debt repayment, clothing, entertainment, and other miscellaneous expenses. The following table is a good example of the budget I create. It presents three top line items: (1) Total Income, (2) Total Expenses, and (3) Ending Cash.

**FIGURE 8: Annual Cash Budget by Month**

|                       | Jan             | Feb             | Mar             | Apr             | May             | Jun             | Jul             | Aug             | Sep             | Oct             | Nov             | Dec             |
|-----------------------|-----------------|-----------------|-----------------|-----------------|-----------------|-----------------|-----------------|-----------------|-----------------|-----------------|-----------------|-----------------|
| <b>Beginning Cash</b> | 0               | \$ 1,770        | \$ 1,540        | \$ 1,310        | \$ 1,080        | \$ 850          | \$ 620          | \$ 390          | \$ 2,160        | \$ 1,930        | \$ 1,700        | \$ 1,470        |
| Paycheck              | \$ 1,500        | \$ 1,500        | \$ 1,500        | \$ 1,500        | \$ 1,500        | \$ 1,500        | \$ 1,500        | \$ 1,500        | \$ 1,500        | \$ 1,500        | \$ 1,500        | \$ 1,500        |
| Financial Aid         | \$ 3,000        |                 |                 |                 |                 |                 |                 | \$ 3,000        |                 |                 |                 |                 |
| <b>Total Income</b>   | <b>\$ 4,500</b> | <b>\$ 1,500</b> | <b>\$ 1,500</b> | <b>\$ 1,500</b> | <b>\$ 1,500</b> | <b>\$ 1,500</b> | <b>\$ 1,500</b> | <b>\$ 4,500</b> | <b>\$ 1,500</b> | <b>\$ 1,500</b> | <b>\$ 1,500</b> | <b>\$ 1,500</b> |
| School Expenses       | \$ 1,000        |                 |                 |                 |                 |                 |                 | \$ 1,000        |                 |                 |                 |                 |
| Rent                  | \$ 800          | \$ 800          | \$ 800          | \$ 800          | \$ 800          | \$ 800          | \$ 800          | \$ 800          | \$ 800          | \$ 800          | \$ 800          | \$ 800          |
| Food                  | \$ 450          | \$ 450          | \$ 450          | \$ 450          | \$ 450          | \$ 450          | \$ 450          | \$ 450          | \$ 450          | \$ 450          | \$ 450          | \$ 450          |
| Clothes               | \$ 30           | \$ 30           | \$ 30           | \$ 30           | \$ 30           | \$ 30           | \$ 30           | \$ 30           | \$ 30           | \$ 30           | \$ 30           | \$ 30           |
| Entertainment         | \$ 100          | \$ 100          | \$ 100          | \$ 100          | \$ 100          | \$ 100          | \$ 100          | \$ 100          | \$ 100          | \$ 100          | \$ 100          | \$ 100          |
| Transportation        | \$ 50           | \$ 50           | \$ 50           | \$ 50           | \$ 50           | \$ 50           | \$ 50           | \$ 50           | \$ 50           | \$ 50           | \$ 50           | \$ 50           |
| Phone / Utilities     | \$ 300          | \$ 300          | \$ 300          | \$ 300          | \$ 300          | \$ 300          | \$ 300          | \$ 300          | \$ 300          | \$ 300          | \$ 300          | \$ 300          |
| <b>Total Expenses</b> | <b>\$ 2,730</b> | <b>\$ 1,730</b> | <b>\$ 1,730</b> | <b>\$ 1,730</b> | <b>\$ 1,730</b> | <b>\$ 1,730</b> | <b>\$ 1,730</b> | <b>\$ 2,730</b> | <b>\$ 1,730</b> | <b>\$ 1,730</b> | <b>\$ 1,730</b> | <b>\$ 1,730</b> |
| Income less Expenses  | \$ 1,770        | \$ (230)        | \$ (230)        | \$ (230)        | \$ (230)        | \$ (230)        | \$ (230)        | \$ 1,770        | \$ (230)        | \$ (230)        | \$ (230)        | \$ (230)        |
| <b>Ending Cash</b>    | <b>\$ 1,770</b> | <b>\$ 1,540</b> | <b>\$ 1,310</b> | <b>\$ 1,080</b> | <b>\$ 850</b>   | <b>\$ 620</b>   | <b>\$ 390</b>   | <b>\$ 2,160</b> | <b>\$ 1,930</b> | <b>\$ 1,700</b> | <b>\$ 1,470</b> | <b>\$ 1,240</b> |

By creating a budget for the entire year, I can better account for inconsistencies in my monthly amounts. For example, refer to the Financial Aid row. Financial aid only comes in twice a year; however, by including it within an annual budget, you can spread the aid over multiple months. Don't spend the entire check in the month it comes in. Those funds need to cover more than just one month. Take a closer look at Figure 8 on the previous page. In most months, the expenses exceed the income. However, the income from Financial Aid in January and August can be used to offset the losses in other months.

The goal is to lower your overall expenses as much as possible. To achieve this, you must understand what you are spending and keep track of those expenditures. Once you come to the horrible realization that you spend your money poorly, you will figure out what costs can be eliminated.

## 1.3 Learning How to Control Costs

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Fixed expenses such as rent, insurance costs, and utilities (power, water, etc.) remain relatively the same from one month to another. As a result, fixed costs are easy to predict and estimate. Controllable or variable expenses, on the other hand, change based on your priorities and available funds. This includes groceries, eating out, gas, clothing, and so on. While variable costs are also easy to predict, they fluctuate more than fixed costs. This is where wiggle room can lead to frivolous spending. If you're not careful, the amount you spend is equal to the amount you bring in. Therefore, it is important to include the actual amount you intend to save as an "expense" line item in your budget rather than just leaving it to chance.

It's wise to have a separate account *strictly* for savings. Some employers will even split your direct deposits into separate accounts, so you never have to touch your savings, making it much easier to control your expenses. Additionally, studies have shown that you are far likelier to achieve your financial goals if you automate the savings process (like having your employer deduct the amount directly from your paycheck). It also requires you to proactively take money out of your savings account to purchase something, which is never a good feeling.

Some budgeting websites will provide you benchmarks based on U.S. averages, against which you can measure your own spending and set goals for your expense categories. If you find yourself spending more than the average American household, you should ask yourself which expenses can be cut or minimized.

Another way to categorize your expenses is to identify *needs* versus *wants*. Your needs come first: food, basic clothing, safe housing, medical care, and other obvious expenses. That's not to say that you can't control those expenses at all. For example, you can always turn your lights off when you leave a room, keep the thermostat at a reasonable temperature, and take shorter showers. Your wants are much lower on the totem pole. Wants include dining out, streaming services, shopping sprees, video games, concerts, and all other forms of entertainment and fun.

In college, I got in the habit of saying "no thanks" to everything at first pass. No to expensive cocktails, no to extended warranties, no to 35 cents more for a large popcorn or soda. After a while, you will also begin to see patterns in your spending which will allow you to better manage your money. The small things add up quickly. Personally, I view the world as one vast network of people and companies looking to trick me into spending my money. I find the more conscious I am about where my money goes, the more likely it is that I say no to unnecessary things.

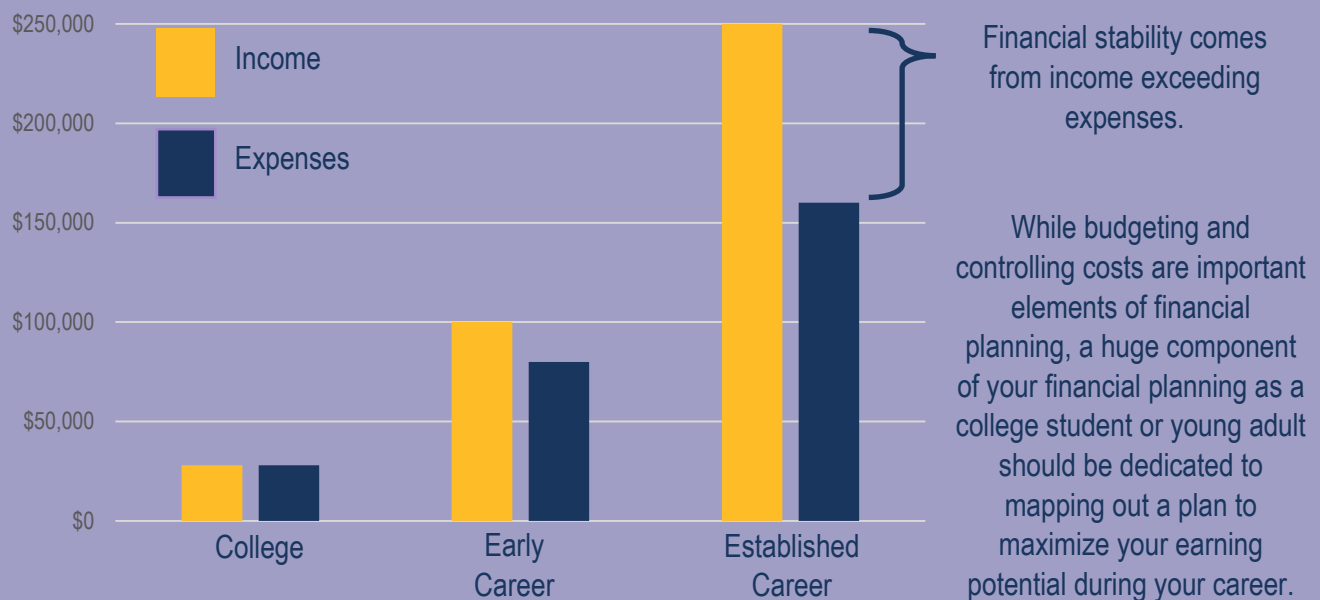


Marc Andrews' book *Hidden Persuasion* highlights the methods advertisers use to convince us to buy their products. We think our decisions are made consciously and rationally based on our wishes, interests, and motivations, but "most of our decisions in daily life are made on an unconscious level, which means we are quite vulnerable to persuasion attempts which affect our unconsciousness."<sup>1</sup> There is a litany of online articles and books dedicated to this issue. If you can't get your expenses under control because you consistently overspend, you may want to further explore the psychology behind your purchasing behavior.

## 1.4 Really Important to Maximize Earned Income

Financial stability comes from increasing the difference between your income and expenses as depicted in the graph below. Obviously, the wider the gap, the more flexibility you will have. And with more flexibility comes more opportunities to save and invest.

**FIGURE 9: Financial Stability Comes from Earning Power More So than Controlling Costs**



Immediately after you graduate from college, there are only so many corners you can cut to reduce your expenses. You will also realize that as you mature in life, your expenses will increase dramatically. I am married with two kids and our monthly expenses range from \$10,000 to \$14,000. By no means do we spend needlessly, but we do live comfortably because our earned income exceeds our expenses. It's important to focus on income while you have ultimate control over that portion of the budget. You can bet that life will only get more costly over time, so learn how to manage your money while you have minimal overhead. But at the same time, a huge component of your financial planning as a college student or young adult should be dedicated to mapping out a plan to maximize

<sup>1</sup> Andrews, M., Van Leeuwen, M., & Van Baaren, R. (2014). *Hidden Persuasion: 33 Psychological Influence Techniques in Advertising*. Laurence King Publishing.

your earning potential during your career. That means using your education to leverage a great first job that you can use to catapult you thorough the rest of your career.

It's important to get out of college and join the labor force in a way that maximizes your earnings. Those first few years out of college can be rough, so increasing your income even by a little bit will provide a more financial flexibility. And again, the greater the difference between your income and expenses, the more stability you have as well.

Most personal finance textbooks focus too much on the expense side of things. I don't believe they do an adequate job of laying out the considerations on the income side. Sure, they may talk about taking a gig economy job to increase your income here and there, but in my opinion, that's not going to have a meaningful impact on your financial wealth. We will devote a substantial amount of time in this book to the process of going to college in a way that will maximize your earning potential. And for that, I need an entire section devoted to the topic.

## CHAPTER 2: Financial Goal Planning and Investing

### 2.1 Wealth-Building Priorities

### 2.2 Goal-Setting

### 2.3 Getting Into the Habit of Paying Yourself First

### 2.4 Short-Term Goals

### 2.5 Mid-Range to Longer-Term Goals

I highly recommend returning to this chapter after you finish the last chapter of this book. In fact, you will benefit from reading each chapter multiple times, as you will have a better understanding of each chapter after reading the others.

I don't see how we can discuss personal financial planning today without addressing mobile investing apps, fractional shares, meme stocks, and cryptocurrency relative to basic wealth-building priorities and traditional investing fundamentals. Mobile investing apps like Robinhood and Acorn have turned young adults into avid investors seemingly overnight. While this is a major positive overall, done recklessly it can result in not reaching your goals, or worse yet, losing money.

Traditionally, the cost of stocks combined with trading transaction fees made investing cost prohibitive for most teenagers and young adults. Most didn't think about investing until they got into the workforce and started contributing to a retirement account. That usually involved selecting a few mutual funds and they were off and running.

This is no longer the case. With just one dollar and 15 minutes of spare time to install a mobile investing app on your smartphone, you can buy and sell fractions of shares without paying any transaction fees. Fractional shares are mere portions of a share of a particular stock. You can buy a half a share, a quarter of a share, etc. for much less than you'd have to pay for the full share. Likewise, these new mobile apps have created new ways to buy and sell shares that in many instances remove the transaction fees to the investor.

These apps have created a significant opportunity to get a head start into the world of investing relative to prior generations. To maximize this opportunity, you should make sure that your investing strategy and the risks you're willing to take match your intended goals. In the past when most of us began investing, it was typically in the context of retirement and retirement accounts. Most retirement accounts limit the available investments to those that are suitable for retirement. Likewise, the retirement accounts allow us to also take advantage of tax-saving strategies associated with investing. As a result, it was pretty easy to match an investing strategy to our intended goal. In some ways it was like bowling with the guardrails up.

Currently, there is WAY too much investing information being thrown at you. You have YouTube videos, TikTok videos, Reddit, WallStreetBets, Discord, friends and family, and much more. You have probably heard, *"You should invest in this stock, this fund, this crypto. Look what I did with this stock, look at how much money I made with that stock. The old way of investing doesn't work. This new way is better. I have a fool-proof strategy to help you pick*

*the right stock and the right stock options. Crypto is the future. I'm going to stay home and day-trade. Meme stock to the moon."*

Each source provides different and inconsistent advice. And even worse, some of that advice can result in complete loss of your investment. So, over the course of the next few chapters, I want to cover some of the common factors that you should consider as you begin to invest in yourself through the stock market. The intention here is to ensure you establish the right set of priorities as it relates to wealth-building, and then match the optimal investing strategy with your intended financial goals. Those factors break down into the following main categories:

#### FIGURE 1: Investing in the Stock Market Chapters

- Handling baseline priorities and then setting realistic goals (this chapter, **Chapter 2**)
- Investing fundamentals (**Chapter 3**)
- Time-tested long-term passive investing strategies (**Chapter 4**)
- Active investing in the stock market (**Chapter 5**)
- Cryptocurrency and Meme stocks (**Chapter 6**)

## 2.1 Wealth-Building Priorities

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I get that you may want to jump right into investing in the stock market. If you are in college and/or young and working a part-time job and have no credit card debt, there isn't any harm in jumping in to see what it's all about. However, if your intention is to build wealth in a serious and systematic way, most personal financial planners will tell you that wealth-building begins with learning how to live within your means. Therefore, before doing anything else, you must learn how to spend less than you bring in. This requires discipline, planning, and budgeting, which we discuss in Chapter 1.

After you learn to consistently spend less than you make, the first steps on your journey to financial independence should be to pay off your credit card debt and establish an emergency savings fund equal to three to six months of your living expenses.<sup>1</sup> As we discuss in Chapters 10-11, it doesn't make a lot of sense to invest your extra cash while you are paying high interest charges to your credit card companies. For example, you may earn \$50 on your investments, but if your interest charges on your credit cards are \$200, you end up losing \$150. In almost all situations, those interest charges will exceed the returns you could earn investing your money. That is the classic one-step-forward two-steps-back approach to personal finance. I discuss this issue in detail in Chapters 10-11 on credit, and credit cards.

Likewise, saving a sum of money equal to three to six months of living expenses can really help you maneuver through the process of unexpectedly losing your job. While you may not think it will happen to you, being prepared could mean that you need to rely on those expensive credit cards.

I'm equally certain that doing their homework is the last thing most college students would think of when it comes to accumulating financial wealth. However, as discussed in Chapter 7, strong academic performance can lead to a

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<sup>1</sup> Financial Independence (Getting to Point X): A Comprehensive Tax-Smart Wealth Management Guide, Second Edition

wider variety of schools to attend, which can lead to more opportunities to balance the costs and benefits of college. Those opportunities can result in better internships opportunities and better mentoring programs. Likewise, we talk about the importance of internships and how they factor into your ability to find a rewarding career out of college in Chapter 8. With a solid career comes the ability to begin to create separation between your income and your expenses. And the more separation between the two, the more money you can use to invest and accumulate wealth.

Most financial planners will tell you to begin saving and investing 15 percent of your earned income for your retirement after you pay off your credit cards and save three to six months of living expenses. You need to prepare for retirement no matter how old you are, as Social Security will never be enough to sustain a decent quality of life. And the sooner you get started, the sooner you can take advantage of compound interest. In Chapter 15, we discuss common retirement saving strategies and the importance of contributing at least enough money to your employer-sponsored 401(k) plan to maximize the employer match. The employer match is basically free money, so why miss out on taking advantage of that benefit?

If your 401(k) has no matching employer contribution, or once you have met your employer match, you might want to put your money into an IRA, and in some instances a Roth IRA. Depending on the 401(k) plan, an IRA may give you more investment options. The goal most financial advisors will argue is setting 15 percent of your earned income to these retirement accounts. We want to use these tax advantaged accounts because they (drumroll) have tax advantages that allow us to either (1) save more money than we otherwise would be able to, or (2) we will have more after-tax cash in retirement. Whether you place your money in a 401(k) or IRA, it is important to diversify your retirement plan investments and focus on growth when you are young and have time to recover from an unexpected downturn in the stock market.

In summary, if you are young and just getting started, beyond speaking with a professional, consider the following first-level financial priorities:

#### **FIGURE 2: First Level Financial Priorities**

- Spend less than you earn
- Pay off high interest credit card debt
- Save three to six months of living expenses
- Contribute to your 401(k) up to the point where you maximize your employer's match
- Contribute to a Roth IRA up to the maximum limit
- Contribute to a 401(k) up to its remaining maximum limit or until you save 15 percent of your earned income.

## **2.2 Goal-Setting**

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But what comes next? Obviously obtaining the right types and levels of insurance is important, which we discuss in various chapters throughout this book. But seriously what is next? What if you are living in the Bay Area and you want to know whether to save for retirement or save to buy a house? Because in the Bay Area it's really hard to do both. What if you want to buy a new car? How should you approach saving for that? What if you want to go on an extravagant vacation one day? How should you approach saving for that? What about sending a kid to college? What about going to college yourself? Paying for a wedding? The list of questions and goals can go on forever.

What if you simply want to invest in something but don't want to wait until you retire to enjoy the rewards of investing? What should you invest in? What stocks should you buy or how should you determine what stocks to buy?

The answer to all of these questions is, "It depends." And it depends on all sorts of different factors, including but not limited to:

### **FIGURE 3: Factors Impacting Financial Goals**

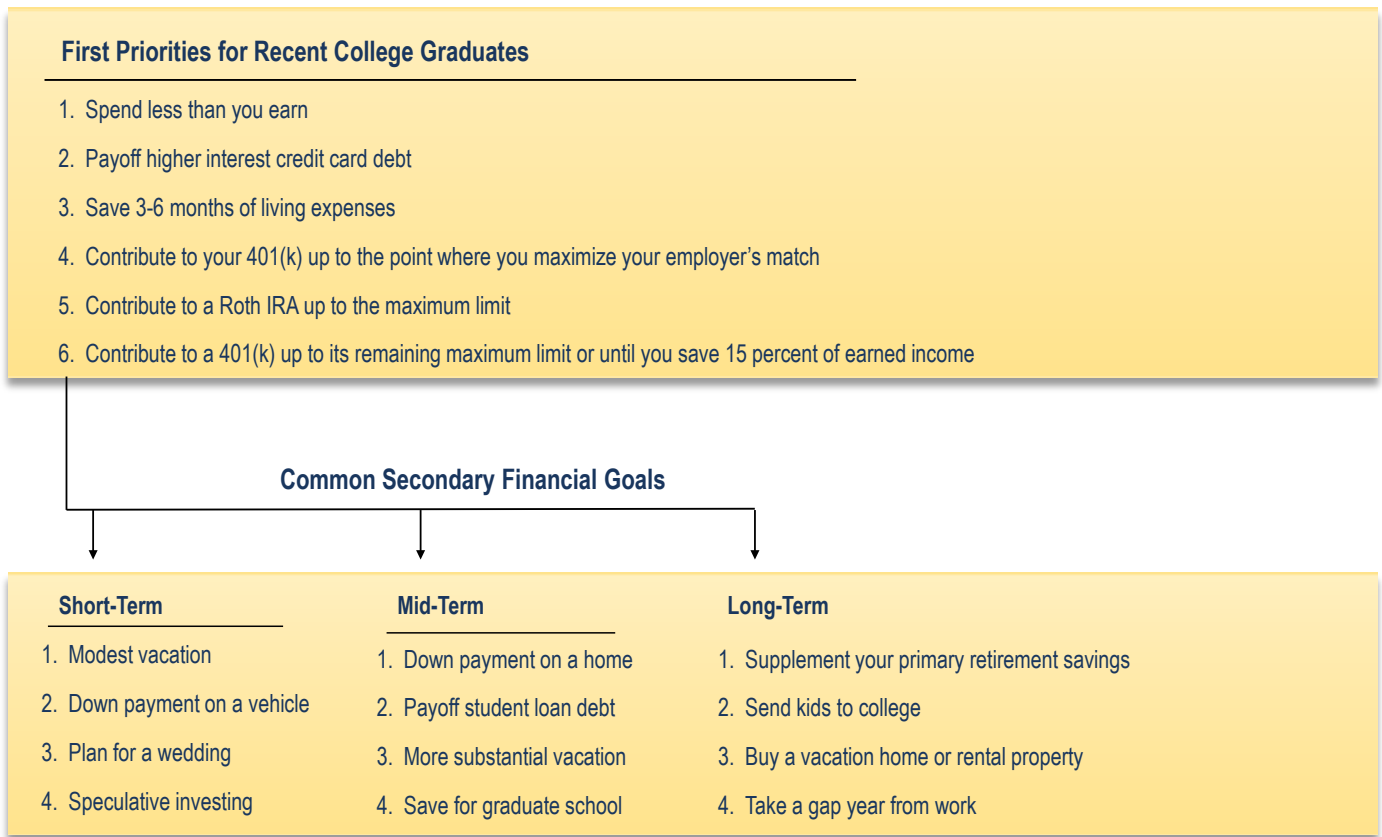
- Your unique list of priorities and goals
- Your age
- Your desired timeline to achieve your goal(s)
- The cost of your particular goal(s)
- Your monthly / annual available funds to throw towards the pursuit of your goal(s)
- The level of risk you are willing to take if you invest your savings in order to attain your goal(s)
- The types of investments you should select if you do decide to invest
- The types of accounts you should use to invest and or save

Most advisors will tell you to address your first-level wealth-building financial priorities before considering other financial goals. Once those are in place, you can begin the process of setting secondary financial goals. Then when it comes to the secondary list of financial goals, those goals depend on your own priorities and specific financial situation.

With respect to your secondary goals, we can discuss a framework to work toward those goals and then how investing can help you reach them. In doing so, we can break out secondary financial goals into how long we believe it would take to achieve them: short-term, mid-range, and long-term. Saving for a modest \$2,500 vacation could be a short-term goal, whereas accumulating \$100,000 for a down payment on a new home could be a mid-range to long-term goal.

Do not attempt to pull off the impossible. Evaluate your personal finances to determine what goals are within your means and time frame. For instance, if you barely make enough to cover expenses, you can't set a goal to save \$500 a month. Your timeline will also depend on the amount of money you can save or allocate to your goal per month or per year. Obviously, the more you can allocate, the sooner you will reach your goal. However, the focus should be on being reasonable when setting your savings rate. You want to avoid placing undue burden on your budget during the savings period and you want to avoid getting discouraged when you don't meet your savings rate.

**FIGURE 4: Outline of First Level Financial Priorities and Secondary Financial Goals**





When setting goals, most financial advisors recommend that goals, whether first priority or secondary, meet the characteristics in the figure below.

**FIGURE 5: Financial Goals Should Include the Following Characteristics**

|               |   |
|---------------|---|
| Specific      | The more specific your goal, the more likely you are to achieve it. Goals that are vague don't work as well as very specific goals. For instance, "I want to spend less and save more" isn't as specific as "I'm going to save \$100,000 for down payment on a new home."   |
| Measurable    | <p>Your timeline will depend on a number of factors, but the total amount of money you need to reach your goal will definitely be important. For instance, if you wanted \$100,000 for a down payment on a new home, then the total amount would be \$100,000. Be realistic about the cost or how much you will need to reach your goal.</p> <p>If it will take a few years to reach your goal, account for increases in the cost between now and the time you believe you will be able to reach that goal. This could be especially true for longer-term goals like saving for a kid's college education. For instance, if you begin saving today when your kid is five years old, the cost of college now and when you kid will actually attend college will surely be different.</p> |
| Attainable    | Do not attempt to pull off the impossible. Evaluate your personal finances to determine what goals are within your means and time frame. For instance, if you barely make enough to cover expenses, you can't set a goal to save \$500 a month. Your timeline will also depend on the amount of money you can save or allocate to your goal on a per-month or per-year basis. Obviously, the more you can allocate, the sooner you can reach your goal. However, the focus should be on being reasonable when setting your savings rate. You want to avoid placing undue burden on your budget during the savings period and you want to avoid getting discouraged when you don't meet your savings rate.   |
| Realistic     | It's also important to be realistic about setting your goals as well. While being a millionaire by the time you are 35 may seem reasonable, it certainly seems much less reasonable if you had to live in your parent's basement until then. Unless it's a really big basement with an ocean view, I'm thinking this may not be realistic.  |
| Time-specific | <p>And finally, set a date you want to accomplish your goal and periodically measure whether you are still on track to hitting that goal. The approach to achieving your financial goals should never be to set it and forget it. You want to monitor your progress to determine whether you are on track or whether you need to reevaluate your current plan.</p> <p>With a specific goal in mind, a reasonable first step in reaching that goal would be to establish a timeline. Your timeline will depend on how much money in total you will need to reach your goal and how much you can contribute to that goal each year.</p>   |

## 2.3 Get into the Habit of Paying Yourself First

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The biggest hurdle to achieving your financial goals is getting started and continuously following through. It can all be overwhelming when you are just getting started. The list of issues you will need to work through is pretty extensive. It may be appealing to hold off on doing anything until you figure out the plan. However, that approach could lead to missed opportunities.

While you are contemplating the landscape, it may be helpful to simply set up a money market account and brokerage account (both discussed later) and even a mobile investing app if you don't yet have one. Then send some money to those accounts. Once you open a brokerage account, then maybe you can establish an IRA account. Once you have your accounts set up, transfer a little money into those accounts. Many financial advisors refer to this as paying yourself first. Sometimes waiting until the end of the month to see how much money you have to invest or to save isn't the best strategy. Sometimes it makes more sense to pay yourself first rather than waiting. And maybe even automate the transfer so that your accounts automatically transfer money on a regular monthly basis. Set small transfer amounts and let it roll. You may find that simply doing that will make the entire process less daunting. Then, as your plan begins to take shape and you have your priorities set, you have the infrastructure in place to act.

In addition to paying yourself first, additional common “tricks” to finding money to allocate to your financial goals include:

**Saving raises** – By definition, a raise is an increase in your current level of earned income. And it would seem to make sense that you don't necessarily need that additional income to maintain your current living standards. You just lived a year at an annual income level before the raise. So why couldn't you live another year at that same amount? Therefore, if you earn a \$3,000 raise, couldn't you allocate that raise to one of your financial goals instead of increasing your consumption? It's typically the case that we grow into our income levels, meaning we learn to spend more as we make more. Your competitive advantage, begin young with relatively little income, is that you are an expert at getting by on very little. So as your income increases, save those increases, and do your best to maintain your current level of consumption rather than allowing it to increase lock step with your increases in income.

**Saving bonuses, tax refunds or any other lump-sum payment** – It may be the case that you live month to month based on your regular income, whether it be weekly, bi-weekly, or what have you. It could be the case that it would be easier to set aside money you don't typically see in your regular paychecks. This could include gifts, selling an old car, or an inheritance in addition to the more common lump-sum payments like bonuses and tax refunds. Again, it's an easy way to set aside a good amount of money quickly with little impact to your day-to-day consumption levels.

**Continue a payment plan** – If you are making installment payments, like car or student loan payments, and those installment payments end, consider “continuing” to make those payments. For example, if your \$400 a month car payment comes to an end, immediately begin making \$400 payments to one of your financial goals. Theoretically you weren't using the \$400 in normal consumption before the car payment ended, so why can't you go without consuming the \$400 moving forward?

**Revisiting your budget or suspend all unnecessary spending** – It gets easy to forget budgeting from time to time. If you have gone a while since looking at your budget, it may surprise you to find that you are spending more

than you should be on certain things, like eating out. Also, even if you are regularly monitoring your budget, it may make sense to freeze all unnecessary spending a few times a year in order to allocate more money to a financial goal.

## 2.4 Short-Term Goals

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Short-term financial goals are goals you want to achieve within the next few months or years. Many common short-term goals include setting a budget, starting an emergency fund, and paying off high credit card debt. I discussed these specific goals above as part of your primary wealth-building activities. These goals should not take a back seat to any other goals, which is why I have addressed them first.<sup>2</sup>

Common additional short-term financial goals can include saving for a car or vacation. They can really include anything, but the key point is that they are generally goals you intend to achieve within a few months to a few years. Because your time horizon is short, most financial advisors will recommend saving your money in an account that does not have investment risk, so that it won't decline in value if the economy slips into a recession. Consider using a money market savings account for these goals because your time horizon for needing the funds is typically less than two years.

A money market account is simply an interest-bearing account. Most money market accounts pay a higher interest rate than regular savings accounts and often include check-writing and debit-card privileges. They also come with restrictions that make them less flexible than a regular checking account. They generally require you to deposit a certain amount of money to open an account and to keep your account balance above a certain level. Many will impose monthly fees if the balance falls below the minimum.<sup>3</sup>

Highly speculative investing seems to have exploded overnight given the rise in popularity of mobile app investing, such as day trading or meme stocks. Technically speaking, this type of investing could be considered a short-term, since many of the investments are bought and sold within a relatively short period of time. This type of investing is more or less gambling in the stock market and should be viewed as gambling rather than investing. Given the popularity in this type of investing, I dedicate Chapter 6 to this issue.

## 2.5 Mid-Range to Longer-Term Goals

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We don't want to blindly jump into investing before we make sure our financial priorities are in order and that we have an understanding as to what we hope to achieve from investing. I will lay out sound long-term investing strategies in the following chapters; however, I want to at least draw the connection between investing and achieving certain mid-range and long-term financial goals.

When it comes to financial goals that involve a number of years to achieve and are specific, like saving for a child's college education or buying your first home, it could be worth the expense to speak with a financial advisor. Most individuals are introduced to investing through a 401(k) tax-advantaged retirement account through work. I discuss

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<sup>2</sup> <https://www.sofi.com/learn/content/smart-short-term-financial-goals/>

<sup>3</sup> <https://www.investopedia.com/terms/m/moneymarketaccount.asp#:~:text=A%20money%20m>

401(k) accounts in detail in Chapter 16. However, there are plenty of reasons to invest in the stock market outside of a tax-advantaged account, especially if you are young and do not want to wait until you retire to benefit from your investments.

I cover investing in the stock market in Chapters 3-6. Before we get to those chapters, I want to discuss investing in the context of a few more common long-term financial goals.

### A. Long Investment Horizon is an Element to Sound Investing

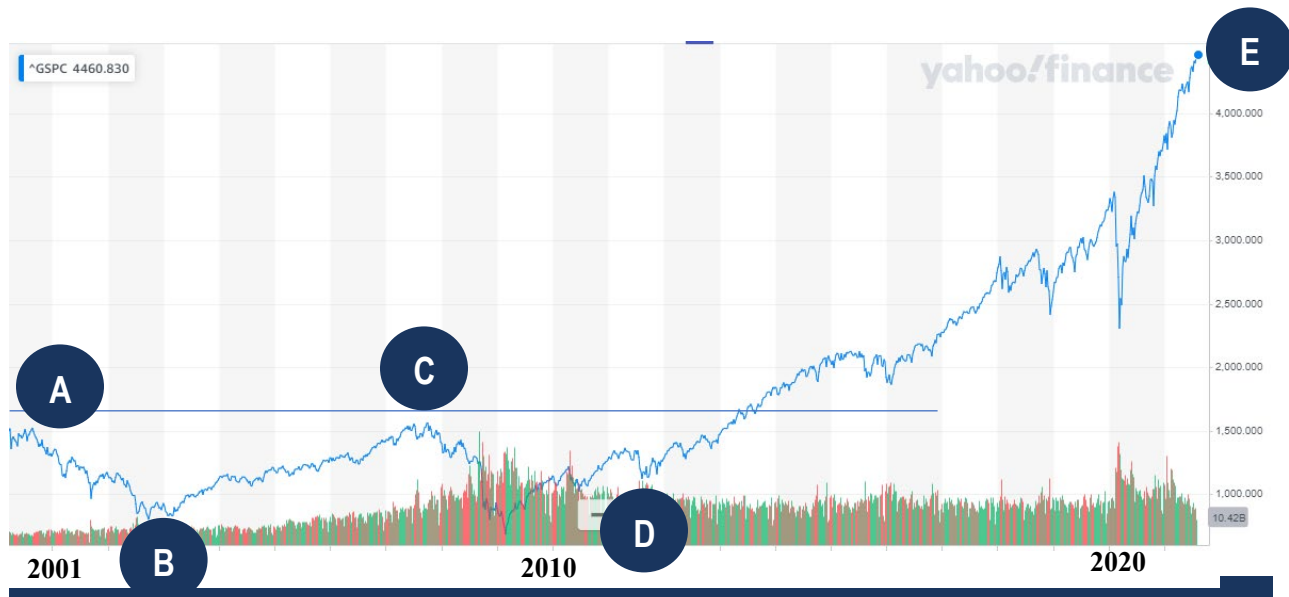
It is generally best to invest in the stock market with money you will not need for at least five years. If you are saving money for a specific purpose within the next few years, for example to buy a car, that money should be in cash and not stocks. You do not want to be forced to sell stock if the market happens to be in a downturn. And you certainly do not want to risk putting off your specific short-term goals like buying a car.

The values of investments depend on the present value of future profit and demand for the stock by investors. There will be strong demand for most types of investments when the economy is strong, income levels of investors are high, earnings levels of firms are high, and the market outlook is optimistic. When economic conditions are weak, income levels of investors are low, income levels of firms are low, and there will be weak demand for most types of investments.

Below is a chart of the S&P 500 Index from 2001 through mid-2021. As you can see from the graph, there have been two long-lasting stock market crashes over the past 20 years, one related to the dot-com bust in 2001-2002 and the second related to the housing market crash in 2008-2009.

If you had invested in 2001, just prior to the first crash (Point A), it would have taken you approximately seven or eight years to earn back your initial investment (Points A to C). Likewise, if you had invested in 2008, just prior to the second crash (Point C), it may have taken five years to recover (Points C to D). In other words, if you invest just prior to a downturn, it may take some time for you to earn your money back, and unfortunately there is no way to know with certainty what the future holds. Are you confident that if you purchased today at Point E there wouldn't be a downturn in the next three to five years?

FIGURE 6: S&amp;P 500 Index Chart



Many firms went bankrupt during the financial crisis in 2008–2009. Most investors of those firms lost 100 percent of their investment. Even stocks that normally perform well over time can experience declines in these market downturns. Many stocks of large well-known companies experienced price declines of 40% or more during the financial crisis in 2008-2009. Stocks and bonds of smaller firms tend to be even more risky, as they commonly experience pronounced fluctuations in their performance level.

A longer time horizon means removing the emotional aspect of investing and not looking at the stock market as a casino where quick profits are made. Obsessing about a particular return you earned over the course of a particular day to the point where you are constantly buying and selling throughout the day, generates fees, commissions, and bonuses for Wall Street. Conversely, simply buying stocks and holding on to them does not generate fees. Thus, it is no mystery why Wall Street prefers speculation and active trading, and downplays investing. Even when you are not directly paying transaction fees to apps like Robinhood and Acorns, those apps are still getting compensated from other entities based on the number of transactions they generate (deal flow). So while it may not seem like it to you directly, those apps get paid more if they have more transactions. Therefore, they have an incentive to convince you to actively trade.

One of your competitive advantages is being young and having time to accumulate wealth in a sustainable, reasoned, and diversified way. When you are young, you can take advantage of time and compounding interest as we discussed in Chapter 1. Just imagine if you had been constantly investing over the past 20 years (during the periods surrounding Points A-E in the graph above). The market would have been increasing and decreasing over that period but gradually making its way to where it is today at Point E.

Constantly investing during the ups and downs is a sound investing strategy referred to as Dollar-Cost-Averaging. Investments you made at Point A would be at a loss by Point B. However, if you purchased more stock at Point B rather than selling, by the time you got to Point C, your Point A investments would be about even with the initial

purchase price, but your Point B purchased stock would have doubled in value between Points B and C. I have heard many investors refer to downturns in the market as a time to buy stock when they are “on sale.”

According to Investopedia, the S&P 500 earned an average annual return of approximately 10 percent over the life of the index. That does not mean that the S&P 500 grew at 10 percent every year. Some years, as we can see from the graph above, there were declines in the value of the index and in other years there were steep increases. Accounting for all the increases and decreases, the index has averaged about 10 percent a year.

### **B. First Home**

Buying your first home is a huge milestone and expense. In fact, it's such a huge expense that many individuals struggle with the idea of whether to contribute to their retirement accounts or whether to save for a down payment on their first home. There are a few options available to you to either delay making that decision, or to help you balance those two priorities.

A great way to avoid having to make this decision now would be to invest in a Roth IRA. I discuss Roth IRAs in detail at Chapter 17. If you are saving for your first home purchase, a Roth IRA account would provide you significant tax advantages. As long as you have owned the account for at least five years, you may withdraw an amount equal to the contributions you've made to your Roth IRA tax- and penalty-free at any time and for any reason. Remember that you contribute after-tax dollars to a Roth IRA, so you've already paid taxes on your contributions. Then with a Roth IRA, your earnings grow tax-free. Once you've pulled out your contributions, you can withdraw up to \$10,000 of the account's earnings or money converted from another account without paying the standard 10 percent penalty, as long as it is for a first-time home purchase.

By contributing to a Roth IRA, you are not locked into an either/or situation. As such, as time goes by you can re-evaluate your priorities. If your priority is buying a house, then at that time you can take money out of your Roth IRA. If it's retirement, then you simply leave your money in the Roth IRA.

There are limits to how much you can contribute to a Roth IRA. We discuss IRA contributions in Chapter 17. It may be the case that you are able to set aside more money towards saving for a down payment than your Roth IRA contributions allow. At this point you can choose between a taxable investment account or your 401(k) Plan. Which one makes the most sense for you depends on your specific financial situation. This is where you would want to discuss your options with a financial advisor. However, the IRS allows you to borrow up to \$50,000 from your 401(k) to buy a home. There are other allowable reasons to borrow from your 401(k). See Chapter 16 for our discussion on 401(k)s. Your 401(k) loan needs to be repaid over a five-year period, but remember that you are really repaying yourself since it was your money to begin with.

There are great debates about whether it makes sense to borrow from a 401(k) to buy a home. Some argue that you lose out on any appreciation while you are paying back your loan. On the other hand, others argue that your 401(k) timeline is so long that the lost appreciation is minimal given the time horizon. In addition, the fact that you are paying interest to yourself rather than a bank or employer, in part makes up for any lost appreciation.

Another option could be to contribute to your retirement accounts up to a point where you have accumulated something like \$20,000, \$50,000, or \$100,000 and then switch gears to saving for the house. That way whatever



amount you have saved up in your retirement accounts continues to grow as you move towards aggressively saving for your down payment.

I will say it again: There is no one way that makes sense for everyone, and all of these decisions depend on your specific situation and priorities, so this is where you would want to discuss your options with a financial advisor.

### C. College Education

If you are saving for your children or spouse's educational expenses, a 529 account provides significant tax advantages. A 529 investment plan is an account that offers tax benefits when you use it to pay for qualified education expenses. You can use a 529 plan to pay for college, K-12 tuition, apprenticeship programs and student loan repayments. A 529 account works much like a Roth account by investing your after-tax contributions in mutual funds, ETFs and other similar investments. Your investments then grow on a tax-deferred basis and can be withdrawn tax-free if the money is used to pay for qualified higher education expenses.<sup>4</sup>

Once you have opened your 529 you can pick target date funds based on the beneficiaries expected dates of attendance. These target date funds typically have high fees and underperform basic ETFs. Some argue that you would be better off investing the money in a taxable account. A number of studies have shown that the investing options available in most 529s are under performing investments

### D. Returns and How They Can Impact a Timeline

We covered the concept of earning a return and earning compound interest in Chapter 1. Those concepts apply to financial goals beyond just retirement. Here, we discuss future value calculators and how to use them.

Let's assume the following: We want to save for a \$100,000 down payment and we can save \$10,000 per year. If we put our annual savings under our pillow instead of in an investment vehicle, we would have to save for 10 years. ( $\$100,000 / \$10,000 \text{ a year} = 10 \text{ years}$ )

Now, let's assume the following except that we invest our \$10,000 at the end of every year and expect to earn an eight percent return on those investments. Under this scenario, it would take us 7.64 years to reach \$100,000, rather than 10 years when we didn't invest our savings. This is the impact of the compound interest. The takeaway is that we can shorten our timeline by investing.

I used the financial calculator at <https://www.calculator.net/finance-calculator.html> to solve this problem. With this calculator, you have the flexibility to determine the answer to various questions. For instance, I just solved for the number of years.

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<sup>4</sup> <https://www.savingforcollege.com/intro-to-529s/what-is-a-529-plan>



**FIGURE 7: Future Value Calculation with Online Financial Calculator**

## Finance Calculator

This finance calculator can be used to calculate the future value (FV), periodic payment (PMT), interest rate (I/Y), number of compounding periods (N), and PV (Present Value). Each of the following tabs represents the parameters to be calculated. It works the same way as the 5-key time value of money calculators, such as BA II Plus or HP 12CP calculator.

Modify the values and click the Calculate button to use

FV
PMT
I/Y
**N**
PV

I/Y (Interest per year) 8 %  
PV (Present Value) \$0  
PMT (Periodic Payment) \$-10000  
FV (Future Value) \$100000  
[+ Settings](#)  

Calculate

Clear

Results

N = 7.637

|                              |              |
|------------------------------|--------------|
| Sum of all periodic payments | \$-76,374.57 |
| Total Interest               | \$-23,625.43 |

To solve for the number of years, I selected the “N” tab of the calculator, which stands for Number of Years. I then plugged in an 8 percent return, \$10,000 annual payment, and a \$100,000 future value. The abbreviations are as follows:

**FIGURE 8: Financial Calculator Abbreviations**

|     |                         |
|-----|-------------------------|
| FV  | Future Value            |
| PMT | Periodic Payment        |
| I/Y | Interest Rate or Return |
| N   | Number of Periods       |
| PV  | Present Value           |

We can easily change the question to: How much would I have to save if I wanted \$100,000 in 10 years and anticipate earning an 8 percent return? I would go to the PMT tab to solve this. Based on these inputs and the calculator, I would have to save \$6,903 per year for 10 years.

**FIGURE 9: Payment Calculation to Derive a Future Value**

Modify the values and click the Calculate button to use

**FV PMT I/Y N PV**

N (# of periods)

I/Y (Interest per year)  %

PV (Present Value)

FV (Future Value)

[+ Settings](#)

**Calculate** **Clear**

**Results**

**PMT = -\$6,902.95**

|                              |              |
|------------------------------|--------------|
| Sum of all periodic payments | \$-69,029.49 |
| Total Interest               | \$-30,970.51 |

At the end of every year, or periodically, you will want to check to ensure you are on track to meet your financial goal. You can do this many different ways, but the easiest may be to go back to the calculator and input your new assumptions. In this scenario, you should have a better understanding of the returns you have been earning, and you should also have something already saved. If you have something already saved, you would input that amount in the PV row.

Unfortunately, you can't go to the stock market and buy stocks that guarantee a return of eight percent, 10 percent, etc. When you buy a certain stock, you have no idea what return you will earn as you own that stock. It could yield a 20 percent return or it could decline in value as well. You just don't know. It would be so much easier to write this if you could.

I discuss risk and returns in Chapter 3. I refer you to that chapter for a more in-depth discussion of this issue. However, in part, your timeline will dictate how much risk you should take and what you should invest in. All else being equal, a shorter time period warrants less risk, whereas a longer period means you can assume more risk, since you have more time to recover from downturns in market.

## CHAPTER 3: Investing Fundamentals

- 3.1 Introduction to Stocks
- 3.2 Introduction to Bonds
- 3.3 Introduction to Mutual Funds
- 3.4 Introduction to Cryptocurrency
- 3.5 Exchanges and Brokers
- 3.6 Tax Implications of Investing

### 3.1 Introduction to Stocks

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When you buy a stock or share in a company, you become a shareholder and are entitled to a portion of the company's profits. Your ownership percentage is determined by the number of shares you own relative to the number of outstanding shares. For example, if a company has 100 shares of stock outstanding and you own one share, you own one percent of the company ( $1/100 = .01$  or 1%). Stocks also have historically been the best hedge against inflation.

Companies sell stock to raise money to operate their businesses and/or pursue new opportunities. A company's stock is initially sold through an initial public offering (IPO). At that point, its stock becomes available for you to buy and sell on an exchange.<sup>1</sup> Stocks are bought and sold mostly on stock exchanges, such as the New York Stock Exchange (NYSE) and the Nasdaq.<sup>2</sup> Typically, investors will use a brokerage account to purchase stock on the exchange, which will list the purchasing price (the bid) or the selling price (the offer).<sup>3</sup> Investors are now able to purchase stocks via mobile apps, such as Robinhood and Acorn.

As a shareholder, you do not *own* a corporation, you own shares issued by corporations. This distinction is important because this limits the liability of both the corporation and the shareholder. For example, if the corporation goes bankrupt, it may have to sell all of its assets to pay off its debts. In this example, you would not have to sell your personal assets to help pay down the corporation's debts. No one can even force you to sell your shares, although those shares are likely to be worthless if the company goes bankrupt.

Owning stock gives you the right to vote with other shareholders on important issues facing the company, receive dividends (which come from the company's profits), and sell your shares to anyone. The price of the stock is influenced by supply and demand, among other variables, which I discuss in Chapter 7.<sup>4</sup> Likewise, as a company's prospects increase, so does its share price. The better the outlook of the company, all else being equal, the higher its stock price. Ideally, you buy stocks when their prices are low and sell them when they are high.

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<sup>1</sup> <https://www.investopedia.com/terms/s/stock.asp>

<sup>2</sup> <http://investing-newbie.blogspot.com/2007/06/>

<sup>3</sup> <https://www.investopedia.com/terms/s/stock.asp>

<sup>4</sup> <https://www.investopedia.com/terms/s/stock.asp>

You can make money investing in stocks by receiving dividends and increases in the stock price. Say you buy a stock for \$35 and you sell it a few years later for \$100, the profit you earned in the increase in the stock price would be \$65 (\$100-\$35). Some companies distribute quarterly income to their stockholders in the form of dividends rather than reinvest that income back into the business. Dividends are typically 1-3 percent of the company's stock price, but not all companies pay dividends.

The older, more-established firms tend to pay high dividends, as they have less chance for substantial growth and therefore less reason to reinvest their income back into the business. Conversely, firms that pay low dividends tend to be smaller and newer firms with more growth opportunities. The stocks of these companies are often referred to as growth stocks. Investment in these growth firms offers the possibility of above-average return because they have not reached their full potential. They are the classic "buy low, sell high" type companies. On the other hand, these firms tend to be riskier because they are more likely to fail or experience very weak performance relative to bigger and/or more established firms.<sup>5</sup>

## 3.2 Introduction to Bonds

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A bond is a debt security.<sup>6</sup> When you buy a bond, you are lending money to a company. In return, the entity selling the bond promises to pay you interest during the life of the bond and also pay you the principal amount when the bond becomes due.

Governments and corporations use bonds to borrow money. Governments need to pay for projects including roads, schools, and dams. Corporations will often sell bonds to pursue new business opportunities or make large capital investments (e.g., to build a new factory). Large organizations typically need far more money than the average bank can provide. Bonds provide a solution to those companies by allowing a pool of investors (like you and I) to assume the role of the lender. We each lend the entity or company a small portion of the total amount it needs, but in total it adds up.<sup>7</sup>

Corporate bonds are debt securities issued by private and public corporations. You can buy investment-grade bonds, which are bonds with high credit ratings.<sup>8</sup> Typically, investment-grade bonds will pay lower interest rates since they carry less credit risk. You can also purchase high-yield bonds which have a lower credit rating, and therefore offer higher interest rates in return for the increased risk.

Municipal bonds are debt securities issued by states, cities, counties, and other government entities. Municipal bonds include:<sup>9</sup>

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<sup>5</sup> <https://www.scribd.com/book/479951631/What-Every-Investor-Needs-to-Know-About-Accounting-Fraud>

<sup>6</sup> <https://www.investor.gov/introduction-investing/investing-basics/investment-products/bonds-or-fixed-income-products/bonds#:~:text=Investors%20buy%20bonds%20because:,provide%20a%20predictable>

<sup>7</sup> <https://www.investopedia.com/terms/b/bond.asp>

<sup>8</sup> <https://courses.lumenlearning.com/atd-lfcc-personalfinance/chapter/bonds/>

<sup>9</sup> <https://courses.lumenlearning.com/atd-lfcc-personalfinance/chapter/bonds/>

**FIGURE 1: Municipal Bonds**

- General obligation bonds are not secured or guaranteed by any assets. Instead, they are backed by the issuer, which has the authority to tax residents to pay bondholders.
- Revenue bonds are guaranteed by revenues from a specific project or source, such as highway tolls or lease fees.
- Conduit bonds are sometimes issued by governments on behalf of private entities such as non-profit colleges or hospitals.

U.S. Treasury Bonds are issued by the U.S. Department of the Treasury on behalf of the federal government. Since U.S. Treasury Bonds are backed by the U.S. government, they are a safe and popular investment. You can purchase Treasury Bills that mature within a few days to a year. You can also purchase notes that mature within 10 years and bonds that mature within 30 years. Finally, Treasury Inflation-Protected Securities (TIPS) are bonds where the principal amounts are adjusted based on changes in the Consumer Price Index, or inflation. TIPS mature within five, 10, or 30 years and pay interest every six months.

Bonds are an attractive investment option because they consistently pay an income stream through interest and principal payments. Bonds can preserve capital while still earning a predictable return. Municipal bonds are further attractive because the interest is generally exempt from federal income tax and also may be exempt from state and local taxes for residents in the states where the bond is issued.<sup>10</sup>

A bond's price can increase over time and therefore could provide a return to you if you were to sell at the higher price. However, a bond's price may decline, which could cause investors to experience loss.

Bonds do have risk, though. For starters, the issuer may fail to make interest or principal payments and thus default on its bonds.<sup>11</sup> Bonds can change in value, and if you intend to sell the bond before it matures, you could end up selling the bond for less than what you paid for it. Typically, rising interest rates will make older bonds less appealing because newer bonds will have a higher rate of interest than older ones. Therefore, if you sell an older bond with a lower interest rate, you might have to sell it at a discount.<sup>12</sup> Inflation reduces purchasing power, which is also a risk for investors receiving a fixed rate of interest.

### 3.3 Introduction to Mutual Funds

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Mutual funds generally can be categorized based on the types of securities they invest in. There are stock mutual funds that sell shares to individuals and then invest those proceeds into stocks of numerous companies. Bond mutual funds sell shares and invest the proceeds in a variety of bonds. Mutual fund portfolio managers decide what securities the mutual fund invests in, relieving us from the burden of having to pick the securities ourselves. Maybe more importantly, mutual funds also provide an easy way for investors to diversify their investment portfolio, since mutual funds hold numerous investments. It has usually been the case that the minimum investment in a mutual fund was between \$500 and \$3,000 depending on the fund. However, given the rise of fractional share mobile apps,

<sup>10</sup> <https://courses.lumenlearning.com/atd-lfcc-personalfinance/chapter/bonds/>

<sup>11</sup> <https://www.investor.gov/introduction-investing/investing-basics/investment-products/bonds-or-fixed-income-products/bonds>

<sup>12</sup> <https://courses.lumenlearning.com/atd-lfcc-personalfinance/chapter/bonds/>

you can now buy fractions of shares in mutual funds for much less than \$500. In fact, you can do it for no more than \$1.

Mutual funds can meet specific investment goals you may have. For example, some mutual funds provide the potential for asset appreciation (increased stock prices), while other mutual funds can provide periodic income (dividends) to investors.

You can earn money from mutual funds through dividend payments generated by the mutual fund's portfolio of securities. Any dividend payments paid to the fund will be forwarded to you. A mutual fund's value changes over time in response to changes in the values of the securities it holds – another example of buy low and sell high. Unfortunately, if the value of the securities held by a mutual fund declines, so too does the value of your investment in the mutual fund. And in those instances, if you sold at a lower price than you purchased, you could incur a loss.

### A. Closed-End Funds vs. Open-End Funds

Closed-end funds issue shares to investors when the funds are first created but do not repurchase shares back from the investor. Instead, closed-end fund shares are bought and sold on the stock exchange. Thus, the market price of the fund shares is determined by the demand for shares versus the supply of the shares being sold. This is very similar to how stocks are priced in the market.

Open-end funds sell and buy back shares directly to and from investors. The funds are typically managed by investment firms. Many investment companies offer a wide variety of separately managed open-end mutual funds, each with its own investment objective. By offering a wide range of mutual funds, these companies satisfy different investment preferences.

Open-end funds are either load or no-load funds. No-load funds sell directly to investors and do not charge a fee. On the other hand, load funds charge a fee (load) when you purchase them. In most instances, the fees go directly to the stockbrokers or financial service advisors who execute the purchase of the mutual fund shares. Because no-load funds do not pay a fee to brokers, brokers are less likely to recommend them to you.

Studies have shown that on average no-load funds perform as well as load funds. Furthermore, after you consider the fact that load funds charge fees, the returns on no-load funds actually exceed the returns on load funds because they are not subject to fees. Sometimes it may make sense to invest in a load fund, if you believe that specific fund can generate higher returns than another alternative. However, all else being equal, it would make sense to purchase no-load funds, since you will not have to pay fees for the same returns.

### B. Expense Ratio

Mutual Funds can incur administrative, legal and clerical expenses along with fund management fees. Some mutual funds have much higher expenses than others, so you should review the annual expenses of any mutual fund in which you intend to invest. You should focus on the expense ratio, as mutual funds with high expense ratios must earn higher-than-average returns in order to make those funds worthwhile. On average, expense ratios are 1.5 percent and can be found on most web pages that report the fund's share price. However, many investment companies offer funds with much lower expense ratios (e.g., Vanguard).

Many mutual funds break their expense ratios into three categories: management, 12b-1 fee, and other. The management fee goes to those managing the fund. The fee typically accounts for the cost of researching securities. The 12b-1 fee pays brokers who invest in the fund on behalf of investors. A mutual fund may be called no-load but still compensate brokers. Other expenses include general business expenses such as mailing and customer service.

Again, research has shown that mutual funds with relatively low expense ratios tend to outperform other funds with similar objectives. This finding suggests that mutual funds with higher expenses ratios may not be worth the price, since you can earn the same returns at a lower cost.

### C. Stock Mutual Funds

#### FIGURE 2: Stock Mutual Funds

- Growth funds – Consist of stocks that have the potential for above average growth.
- Capital appreciation funds – Consist of stocks that are expected to grow at a very high rate. These stocks tend to pay low dividends in order to reinvest earnings back into the company.
- Small capitalization funds (Small-cap) – Consist of stocks of fairly small companies with a market capitalization (or market value) of less than \$2 billion.
- Mid-size capitalization funds (Mid-cap) – Consist of stocks of medium-size companies with a market capitalization (or market value) between \$2 billion and \$10 billion.
- Equity income funds – Consist of stocks that pay above-average dividends. The companies tend to be larger, more stable, with less potential for growth or returns but relatively less risky.
- Balanced growth and income funds – Consist of both growth and income stocks.
- Sector funds – Consist of stocks in a specific industry or sector. If you expect a specific industry to perform well, you may want to invest in sector funds. Sector funds allow you to invest in a lot of different companies within the same industry with less money than if you purchase the specific shares of each company.
- International stock funds – Consist of stocks outside of the U.S. Some funds focus on specific countries or regions and some regions and industries. These funds allow you to invest in a foreign country by relying on an experienced fund manager. International funds usually are more expensive, as it's more difficult to monitor companies in other countries. Also, transaction costs are typically higher. If an international fund also carries U.S. stock, then it is referred to as a global fund.
- Socially responsible stock funds – Focus on firms that place a greater importance on corporate governance and avoid controversial companies. A socially responsible fund would likely not invest in cigarette, gun, or alcohol companies. On the other hand, it would likely invest in green companies that focus on clean and renewable energy.

### D. Stock Index Funds

Index funds attempt to mirror the movement of an existing stock index. Index funds should earn returns similar to the index returns. For example, Vanguard offers an index fund containing a set of stocks that earns returns consistent with the returns of the stocks included in the S&P 500 index. It may not contain all the stocks in the S&P 500 index, but it is still able to mimic the index's movement.



There are all sorts of index funds. There is an index fund for the entire stock market (the Wilshire 5000). There are small capitalization index funds that attempt to mirror a small cap index such as the Russell 2000. There are index funds that mirror foreign stocks, foreign countries or foreign sectors.

Index funds are a great investment alternative to actively managed mutual funds. Their performance is similar to the actively managed mutual funds but they come with lower expenses than a typical mutual fund. This is because they are not actively managed. Index funds do not incur steep expenses because they do not research specific stocks. Their goal is to simply mirror the index's returns. Likewise, the portfolio of stocks in the index fund are not frequently revised, which means less transaction costs than traditional mutual funds. Some index funds have expense ratios between 0.2 and 0.3 percent, and sometimes even lower, which is substantially lower than the expense ratios of actively managed mutual funds.

In addition to having lower expense ratios, index funds may offer similar returns to actively managed mutual funds. Research has found that managed mutual fund returns are frequently lower than the returns of an existing stock index. Thus, you could get the same or better returns for less cost than a traditionally managed mutual fund.

## E. Hybrid Funds

### FIGURE 3: Hybrid Funds

- Include both stocks and bonds to balance the growth of stocks and the stability and income of bonds. There are many different types of hybrid funds, including:
  - Asset allocation funds (balanced) – Consist of a fixed percentage of stocks and bonds. A manager would only make small adjustments as the market changes.
  - Life cycle funds (age-based or target date) – The allocation of stocks and bonds changes automatically as the investor grows older. The allocation for a young investor would be heavily in stocks. As the investor ages, so does the percentage of bonds in the portfolio.

## F. Stock Exchange-Traded Funds

Exchange-Traded Funds (ETFs) mimic particular stock indexes similar to index funds but are traded on a stock exchange like closed-end funds.<sup>13</sup> Their share prices change throughout the day. There are ETFs that mimic and represent a number of different sector indexes like technology or banking. ETFs are ideal for investors that want to invest in a particular *sector* but do not have strong preferences on the stocks within that sector. ETFs are also beneficial for investors that want to invest in a particular *country's* stock market, but again, do not have strong preferences on the particular stocks.

ETFs have a fixed number of shares similar to closed-end funds. The key difference between ETFs and open- and closed-end funds is that they are not actively managed. ETFs are an efficient way to invest in a particular stock index. Likewise, ETFs usually require less money to invest in them relative to their mutual fund counterparts.

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<sup>13</sup> What-Every-Investor-Needs-to-Know-About-Accounting-Fraud, by Jeff Madura, published by McGraw-Hill Education

There is a wide variety of ETFs available that you can use to generate income, speculate, and to hedge or partly offset risk in your portfolio. In addition to the stock, bond, and industry ETFs, there are also commodity, currency, and inverse ETFs.

## G. Bond Mutual Funds

There are several types of bond mutual funds:

### FIGURE 4: Types of Bond Funds

- Treasury bond funds focus on investments in Treasury bonds.
- Ginnie Mae funds invest in bonds issued by the Government National Mortgage Association. These bonds have a low degree of default risk because they are issued by the government.
- Corporate bond funds invest in bonds issued by high-quality firms and, as such, they have a low degree of default risk.
- High-yield junk bond funds invest in bonds issued by relatively risky companies subject to default risk. Therefore, these bonds tend to offer a higher return to compensate for the greater risk.
- Municipal bond funds invest in municipal bonds. Interest income from municipal bonds is exempt from federal taxes. Thus, municipal bond funds are attractive to high-income earners in the higher tax brackets.
- Index bond funds are intended to mimic the performance of certain bond indexes, much like stock index funds.
- International bond funds hold bonds from companies in various parts of the world.

All of these bond funds can be further classified by maturity dates, which means that some of the bond fund types can hold bonds with maturity dates of 8-12 years, 13-30 years, etc.

## 3.4 Introduction to Cryptocurrency

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Cryptocurrency is a digital or virtual currency that is nearly impossible to counterfeit. Many cryptocurrencies, like Bitcoin, are decentralized networks based on blockchain technology. Blockchain technology is a distributed ledger enforced by a network of computers. A key aspect to cryptocurrencies is that there is no central authority, and thus, they are seemingly immune to government interference.

Cryptocurrencies are denominated in terms of virtual “tokens” that can be used to purchase goods and services from companies that accept a particular cryptocurrency. Bitcoin was the first, most popular, and most valuable blockchain-based cryptocurrency. There are now thousands of alternate cryptocurrencies with various functions and specifications.

The Internal Revenue Service (IRS) considers cryptocurrency a financial asset. Therefore, any profit you may earn on the purchase and sale of any cryptocurrency will be taxed as a capital gain. I assume that the IRS will be issuing further guidance on how to account for taxable cryptocurrency transactions.

Most cryptocurrencies use “wallets” or account addresses that have a public key, and a private key known only to the owner. The owner uses the private key to sign transactions. Fund transfers are completed with minimal

processing fees, unlike the steep fees on wire transfers charged by banks and other financial institutions. Cryptocurrencies are not stored on a central database, and therefore a digital cryptocurrency balance can be wiped out by the loss or destruction of a hard drive. Thus, if you invest or purchase cryptocurrency, you will need to use a backup copy of the private key on a separate hard drive. Cryptocurrency blockchains are highly secure, but other aspects of cryptocurrency markets, including exchanges and wallets, are susceptible to hacking. Several online exchanges have been the subject of hacking and theft, sometimes resulting in millions of dollars worth of “coins” stolen.<sup>14</sup>

Market prices for cryptocurrencies are based on supply and demand. The rate at which a cryptocurrency can be exchanged for another currency can fluctuate widely, since the design of many cryptocurrencies ensures a high degree of scarcity.<sup>15</sup> You can purchase cryptocurrency through crypto exchanges like Coinbase and Cash App.

## 3.5 Exchanges and Brokers

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A stock exchange is where stocks are bought and sold. You can buy various financial instruments through a stock exchange, including stocks and bonds. Exchanges bring together corporations, governments, and investors with the sole purpose of buying and selling securities. Exchanges essentially help create liquidity in your investment, meaning when you want to buy stock, there is stock there for you to buy, and when you want to sell your stock, there is someone there to buy it. Exchanges also ensure that financial information is transmitted to investors and financial professionals in a timely manner.

### A. The New York Stock Exchange and the Nasdaq

The two biggest U.S. stock exchanges are the New York Stock Exchange (NYSE) and the Nasdaq.

The NYSE is the world’s largest stock exchange and auction market. At an auction market, “Designated Market Makers” literally stand on the market floors. Each Market Maker specializes in a particular stock that they buy and sell in the auction. It is generally the case that the most well-known and credible firms trade on NYSE because they have to meet initial listing requirements and comply with annual maintenance requirements. To continue to trade on the NYSE, companies must maintain at least a \$4 per share price.<sup>16</sup>

The Nasdaq is referred to as a screen-based exchange because buyers and sellers are only connected via a network of computers. Market Makers, also known as dealers, carry their own inventory of stock and are required to post their bid and ask prices. The listing requirements on the Nasdaq are similar to the NYSE (e.g., companies must maintain at least a \$4 per share price).<sup>17</sup>

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<sup>14</sup> <https://www.investopedia.com/terms/c/cryptocurrency.asp>

<sup>15</sup> <https://www.investopedia.com/terms/c/cryptocurrency.asp>

<sup>16</sup> <https://www.investopedia.com/terms/l/listingrequirements.asp>

<sup>17</sup> <https://www.investopedia.com/terms/l/listingrequirements.asp>

## B. Over-the-Counter

If a company does not maintain the requirements to trade on the NYSE or Nasdaq, it can be delisted to an over-the-counter (OTC) market. OTC exchanges generally list smaller companies, many of which once traded on the NYSE or Nasdaq but have been delisted. The two most common OTCs are described in the figure below.<sup>18</sup>

**FIGURE 5: Types of OTCs**

- **Over-the-Counter Bulletin Board (OTCBB)** – An electronic exchange of Market Makers. Companies that fall off the Nasdaq usually end up on the OTCBB. There are no quantitative minimums or no minimum annual sales or assets requirements to be listed on the OTCBB.
- **Pink Sheets** – A listing service that doesn't require companies to register with the Securities and Exchange Commission. Companies listed on the Pink Sheets are not required to submit quarterly reports, which means investors are in the dark about the performance of these companies for most of the year.

## C. Other Exchanges

There are many other stock exchanges throughout the world. Some of the larger exchanges are located in Asia and Europe. There are also exchanges directed at digital currencies.<sup>19</sup>

Coinbase is the leading cryptocurrency exchange in the U.S. Coinbase serves retail investors and custodial accounts for institutions. Bitcoin is the most popular cryptocurrency; however, others such as Ethereum and Litecoin are traded on Coinbase.<sup>20</sup>

Binance is the largest cryptocurrency exchange, with an average trading volume of 2 billion per day. Binance does not allow for deposits in U.S. dollars. However, you can buy and sell cryptocurrencies with a credit or debit card.<sup>21</sup>

Kraken is a San Francisco-based cryptocurrency exchange where you can buy and sell cryptocurrencies using various government-backed currencies, including U.S. dollars, euros, Canadian dollars, and the Japanese yen. A number of virtual currencies can be traded via Kraken, including Bitcoin, Ethereum, EOS, and Monero.<sup>22</sup>

## D. Brokerage Firms

A brokerage firm is an entity that places trades on your behalf. If you wanted to purchase a particular company's stock, you would open a brokerage account and instruct that company to purchase your desired stock. Although the brokerage executes the orders, the investments belong to you.<sup>23</sup>

<sup>18</sup> <https://www.investopedia.com/terms/l/listingrequirements.asp>

<sup>19</sup> <https://www.investopedia.com/terms/l/listingrequirements.asp>

<sup>20</sup> <https://www.investopedia.com/terms/l/listingrequirements.asp>

<sup>21</sup> <https://www.investopedia.com/terms/l/listingrequirements.asp>

<sup>22</sup> <https://www.investopedia.com/terms/l/listingrequirements.asp>

<sup>23</sup> <https://www.investopedia.com/terms/b/brokerageaccount.asp>

There are many different types of brokerage accounts and brokerage firms. Some full-service brokers provide a good amount of investment advice and charge relatively high fees for that guidance.<sup>24</sup>

On the other hand, there are online brokers that simply provide a secure interface that allows you to buy and sell securities, and they charge relatively low fees for this service. Brokerage firms and accounts may differ in terms of execution speed, analytical tools, and the types of securities you can buy and sell.<sup>25</sup>

### **i Full Service Brokerage Firms**

If you are looking for a financial advisor, you should open an account with a full-service brokerage firm like Merrill Lynch, Morgan Stanley, Wells Fargo Advisors, or UBS. Financial advisors are paid to help you develop investment plans and to execute trades based on those plans.<sup>26</sup>

These full-service brokerage accounts will charge you either a commission on trades or advisor fees. A commission account will generate a fee any time an investment is bought or sold, whether the recommendation came from you or the advisor. Conversely, advisor fee accounts usually charge a flat annual fee, ranging from 0.5 to 1.5 percent of the total account balance.<sup>27</sup>

### **ii Discount Brokerage Firms**

If you are looking for a lower fee, do-it-yourself approach, you should consider going with a discount brokerage firm. These discount brokerage firms like Charles Schwab, TD Ameritrade, E\*TRADE, Vanguard, and Fidelity offer fewer services in exchange for lower fees.<sup>28</sup>

If you sign up with a discount broker, you could open a regular taxable brokerage account or retirement account. Usually these accounts are free as long as you are able to fund the account with at least \$500. To buy or sell most stocks, options, or exchange-traded funds (ETFs), there is little or no commission. Some discount brokers may charge fees for non-U.S. stocks or thinly traded stocks, but this varies from one broker to the next.<sup>29</sup>

### **iii Online Brokerage Firms**

Online brokerages (or mobile investing apps) like Robinhood offer commission-free trading and no minimum account requirements. Firms like Robinhood bypass commissions and generate revenue from a practice known as payment for order flow.<sup>30</sup>

There are drawbacks to zero-fee trading. For instance, Robinhood does not offer investment advice that's available from traditional brokerage firms. Likewise, some mobile investment apps do not support annuities or retirement

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<sup>24</sup> <https://www.investopedia.com/terms/b/brokerageaccount.asp>

<sup>25</sup> <https://www.investopedia.com/terms/b/brokerageaccount.asp>

<sup>26</sup> <https://www.investopedia.com/terms/b/brokerageaccount.asp>

<sup>27</sup> <https://www.investopedia.com/terms/b/brokerageaccount.asp>

<sup>28</sup> <https://www.investopedia.com/terms/b/brokerageaccount.asp>

<sup>29</sup> <https://www.investopedia.com/terms/b/brokerageaccount.asp>

<sup>30</sup> <https://www.investopedia.com/terms/b/brokerageaccount.asp>

accounts. Robinhood's model has been so successful that the major discount brokers switched to a zero-commission model for most stock trades, demonstrating that customers prefer this approach.

There are multiple mobile investing apps and each has its own strengths and weaknesses. Depending on your investing objectives, one app may be better suited than another.

#### **FIGURE 6: Factors to consider when selecting a mobile investing app**

- What securities can you buy with the app? Are the securities limited to a select few or can you buy a wide variety of securities including mutual funds, ETFs, and cryptocurrency? Can you purchase fractional shares?
- What are the fees? Are there commission fees on trades or are there monthly fees? Are there account minimums required to avoid fees?
- Do you get a free stock or anything else when you sign up?
- Does the app provide IRAs?
- What are the customer support features and customer reviews?
- What research tools are available and are there any additional fees to access them?
- Does the app provide a robo-investor or investment advice?
- Can you transfer your account or your stocks to another app?

#### **iv Financial Advisors**

If you think you may need help with investing, you should seek advice from a licensed investment firm or individual, professionally trained to provide financial assistance. If you go down this path, you should contact different firms, seek recommendations from others, and definitely speak with the individual who would be providing advice to you. You will want to make sure the advisor you select specializes in the areas of investing that are consistent with your investment goals.

Registered investment advisers may be found in a brokerage firm, bank, or insurance office. Investment advisors generally charge fees in the range of 0.5 to 1.5 percent of your invested assets per year. Fees can also be higher in some instances. Keep in mind the costs of professionally managed investments and brokerage fees will impact your total returns. The higher the fees, the lower your returns. Due to compounding, it can make a big difference over a long period of time.

Financial advisors who are registered with the Securities and Exchange Commission have a fiduciary duty to put your best interest first, rather than just making recommendations that are deemed "suitable." Commissioned brokers, on the other hand, are allowed to recommend investment products that are "suitable." While this may not seem like a big deal, a lower standard gives them the ability to suggest products that provide them with bigger payouts such as those found in actively managed funds.

If you intend to invest only in large publicly traded ETFs or sector funds with very low expenses, you may be better off going with a discount broker.

## 3.6 Tax implications of investing

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Any profit you earn on the sale of a stock or bond generally is taxable at different rates depending on how long you owned the stock. Gains on sales of stock are taxable as follows:

Long-term capital gains tax is a tax on profits from the sale of an asset held longer than a year. Long-term capital gains tax rates are currently 0, 15 or 20 percent, depending on your taxable income and filing status.

- Short-term capital gains tax is a tax on profits from the sale of an asset held for a year or less. Short-term capital gains tax rates are the same as your usual income tax bracket.

In addition to paying taxes on gains from selling stock, you are also going to have to pay taxes on any dividends or interest paid to you from stocks or bonds. For tax purposes, there are qualified dividends and nonqualified dividends.

- Nonqualified dividends, also called ordinary dividends, are taxed at your regular income tax bracket.
- Qualified dividends are taxed at the capital gains rates of 0, 15 or 20 percent, depending on your taxable income and filing status.

You might pay less tax on your dividends by holding the shares long enough for the dividends to count as qualified. Just be sure that doing so aligns with your other investment objectives.

Capital losses are instances when you sell a stock or bond for less than what you paid for it. The difference between all your capital gains and all your capital losses in a given year is called your “net capital gain.” Your taxes are based on your net capital gain. As we discuss in greater detail in Chapter 19, if your losses exceed your gains, you can use those losses to offset up to \$3,000 of your ordinary income.

As I discuss at the beginning of this chapter and at length in Chapters 16-19, dividends, interest, and capital gains held inside a traditional 401(k) or IRA are tax-deferred until you begin withdrawing from the account in retirement. Dividends, interest, and capital gains are tax-free if you hold them in a Roth 401(k) or Roth IRA.



## CHAPTER 4: A Young Beginner's Approach to Investing in the Stock Market

- 4.1 The Relationship Between Risk and Return
- 4.2 The Relationship Between Allocation and Risk
- 4.3 The Relationship Between Diversification and Risk
- 4.4 Investing in Funds to Easily Achieve Diversification

Consistent, diversified long-term investing is the key to accumulating wealth for the young investor. As a young investor, you have more time to earn compound returns on your investments and you don't need to chase astronomical returns by speculating in unproven securities or companies. Time is by far your biggest ally in this fight. Therefore, reasonable diversified returns over a number of years should be your primary investing strategy. It is the investing strategy most financial advisors would encourage you to employ.

If you are 25 years old and contributing to your retirement account, you are 40 years away from being able to enjoy the benefits of your efforts. So, I can see how you would want to contribute some money into an account that you can access before you retire. However, this effort is often difficult, since it should come after you are already contributing 15 percent of your earned income to your retirement and may require you to overcome some common investing errors. The most obvious is not getting started and then sticking to a coherent and workable investment strategy.

Yet, at the same time, *as a young investor you can afford to take on risk in an intelligent way to try and achieve greater returns*, since you have more time to recover from possible declines in the values of your investment. I understand how picking specific companies to invest in, betting on meme stocks and cryptocurrency, along with stories about day trading, appear to be more enjoyable and lucrative investment strategies. I see how it could seem like you are missing out by not investing in Bitcoin or GameStop.

However, securities with those higher returns usually come with much greater risk and volatility, so you could lose a substantial amount of money in a short period of time. As such, investing in these securities or employing these investment strategies should be limited to a small percentage of your overall investment portfolio. When or if you lose large portions of your investment portfolio by employing these speculative strategies, you should not let it discourage you from continuing to practice a long-term diversified strategy.

### 4.1 The Relationship Between Risk and Return

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Almost all investments are going to expose you to some level of risk. However, the more risk you assume, the greater your average rates of return over time, and the greater the returns, the more money you make.

## A. Rate of Return on an investment

Our main objective when investing in the stock market is to make money. We can make money from dividends and interest payments or from increases in the value of our investments. The money we make is collectively referred to as our return, and we often refer to our return in relation to our initial investment. The return on an investment is the gain or loss on that investment relative to the price paid for the investment.

For example: You buy a share of stock for \$100. Over the course of a year, the stock pays you a cash dividend of \$4. Your cash dividend is four percent of your original purchase price ( $\$4/\$100$ ). Thus, your return on your investment is four percent. The stock increases in value to \$104 (another gain of \$4, or another four percent return on investment), so the combined return – the dividend income of \$4 and the gain in value of \$4 – results in a gain of \$8, for a combined return on investment of eight percent ( $\$8/\$100$ ).

When I discussed compound interest and investing your money in Chapter 1, I assumed you could invest your money and earn an eight percent return. I then presented some scenarios illustrating the amount of money you would have if you continued to earn an eight percent return every year. Our example in the preceding paragraph is one way you could earn an eight percent return. Keep in mind that in order to keep getting the benefits of compound returns, you will have to reinvest the \$4 in dividends that you received in the example above.

## B. Risk of an investment

Usually it is the case that the higher the return, the greater the risk. Therefore, the amount of risk you are willing to assume depends, in part, on the amount of return you expect to earn. Because there are two sources of return: (1) cash flow (dividend and interest) and (2) capital gains (increases in the stock price), you need to consider two types of risk that might adversely affect your ability to meet your financial goals:

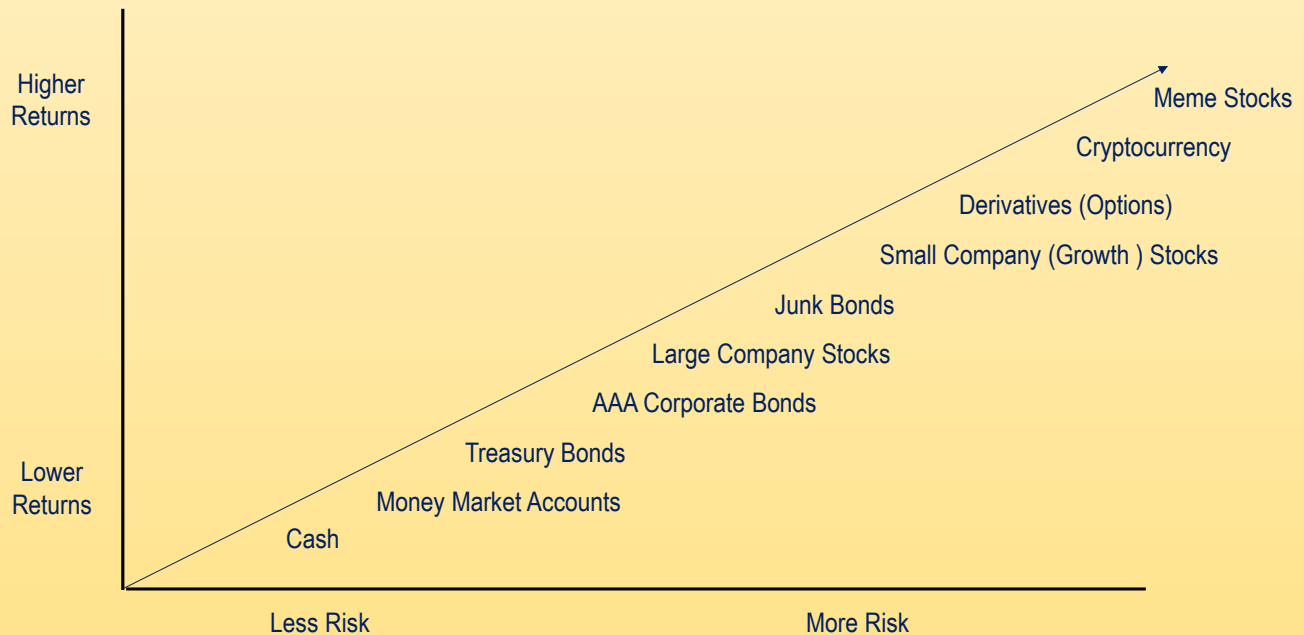
### **FIGURE 1: Investment Risk**

- The risk that you won't receive dividends and interest.
- The risk that the value of your investment won't increase.

Some investments have more risk than others. For instance, small companies are more likely to fail and less likely to pay dividends, so they are more risky (i.e., there is a higher probability that you will lose money investing in them). On the other hand, the federal government has never defaulted on its obligation to pay interest, so the risk associated with Treasury bills or bonds is low.

The following graph presents the positive relationship between risk and return. Investments towards the bottom left of the chart tend to be lower risk and provide lower returns. Investments on the upper right of the chart tend to be higher risk, and therefore typically provide higher returns over the long term. There are arguments that any one investment could be higher or lower in risk or return than another. The point is that Treasury bills tend to be less risky than growth stocks. Whether one specific growth stock is more or less risky than a particular junk bond is not the point of this graph.

**FIGURE 2: Investment Class and Relative Risk**



Where you are in life will have a significant impact on where you fall on the risk/return investing graph. In college, or the early life-cycle stages, your primary focus should be the investment into your education, career, and earning power. Basically, the focus should be to build your human capital. During this time, your focus is most likely on liquidity and safety. However, with the little money you have to invest in the stock market, students at this stage can afford to take on significant risk.

During your prime working years, the wealth accumulation stage of your life, you would also tend to be willing to take risks to accumulate the funds necessary to achieve your goals. Thus, the focus shifts from human capital to financial capital. Likewise, as you approach retirement, your focus shifts again to protecting your wealth rather than growing it. Thus, you tend to be more risk-averse.

When sitting down to invest, thinking about your stage in life and the risk graph above should help you decide what types of investments to hold in your portfolio. There is no right or wrong answer here. It usually depends on your personal preferences. However, speaking with a financial advisor could help you better understand some of the various risks associated with each type of investment. A better understanding may provide you with some assurance that additional risk is acceptable, or less risk is warranted.

## C. Types of Investment Risk

There are various types of risks associated with investing. Prior to investing, it makes sense to have some understanding of the risks you could face with a particular investment.

### FIGURE 3: Types of Risk

- Debt securities could be subject to inflation risk, interest-rate risk, reinvestment risk, default risk, liquidity risk, and market risk.
- Equity investments could be subject to inflation risk, reinvestment risk, and market risk.

All else being equal, as overall risk increases for any particular investment, so does the level of expected return. In other words, investors demand higher expected returns for riskier investments.

### i Market Risk

All investments are subject to risk associated with general market movements and economic conditions: “market risk.” During recessions, when companies cut back on spending, profits are down, and unemployment rates are high, stock prices tend to decline. When stock prices decline across the board, analysts refer to this as a “bear market.” This is not to be confused with the “bull market,” which is characterized by increasing stock prices, higher profits, lower interest rates, and economic growth. Although both bond and stock prices are influenced by market conditions, they don’t necessarily move together.

### ii Inflation Risk

With most investments, no matter how safe, you will be subject to inflation risk, or the loss in spending power over the life of the investment. Thus, the minimum return you would require from any investment would include compensation for the fact that your buying power will decline over time. Typically, inflation has averaged between two and three percent per year, so you would expect to earn at least two to three percent a year on any investment to compensate for inflation. In other words, things will be more expensive at the point when you cash out your investment, so you want to make sure you get compensated for that.

This is why it’s dangerous to keep your money in a savings account over long periods of time. Your money grows at very modest rates (half a percent or a quarter percent), yet if inflation is growing at two percent, then year after year, your buying power slowly decreases as inflation outgrows your savings. Therefore, there is risk in doing nothing.

### iii Interest-Rate Risk

Changes in interest rates can have an effect on all investments, especially bonds. All else being equal, increases in interest rates have a negative impact on the value of bonds. The longer the term of the bond, the greater the impact on the bond’s value. Investors expect to be compensated for “interest rate” risk, which is why the returns on bonds are usually more than savings accounts. Since short-term securities have a lower interest-rate risk, they provide a lower return on investment, all else being equal.

If you anticipate interest rates changing, you will want to factor that into your decision to purchase bonds or bond funds. If you intend to hold the bond to maturity, then maybe it's not as significant of an issue for you. However, if you intend to buy and sell bonds, and interest rates are expected to increase, you may not be able to sell the bond for as much as you had hoped.

#### iv Default Risk

There is risk associated with receiving expected cash flows (dividend and interest payments). Any entity can experience financial difficulties; however, some entities are more likely to default than others. The issuers of riskier types of bonds have to pay investors a greater rate of return (interest payments) to compensate for greater default risk. This is why junk bonds pay higher interest payments than Treasury bonds.

#### v Liquidity Risk

Some investments are difficult to sell in certain circumstances, or simply take longer to sell. Generally, these are assets with no readily available market or long transaction lead times. Liquidity risk is the risk that you would be forced to sell your investment for less than its worth because you need the cash right away. Most publicly traded stocks and bonds do not have this problem, since you can sell them on a moment's notice during regular business hours. Examples of assets that cannot readily be converted to cash include real estate, jewelry and collectibles.

## 4.2 The Relationship Between Allocation and Risk

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Asset allocation relates to how you allocate your money across and within various types of investments. This refers to the fact that you can distribute your investment portfolio across stocks, bonds, and cash generally. And then you also must decide on the specific investments within each category. The goal behind allocation is to align your portfolio of investments with your tolerance for risk and your time horizon.<sup>1</sup> At a high level, there are three common types of investments:<sup>2</sup>

### FIGURE 4: Three Types of Investment Risk

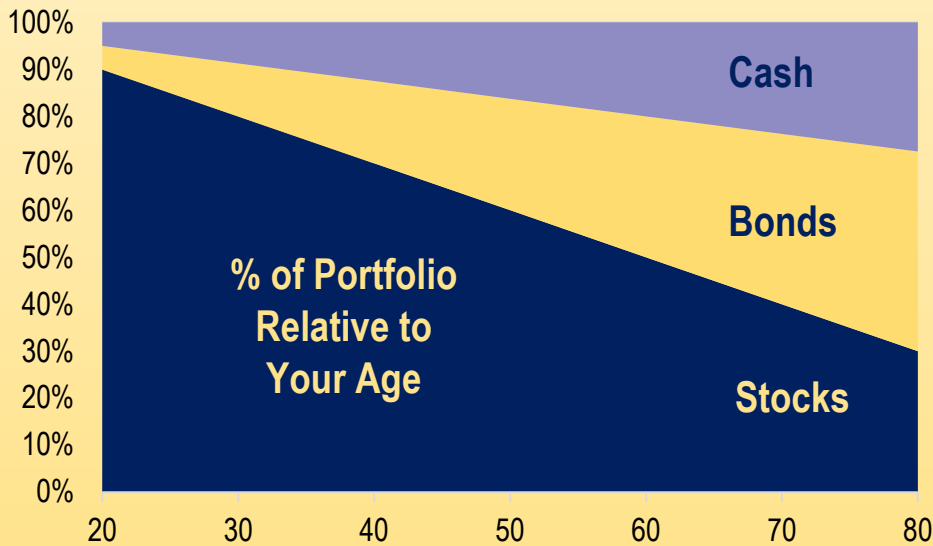
- Stocks, which historically have offered the highest rates of return. Stocks are generally considered riskier or more aggressive assets.
- Bonds, which typically provide lower rates of return than stocks, but tend to be less volatile. Bonds are usually considered safer or more conservative assets.
- Cash, which mostly refers to cash equivalents, such as savings accounts, money market accounts, certificates of deposit (CDs), cash management accounts, treasury bills, and money market mutual funds. Investors can enjoy potential upside with very low levels of risk.

The relative proportion of each investment category depends on: (1) your time horizon – how long before you need your money and (2) your risk tolerance – how much risk you can tolerate (or how much you can afford to lose in the short term for the potential to earn greater returns over the long term).

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<sup>1</sup> <https://www.forbes.com/advisor/investing/what-is-asset-allocation/>

<sup>2</sup> <https://www.forbes.com/advisor/investing/what-is-asset-allocation/>

**FIGURE 5: Relative Proportion of Each Investment Category**

### A. Asset Allocation and Time Horizon

Your time horizon is the amount of time between now and when you will want to convert your investments to cash. If you are intending to buy a new car in a few months, you have a short time horizon. If you are saving for retirement in 35 years, you have a long time horizon.

With a short time horizon, you have less flexibility to recover from market downturns. That's why for a short time horizon, most financial advisors will suggest keeping most of your investments allocated to cash equivalents, like savings or money market accounts, CDs, or even certain high-quality bonds. You don't earn much, but your risk is low, and you won't lose the money you need to buy that new car.

With longer time horizons, you can take on substantially more risk since you have more time to recover from downturns in your investments. You could allocate most of your investments to stocks or equity funds, which offer greater opportunities for growth.

For goals that have less well-defined timelines or more flexibility, like wanting to buy a new car at some point in the future but without a set date in mind, you can take on more risk assuming you can delay if your investments initially decline in value.

### B. Asset Allocation and Risk Tolerance

Risk tolerance has to do with the amount of risk you are willing to take to achieve a particular return on your investment. This is a hugely personal choice and there is no right or wrong answer. You can be a risk taker or you can be risk averse.

If you don't like the idea that the value of your investments can swing up and down dramatically, even if you understand that those swings are a normal part of the economic cycle, you probably have a lower risk tolerance. If

you understand economic cycles and can handle the downturns, AND you have a long-term investment time horizon, your risk tolerance is probably high.<sup>3</sup>

Your risk tolerance is going to influence your asset allocation. The amount of risk you are willing to take will dictate the proportion of your money you allocate to aggressive versus conservative investments. In turn, this will dictate the portion of your investment portfolio you allocate to stocks and the portion you allocate to bonds and cash.<sup>4</sup>

No matter how conservative you are, your investments may lose money at some point in the investment cycle. However, depending on your level of risk, those swings can be less volatile if you have most of your investments in conservative assets.<sup>5</sup>

### C. Why Asset Allocation is Important

Choosing the right asset allocation can maximize your returns (i.e., allow you to earn the most money) relative to the amount of risk you are willing to take (i.e., the amount of money you invest in the stock market). Buying a mutual fund or an index fund can provide diversification over hundreds, if not thousands, of stocks or bonds, but they are mostly the same type of asset. A stock index fund offers diversification in stocks but not bonds. Therefore, you are not diversified in terms of asset allocation.<sup>6</sup>

To diversify your asset allocation, you would split your money between a stock index fund and a bond index fund. This helps protect your money because stocks and bonds typically move in opposite directions. When stocks go up, bonds generally go down. Or when bonds go down, stocks generally go up. Allocating your money across the two asset classes can position your portfolio to retain value and grow no matter what markets are doing.<sup>7</sup>

### D. Three Asset Allocation Scenarios

Following are three scenarios that illustrate asset allocation in relation to age. It is important to keep in mind that these are not recommendations as much as they are examples to illustrate how allocation could change over time.

Scenario 1: You are in your 20s and have more than 40 years until you retire. Therefore, you can take on more risk. The financial markets will have ups and downs, but you are more interested in holding investments that will offer the potential for a higher rate of return. You could theoretically want a diversified portfolio that allows you maximum exposure to the stock market and its historically high rates of return.

#### **FIGURE 6: In This Scenario, Your Portfolio Could Look Like This<sup>8</sup>**

- 80% stocks (40% large-cap stocks, 30% mid-cap stocks, 30% small-cap stocks),
- 15% bonds, and
- 5% cash

<sup>3</sup> <https://www.forbes.com/advisor/investing/what-is-asset-allocation/>

<sup>4</sup> <https://www.forbes.com/advisor/investing/what-is-asset-allocation/>

<sup>5</sup> <https://www.forbes.com/advisor/investing/what-is-asset-allocation/>

<sup>6</sup> <https://www.forbes.com/advisor/investing/what-is-asset-allocation/>

<sup>7</sup> <https://www.forbes.com/advisor/investing/what-is-asset-allocation/>

<sup>8</sup> <https://www.forbes.com/advisor/investing/what-is-asset-allocation/>



Scenario 2: You are 40 years old and have a 15-year investment horizon. In this situation, you may want to assume a moderate level of risk. You have more than a decade until you want your money but less time to recoup any major market losses. Maybe you would be willing to take on some risk to keep your money growing but don't have multiple decades to replace any money you might lose.

**FIGURE 7: In This Scenario, Your Portfolio Could Look Like This <sup>9</sup>**

- 60% stocks (60% large-cap stocks, 20% mid-cap stocks, 20% small-cap stocks),
- 30% bonds, and
- 10% cash

Scenario 3: You are 60 years old and beginning retirement. Losing money isn't an option, since the money needs to last for at least the next 20 years. You still want a diversified portfolio but one that helps preserve your capital while offering opportunities for upside.

**FIGURE 8: In this scenario, your portfolio could look like this <sup>10</sup>**

- 30% stocks (100% large-cap stocks),
- 50% bonds, and
- 20% cash

Different time horizons and different levels of assumed risk dictate how you would choose to allocate the assets in your portfolio. These profiles should give you an idea of how asset allocations can change based on different risk tolerances and time horizons. You should not view these as the right or wrong allocations. Your specific allocations will depend on your specific circumstances and the amount of risk you are willing to assume.<sup>11</sup>

It should also highlight that asset allocation isn't a one-time thing. Your desired asset allocation will change over time as you get closer to your goals. At the same time, you may notice a movement of your allocations from one year to another. This could happen if stock values rise suddenly or if bond interest rates (and their associated prices) fall.<sup>12</sup>

## 4.3 The Relationship Between Diversification and Risk

If you are picking stocks within Robinhood or Acorn, keep in mind that no matter what anyone tells you, picking that one right stock that will go "to the moon" is really difficult. No matter how young or old you are, how much experience you have investing, how plugged into TikTok or social media you are, how many books you've read or people you have talked to, picking stocks is hard. Not only is it hard, you are bound to get it wrong, and get it wrong often.

Sure, you can buy a stock and it can increase in value and you could convince yourself you're on the right track. But what if your friend bought a different stock and it increased in value more than yours? Even worse, what if your stock decreased in value and your friend's increased in value? And what if yours decreased in value dramatically?

<sup>9</sup> <https://www.forbes.com/advisor/investing/what-is-asset-allocation/>

<sup>10</sup> <https://www.forbes.com/advisor/investing/what-is-asset-allocation/>

<sup>11</sup> <https://www.forbes.com/advisor/investing/what-is-asset-allocation/>

<sup>12</sup> <https://www.forbes.com/advisor/investing/what-is-asset-allocation/>

Wouldn't you wish you had purchased your friend's stock rather than the one you actually purchased? The problem is that at the time each of you purchased your respective stocks, there was no way to know with certainty which stock would do better than the other.

That is why diversification is key. If you were diversified, theoretically, you would own all sorts of different stocks and it would not matter which one did better than the other because you owned many of them. Different investments yield different returns at different times, so it helps to own a variety. When you invest in different types of investments and asset classes (stocks, bonds, cash, etc.) you are diversifying. Diversification means you are lowering your risk by spreading your money across and within different asset classes. It's one of the best ways to manage returns during market ups and downs and to maintain the potential for growth over the long run.<sup>13</sup>

You are at a clear advantage given your age. An investor's age affects how much risk you can take on. Since you are young, you can seek out bigger returns by taking bigger risks. This may seem like an invitation to gamble on big payoffs, but it is not. Instead of gambling or investing in highly speculative stocks, you should look to invest in companies that have higher risk but greater upside potential over the *long term*. Small-cap stocks have higher risk but also a higher potential for return. Small-cap stocks are those of smaller and less-established companies, but many of them go on to become household names with long-term rising stock values. Many go nowhere as well. As a young investor, you could invest in a diversified portfolio, or index fund, of small-cap stock to earn high-than-average returns.<sup>14</sup>

While there are no hard and fast rules about how many different types of stocks you should own, two or three stocks are unlikely to provide enough protection against market ups and downs. Generally speaking, the wider the number of holdings, the greater the diversification benefits. According to the Schwab Center for Financial Research, you should be concerned if a single stock accounts for 10 percent or more of your total stock investments.<sup>15</sup> Likewise, many financial advisors will suggest a single stock should not account for five to 10 percent or more of your total stock investments.<sup>16</sup>

All investments are going to fluctuate, so allocating your money across different asset classes, different industries, and different geographical locations will normalize the fluctuation in returns. In addition, every time you buy or sell a stock you may need to pay a trading fee or commission. And the more stocks and bonds you own, the more expensive investing can get. Some argue that a well-diversified portfolio should include at least 20 stocks. Can you afford the trading fees and the time and energy to research all of those company stocks? Maybe you don't have to pay the trading fees with your mobile app investing tool, but when you get serious and have more money at stake, chances are it will get more expensive to move from one stock to another. Fees add up and, over time, can eat into your investment returns.

## 4.4 Investing in Funds to Easily Achieve Diversification

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An easy and inexpensive way to diversify your investments is to invest in index or mutual funds. As we discussed in Chapter 3, an index or mutual fund is a broad portfolio of stocks that you can buy in one transaction. A fund is an entity that takes money from a number of investors and pools it together. The fund invests the money in different

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<sup>13</sup> <https://www.schwabmoneywise.com/essentials/the-advantages-of-diversification>

<sup>14</sup> <https://www.investopedia.com/articles/younginvestors/09/common-mistakes-young-investors.asp>

<sup>15</sup> [https://www.schwabmoneywise.com/public/moneywise/essentials/the\\_advantages\\_of\\_diversification](https://www.schwabmoneywise.com/public/moneywise/essentials/the_advantages_of_diversification)

<sup>16</sup> <https://www.investopedia.com/articles/younginvestors/09/common-mistakes-young-investors.asp>

types of assets, including stocks, bonds, commodities, and even real estate. An investor buys shares in the fund that represent an ownership interest in a portion of the assets owned by the fund. Mutual funds are designed for longer-term investors. You can achieve diversification in a single investment with a small amount of money.<sup>17</sup>

According to Charles Schwab, you can diversify your portfolio of investments in three ways:<sup>18</sup>

#### FIGURE 9: Diversification

- Across asset classes with a long-term asset allocation plan that combines different categories of major types of investments, such as stocks, bonds, commodities (e.g., gold, other precious metals), and cash.
- Within asset classes so you're not too concentrated in any one market sector (e.g., technology or health care), company, company size (e.g., large cap, mid cap, small cap), or country.
- By mixing investing styles through a combination of value and growth stocks. This will help reduce the risks associated with investing strategies that perform better or worse in certain markets.

### A. Style and Fund Type

There are all different types of mutual funds and index funds that you can invest in. There are stock funds, bond funds, money market funds, and funds that combine stocks and bonds. Stock funds invest in corporate stocks. The most common stock index funds are S&P 500 index funds. S&P 500 funds offer good returns over time; they are diversified and a relatively low-risk way to invest in stocks.<sup>19</sup>

If you prefer current income from your portfolio, then income funds may be a better choice. These usually consist of bonds and other debt instruments that pay interest regularly. These funds can be less risky than the S&P 500 funds depending on the types of bonds within the fund. However, as we discussed above, bond funds carry risk despite their lower volatility.<sup>20</sup>

There are also target date funds, which hold a mix of stocks, bonds, and other investments. The mix gradually shifts according to the fund's objective. Target date funds are ideal for retirement investing, as they allocate appropriately as you progress to retirement.<sup>21</sup>

<sup>17</sup> <https://www.investopedia.com/articles/investing/092915/trading-mutual-funds-beginners.asp>, and

<https://www.schwabmoneywise.com/essentials/the-advantages-of-diversification>

<sup>18</sup> [https://www.schwabmoneywise.com/public/moneywise/essentials/the\\_advantages\\_of\\_diversification](https://www.schwabmoneywise.com/public/moneywise/essentials/the_advantages_of_diversification)

<sup>19</sup> <https://www.schwabmoneywise.com/essentials/the-advantages-of-diversification>, and <https://financekatta.com/how-to-choose-best-mutual-fund-for-you/>, and <https://www.investopedia.com/investing/how-pick-best-mutual-fund/#:~:text=The%20time%20frame%20for%20holding,may%20be%20a%20better>

<sup>20</sup> <https://www.schwabmoneywise.com/essentials/the-advantages-of-diversification>, and <https://financekatta.com/how-to-choose-best-mutual-fund-for-you/>, and <https://www.investopedia.com/investing/how-pick-best-mutual-fund/#:~:text=The%20time%20frame%20for%20holding,may%20be%20a%20better>

<sup>21</sup> <https://www.investor.gov/introduction-investing/investing-basics/investment-products/mutual-funds-and-exchange-traded-1#:~:text=A%20mutual%20fund%20is%20a,buy%20shares%20in%20mutual%20funds>

## B. Stock Funds

Long-term capital appreciation funds and growth funds strive to achieve capital appreciation (i.e., the share price will be worth more than the price you paid for the share). Growth funds invest primarily in stocks that typically do not pay a regular dividend but have potential for above-average financial returns because the underlying investments are in companies that are growing quickly. These funds are ideal for the young investor with a long-term horizon who wants to assume a bit more risk to try and achieve higher returns. The time frame for holding this type of mutual fund should be a minimum of five years.<sup>22</sup>

The types of companies included in growth funds are typically those with high sales and/or earnings growth from year to year. These companies tend to be smaller with new and exciting ideas. As such, they may present more risk. Growth can be the result of many factors, including a high-demand product, a strong management team, a recognizable brand, great marketing, or continuing research and development of new and exciting products or services.

The focus for you, the young investor, should most likely be on growth companies, growth industries, and/or growth or emerging economies. Growth is key because, all else being equal, with more growth comes more profits and value eventually. And the more it's worth in the future, the more you likely make.

Income funds invest in stocks that pay regular dividends. Dividend stocks are those from companies that place more emphasis on distributing their income to their investors than reinvesting that income back into the business. Therefore, the companies tend to be more established and mature firms. As a general rule of thumb, a good dividend would be one that provides a yield greater than the interest rate on a 10-year treasury bond.<sup>23</sup>

Index funds track a particular market index such as the Standard & Poor's 500 Index. And sector funds specialize in a particular industry segment.

There is no right or wrong answer when it comes to choosing between growth stock funds or income stock funds, index funds or sector funds. It's totally your preference. In fact, you can invest in all of them, or you could do one for a bit, then switch to the others.<sup>24</sup>

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<sup>22</sup> <https://www.investor.gov/introduction-investing/investing-basics/investment-products/mutual-funds-and-exchange-traded-1#:~:text=A%20mutual%20fund%20is%20a,buy%20shares%20in%20mutual%20funds>, and

<https://www.investopedia.com/investing/how-pick-best-mutual-fund/#:~:text=The%20time%20frame%20for%20holding,may%20be%20a%20better>

<sup>23</sup> <https://www.investor.gov/introduction-investing/investing-basics/investment-products/mutual-funds-and-exchange-traded-1#:~:text=A%20mutual%20fund%20is%20a,buy%20shares%20in%20mutual%20funds>

<sup>24</sup> Designing Successful Target-Date Strategies for Defined Contribution Plans: Putting Participants on the Optimal Glide Path

### C. Return and Risk of Stock Mutual Funds

#### FIGURE 10: You Can Make Money by Investing in Stock Mutual Funds in Various Ways

- The value of the stocks owned by the mutual fund increase, thereby increasing the value of the fund's stock price.
- If the stocks that the mutual fund owns pay dividends to the mutual funds, then the mutual funds will forward you your share of those dividend payments.
- If the mutual fund sells shares in a stock at a gain, those gains will be forwarded to you as well.<sup>25</sup>

All stock mutual funds are going to experience the same risks and benefits as the broader stock market. When the stock market declines, prices of stocks held by a stock fund usually decrease. Conversely, when the market is strong, the stock prices of the fund increase. This movement with the general stock market is often referred to as market risk. Because a mutual fund contains different stocks, the adverse impact caused by any single stock is reduced. However, in an economic downturn, most stocks tend to decline in value.<sup>26</sup>

You can potentially earn very high returns investing only in growth stocks within one particular market segment (such as a technology fund), but that also comes with very high risk. A fund that further invests only in growth stocks of small firms in a small foreign country has even more potential return and risk. Smaller stocks tend to be riskier than larger stocks; therefore, mutual funds that hold mostly small stocks are riskier than mutual funds that hold mostly larger stocks. Yet, given the higher expected returns, some investors still prefer mutual funds consisting of small stocks.<sup>27</sup>

Broad stock index funds show similar performance to the market in general. Therefore, their expected returns are somewhat limited, but so are their risks. Growth stock funds offer potentially higher returns than a broad index fund, but they also come with more risk (more potential for a large decline in value).<sup>28</sup>

### D. Return and Risk of Bond Mutual Funds

You can make money by investing in bond mutual funds in the same ways as stock mutual funds (capital appreciation and dividends). All of these returns are also subject to income taxes, as we discuss in Chapter 19.

All bond funds are all influenced by general bond market conditions. The performance of a bond, and therefore a bond mutual fund, is dependent on the general movements of interest rates. When interest rates rise, prices of bonds decrease, and therefore bond fund share prices decrease. This is often referred to as interest rate risk.<sup>29</sup>

The prices of all bonds change in response to changes in interest rates, but the prices of longer-term bonds are the most sensitive to interest rates. Thus, if you wanted to reduce your exposure to interest rate risk, you could select a bond fund that focuses on bonds with short terms to maturity.<sup>30</sup>

<sup>25</sup> Personal Finance, Second Edition, Vickie Bajtlesmit, Chapter 13: Investing in Mutual Funds and Real Estate

<sup>26</sup> Personal Finance, Second Edition, Vickie Bajtlesmit, Chapter 13: Investing in Mutual Funds and Real Estate

<sup>27</sup> Personal Finance, Second Edition, Vickie Bajtlesmit, Chapter 13: Investing in Mutual Funds and Real Estate

<sup>28</sup> Personal Finance, Second Edition, Vickie Bajtlesmit, Chapter 13: Investing in Mutual Funds and Real Estate

<sup>29</sup> Personal Finance, Second Edition, Vickie Bajtlesmit, Chapter 13: Investing in Mutual Funds and Real Estate

<sup>30</sup> Personal Finance, Second Edition, Vickie Bajtlesmit, Chapter 13: Investing in Mutual Funds and Real Estate

The performance of many bond mutual funds is also dependent on the default risk of the individual bond holdings, or how likely it is that the company cannot pay the bond back at maturity, as discussed in Chapter 3. Bond funds that invest most of their money in bonds with high degrees of default risk tend to offer higher potential returns to investors to compensate for the high degree of risk. Under favorable economic conditions, the issuers of those bonds may be able to make all the required payments, and those bond funds will perform very well. If economic conditions are weak, some of the bond issuers may not be able to make all the required payments, and therefore, those funds may not do as well.<sup>31</sup>

Default risk is independent of interest rate risk. Some bond funds, such as long-term Treasury bond funds, have no (or a low) default risk since they are backed by the U.S. government. However, they have a high level of interest rate risk given their long time period. Other bond funds, such as short-term high-yield bond funds, have a low level of interest rate risk given their short time period and a high level of default risk given their company makeup. Long-term high-yield bond funds, are highly exposed to both default risk and interest rate risk given the makeup of the company and the long time period.<sup>32</sup>

Treasury bond funds with a short term remaining until maturity have no exposure to default risk and limited exposure to interest rate risk. The expected returns on these funds are relatively low, however. High-yield bond funds that invest only in junk bonds with long terms to maturity have the potential for very high return to account for the default and interest rate risks.<sup>33</sup>

There are all sorts of mutual funds and index funds. Some bond mutual funds are not as highly exposed to risk because they invest only in corporate bonds issued by the most creditworthy corporations. Other bond mutual funds are highly exposed because they invest in bonds issued by relatively weak corporations that pay high coupon rates.<sup>34</sup>

### E. Passive v. Active

Active investing is an investment strategy that involves selecting a group of stocks and bonds to try and achieve higher returns than the general market. Active investing is also referred to as attempting to “beat the market.” Actively managed funds have portfolio managers who make decisions regarding which securities and assets to include in the fund. These services are what drive the expense ratios.<sup>35</sup>

As we discussed above, mutual fund companies charge fees. Some funds charge load fees that can either be charged at the time of purchase or at the time you sell the fund. A front-end load fee is paid out of the initial investment when you buy shares in the fund, whereas a back-end load fee is charged when you sell your shares in the fund.<sup>36</sup>

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<sup>31</sup> Personal Finance, Second Edition, Vickie Bajtlesmit, Chapter 13: Investing in Mutual Funds and Real Estate

<sup>32</sup> Personal Finance, Second Edition, Vickie Bajtlesmit, Chapter 13: Investing in Mutual Funds and Real Estate

<sup>33</sup> Personal Finance, Second Edition, Vickie Bajtlesmit, Chapter 13: Investing in Mutual Funds and Real Estate

<sup>34</sup> Personal Finance, Second Edition, Vickie Bajtlesmit, Chapter 13: Investing in Mutual Funds and Real Estate

<sup>35</sup> <https://www.investopedia.com/investing/how-pick-best-mutual-fund/#:~:text=The%20time%20frame%20for%20holding,may%20be%20a%20better>

<sup>36</sup> <https://www.investopedia.com/investing/how-pick-best-mutual-fund/#:~:text=The%20time%20frame%20for%20holding,may%20be%20a%20better>



## CHAPTER 4: A Young Beginner's Approach to Investing in the Stock Market

Both front-end and back-end loaded funds typically charge three to six percent of the total amount invested or distributed, but can be as much as 8.5 percent. These fees are intended to discourage turnover and cover administrative charges associated with the investment.<sup>37</sup>

There is also a third type of fee, called a level-load fee. The level-load is an annual charge amount deducted from assets in the fund. Likewise, there are management expenses that need to be paid. These fees are expressed as an expense ratio and is the total percentage of fund assets being charged to cover fund expenses. The higher the ratio, the lower your return will be at the end of the year.<sup>38</sup>

The efficient market hypothesis (EMH) states that share prices reflect all known information, and therefore, beating the market over the long term is nearly impossible. According to the EMH, stocks always trade at their intrinsic values, making it impossible for you to purchase undervalued stocks or sell stocks for inflated prices. Therefore, there would be no way to outperform the overall market through expert stock selection or market timing over the long term. Under the EMH, the only way you can obtain higher returns is by purchasing riskier investments.<sup>39</sup>

Studies have consistently shown that most professional investors (fund managers) aren't able to "beat the market" consistently, supporting the idea behind the EMH. S&P Dow Jones Indices regularly research how actively managed mutual funds perform compared to the S&P 500 index. Actively managed funds buy and sell stocks and are managed by professionals, often with very high salaries.<sup>40</sup>

The S&P Dow Jones Indices report published in April 2020 includes data for all of 2019. According to this report, 88.99% of large-cap US actively managed funds have underperformed the S&P 500 index over 10 years.<sup>41</sup>

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<sup>37</sup> <https://www.investopedia.com/investing/how-pick-best-mutual-fund/#:~:text=The%20time%20frame%20for%20holding,may%20be%20a%20better>

<sup>38</sup> <https://www.investopedia.com/investing/how-pick-best-mutual-fund/#:~:text=The%20time%20frame%20for%20holding,may%20be%20a%20better>  
<sup>39</sup>

[https://www.investopedia.com/terms/e/efficientmarkethypothesis.asp#:~:text=The%20efficient%20market%20hypothesis%20\(EMH\)%20or%20theory%20states%20that%20share,low%2Dcost%2C%20passive%20portfolio.](https://www.investopedia.com/terms/e/efficientmarkethypothesis.asp#:~:text=The%20efficient%20market%20hypothesis%20(EMH)%20or%20theory%20states%20that%20share,low%2Dcost%2C%20passive%20portfolio.)

<sup>40</sup> <https://stockanalysis.com/can-you-beat-the-market/>

<sup>41</sup> <https://stockanalysis.com/can-you-beat-the-market/>



**FIGURE 11: Percentage of U.S. Equity Funds Outperformed by Benchmarks**

| <b>Report 1: Percentage of U.S. Equity Funds Outperformed by Benchmarks</b> |                           |                   |                   |                   |                    |                    |
|---|---------------------------|-------------------|-------------------|-------------------|--------------------|--------------------|
| <b>FUND CATEGORY</b>  | <b>COMPARISON INDEX</b>   | <b>1-YEAR (%)</b> | <b>3-YEAR (%)</b> | <b>5-YEAR (%)</b> | <b>10-YEAR (%)</b> | <b>15-YEAR (%)</b> |
| All Domestic Funds  | S&P Composite 1500        | 70.01             | 71.92             | 83.27             | 89.33              | 89.10              |
| All Large-Cap Funds   | S&P 500                   | 70.98             | 71.13             | 80.60             | 88.99              | 90.46              |
| All Mid-Cap Funds   | S&P MidCap 400            | 31.67             | 45.97             | 64.41             | 84.22              | 88.27              |
| All Small-Cap Funds   | S&P SmallCap 600          | 38.50             | 61.02             | 77.37             | 88.61              | 89.08              |
| All Multi-Cap Funds   | S&P Composite 1500        | 69.25             | 68.17             | 82.31             | 89.02              | 90.21              |
| Large-Cap Growth Funds  | S&P 500 Growth            | 33.33             | 42.28             | 60.00             | 89.46              | 92.72              |
| Large-Cap Core Funds  | S&P 500                   | 69.53             | 83.57             | 93.83             | 97.38              | 91.95              |
| Large-Cap Value Funds   | S&P 500 Value             | 97.23             | 82.21             | 88.92             | 91.89              | 81.41              |
| Mid-Cap Growth Funds  | S&P MidCap 400 Growth     | 9.30              | 19.23             | 51.22             | 78.28              | 85.71              |
| Mid-Cap Core Funds  | S&P MidCap 400            | 40.54             | 59.83             | 82.46             | 92.09              | 95.24              |
| Mid-Cap Value Funds   | S&P MidCap 400 Value      | 65.00             | 78.43             | 88.71             | 88.30              | 93.67              |
| Small-Cap Growth Funds  | S&P SmallCap 600 Growth   | 13.79             | 21.79             | 67.71             | 82.35              | 93.37              |
| Small-Cap Core Funds  | S&P SmallCap 600          | 41.35             | 74.71             | 91.36             | 96.72              | 92.35              |
| Small-Cap Value Funds   | S&P SmallCap 600 Value    | 80.00             | 82.57             | 92.04             | 96.77              | 92.77              |
| Multi-Cap Growth Funds  | S&P Composite 1500 Growth | 45.24             | 59.60             | 75.81             | 87.80              | 91.28              |
| Multi-Cap Core Funds  | S&P Composite 1500        | 74.45             | 88.38             | 94.01             | 93.12              | 91.11              |
| Multi-Cap Value Funds   | S&P Composite 1500 Value  | 91.80             | 92.17             | 96.04             | 96.38              | 86.96              |
| Real Estate Funds   | S&P United States REIT    | 26.58             | 54.76             | 63.41             | 81.61              | 83.10              |

Source: S&P Dow Jones Indices LLC. Data as of Dec. 31, 2019. Returns shown are annualized. Past performance is no guarantee of future results. Table is provided for illustrative purposes.

As the chart above demonstrates, over a 10-year period, 78-97 percent of actively managed stock funds did not beat the indexes they were benchmarked against. In fact, all professional fund investing styles underperformed the market – large-caps, mid-caps, small-caps, all caps, value, growth, etc. It is not uncommon for someone to beat the market for one to three years at a time. But that can largely be attributed to luck.<sup>42</sup>

These conclusions are not limited to S&P Dow Jones Indices. According to Bank of America Merrill Lynch, in 2009, the portion of invested capital in actively management U.S. equity funds had nearly a 3:1 advantage over index funds. Now, it's almost 50/50. Active management has consistently declined as a percentage of total types of funds, largely due to high fees and the majority of the actively managed funds underperforming their respective benchmarks.<sup>43</sup>

These data demonstrate that investment professionals, who analyze stocks full-time with a vast amount of available resources at their disposal, cannot beat the market over the long term. As a result, more and more investors are choosing to invest in index funds that provide the same or better returns at lower fees.

Most EMH believers choose to simply invest in index funds or exchange-traded funds (ETFs). Index funds seek to track and duplicate the performance of a benchmark index. The fees are generally lower than they are for actively managed funds. Index funds and ETFs are generally considered ideal core portfolio holdings for retirement accounts like IRAs and 401(k)s. Even the legendary investor Warren Buffett recommends index funds as a haven for savings. Rather than picking your own set of individual stocks, he says it makes more sense for the average investor to buy

<sup>42</sup> <https://stockanalysis.com/can-you-beat-the-market/>

<sup>43</sup> <https://www.financialsamurai.com/the-percentage-split-between-active-and-passive-fund-management/>

all of the S&P 500 companies at the low cost an index fund offers. The S&P 500 index is one of the most common index funds and is an index of 500 large-cap stocks in the US. The S&P 500 is also the most commonly used benchmark of overall stock market performance. It has averaged returns of 8-10 percent per year, which is large enough to build financial wealth.<sup>44</sup>

If you are just getting started, investing in index funds over actively managed funds is likely the preferred investment strategy. You obviously won't beat the market by investing in index funds, but at least you won't perform much worse than the market as a whole, and by investing in funds, you will earn returns similar to the more expensive actively managed mutual funds. More importantly, you can easily get started while you continue to learn and understand the various nuances associated with active investing and selecting the right actively managed mutual fund.<sup>45</sup>

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<sup>44</sup> <https://www.investopedia.com/terms/i/indexfund.asp>, and <https://stockanalysis.com/can-you-beat-the-market/>

<sup>45</sup> <https://stockanalysis.com/can-you-beat-the-market/>

## CHAPTER 5: Beginner's Guide to Active Investing

- 5.1 Active vs Passive Investing
- 5.2 Active Investing Basics
- 5.3 Understanding Stock Prices
- 5.4 Understanding Fundamental and Technical Analyses
- 5.5 Understanding Growth Stocks and Value Stocks

### 5.1 Active vs. Passive Investing

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Active investing is an investment strategy that involves picking your own set of stocks and bonds to try and achieve higher-than-average market returns. Active investing is also referred to as attempting to “beat the market.” Studies have consistently shown that most professional investors who actively manage investments aren’t able to “beat the market” consistently. In fact, almost half of all invested capital in the U.S. stock market is now in index funds, since it is possible to earn comparable returns to those of actively managed portfolios without the high fees.

You might be thinking that you can build enough knowledge to predict the performance of a particular stock or pick the right stock to invest in. There is a litany of information out there on how to do that. You can review past dividend yields, price-to-earnings ratios, cashflow projections, analyst reports, watch YouTube videos. But at the end of the day, how do you know that the investments you selected are going to perform better than the hundreds of other companies you ignored or chose not to invest in? Often, a particular stock can seem like a sure bet, but a scandal might ensue related to management, accounting, or operations – and just like that, the stock price tanks and you lose.

Investment professionals have a hard time keeping up with all of this information to pick the right mix of stocks. And keep in mind that they are supported by a team of analysts and powerful computer software and spend every day analyzing different investments. These individuals consider and review all aspects of a company’s value, including dividend yields, profit forecasts, growth opportunities, market forces, and management skill sets. They also speak regularly to executives at these companies regarding all of these issues. There is no way you will have better information to inform your decisions than these investment professionals.

Even if you are able to do your own research on a few companies or investments, you will need to analyze all other similar investment options. Otherwise, how will you know that the investments you have chosen are the most likely to succeed and perform well? The active fund performance relative to index fund performance data demonstrates that investment professionals – who analyze stocks full time with a vast amount of available resources at their disposal – cannot beat the market. This begs the question: If professionals cannot beat the market, how can the average part-time investor beat the market?

I have a CPA license. I’m accredited in business valuation. I have valued companies, stocks and intellectual property for more than 25 years. I have testified in federal court on valuation issues. Nevertheless, I don’t feel confident picking stocks, so I don’t bother. My attempt to earn higher returns is usually limited to placing my money on growth stock index funds (diversified higher risk funds), rather than trying to determine which specific stocks to invest in. I

have always felt that the stock-by-stock approach to investing feels more like speculation and gambling than it does investing.

Furthermore, taxes on gains are a major hurdle to “beating the market” for you and me. We can lose a good portion of our returns when we are forced to cash out and pay taxes on realized gains. Even if you are successful at constantly buying and selling to beat the market, you will then be required to pay capital gains and/or ordinary incomes taxes on the gains. But buying and holding a diversified portfolio of investments for a relatively long term allows you to defer paying taxes until you actually sell those investments and realize the gains.

Your emotions present another obstacle to beating the market. Unfortunately, most of us tend to buy when stocks are at their high and performing well and sell low out of fear when those same stocks are performing poorly. Locking your money into index funds and consistently contributing help alleviate some of these headaches.

## 5.2 Active Investing Basics

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There is nothing wrong with picking stocks on your own. In fact, you could add a few stocks that you picked on your own in addition to investing in index funds. There is no reason why you can't do both. You can invest in funds to hedge your bets, then you could put some portion of your money into specific stocks you believe will be winners. Then, if you end up underperforming the market, at least it won't be by as large of a loss because you had a big chunk of your money in an index fund.<sup>1</sup>

Buying stock is buying an ownership position in a company. Don't just buy stock because you think it will go up in the future; buy it because you believe that the company is going to do well over time.<sup>2</sup> Maybe you like their product or what the company stands for. Maybe you like the industry or the direction management has taken the firm. However, keep in mind that most financial advisors will tell you that you should never allow one company's stock to represent more than 5-10 percent of your overall value.

No matter what type of stock you buy or sell, it's important to try to leave emotion out of the equation as much as you can. Setting your emotions and your hunches aside is hard to do in general. It's especially hard when it comes to the lure of making a lot of money or the possibility of losing it all. Even experienced traders fall into this trap now and then. So, if it happens, don't beat yourself up.

Generally, there is no right or wrong time to invest in stocks, so avoid trying to “time” the market. Not even the most experienced investors can do it, except occasionally, and often by chance. So, do not think you can. When it's time for you to invest, invest.

Do not borrow money to invest. This is never a good idea no matter what anyone says. Period. Don't borrow from your mom, your credit card company, or your broker.

In some cases, an initial public offering (IPO) is a good way for a corporation to raise capital to expand its business. New shares are sold and the cash goes directly into the company. This is what you would want to have happen. Reinvestment into the company could lead to greater profits down the road. In other instances, an IPO is simply a way for company insiders to sell their stock and take their profits. In this case, the cash does not go to the company

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<sup>1</sup> <https://stockanalysis.com/can-you-beat-the-market/>

<sup>2</sup> <https://stockanalysis.com/can-you-beat-the-market/>

and the chance for future profit evaporates. Most IPOs are a combination of the company selling stock and insiders selling out, but those that are weighted toward insiders selling their stock are generally the ones to avoid.

Furthermore, IPO shares are mostly sold to institutional investors. You usually can't buy them until the first day of trading, which is after some initial investors have already sold and taken their profits. In that case, you are not getting in on the IPO but are actually buying shares in the open market and probably paying more than the IPO price.

Before you buy a stock, set your sell price to remove some of the emotion. You might only be willing to lose 10 percent or gain 10 percent. Once that happens, you sell. You don't want to hold on to stocks long after bad news has surfaced or expected results failed to occur. It's a wake-up call that money would be better invested elsewhere.

## 5.3 Understanding Stock Prices

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There is a reason why professional investors are not able to consistently beat the market over the long term. All legal stock trading is speculation to some degree. There are just too many moving parts to nail down. And even then, there is just no predicting the future no matter how hard you try.

To better understand the complexities behind active investing, it is helpful to try to figure out what factors determine a company's stock price. From there, we can begin to discuss some of the key factors that lead to stock price changes.

We can first think of a company's stock price as its true or intrinsic value – the value of the stock based on analytical valuation models that are rooted in valuation principals. An analytical valuation model first estimates a company's expected cashflow over a 5-10 year period. Then the model will determine a company's value by discounting to a present value the expected annual net cashflow of the business. The model will discount all expected cashflow at a rate commensurate with the risk and resulting return investors would require to invest in the business.<sup>3</sup> Then the model will allocate that present value to the various outstanding shares of the company. Those shares can include common and preferred shares of the business.

We can also think of a company's stock price in terms of general market perception of a company and demand for that company's stock, or the price investors are willing to pay for the company's stock. Analysts typically refer to this as market value. A stock's market value is rooted in the stock's intrinsic value but also is generally influenced by investor demand. If there is substantial demand for a stock, the "market," or the demand for that stock, can drive up the price of the stock. Stock prices will rise when the number of investors who want to purchase a company's stock exceed the number of investors who want to sell the stock.

Whether we are talking about intrinsic or market value, there are a few key drivers to a company's stock price. Those key drivers include future expectations regarding the performance of the company, how the company performs relative to those expectations, and changes in company expectations over time. The more optimistic the expectations about the company, the greater the company's value, intrinsic or market. If a company can meet or exceed expectations, its stock price is likely to increase. Additionally, if future expectations regarding the company become more optimistic, we would expect to see increases in the company's stock price.

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<sup>3</sup> <https://onlinelibrary.wiley.com/doi/book/10.1002/9781118846780>

Therefore, if looking to “beat the market,” we want to invest in those companies that are expected to perform best over time. And even better, we want to invest in companies that meet or exceed expectations while continuously raising their expectations.

## A. A detailed look at intrinsic value

Valuation models can be highly detailed and complicated but usually center around three primary inputs: the expected future cashflow of the business, the growth in that cashflow over the life of the business, and the risk of achieving those cashflows. Behind each of these key inputs are additional assumptions and estimates based on research and analyses. Once an analyst determines equity value, that equity value needs to be allocated to all the outstanding stock.

### i Cash Flow and Growth in Cash Flow

Cash flow is the total amount of money left at the end of each year that can be distributed to the shareholders or reinvested into the company. The greater the amount of expected cash flow, the more valuable the company stock.

Growth in cash flow is the year-to-year increase in the amount of cash that is free to be distributed to the shareholders or reinvested into the company. The greater the growth in expected cash flow, the more valuable the company stock.

To properly estimate cash flow, a stock analyst needs to first consider a host of factors that impact revenue, which would include, but would not be limited to:

#### **FIGURE 1: Factors That Would Impact Estimated Future Revenue**

- Specific industry trends, including competition, product lifecycles, and innovation,
- The company's business cycle and where the company is within that business cycle,
- Macro-economic factors,
- Customer demand and changes in customer demand,
- How the subject company's products and services compare to its competitors' products and services.

And again, to properly value a company and its stock, the analyst needs to not only consider these factors but estimate how they will impact sales for the next 5-10 years.

Cashflow is the difference between revenue and expenses. Therefore, an analyst must also consider a host of factors that impact the company's expenses. Those factors could include the quantity, prices, and availability of the raw materials needed to bring the subject company's products to market. An analyst also needs to consider vendor relationships between the company and its suppliers, labor supply and demand to make the products and distribute them, and how supply and demand factors will impact labor prices over the next 5-10 years.

### ii Risk and Return

Risk is related to achieving the expected level of cash flow that can be distributed to shareholders. The more likely it is the company will achieve the cash flow year after year, the less risk and the more valuable the company stock.



Basic valuation theory states that the risk in a company is commensurate with the required return investors demand in order to invest in that company.

Additionally, an analyst must determine the relative risk and return investors require to estimate the appropriate discount rate to employ. To derive the right discount rate, they need to estimate the risk-free rate over the life of the investment, plus the equity risk premium associated with the specific company. The analyst then needs to determine the market returns and how the target company compares to the relative market, as well as how much debt the company will assume over the next 5-10 years. An analyst also needs to calculate the before-tax and after-tax interest rates.

### iii Allocating Equity Value

Once the analyst estimates the equity value of the company, they need to allocate that value across the various equity classes. Preferred stock and common stock have different values, and allocating equity value across the two requires an understanding of option valuation and complicated option valuation models.

Given the complexities of these models and the numerous inputs regarding future expectations, it's not uncommon for analysts to calculate different values for a business and resulting stock prices. For example, two different analysts can generate two different estimates of future cash flow for the same company. One might estimate cash flow to be \$1,100,000 over the next few years, while another might estimate it to be slightly more conservative at \$1,000,000. These two inputs would yield two different valuation results.

## B. A Deeper Look at a Stock's Market Value

A stock's market value is the price investors are willing to pay for the stock and is deeply rooted in the valuation principals discussed above. However, it is also influenced by investor demand. Stock prices rise when the number of investors who want to purchase a company's stock exceed the number of investors who want to sell the stock. Conversely, prices decline when the number of investors who want to sell a company's stock exceed the number of investors who want to purchase the stock. Four of the more common factors that impact demand include:

### FIGURE 2: Factors Impacting Customer Demand

- Company earnings and cash flow
- Economy
- Expectations
- Emotion

### i Reported and Expected Earnings

Public companies typically report expected earnings and cash flow once each quarter. Stock prices generally decline if companies do not meet or exceed their own projections or the consensus estimates of research analysts. Stock prices generally rise when companies meet or exceed their estimates and provide optimistic guidance related to upcoming quarters.<sup>4</sup>

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<sup>4</sup> <https://finance.zacks.com/factors-determine-price-stocks-2313.html>



## ii Economy

Economic factors such as interest rates and unemployment impact stock market prices. As the economy slows, stock prices tend to have difficulty increasing in value. Conversely, stock prices generally have an easier time increasing in a strong economy. For instance, if the U.S. Federal Reserve increases short-term interest rates to try and manage inflation, those higher rates usually mean higher borrowing costs for individuals and businesses. As a result, individuals tend to cut back on non-essential spending, and businesses will earn less income due to increased interest expense. Rising unemployment leads to less revenue and profit for companies, and all else being equal, less profit means lower stock prices. However, if the Federal Reserve lowers rates to stimulate economic growth, consumer spending and business profit generally increase, which leads to increases in stock prices.<sup>5</sup>

## iii Expectations

As we discussed in the previous section, a company's stock price reflects future expectations about everything from revenues and profits to election outcomes. Stock markets tend to look ahead six months or more, and companies generally provide guidance on their expectations for the upcoming quarters. Analysts use this data, among others, to publish their guidance on expected earnings and target price ranges. Stock prices also reflect expectations about global economies, since many companies rely on overseas markets to drive revenue growth. The more favorable analyst expectations, the more likely the stock price will increase.<sup>6</sup>

## iv Emotion and Social Media

Unfortunately, human emotions, such as fear and greed, also impact stock prices. A rumor about a new product release could lead to a sharp increase in a company's stock price. Likewise, social media promotion can have a substantial impact on a company's stock price. Also, fear about interest rates, adverse public policy changes, and increases in corporate tax rates could lead to sell-offs and stock price declines. These price swings often have nothing to do with the underlying fundamentals of the individual stock. Experienced investors know that the underlying business fundamentals are going to determine long-term prices.<sup>7</sup>

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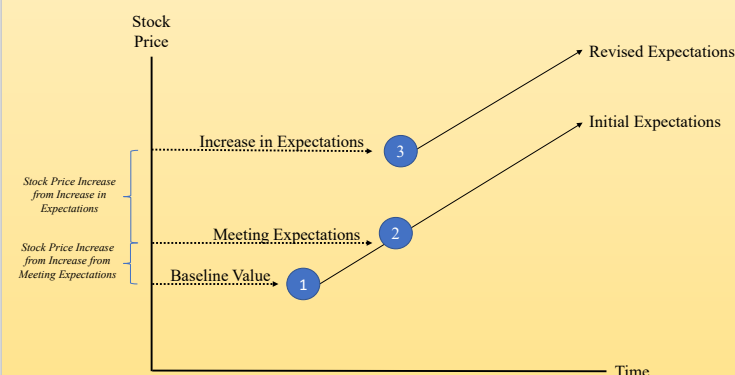
<sup>5</sup> <https://finance.zacks.com/factors-determine-price-stocks-2313.html>

<sup>6</sup> <https://finance.zacks.com/factors-determine-price-stocks-2313.html>

<sup>7</sup> <https://finance.zacks.com/factors-determine-price-stocks-2313.html>

## C. Intrinsic and Market Value Conclusions

**FIGURE 3: Intrinsic and Market Value Conclusions**



## 5.4 Understanding Fundamental and Technical Analyses

There is no be-all and end-all strategy to picking the right group of stocks. If there was such a strategy, professional fund managers would be consistently employing those methods and consistently beating the market.

The process of analyzing stocks to determine which to pick versus which to pass on is time-consuming, complex, can take years to master, and requires information you likely don't have access to. It also requires your full attention. And no matter how much time and energy you employ, you will never predict the future with 100 percent certainty, so there will always be something you get wrong or don't anticipate. Just refer back to all the factors that go into a company's intrinsic and market values.

Fundamental and technical analysis are two popular methods to help pick the right set of stocks. Each is imperfect in its own way, but each also has its strengths.

### A. Fundamental Analysis

Fundamental analysis examines the underlying company's business, as well as conditions within its industry and in the broader economy to attempt to identify stocks with strong growth potential. The end goal with fundamental analysis is to compare your estimate of a stock's intrinsic value to a stock's current market price to see whether the security is undervalued or overvalued. In its truest form, a fundamental analysis would seek to replicate the valuation models discussed above.

Analysts typically study the overall state of the economy, the strength of the specific industry in which the company operates, and the individual company characteristics.<sup>8</sup> Analysts use public data to evaluate the company. They can use revenues, earnings, future expected growth, return on equity, profit margins, and other data to determine a company's underlying value and growth potential. Much of these data are available in a company's financial statements.<sup>9</sup>

<sup>8</sup> <https://www.investopedia.com/terms/f/fundamentalanalysis.asp>

<sup>9</sup> <https://www.investopedia.com/terms/f/fundamentalanalysis.asp>

As we discussed above, the resulting value from a fundamental analysis is only an estimate, the analyst's educated opinion of what the company's share price should be worth.<sup>10</sup> This value could be different, depending on the assumptions you make about the various inputs to the model. The conclusion is then compared to the current market price. The next obvious question then is whether the market is missing the value of the stock or is your analysis missing the mark?

When setting out to determine a stock's intrinsic value, you will most likely look at quantitative and qualitative factors.

### FIGURE 4: Quantitative and Qualitative Factors that Impact Intrinsic Value

- Quantitative factors are the measurable characteristics of a business and include information that can be shown in numbers and amounts. As such, most quantitative data, including revenue, profit, assets, and liabilities, will come from financial statements. Common metrics analysts will use are earnings per share, price-to-earnings ratio, price-to-earnings growth, and dividend yield.
- Qualitative factors are less tangible and relate more to the nature of something, rather than to its quantity. They can include the quality of a company's management, the quality of its assembled workforce, its brand-name recognition, patents, etc.<sup>11</sup>

Investment firms, brokerage firms, securities analysts, asset management companies and various other investment managers will perform their own fundamental analysis of a company, often on a regular basis. They will often publish their results in what are referred to as "analyst reports." Analyst reports provide guidance as to whether you should invest in specific companies. These reports can focus on recent financial results, and the analyst's expected share price movements. These reports can provide valuable information, including but not limited to the current and future outlook for the state of the industry. These reports often also rely on the company financials as well as interviews with top management, a review of peer performance and macro/micro economic indicators, among other inputs.<sup>12</sup> You may be able to review the analyst reports for companies you are interested in rather than attempt to estimate a company's intrinsic value on your own. Check with the financial institution where you opened, or plan to open, your investment account (e.g., Merrill Lynch, Schwab, E-Trade, etc.).

## B. Technical Analysis

Technical analysis focuses on changes in a company's stock price and changes in stock trading volumes. Technical analysis attempts to predict the various ways supply and demand for a security will affect changes in that security's price. This entire analysis assumes that past trading activity and price changes of a security can be used to estimate and predict a security's future price movements. Some investment professionals will use technical analysis in combination with other forms of research.<sup>13</sup>

An Internet search will yield hundreds of different types of technical analyses. There are also numerous types of trading systems to help forecast and trade on price movements. Some indicators are focused on identifying the current market trend, while others are focused on determining the strength of a trend and the likelihood of its

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<sup>10</sup> <https://www.investopedia.com/terms/f/fundamentalanalysis.asp>

<sup>11</sup> <https://www.investopedia.com/terms/f/fundamentalanalysis.asp>

<sup>12</sup> <https://ggg.libguides.com/c.php?g=106864&p=3542500>

<sup>13</sup> <https://www.investopedia.com/terms/t/technicalanalysis.asp>

continuation. Commonly used tools include charting patterns including trendlines, channels, moving averages, and momentum indicators.<sup>14</sup>

The two major types of technical analysis are chart patterns and technical (statistical) indicators. Chart patterns are designed to predict where prices are headed, whereas technical indicators are a statistical form employing mathematical formulas using prices and trading volumes.<sup>15</sup>

## 5.5 Understanding Growth Stocks and Value Stocks

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### A. Investing in Growth Stocks

Growth companies are those anticipated to grow cash flow at a rate significantly above the average growth for the market. These stocks generally reinvest any cash flow back into the business to help finance growth.<sup>16</sup> As such, they do not typically pay dividends. Most investors make money through investing in growth stocks by the classic buy low, sell high strategy, or capital appreciation.

Growth companies may not have a history of actual cash flow but are expected to earn cash flow in the future. Recall that a stock's value is derived more so through expectations than past or current results. Growth stocks can be found in any sector or industry. They can be an emerging company in an established market or emerging industry. Many small-cap stocks are considered growth stocks. However, some larger companies are also considered to be growth companies.

Growth stocks tend to share similar traits, such as having unique products, holding patents, or having access to technologies that give them a competitive advantage. They may have higher research and development expenses to continue to innovate and stay one step ahead of their competitors. Because of their superior products and commitment to continuous improvement, some growth companies can have a loyal customer base.

As I noted earlier, higher growth expectations typically lead to higher stock prices. Therefore, growth stocks will appear to be higher priced than the broader market relative to current earnings and cash flow. This is because most investors are willing to pay a higher price with the expectation of selling at even higher prices as the companies continue to *meet and exceed expectations*.<sup>17</sup>

It is difficult to predict earnings for emerging companies or companies within emerging industries with no history of actual profit. Therefore, investment in growth stocks can be risky and more volatile than the broader market if you are picking companies with no real track record of success. If the company fails to meet expectations, investors can expect to see declines in the company's stock price since those investors are paying a high price for the growth stock. The high stock price could fall sharply on any negative news about the company, particularly if sales growth or earnings disappoint Wall Street.<sup>18</sup>

If you find yourself selecting growth stocks in emerging markets or from emerging companies to attempt to beat the market, then you are not really trying to beat the market. Instead, you are assuming more risk in order to earn a

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<sup>14</sup> <https://www.investopedia.com/terms/t/technicalanalysis.asp>

<sup>15</sup> <https://www.investopedia.com/terms/t/technicalanalysis.asp>

<sup>16</sup> <https://www.investopedia.com/terms/t/technicalanalysis.asp>

<sup>17</sup> <https://www.merrilledge.com/article/growth-vs-value-investing-two-approaches-to-stocks>

<sup>18</sup> <https://www.merrilledge.com/article/growth-vs-value-investing-two-approaches-to-stocks>

higher return. Beating the market would be more like selecting a group of individual stocks within the S&P 500 in hopes that those selected stocks yield a higher return than the S&P 500 index return. So, if you are finding yourself leaning toward selecting several growth stocks in order to try and earn higher returns than the S&P 500 returns, then you may want to consider investing in growth stock index funds.

## **B. Investing in Value Stocks**

Value stocks are those that have fallen out of favor with investors but still have good fundamentals. They can also include stocks of new companies that investors have not yet recognized. Value stocks generally are priced lower than the broader market relative to their current earnings and cash flow. The idea behind value investing is that stocks of good companies with good fundamentals will bounce back if and when the true value is recognized by other investors. Essentially, value investing involves investing in companies where the intrinsic value is greater than the market value.<sup>19</sup>

Many value investors believe there are opportunities to be gained when stock prices decline due to investors overreacting to recent company problems, such as disappointing earnings, negative publicity, or legal issues.<sup>20</sup>

In a nutshell, I'm not certain the average investor has the ability to determine the difference between intrinsic value and market value. Likewise, when a company's stock price declines due to bad news, that usually means the company is not meeting its expectations. Is this the type of company you want to invest in?

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<sup>19</sup> <https://www.merrilledge.com/article/growth-vs-value-investing-two-approaches-to-stocks>

<sup>20</sup> <https://www.merrilledge.com/article/growth-vs-value-investing-two-approaches-to-stocks>

## CHAPTER 6: Cryptocurrency and Meme Stocks

### 6.1 Investing in Cryptocurrency

### 6.2 Investing in Meme Stocks

### 6.3 Constant Trading on Apps

Investing in index funds is the best way to get started in the stock market, as we discussed in Chapter 4. There is also nothing wrong with supplementing your index funds with a few stock picks on your own. However, as we discussed in Chapter 5, actively trying to “beat the market” with your own stock picks is incredibly difficult and time-consuming.

The last thing you should do is load up on cryptocurrency and meme stocks as your primary investing strategy. Investing in cryptocurrency and meme stocks is nothing more than a different form of gambling. If you decide to do it, just make sure it is not at the expense of long-term, consistent, diversified, and properly allocated investing.

## 6.1 Investing in Cryptocurrency

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Cryptocurrency is a digital form of payment that can be exchanged online for goods and services. Cryptocurrencies use blockchain, a decentralized technology spread across many computers that manages and records transactions. Part of the appeal of this technology is its security.<sup>1</sup>

Some cryptocurrency investors believe cryptocurrencies will be the currency of the future. Additionally, some supporters like the fact that cryptocurrency is a decentralized system that does not rely on a central bank to manage the supply. Some cryptocurrency investors also like the idea that it can be more secure than traditional payment systems. Finally, many are attracted to cryptocurrency because transactions using cryptocurrency are difficult for governments to track. That is obviously an advantage if you are engaged in illegal activities or simply trying to avoid paying taxes. Many companies have issued their own cryptocurrencies, often called tokens, which can be traded in for the good or service that the company provides. These coins are like poker chips or video game tokens.

The total value of all cryptocurrencies as of August 2021 was approximately \$1.9 trillion, according to CoinMarketCap. The top cryptocurrencies as of August 2021, according to Forbes.com were:<sup>2</sup>

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<sup>1</sup> <https://www.nerdwallet.com/article/investing/cryptocurrency-7-things-to-know>

<sup>2</sup> <https://www.forbes.com/advisor/investing/top-10-cryptocurrencies/>

**FIGURE 1: Top Cryptocurrencies Based on Market Cap**

- Bitcoin (BTC), Market cap: Over \$856 billion
- Ethereum (ETH), Market cap: Over \$357 billion
- Binance Coin (BNB), Market cap: Over \$70 billion
- Cardano (ADA), Market cap: Over \$69 billion
- Tether (USDT), Market cap: Over \$64 billion
- XRP (XRP), Market cap: Over \$50 billion
- Dogecoin (DOGE), Market cap: Over \$40 billion
- USD Coin (USDC), Market cap: Over \$23 billion
- Polkadot (DOT), Market cap: Over \$25 billion
- Solana (SOL), Market cap: Over \$20 billion

Cryptocurrencies do not generate cash flow on their own, so the price of the currency is driven by supply and demand. To make money from investing in cryptocurrency, someone else has to pay more for that currency than you did. In a nutshell, investing in cryptocurrency is pure speculation, and investments in cryptocurrency can be hugely volatile. For instance, take a look at Bitcoin's price changes over time.

**FIGURE 2: Bitcoin Price Changes**

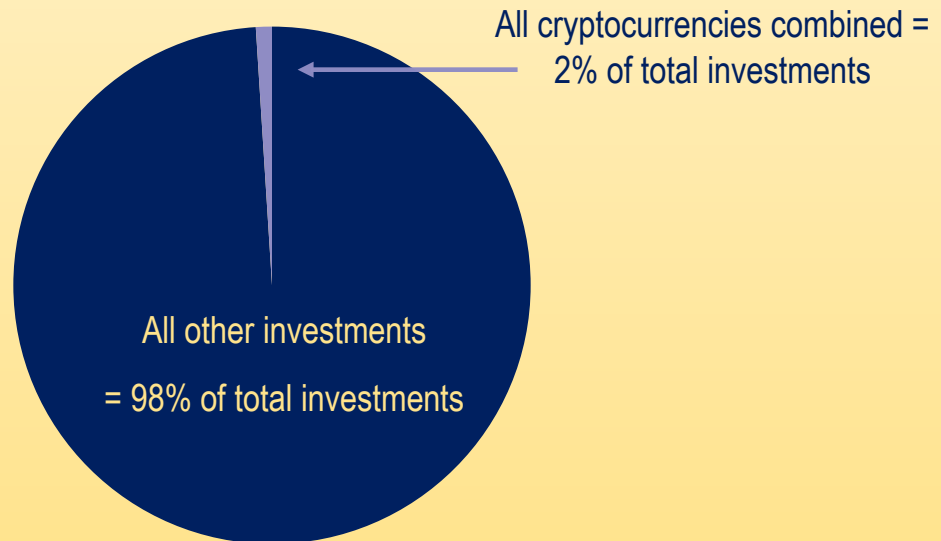
There really is no telling where cryptocurrencies are headed. They could take off from where they are now or they could significantly decline in value. Likewise, there is no telling where any one specific cryptocurrency is heading. At the same time, some financial advisors don't necessarily say DO NOT BUY cryptocurrency altogether. I have seen many financial advisors suggest folding a small amount of cryptocurrency into a well-balanced portfolio.

Rather than investing in one cryptocurrency, you could diversify your investment in the top five or top 10 currencies. For instance, if you are intending to invest \$1,000 in crypto, you could invest \$100 into 10 different currencies, or \$200 into five different currencies.



Keep in mind that most financial advisors suggest investing only 5-10 percent of your overall portfolio into any one security. Given the volatility and speculative nature of cryptocurrency, I recommend keeping your entire crypto portfolio at the low end of this range or lower. The \$1,000 invested in 10 different cryptocurrencies should be around two percent of your overall portfolio.

**FIGURE 3: Percentage of Total Investments to be Allocated to Cryptocurrencies**



## 6.2 Investing in Meme Stocks

Meme stocks are company stocks promoted on social media platforms like Reddit, TikTok, YouTube, Discord, and Telegram to create viral interest, which hopefully translates into increases in that company's stock price. GameStop is probably the most well-known meme stock, as it was one of the first stocks to increase astronomically in price and did so during the COVID-19 pandemic. Investing in these types of assets is incredibly risky since the values of these assets are based on market manipulation and speculation rather than the underlying business prospects of the company.

GameStop is primarily a brick-and-mortar video game retailer with more than 5,000 stores. Even pre-pandemic, GameStop suffered massive losses from negative trends in its industry and many considered it a dying business. It is often compared to Blockbuster – the now-defunct brick-and-mortar video rental company. Just as people no longer rent videos by going to a store and checking them out, there is no need to go to a video game store to buy something that you can easily buy and download from home. GameStop's stock price had been declining for years, and by January 4, 2021 its stock price was \$17.25.

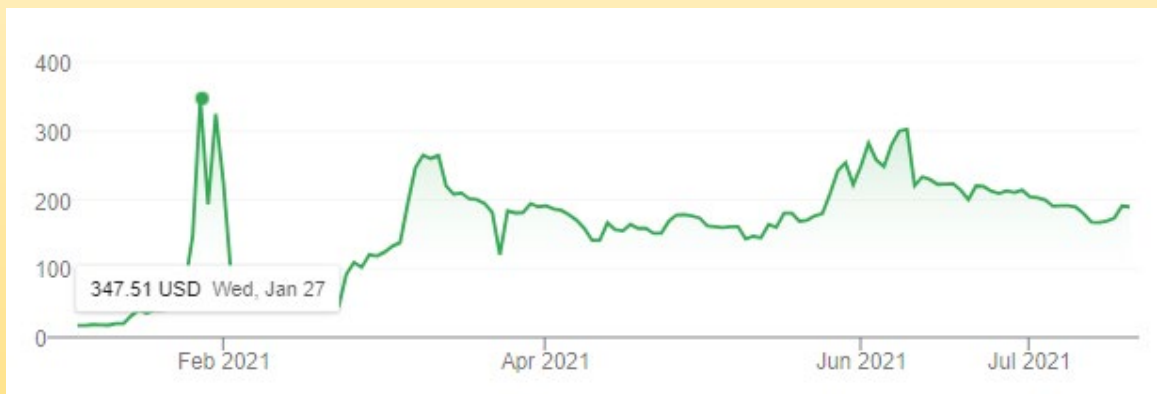
During this time, several hedge funds decided that GameStop was bound to fail, so they bet against it by shorting the stock, meaning they borrowed the stock from investors and then sold it with the intention of buying new stock at a lower price and then returning it to the original lender. It's the equivalent of buying low and selling high, but in reverse order (borrow the stock, sell it at what is hopefully a high price, then buy it back later at a lower price to return it to whoever you borrowed it from).

Small retail investors (like you and me) collaborated on discussion sites like Reddit to prop up the price of GameStop's stock to play games with the hedge funds. With ample amounts of spare time as we were under stay-at-home orders due to the pandemic, stimulus checks, social media, and no-cost trading apps like Robinhood, GameStop's stock price exploded. GameStop's stock price increased from \$17.25 per share on January 4, 2021, to \$348 per share by January 28, 2021, creating what is referred to in finance as a "short squeeze." The hedge funds had to purchase GameStop stock at these high market prices to return the shares they had originally borrowed. All that buying among retail investors and the hedge funds sent GameStop stock skyrocketing. In short, the hedge funds bet Game Stop stock would decrease because it is a dying business, but they didn't count on an army of small investors collaborating to drive up the price of the stock for no apparent reason.

Since GameStop, there have been numerous meme stocks, including AMC Entertainment, BlackBerry, Clover Health, and Virgin Galactic. You can quickly compile a list of meme stocks by going to WallStreetBets on Reddit or simply doing an Internet search on meme stocks. Likewise, there is no shortage of success stories or snapshots of a company's stock price returns over a select period of time that makes the stock sound really exciting. Everyone on the Internet has a story to tell about the next big meme stock and why you should invest in the one they are promoting or reviewing.

Many feel that GameStop's skyrocketing stock prices were the classic little guys versus the big guys. In this instance, the little guys were retail investors trading on Robinhood and other stock trading apps, and the big guys were the hedge funds and other institutional investors. Maybe it was and maybe it wasn't. There is no denying that if you bought in early January and sold on January 27th, you made a ton of money.

**FIGURE 4: GameStop Stock Prices**



I had a student who made about \$200,000 on GameStop and I have a friend who knows someone who bought a house with their GameStop profits. I can see how you can quickly work yourself into a frenzy trying to figure out what meme stock to invest in so you don't miss out on the next big opportunity. Plenty of people can make an incredibly risky investment sound like a sure thing on social media.

With meme stocks, the game is all about speculation and buying and selling at the right time. The values of meme stocks are not tied to traditional investing fundamentals. Instead, their values are based on social media promotion and market speculation. It's basically gambling, but in the stock market.

Most traditional, well-established investors will stay away from these stocks since there is no way to apply reason to the changes in their values. If you decide to invest in these assets, you should have a predetermined strategy before buying. Unfortunately, investing fundamentals and traditional investing strategies discussed in textbooks or

on YouTube are not going to help you better predict which meme stocks to buy and sell. They may claim they are able to do so, but I promise they can't. To try and learn the traditional fundamentals of stock-picking so you can outsmart the meme stock game is a fool's errand. Investing in these assets is all about guessing right, since the entire game is based on speculation and/or social media promotion. As such, there is a ton of risk associated with meme stocks and not everyone makes money investing in them. For every success story, there is a horror story to match.

Just take a look at GameStop: If you bought GameStop stock on January 22nd at \$65 and sold on January 27th at \$348, you would have made a ton of money over that five-day period.

If you bought just five days later on January 27th and you were still holding that stock today, you would be at a 50 percent loss.

**FIGURE 5: GameStop Price Changes**

|                     | First 5-day Period | Second 5-Day Period | Bought at Peak and Still Holding |
|---------------------|--------------------|---------------------|----------------------------------|
| Purchase Price      | \$65               | \$348               | \$348                            |
| Sale Price          | \$348              | \$92                | \$173                            |
| \$ Gain/Loss        | \$283 Gain         | \$256 Loss          | \$175 Loss                       |
| % Increase/Decrease | 335% Increase      | 74% Decrease        | 50% Decrease                     |

Good luck trying to figure out which stocks will spike (before they spike), when they will spike and what the maximum spike will be, and what they will do after they spike. Again, it's all speculation and you are never going to figure it out. If you are going to partake in this type of speculating, you should first develop a strategy to help mitigate some of the risk.

### A. Invest Only What You Can Afford to Lose

You don't want to buy high and sell low with your life savings, so buying meme stocks should be limited to a small portion of your income. Speculating in meme stocks should never be your main investment strategy.

Anything that motivates you to begin saving and investing is a good thing. If this is enough to get you motivated to open an account and start investing, or to get you to budget and save to invest, then I encourage you to open an account, buy some meme stocks and cryptocurrency, and let things ride. I would do it with the apps that allow you to buy fractional shares, the whole nine yards. It's important to figure this stuff out on your own while you are young and don't have a lot of money to lose.

The general rule with speculating on these risky assets is don't put in more than you can afford to lose, since you stand a good chance of losing what you put in. Furthermore, most traditional financial planning textbooks will advise you not to invest in stocks until you have your retirement savings and home squared away. The standard rule is to limit your investment in one particular stock to 5-10 percent of your total investments. These standards apply to the average everyday stocks, not the meme stocks. The percentages should be lower since they are riskier.

I am certain that most young adults who decide to invest in these assets blatantly violate these general rules. If your goal is to simply gamble with some portion of your money after understanding a more strategic investing approach, then don't put in more than you can afford to lose. Never leverage or borrow to invest in these assets, and don't make this your entire investing strategy – simply fold it into your diversified portfolio.

## **B. Identify Your Criteria for Buying**

The strategy behind what stocks you buy and when is your choice. You should develop a plan, though. If your intention is to buy meme stocks, then you want to pick stocks that have yet to gain a lot of attention (and thus are less inflated) or ones that already have some level of attention. You should try to decide on your strategy before jumping in, as the risks and rewards between the two different types of meme stocks could be very different.

A stock with little attention or traction may not dip in price as much as others, but it may not surge like some of the others if it never gains traction. It's also unclear whether the returns associated with meme stocks after the initial price spike are better than what you can earn in the market from a more traditional set of stocks. If you buy a meme stock after the initial price spike, there may not be much benefit in buying that meme stock as opposed to another stock. Furthermore, the price may still be slightly elevated from the initial frenzy so that the most likely outcome could be declines as the price settles back down to a more normal level. The goal here is to at least try to define your criteria for buying.

## **C. Predetermine the Exit Strategy**

If you decide to go into the meme stock or crypto market, you should have an exit strategy – you should force yourself to sell or cash in at certain points. Those points could be after you reach a 10 percent return, 25 percent return, 50 percent return, or whatever number you decide. You should also have a lower bound set, so when you hit that particular level of loss, you sell. It could be that you sell if you hit a five percent loss or 10 percent loss. The point being that you should have some predetermined plan in order to try and manage some of your risk.

## **D. Harvest Gains and Losses**

If you invest \$100 and that \$100 increases to \$150, you could sell a portion of your stock so you get your \$100 back. At that point, the only amount of money you have tied up in these speculative stocks (\$50) is "house money." Therefore, if the investment completely drops in price, your losses never exceed your initial investment.

## **E. Understand the Tax Consequences of Buying and Selling**

Buying and selling stocks can trigger unintended tax consequences, so it's important to understand at least the basics before you begin buying. Capital gains is a tax on the profit from the sale of stocks and bonds. Say for example you purchase a stock for \$10 and then you sell it for \$100. Your profit (or capital gains) would be \$90 and would be subject to capital gains tax.

The capital gains tax rates first depend on whether you held the asset you are selling for more than a year. Your capital gains are considered short term if you held the asset for less than a year and are taxed at ordinary income tax rates. If you held the asset for more than a year, your capital gains are considered long term and are taxed at rates of 0, 15, or 20 percent, depending on your level of income. See Chapter 19 for a discussion on capital gains tax.

## 6.3 Constant Trading on Apps

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Investing with your mobile app is both a blessing and a curse. Anything that gets you into the market earlier is a great tool. However, if you're constantly buying and selling in order to chase that next big investment but don't actually end up getting anywhere, then what's the point to getting into the market early?

Financial services companies or "e-brokers" such as Robinhood, E-Trade, Acorns, and Charles Schwab earn money from the payment for order flow (PFOF). Market makers, like Citadel Securities or Virtu, pay e-brokers for the right to execute customer trades. Then the e-broker is paid a small amount for shares routed to the market makers.<sup>3</sup> For example, Robinhood made \$180 million in the second quarter of 2020 alone, most of which came from options trading.<sup>4</sup> These apps earn money every time a stock is traded, even though they don't charge any fees.

Robinhood makes 17 cents per 100 equity shares; Charles Schwab makes 11 cents per 100 shares. The disparity is even greater for options trading with TD Ameritrade and Robinhood earning 58 cents off options.<sup>5</sup>

Tim Welsh, CEO of wealth management consulting firm Nexus Strategy, says that options are traded less frequently since there's a larger spread between the "bid" (the price buyers are willing to pay) and the "ask" (the price sellers want). Furthermore, retail brokers insist that trading options are far more lucrative.<sup>6</sup>

"It's a huge conflict of interest for these free trading platforms," Welsh said. "The Citadels, the active traders of the world, know that Robinhood has much more unsophisticated traders, so they can make money [off] them."<sup>7</sup> In fact, \$111 million of that \$180 million Robinhood earned in the second quarter of 2020 was off options trades alone.<sup>8</sup>

"I think they should put a cigarette warning label on Robinhood," Welsh continued, "because it could be hazardous to your financial health the more you trade. Every study on planet Earth has shown day traders that are not sophisticated do not make money. They [gamify] it, they throw confetti after each trade, they make it 'free' but, ultimately, it's a loser's game."<sup>9</sup>

These companies won't necessarily look out for you or your financial well-being. At the end of the day, these companies' main objective is to make money. It's up to you to strategize. If you do not have a clear strategy, constant nudges to buy and sell (trade), especially options, could lead you down the wrong path.

It also seems like everyone on YouTube and Instagram claims to have the best approach to beating the market. Maybe they do, but I'm highly skeptical given everything we discussed in the last few chapters. Think about it this way: If someone has a great approach to beating the market, why would they tell the world about it? Why wouldn't they just use it to get rich themselves? Why are they chasing subscribers on YouTube, Instagram or TikTok if they already have a way of getting rich?

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<sup>3</sup> <https://www.cnbc.com/2020/08/13/how-robinhood-makes-money-on-customer-trades-despite-making-it-free.html>

<sup>4</sup> <https://www.cnbc.com/2020/08/13/how-robinhood-makes-money-on-customer-trades-despite-making-it-free.html>

<sup>5</sup> <https://www.cnbc.com/2020/08/13/how-robinhood-makes-money-on-customer-trades-despite-making-it-free.html>

<sup>6</sup> <https://www.cnbc.com/2020/08/13/how-robinhood-makes-money-on-customer-trades-despite-making-it-free.html>

<sup>7</sup> <https://www.cnbc.com/2020/08/13/how-robinhood-makes-money-on-customer-trades-despite-making-it-free.html>

<sup>8</sup> <https://www.cnbc.com/2020/08/13/how-robinhood-makes-money-on-customer-trades-despite-making-it-free.html>

<sup>9</sup> <https://www.cnbc.com/2020/08/13/how-robinhood-makes-money-on-customer-trades-despite-making-it-free.html>

## CHAPTER 7: Attending the Right Four-Year University

7.1 Maximize Your Performance in and out of the Classroom to Increase Your Academic Eligibility

7.2 Calculate and Understand the Real Cost of Your Education

7.3 Properly Measure the Benefits Provided by the Program You are Applying to

Obtaining a bachelor's degree is one of the most significant life experiences for young adults. Deciding on a major and which school to attend is a highly personal choice. Factors you are likely to consider when selecting a school to attend can include the cost to attend, campus location, your academic eligibility, the specific majors offered (or lack thereof), the school's ability to prepare you for graduate school, and job prospects for new graduates.

Regardless of which factors are most important to you, your decision surrounding the right school to attend will undoubtedly include a host of financial considerations, such as the total cost of your education and the debt you will need to incur to complete it. When it comes to the financial factors, the goal shouldn't necessarily be to choose the perceived lowest cost option to assume the least amount of debt possible. There is a difference between the price you pay for a particular college and the college's sticker price. Financial aid is available at all accredited colleges, and some more expensive private schools may have more financial aid available, thus lowering the annual cost for you to attend that school. Measuring the real cost of a college could prevent severe negative effects on your finances.

Your financial considerations should include the financial benefits as well—factors many students fail to consider. Some of the more expensive schools may have higher-quality programs, thus providing better opportunities for their graduates than the lower-cost options. Often, the better schools increase your chances of graduating in four years rather than five or six. One school may have a lower annual cost to attend than another; however, if on average it takes students six years to graduate from that college, then the total cost over the six years should be compared to the total cost over four years at another school.

Additionally, some of the more expensive schools may have higher quality programs and, as a result, provide better employment opportunities for their graduates or better prepare them for grad school. The better opportunities at the more expensive schools may far exceed the additional cost to attend those schools. Contrary to popular belief (from a financial point of view), it may be more financially sound to attend a more expensive school.

Another important factor to consider when selecting a college or university is the location of the school. The location can determine internship opportunities at companies that may offer a better salary upon graduating. For instance, a student majoring in animation may want to consider a university such as CSU Fullerton that offers internship opportunities with Disney, as opposed to a university in San Bernardino where internship opportunities are not near the campus.

This section of this book intends to lay out the major financial considerations and provide you with some tools and resources to apply to them. The financial factors for you to consider when it comes to your education include:



**FIGURE 1: Financial Considerations Related to Your Education**

- Maximize your performance in and out of the classroom to increase your academic eligibility
- Calculate and understand the real cost of your education
- Measure the benefits provided by the program to which you are applying

## **7.1 Maximize Your Performance In and Out of the Classroom to Increase Your Academic Eligibility<sup>1</sup>**

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One of the greatest assets you have as a community college student is your ability to impact the trajectory of your life's path. You have the opportunity to choose any direction or goal, any career, any field of study, any school. And then you get to wake up every morning to work towards those goals. Your journey through community college can have a profound impact on your life for years beyond college. Some students thrive in this environment, while others become overwhelmed and paralyzed with the vast choices and decisions that need to be made. Nevertheless, community college is one of your greatest competitive advantages.

Regardless of whether or not you know what you want to do, five years out of college most of you will likely be doing something different than what you have in mind today. Therefore, what you decide to major in, where you go to school, and what career choice you make just before you graduate may not make much of a difference in the long run.

You might be thinking, then what's the point? Here is the point: The better you are at what you are doing now, the more opportunities will present themselves later. And that applies to community college, your four-year colleges, your first job out of college, your second job, and so on. If you are the type of student who is languishing in community college trying to figure out what you are going to do when you grow up, I would encourage you to shorten the horizon and simply focus on excelling in community college.

Work with counselors to identify areas of interest and target and reach schools in those areas of interest to transfer out of community college. Work with counselors to develop an academic plan. And most importantly, again, put together your absolute best efforts in working towards that plan.

### **A. Develop an Academic Plan and Research Guaranteed Transfer Agreements**

A key element of affording college is maximizing your academic eligibility to increase the available options of schools to attend. With a wider selection, it is more likely you will find a college that balances all the important factors, such as cost relative to benefits.

Success in the classroom begins with actively reaching out to college counselors and advisors to identify schools and majors you are interested in pursuing. You should also develop an academic plan to ensure you take the right courses to be considered for admission. You can have a 4.0 GPA, but if you are missing even one prerequisite, some schools may not even consider you for admission.

Likewise, for community college students, public universities have programs that guarantee junior transfer admission if you take the required courses and earn the required GPA. The bottom line is, the sooner you develop

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<sup>1</sup> <https://medium.com/@CalAdmissions/top-admissions-tips-for-transfer-applicants-140fdf38521d>



an academic plan and identify the list of potential schools you would like to attend, the more likely it is that you finish the process efficiently and with a wider set of options. There is nothing worse than taking classes that don't end up transferring. The more classes you take that do not transfer, the longer you remain in community college. Furthermore, the longer you take in community college, the more expensive everything becomes and the less likely you will transfer or graduate.

For certain majors, such as engineering, computer science, biochemistry, and pre-med, it might make more sense to stay longer at community college before transferring in order to save money. These majors are considered "high unit majors," which require more units of math (calculus, linear algebra) and/or sciences (physics, chemistry) as lower-division prerequisites before being able to take upper-division courses. As a result, these majors often take more than four years of college to complete. Even though there is a minimum requirement to be eligible to transfer, this will just mean whatever lower-division courses a student does not take in the community college, they will still be required to complete at the university at the lower-division level. Developing an academic plan with counselors and university representatives will help you identify and take the right set of classes in the most efficient way possible.

### **B. Learn How to Succeed in the Classroom**

Academic performance is an important element when it comes to college admission. Colleges will generally place more emphasis on transfer applicant coursework, since transfer students have much less flexibility to meander through insignificant courses once they get into a university. In many instances, transfer students only have two years to complete their degrees. This doesn't mean that you need to lock into a 4.0 GPA, but it does mean that you should do as well as you can in your coursework because it will be important in the transfer process. Obviously, the higher the GPA, the more likely it is you qualify for admission at a wider range of schools, but timeliness takes precedence here.

I was never a great student in high school and was an average student during my first few semesters in community college. It was in community college that I realized that succeeding in the classroom was as much about grit, time management, routine, and practice as it was about intelligence. The deeper I got into my community college experience, the more I realized that I could work my way to a good grade no matter how hard the subject. I am a strong believer in setting high expectations for yourself, then putting in the time and effort necessary to hit those expectations. Again, it doesn't mean you are guaranteed a 4.0 GPA, but it does help maximize your academic results.

There are several habits you can develop to become a better student and increase your academic performance. Those habits include knowing how to prepare for class, how to take notes the right way, what to do after class, how to approach homework, and how to prepare for exams. Many community colleges have student resources directed at empowering students with such tools and habits. Many community colleges offer free tutoring in their learning centers. I suggest contacting and visiting the learning centers at your school and talking to your college counselors to take advantage of the resources that are available at your school so you can maximize your in-class performance.

### **C. Build Relationships with Students, Teachers, Counselors, and Administrators**

Schools tend to place a good amount of weight on professor recommendations in transfer applications. Likewise, studies have shown that developing a good relationship with your professor has an extremely positive effect on your

performance in the course. So be sure to develop and maintain relationships with professors.<sup>2</sup> Teachers and professors appreciate when students ask for help or express concern. Taking advantage of your teacher's office hours (or even sending them a quick email) can mean the difference between a good grade and a poor grade. I promise you won't be bothering them.

These relationships also lead to becoming aware of scholarships and grants. Professors, counselors, and school administrators can assist with the scholarship application process and letters of recommendation for these scholarships.

#### **D. Extracurriculars, Your Life Experience and Your Ability to Overcome Obstacles**

Even though schools will place a good amount of emphasis on junior transfer grades, this doesn't mean a bad semester is an automatic deal-breaker. If you have a few bad semesters, you should address these semesters in your application essays by explaining if you had to work, became ill, etc. Not addressing those semesters or what was happening at the time that may have influenced your ability to get better grades could leave the transfer admissions office with an inaccurate picture.

In my experience, many community college students must work to support themselves and their families. As a result, community college students may not have as many extracurricular activities as their counterparts at four-year universities. In this case, community college students should highlight their individual stories and share their struggles in their transfer applications. Community college students should not be afraid to highlight their academic path, personal journeys, or other experiences. Those stories tend to provide a depth that many other students do not have. Anything a student does outside of the classroom can be considered an "extracurricular activity." This includes being a parent, taking care of a family member, or having a job.

Do not be modest. Be proud of your unique journey and use it to your advantage in your college application essays. To many, working full time, taking a full load of courses, raising a family, and possibly even taking classes at multiple community colleges may seem normal. This is not generally the case though, and certainly not for an entire applicant pool. Keep in mind that you want to highlight the *result* of the challenge and not the challenge itself. You want to demonstrate growth and your ability to overcome obstacles by describing how your challenges have shaped who you are.

## **7.2 Calculate and Understand the Real cost of Your Undergraduate Education**

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The real cost of attending a particular school depends on several factors, the major ones being the school's tuition sticker price, room and board, and the amount of free aid you receive from a particular school. Several colleges offer financial aid "gifts" in the form of grants and scholarships that do not need to be paid back upon graduation. This is typically called "Free Aid." Depending on your family's income level, the amount of Free Aid you receive from a particular college can be significant. The Free Aid you receive reduces the cost of college tuition. Therefore, the true cost or "Net Cost" of a school equals the price tag of the school listed on its website, minus all the Free Aid you are likely to receive from that school.

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<sup>2</sup> *What Successful Transfer Students Do Differently*. Top Tier Admissions. (2014, February 10). <https://www.toptieradmissions.com/successful-transfer-students-differently/>.

## A. Sources of Free Aid

Some financial aid is U.S. taxpayer-funded to help pay for all or some portion of an individual's college education. Understanding the complexities of financial aid and working through the true cost of your education after accounting for financial aid can be complicated. As mentioned earlier, most colleges offer Free Aid or "gifts" in the form of grants and scholarships that do not need to be paid back upon graduation. I recommend that you contact the universities you are interested in attending to get the most relevant information about their financial aid options.

However, if you are not familiar with the process already, the first step in obtaining financial aid is to file the Free Application for Federal Student Aid (FAFSA). This application is used by many state agencies and universities to determine how they can help you. The FAFSA is available through the U.S. Department of Education's website. You can begin filling out the form as early as October 1 for the following academic year. While the deadline for the FAFSA is usually June 30, that deadline is usually only for federal financial aid. Many schools that use the FAFSA have their own deadlines for submission, so make sure you contact the school as well.

You can list up to 10 colleges on your FAFSA application. After you submit the FAFSA application, the colleges you listed will send you a school aid offer or an award letter, which will provide you with the financial aid you will receive at each college.

Several categories of financial aid will be included in the award letter: Grants, Scholarships, Federal and Private Loans, Work-study, and many other programs. These different categories of financial aid are typically provided by separate entities, such as federal and state agencies, colleges, high schools, foundations, and corporations. In addition to the various categories, there are two types of financial aid: need-based and merit-based. Federal need-based aid is determined by a student's ability (or inability) to pay for college, whereas merit-based aid is granted to a student for a specific talent or an athletic or academic ability. You've probably heard the term "full ride," which is a merit-based scholarship that includes tuition costs, book fees, and room and board.

It is important to note again that since Free Aid does not need to be repaid, it reduces the overall cost to attend a particular school.

### i Grants<sup>3</sup>

A grant is a form of financial aid that typically doesn't have to be repaid (unless a student drops out or gets expelled). Grants can come from the federal government, state government, colleges, and/or a private or nonprofit organization. Students should do their research and apply for any grants they might be eligible for, and they should be sure to meet application deadlines. Many grants are never given out because no one applies for them, so always apply; it's free money.

The U.S. Department of Education (ED) offers several federal grants to students attending college or career schools. Most of the grants offered by the ED are need-based and the different types of grants include:

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<sup>3</sup> <https://studentaid.gov/understand-aid/types/grants>

**FIGURE 2: Need Based ED Grants**

- Federal Pell Grants
- Federal Supplemental Educational Opportunity Grants (FSEOG)
- Iraq and Afghanistan Service Grants
- Teacher Education Assistance for College and Higher Education (TEACH) Grants

Visit the Federal Student Aid website for more information about the various types of grants, including eligibility, amounts, and potential repayment scenarios.<sup>3</sup>

## ii Community College and University-Provided Scholarships

Community college and university-provided scholarships are most commonly determined based on the FASFA application and, therefore, will most commonly be included in the school's Award Letter. The largest school-specific awards tend to come from the larger or more respected universities. This is due to the fact they have greater endowments and therefore have more resources available to distribute to students. Many small liberal arts colleges are committed to offering generous financial aid as well. Students can earn merit-based scholarships by meeting or exceeding certain standards set by the scholarship-giver. Likewise, merit scholarships might be awarded based on academic achievement or academics, special talents, traits, interests, or a combination of these. Scholarships vary in amount and as such, some might cover the entire cost of tuition, or it might be a one-time award of a few hundred dollars.

You will want to research scholarship opportunities at your intended schools as a major part of your college search. You will want to find out if local universities have scholarships for students from your local area. Additionally, many major universities are offering full-tuition scholarships or other substantial awards to high-qualifying students, either in the form of need-based or academic scholarships for college. This continues to highlight the importance of placing utmost importance on your performance in the classroom.

Finding a good university scholarship can be a big factor in choosing a college. There tends to be a lot of competition, and applications are often due early in the academic calendar. The sooner you are aware of deadlines and expectations, the better off you will be.

When it comes to paying for college, merit aid is one way to lower the overall cost of attendance. Merit aid is a form of college financial aid that is not based on need but is awarded based on academic, athletic, artistic or special-interest merit.<sup>4</sup> According to Peter Cappelli's book, *Will College Pay Off?*, most merit aid comes from colleges and is mostly about those colleges attracting better students to a school to increase their national ranking.<sup>5</sup> Since the national ranking relates to the quality of the incoming freshman class, it is likely the case most of this aid goes to freshman rather than junior transfer students.

"All Ivy League schools, as well as several other very selective schools like Stanford, MIT, and Caltech, do not give any academic merit scholarships. No matter if you discovered a cure, created the world's greatest invention, won an Academy Award or an Olympic gold medal," said Mande Heller Adler, founder, and president of International

<sup>4</sup> Powell, F., & Kerr, E. (2021, February 1). *17 Things to Know About Merit Aid Scholarships*. U.S. News & World Report. <https://www.usnews.com/education/best-colleges/paying-for-college/slideshows/things-to-know-about-merit-aid-scholarships>.

<sup>5</sup> Cappelli, P. (2015). *Will College Pay Off?: A Guide to the Most Important Financial Decision You'll Ever Make*. PublicAffairs.

College Counselors. While they don't offer merit aid, Ivy League schools are known to be generous with meeting full financial needs.<sup>6</sup>

The question for students receiving merit-based aid then becomes whether they want to take the discount price offered through merit aid and go to a less selective school or pay more and go to a more elite school. Prospective students should be sure to research the policies at each college to which they are applying. "Some schools automatically offer students merit-based aid after they apply," Adler noted. "For other schools, students need to complete separate applications to be considered for this type of aid."<sup>7</sup>

### iii Private Scholarships

#### **FIGURE 3: Private Scholarships**

- Tau Sigma Honor Society Scholarship: \$500-\$5,000
- Pearson Scholarship for Higher Education: \$5,000
- Jack Kent Cooke Foundation Undergraduate Transfer Scholarship: Amount varies

Private foundations, nonprofits, for-profit corporations, and philanthropists are typically the entities that issue private scholarships. According to the U.S. Department of Education, there are thousands of scholarships offered by schools, employers, individuals, private companies, nonprofits, communities, religious groups, and professional and social organizations.

There are scholarships based on who you are as a student. For instance, there are scholarships for women or graduate students, scholarships related to a student's parent's work, or because the student comes from a particular background. Students can learn about scholarships in several ways, including reaching out to the financial aid office at the school they plan to attend and checking the information in a public library or online.

Students interested in obtaining private scholarships should start their search with local scholarships, since these awards are often less competitive. Students may be inclined to only apply to the larger scholarships, but the small awards add up. Yes, it's more work to opt for the smaller awards, but spending 10 hours on 10 applications to win \$500 still works out to be equal to \$50 per hour. Not a bad return on the invested time, right?

It is wisest to start the process early, apply for many scholarships, and follow all the instructions and deadlines. You can create a master mission statement that includes all the major points you want to make on your college and scholarship applications. Having a mission statement document can cut down on the time and energy you spend on applying for scholarships. You need to edit and tailor your mission statement to the specifics of the scholarship, so make sure you research each individual scholarship beforehand.

You should also research the groups you have a connection to, including any employers, unions, religious institutions and local community groups. Local high schools and community colleges can be a great resource for finding those awards. Experts say that it is important to use a few national scholarship database websites to help

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<sup>6</sup> Powell, F., & Kerr, E. (2021, February 1). *17 Things to Know About Merit Aid Scholarships*. U.S. News & World Report. <https://www.usnews.com/education/best-colleges/paying-for-college/slideshows/things-to-know-about-merit-aid-scholarships>.

<sup>7</sup> Powell, F., & Kerr, E. (2021, February 1). *17 Things to Know About Merit Aid Scholarships*. U.S. News & World Report. <https://www.usnews.com/education/best-colleges/paying-for-college/slideshows/things-to-know-about-merit-aid-scholarships>.

you locate scholarship opportunities. The U.S. Department of Education recommends these free sources of information about scholarships:

**FIGURE 4: Free Sources of Private Scholarship Information**

- the financial aid office at a college or career school
- a high school or TRIO counselor
- the U.S. Department of Labor's FREE scholarship search tool
- federal agencies
- state grant agencies
- libraries' reference sections
- foundations, religious or community organizations, local businesses, civic groups, or organizations (including professional associations) related to a particular field of interest
- ethnicity-based organizations
- the student's employer or the student's parent's employer

**iv Military Service Members and their Families Can Get Free Tuition at Community Colleges, Cal States, and UCs**

Students who serve in the military earn the entitlement of having tuition paid for up to a bachelor's degree. In some cases, they can have their education paid up to a master's degree and/or a doctoral degree. They also receive a book stipend and monthly stipend that varies based on the cost of living in the school's location. The most common benefits for student veterans are the GI Bill and the Veterans Readiness and Employment program through the Department of Veterans Affairs [www.va.gov](http://www.va.gov).

Family members (spouses and children) of military veterans may also have their tuition covered at any community college, Cal State university, or UC based on the military veteran's military service status. The tuition can be covered anywhere from an associate degree up to a bachelor's, master's, and/or doctoral degree. This benefit is provided by Cal Vet [www.calvet.ca.gov](http://www.calvet.ca.gov) and is for students who are legal residents of the state of California regardless of where the veteran family member resides. Benefit varies by state. Additionally, some family members may qualify for a monthly stipend through the Department of Veteran Affairs based on the veteran's military service status. The monthly stipend is separate from the Cal Vet tuition fee waiver, which may be used at the same time based on benefit qualification.

**v Tuition Coverage for Students with Disabilities**

Students with disabilities have access to various state and federal programs that assist to pay for their education leading to employment. California Department of Rehabilitation (CA DOR) [www.dor.ca.gov](http://www.dor.ca.gov) will pay for tuition, books, and any costs for training (education), with the goal that this training leads to employment. Earning a bachelor's degree, a master's, and/or a doctoral degree leads to employment, which is why CA DOR will pay for the cost of tuition for students with disabilities. The level of degree CA DOR will pay for depends on what is required to obtain that job. For example, an accountant requires a bachelor's degree, so CA DOR will pay for tuition, books, and other education costs up to a bachelor's degree. If the goal is to become a clinical therapist, which requires a master's degree, CA DOR will pay for tuition, books, and other education costs up to a master's degree.



## B. Free Aid and Net Cost

The real cost of attending a particular school depends on multiple factors, the major ones being the school's tuition sticker price, room and board, and the amount of Free Aid you receive. Depending on your family's income level, the amount of Free Aid you receive from a particular college can be quite surprising. The Free Aid you receive reduces the cost of tuition at a particular college. Therefore, the true cost (or Net Cost) of a school equals the price of the school listed on its website, minus all the Free Aid you are likely to receive from that school.

**FIGURE 5: Net Cost Example**

|                              |            |
|------------------------------|------------|
| Cost of Attendance (Example) | \$50,000   |
| Free Aid (Example)           | (\$35,000) |
| Net Cost                     | \$15,000   |

The larger school-specific awards tend to come from the bigger or more respected universities, due to the fact they have large endowments, and therefore have more resources to distribute to students. As such, schools with high price tags may be affordable to certain students. For instance, according to Harvard University, the total 2020-2021 cost of attending Harvard without financial aid was \$72,391 for tuition, room, board, and fees combined.<sup>8</sup> Yet, Harvard requires no contribution from Harvard families with annual incomes below \$65,000 and asks from 0 to 10% of income for those with incomes up to \$150,000.<sup>9</sup> This means you would be required to pay only \$15,000 a year to attend Harvard if your family's annual income was approximately \$150,000.

Much is the same at Stanford University here in Northern California. According to Google, the average cost to attend Stanford was \$74,570 in 2020-2021, yet the Net Cost was \$10,928 after Free Aid for a family's annual income of \$75,000-\$110,000. Do not underestimate the utility of financial aid.

The initial cost or price tags of Stanford and Harvard are high enough to scare most students away. However, many California community college student family incomes fall within the range of \$75,000-\$110,000 per year. Thus, the cost of Stanford or Harvard may be within reach for these students.

**FIGURE 6: Cost of Attendance After Financial Aid, Stanford and Harvard**

|   | Stanford | Harvard  |
|---|----------|----------|
| Cost of Attendance (2020-2021)                  | \$74,570 | \$72,391 |
| After Financial Aid - Income level of \$150,000 | \$10,928 | \$11,000 |

I use Harvard and Stanford as extreme examples to illustrate a point. Keep in mind that these schools are still incredibly difficult to get into and not every student will qualify academically. We can still apply the same Net Cost concept to less expensive schools. Take for instance the difference between San Jose State University (SJSU) and the University of California, Santa Barbara (UCSB).

Based on what we think we know about the cost of college tuition in California, most students would assume that the public state university SJSU would be less expensive than UCSB. If you go to SJSU's website, the school

<sup>8</sup> <https://www.harvard.edu/about-harvard/harvard-glance>; <https://handbook.fas.harvard.edu/book/tuition-and-fees>;  
<https://www.gse.harvard.edu/financialaid/tuition>

<sup>9</sup> <https://www.harvard.edu/about-harvard/harvard-glance>



clearly states that its tuition in 2020-2021 for 6.1 or more units is only \$3,926 per semester.<sup>10</sup> It seems like that would be the cheapest available option, right? According to Google, however, the total annual cost to attend SJSU for a student living on campus is approximately \$30,065 when you factor in all costs such as tuition, books, and room and board.<sup>11</sup>

Alternatively, according to Google, the total cost to attend UCSB for a student living on campus is approximately \$37,765 when you factor in all costs such as tuition, books, and room and board.<sup>12</sup>

All else being equal, a student making decisions based solely on the lowest cost option may be inclined to rule out UCSB and opt to go to SJSU given the list price of each school. Considering the Free Financial Aid though, the conclusion isn't so obvious. According to Google, the average cost to attend each university, after considering Free Financial Aid for a student family annual income of \$75,000-\$110,000 is as follows:

**FIGURE 7: Cost of Attendance After Financial Aid**

|  | UCSB     | SJSU     |
|--|----------|----------|
| In-State Cost of Attendance (2020-2021)            | \$37,765 | \$30,065 |
| After Financial Aid – Income of \$75,000-\$110,000 | \$21,096 | \$20,625 |

Even though UCSB has a higher price tag, after considering the Free Aid that may be available to you (at that income level), the cost difference between UCSB and SJSU may not be enough to warrant one school over the other. Therefore, I encourage you to assemble a list of potential colleges you may want to attend regardless of the listed price tag of the college. Then, visit their websites and/or do your research about all Free Aid available based on your specific income and their available aid at that income. As the above example shows, your list of realistic potential schools may expand. And with an expanded list of schools, you may be able to leverage more value out of your education.

Most colleges provide Net Cost calculators to help you navigate the true cost of your education at their school. Likewise, Google and many other private websites contain tons of information on available financial aid options.

### i Reduce the Timeline Towards Graduation to Lower Total Costs<sup>13</sup>

Only 40 percent of full-time students graduate on time and 60 percent graduate within six years. Since the time it takes to finish a degree varies, adding extra years to complete the degree could dramatically add to the costs. For example, if your annual net cost of college is \$20,000, then two additional years to graduate could add \$40,000 to the overall cost. Making matters worse is the opportunity costs associated with delayed graduation. Assume your annual salary upon graduation would be \$45,000 a year. Two additional years to graduate could add another \$90,000 to the overall “cost” of graduating in six years rather than two. Thus, delaying graduation by two years can have a \$135,000 impact (\$45,000 + \$90,000).

<sup>10</sup> <https://www.sjsu.edu/tuition-and-fees/>

<sup>11</sup> Google search, “Colleges in California, San Jose State”

<sup>12</sup> Google search, “Colleges in California, University of California, Santa Barbra”

<sup>13</sup> Cappelli, P. (2015). *Will College Pay Off?: A Guide to the Most Important Financial Decision You'll Ever Make*. p.180-181. Public Affairs.

In fact, according to Peter Cappelli, graduation rates are the most important factor you should look at when comparing schools. Colleges have a good amount of control over graduation rates through their support programs. A more expensive private school with ample support programs that graduates a large percentage of its freshmen in four years may be cheaper than a state university where freshmen take longer to graduate. There are big differences between colleges with respect to graduation rates. For example, in Pennsylvania, Penn State's graduation rate is 65 percent and at the University of Pennsylvania, a top tier school in the state, the graduation rate is 98%.

*"If you're thinking about probabilities, is it worth it to pay more to get the kind of support and systems and major design and everything that gets kids out in four years? Yeah, probably, it absolutely is. The first thing to think about are things like will my kid graduate on time? Financial aid matters a lot. State universities, private universities — now, the average difference in tuition between private and state for kids getting financial aid is only \$9,000. Public institution tuition has gone up 50% faster than private. Financial aid in lots of places has gone up pretty high. Thinking that public institutions will be cheaper is not necessarily true."*<sup>14</sup>

Similarly, Ron Lieber's *The Price You Pay for College* suggests that you'll also want to ask about the so-called first-year persistence and retention data by department or program since they can vary widely within a large university that has many different undergraduate tracks.<sup>15</sup>

This same analysis can be applied to the comparison of SJSU and UCSB. SJSU's graduation rate is 62 percent, while UCSB's is 82 percent.<sup>16</sup> All things being equal, you could increase your chance at graduating by 33 percent (20% / 62%) at no extra cost by attending UCSB as opposed to SJSU.

Another factor extending graduation is difficulty completing majors. Complicated majors wherein prerequisites must be taken in order or sequence can delay completion if students can't get into the courses they need when they need them. This is also where public and private schools differ. The state universities, which have been negatively impacted by budget constraints the last few years, are having more trouble getting students to complete majors because they have trouble filling classes. It's an issue when you're thinking about which college to go to.<sup>17</sup>

According to *Will College Pay Off*, when colleges were asked what helped with their retention challenges, the schools offered the following responses, which can also be used for sorting out where to go to college: <sup>18</sup>

### **FIGURE 8: Student Retention Considerations**

- Freshman seminar/university 101 for credit
- Tutoring programs – there must be a physical location and students must participate
- Advising interventions with selected student populations
- Mandated course placement testing program
- Comprehensive learning assistance center – these programs help identify learning deficits and challenges

<sup>14</sup> Cappelli, P. (2015). *Will College Pay Off?: A Guide to the Most Important Financial Decision You'll Ever Make*. PublicAffairs, pp.180-181.

<sup>15</sup> Lieber, R. (2021). *The Price You Pay for College*. Harper, p. 100.

<sup>16</sup> Google search, "Colleges in California, University of California, Santa Barbara"

<sup>17</sup> Cappelli, P. (2015). *Will College Pay Off?: A Guide to the Most Important Financial Decision You'll Ever Make*. PublicAffairs, pp.180-181.

<sup>18</sup> Cappelli, P. (2015). *Will College Pay Off?: A Guide to the Most Important Financial Decision You'll Ever Make*. PublicAffairs, pp.75-76.

There may be additional options available to reduce the time until graduation. Those factors can include:

**FIGURE 9: Options to Reduce the Time at College**

- Attending community college to complete some or all your lower-division courses.
- Check to see if your school extends credit based on your knowledge or life experiences and whether you can manage your course work to reduce costs.
- Ask your school whether it's possible to “test out of” any classes. If you don't take a class, you may not have to pay for the credits.
- Most schools charge a set price for a specific number of units per semester or quarter. If academically possible, take the maximum number of units allowed. This strategy reduces the amount of time needed to graduate.

The faster you graduate and the less time spent in college, the sooner you can get into the workforce and start generating income. Students should have fun in college, at a limited financial cost. The sooner you graduate and begin generating income, the more stable and financially fit you can be to have better quality fun.

## ii Room and Board and Work

Room and board cost is a large component of a college education and can vary widely depending on the location of the school you are considering. For instance, the 2021 estimate for on-campus room and board was approximately \$9,000 at Iowa State<sup>19</sup> and approximately \$19,000 at UC Berkeley and NYU.<sup>20</sup>

Room and board will also vary depending on whether you live on or off campus and, more specifically, if you live with family or on your own, near campus. I cross paths with countless students who opt to attend the local state university because it's close to home and they can therefore live with their parents to avoid the added expense of room and board. This can make a lot of sense if the list of alternative schools that require a student to move does not provide any additional benefits beyond the local state university. But if the alternative is a school that provides measurably more benefits than the local state university, students should seriously consider the net benefits of attending those schools. The question for students then becomes whether they want to take the discounted price offered through staying at home, or move to a new location where they would be required to pay room and board to attend a better school.

## iii Work-Study

Work-study is a program that provides aid to schools to employ eligible students in part-time jobs. Most of the aid comes from the federal government, but some states provide funds for it as well. Federal work-study provides part-time jobs for undergraduate and graduate students with financial needs, allowing them to earn money to help pay education expenses. The program encourages community service work and work related to the student's course of study. You need to file a FAFSA application to qualify for work-study programs.

<sup>19</sup> <https://www.financialaid.iastate.edu/cost/cost-of-attendance/undergraduate-students/>

<sup>20</sup> <https://www.nyu.edu/admissions/financial-aid-and-scholarships/applying-and-planning-for-undergraduate-aid/tuition-and-other-costs/cost-of-attendance.html#general>; <https://financialaid.berkeley.edu/how-aid-works/student-budgets-cost-of-attendance/>

You may work on campus, usually for your school, and if you work off campus, your employer will usually be a private nonprofit organization or a public agency. Work off campus must be in the public interest. You can expect to earn at least the current federal minimum wage. However, you may earn more, depending on the type of work you do and the skills required for the position.

About six percent of college students have work-study positions. About one-third report that their job was in some way related to their courses, and they earn an average of \$2,850 per year.<sup>21</sup>

## 7.3 Properly Measure the Impact Your School Can Have on the Jump from College to Career

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### A. Graduating on Time

As noted in the previous section, graduating in four years rather than five or six years (or even longer) has a tremendous impact on your overall cost of attending college. Therefore, comparing the four-year graduation rates between colleges is one way to measure the benefit a particular school provides.

### B. Starting Salary

When college undergrads were asked why they decided to get a bachelor's degree, the most cited reason was to get a good job.<sup>22</sup> According to Gallup's 2014 Gallup-Purdue Index Report—the largest poll of college graduates in history—having a good job is a crucial factor in overall well-being, given how much time we spend at work. I went back to school because I thought I could make more money after graduating from college than I could have without going to college. I wouldn't have spent four years at community college while working full-time if I didn't believe I would be better off with the degree.

If this is the premise behind going to college for you, then measuring the benefits of a particular college should relate to how well it will provide you with employment opportunities. Many studies have been conducted about the financial benefits of obtaining a college education. For example, I often hear that if you go to college, you can expect to earn more over your lifetime than if you didn't go to college. Some studies say it's a million dollars more if you go to college, some say two million, some say it's 60 percent more.

The net cost shouldn't be the only financial consideration. In addition to cost, you should also measure the financial benefits the college provides to properly measure the financial impact of going to that particular college. For instance, say you are considering two schools, each school costs the same amount to attend after factoring in all the relevant costs. However, the average starting salary for graduates from one school is \$10,000 more than the other. In this instance, from a financial point of view, it would make sense to go to the school that provides its graduates with a higher starting salary.

So, does going to one college over another lead to a better job or better salary after graduation? The data would tend to suggest the answer is yes when comparing elite schools to all others. However, it's harder to determine definite incremental benefit when you are on the margins. Most colleges report data showing the average salaries

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<sup>21</sup> Cappelli, P. (2015). *Will College Pay Off?: A Guide to the Most Important Financial Decision You'll Ever Make*. Public Affairs. p. 126.

<sup>22</sup> Crabtree, S. (2019, January 22). *Six College Experiences Linked to Student Confidence on Jobs*. <https://news.gallup.com/poll/246170/six-college-experiences-linked-student-confidence-jobs.aspx>.

their graduates earn, both directly after graduation and even well into their careers. These data are readily available at sites like [www.payscale.com](http://www.payscale.com).

In the previous section, we compared the cost to attend Harvard, Stanford, SJSU, and UCSB. Let's now consider the average starting salary straight out of college for graduates of those schools.<sup>23</sup>

**FIGURE 10: Cost of Attendance After Financial Aid and Average Starting Salary**

|   | Harvard  | Stanford | UCSB     | SJSU     |
|---|----------|----------|----------|----------|
| In State Cost of Attendance (2020-2021) After Financial Aid | \$11,000 | \$10,928 | \$21,096 | \$20,625 |
| – Income level of \$75,000-\$110,000                        |          |          |          |          |
| Average Starting Salary                                     | \$76,400 | \$81,800 | \$59,900 | \$64,800 |

Based on these data, we can conclude that Harvard and Stanford are clear winners. For a student with a family income of 110,000 or less, the cost is substantially lower and the average starting salary significantly higher for Harvard and Stanford. However, it's harder to see much difference between UCSB and SJSU.

The interesting question is whether the difference in the average starting salaries tells us anything about how well a particular school creates opportunities for its graduates. Furthermore, what if there is only a minimal difference in starting salaries between two schools like the difference between UCSB and SJSU? Does this mean that the two schools provide equal job opportunities and thus are of equal value when it comes to finding a job or landing a meaningful career?

While that is a hard question to answer, I think it depends on you as a student, the schools you are comparing, and your contemplated major. This data can be helpful, but I would treat it with some level of skepticism. I believe that graduates of some of the more highly ranked colleges, such as Stanford and UC Berkeley, have higher average starting salaries than some of the large public universities, such as San Francisco State and San Jose State. There can be a litany of reasons for these differences. It could be that a more selective group of companies recruit from Harvard and Stanford and do not recruit from San Jose State and San Francisco State as often. It could be that students graduating from these schools go into higher-paying careers than those from San Jose State and San Francisco State. It could be how schools collect and report such data.

It's also risky to rely on average salaries, as they are only averages. It could be the case that when you drop down to the average starting salary by the school and then by major, the conclusion changes. The average starting salary also doesn't tell us anything about the graduates who did not get a job, the choices the students made upon graduation, or whether starting salary is of value when it comes to a job or career.

Contacting the career center and properly researching the opportunities available on a school-by-school and major-by-major basis is the best way to begin thinking about the issue. Career centers often will remain available to students years after they graduate. They can help you get in touch with recruiters, prepare for interviews, and even review your resumé.

<sup>23</sup> <https://www.payscale.com/college-salary-report/bachelors>

### FIGURE 11: College Career Center Considerations

- How many companies recruit at each school?
- How many students graduate with jobs?
- How many offers does the typical graduate receive before graduating?
- What services does the career center from each school provide?

### C. The Gallup Poll Six Factors

Gallup partners with Purdue University and Lumina Foundation to conduct a nationally representative study of college graduates with Internet access called the Gallup-Purdue Index. The Gallup-Purdue Index is the first measure to evaluate the long-term success of graduates in their pursuit of great jobs and great lives, as measured by the Gallup Employee Engagement Index and Gallup-Sharecare Well-Being Index, respectively. The Gallup-Purdue Index examines college experiences such as internship participation, involvement in extracurricular activities, relationships with professors, and having student loans. It also provides higher education leaders with productive insights that will help them make meaningful performance improvements.<sup>24</sup>

According to Gallup, only 30 percent of the individuals polled in their 2014 college graduate index felt fully engaged at their workplace, meaning that 70 percent of the respondents spent all this time and money to get a college education and did not feel fully engaged at work. In other words, they did not like their jobs.

If only 30 percent of students find a satisfying career after graduating, how can you approach your education so that you end up satisfied with your job and career after you graduate? Let's look at what the Gallup survey respondents said about the aspects of their college that had contributed to their engagement at work.<sup>25</sup> Gallup listed six crucial factors that were common amongst the 30 percent group:

### FIGURE 12: Gallup Poll Factors that Lead to a Satisfying Career After Graduating

1. They were involved in extracurricular activities at school.
2. They had an internship or job wherein they could apply what they had learned in the classroom.
3. They were involved in an academic project at school that took at least a semester to complete.
4. They had a professor who cared about them.
5. They had a professor who made them excited about learning.
6. They had a professor who encouraged them to pursue their dreams.<sup>26</sup>

Three of the factors listed are directly related to mentorship. In other words, those students who landed a satisfying career most likely had a mentor at some point in college. Furthermore, they likely had an internship, and/or were fairly involved in a school project, and/or had some involvement in extracurricular activities.<sup>27</sup>

<sup>24</sup> How Does the Gallup-Purdue Index Work? Gallup.com. <https://www.gallup.com/174167/temp-methodology-gallup-purdue-index-methodology.aspx>.

<sup>25</sup> Lieber, R. (2021). *The Price You Pay for College*. Harper. Chapter 9.

<sup>26</sup> Lieber, R. (2021). *The Price You Pay for College*. Harper. Chapter 9.

<sup>27</sup> Lieber, R. (2021). *The Price You Pay for College*. Harper. Chapter 9.



## i Mentors

If having a mentor is a critical factor in finding a rewarding job straight out of college, then it would make sense to attend schools that provide opportunities for their students to connect with mentors. The Gallup-Purdue Index showed that graduates with at least one professor who excited them about learning, who cared about them as a person and was a mentor, have more than double the odds of being engaged at work after graduation and thriving in their lives.<sup>28</sup> In fact, according to Gallup's research, 63 percent of those surveyed who have achieved great jobs and great lives, stated that they had at least one professor who excited them about learning.<sup>29</sup> Unfortunately, this information is almost impossible to find, so contacting your intended schools would be the best source for this information. Gallup created the following checklist to help students obtain the right information when visiting campus and/or speaking with campus representatives:

### **FIGURE 13: Campus Visit and School Representative Questions**

- What kind of mentorship opportunities does the college/university offer (e.g., with faculty, graduate students, or upperclassmen)?
- What's the percentage of students involved in long-term projects (e.g., research opportunities for undergraduate students or semester-long projects)?
- How are faculty members evaluated by the college/university? Is mentoring/direct interaction to support students one of the elements of evaluation?
- How does the college/university support faculty-student interaction outside the classroom (e.g., a faculty member joining a group of students for lunch, service learning, and faculty advising of student organizations)?
- How will professors excite me about learning?
- Will instructors care about me as a person?
- Will mentors encourage me to pursue my goals?

Answers to these questions should demonstrate the focus on the quality of your learning experience. Hopefully, these questions will help you get a sense of the school's emphasis in preparing you for your career.

Ideally, you would attend a school with many full-time faculty members with ample amounts of time to devote to your education. Unfortunately, this is likely not going to be the case as many schools rely heavily on adjunct (part-time) faculty. Adjunct faculty are likely to be underpaid and overworked. They also don't spend a lot of time on campus, and most of them probably don't even have an office on campus. Thus, adjunct faculty don't usually make the best mentors.

So, when trying to determine the odds of attending a school that will provide mentoring opportunities, begin by focusing on the number of tenured, full-time faculty who are teaching the mandatory courses in your major. Find the list of junior and senior courses you will be required to take for your intended major and match up those courses in the class schedules. From the class schedules, you can then determine how many of those courses are taught by tenured or adjunct faculty (or by graduate students) by reviewing the instructor profiles on the department's website. Schools with more tenured faculty teaching the mandatory courses tend to be those schools placing more

<sup>28</sup> <https://www.purdue.edu/checklist/>

<sup>29</sup> <https://www.purdue.edu/checklist/>



emphasis on teaching as well as the educational experience of their students. Likewise, be aware that adjunct professors and large class sizes typically have negative effects on the student experience.<sup>30</sup>

You can also search the instructors teaching the mandatory classes on RateMyProfessor. I'm not the biggest fan of RateMyProfessor, but you may find student reviews useful, and we've already talked about the impact teachers and professors can have on a student's learning experience.

You can also ask the school what portion of the tenured track review process depends on teaching responsibility. Schools that place little emphasis on teaching and more emphasis on research in the tenure process may say something about the importance they place on teaching. You can ask the school directly how much emphasis they place on requiring their faculty to become mentors.

A mentor may not always be a professor. A dean of students, career counselor, spiritual leader, or financial aid officer can fill the role.<sup>31</sup> And therefore, schools that provide a good amount of support services, like career counseling and tutoring may also provide opportunities for mentoring. On this issue, low graduation rates are also a bad sign, according to Ron Lieber.<sup>32</sup> In *The Price You Pay for College*, Lieber also suggests that big, mostly public schools (along with the Ivy Leagues) scored last and second to last according to surveys tracking such information on mentoring.

## ii Projects / Internships

Internships and projects that took longer than a semester were high on the list of college experiences that led to a good job or rewarding career, according to the Gallup-Purdue Index. Furthermore, Lieber says surveys of employers who hire college graduates demonstrate what is most important to employers has little to do with the academic experience. "It has to do with experiences that are work-like on the college campus. It has to do with internships and summer jobs and extra-curricular activities. That's what they care more about than the academic material."<sup>33</sup>

It's clear from both the student's and employer's perspective that internships and/or campus work experience or projects are important factors when seeking employment out of college. Therefore, when identifying schools to attend and the benefits provided by that school, you should place some importance on these factors. Contacting your top schools would be the best source for this information. Gallup has created yet another checklist to help students obtain the right information when visiting campus and/or speaking with campus representatives. Gallup's checklist includes asking questions around the following:

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<sup>30</sup> Lieber, R. (2021). *The Price You Pay for College*. Harper. Chapter 10.

<sup>31</sup> Lieber, R. (2021). *The Price You Pay for College*. Harper. Chapter 9.

<sup>32</sup> Lieber, R. (2021). *The Price You Pay for College*. Harper. Chapter 10.

<sup>33</sup> Cappelli, P. (2015). *Will College Pay Off?: A Guide to the Most Important Financial Decision You'll Ever Make*. PublicAffairs.

**FIGURE 14: Campus Questions Regarding Internship and Project Questions**

- What internships/co-ops does the college/university offer to students (e.g., work arrangements where students can apply directly what they are learning in the classroom)?
- What percentage of students are involved in internship/co-op programs?
- Are scholarships or stipends available to support study-abroad programs?
- What does the college/university do to promote all students' active involvement in campus organizations, extracurricular, and volunteerism?
- Are there projects that may take a semester or more to complete in the program I'm applying for?

Answers to these questions should highlight your school's focus on career services, placement, and counseling services. If your school prioritizes recruiting, companies are likely to visit the campus, seeking to hire good candidates. According to the Gallup-Purdue Index, "Graduates who had experiential and deep learning, such as a job/internship or long-term school project, and who were involved in extracurricular activities and organizations, had double the odds of being engaged at work and having a great sense of well-being."<sup>34</sup>

Given the importance internships play on obtaining a meaningful job upon graduation, it makes sense to go to a school in an area wherein you can find local internships related to your major.

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<sup>34</sup> <https://www.purdue.edu/checklist/>

## CHAPTER 8: The Jump from School to Work

- 8.1 The Risk of Underemployment
- 8.2 What do Employers Look for in College Graduates
- 8.3 Your Brand
- 8.4 Marketing Your Brand
- 8.5 The Recruiting Process

### 8.1 The Risk of Underemployment

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Graduating from college doesn't entitle you to some great job or career or that infamous \$1 million that we talked about in the previous section. Going to one particular college over another and/or majoring in a "hot" major also doesn't entitle you to a satisfying career or good job out of college. Picking the right college and the right major can increase your probabilities, but again, no guarantees. And since there are no guarantees, the process of finding that great first job out of college shouldn't end by simply selecting the right school to attend and the right subject to major in. It should extend to the way in which you go to college as well.

Going to college the "right way" can be just as important as picking the right college to attend. And in many instances, going to college the right way may be even more important than the school and major. Attending college should be about broadening your understanding of the world and developing skills that will benefit you throughout your lifetime. But it should also be about marketing yourself and acquiring the skills employers are looking for to land the best possible job out of college. Because if you don't find the right job out of college, the impact can be significant and detrimental for years.

We can equate the risk of not finding the right job out of college with the risk of being underemployed. Merriam-Webster defines underemployment as "the condition in which people in the labor force are employed at less than full-time or regular jobs or jobs inadequate concerning their training or economic need." Strada Institute for the Future of Work and Burning Glass Technologies, a career market analytics company, analyzed more than 4 million resumés and job postings to study the effects of underemployment. Its research found that for every 100 college graduates, 43 are underemployed in their first job, 29 are still underemployed five years later, and 21 are still underemployed 10 years after graduating. Research also found that college graduates who do secure a job below their credentials tend to earn less than their counterparts. Strada found that underemployed college graduates (ages 22-27) earn on average \$37,000 in the years immediately after earning their bachelor's degree. By comparison, the average salary for graduates employed in college-level work is more than \$47,000. This is a 27 percent difference.<sup>1</sup>

This difference in pay continues as underemployed graduates find it difficult to catch up once they fall behind. According to Strada, graduates who are underemployed in their first job are five times more likely than their counterparts to be underemployed five years later. On the other hand, those who have a first job appropriate to their background rarely fall into underemployment.

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<sup>1</sup> [https://www.burning-glass.com/wp-content/uploads/permanent\\_detour\\_underemployment\\_report.pdf](https://www.burning-glass.com/wp-content/uploads/permanent_detour_underemployment_report.pdf)

There are further benefits to avoiding underemployment, according to the study. Not only do graduates acquire on-the-job skills, but they make connections that help them land future jobs and boost their chances for higher-paying work in the years to follow.<sup>2</sup>

You should therefore be strategic about the search for your first job. These are the factors to consider while still in college as it pertains to your first job out of college:

**FIGURE 1: Searching for a Job While in College**

- Understand what employers are looking for
- Develop your brand or human capital
- Know how to market yourself
- Know when to get started

## 8.2 What do Employers Look for in College Graduates?

Some employers for certain job openings will look for skills directly related to a major. For example, accounting firms may look for accounting majors, and computer gaming companies looking for software coders may look for computer engineering majors. However, once you move beyond those job-specific skills, most employers begin to look for certain attributes, skills, and characteristics in their college graduate new hires, not necessarily their major or degree.

According to the National Association of Colleges and Employers (NACE), employers want to see work experience and relevant work experience when hiring new graduates.<sup>3</sup> According to NACE's 2017 Job Outlook Report, nearly 91 percent of employer survey respondents preferred that their candidates have work experience, and 65 percent of the group indicated that they preferred their candidates to have relevant work experience. Another 26 percent of respondents preferred work experience of any type. Meanwhile, a mere 5 percent said work experience was not a factor when hiring new graduates.<sup>4</sup>

According to the same report, more than half of the respondents preferred that candidates' work experience came from an internship or co-op. The remaining percentage of respondents had no preference in how candidates gained their work experience.<sup>5</sup>

Likewise, according to *Will College Pay Off*, "What employers want from college graduates now is the same thing they want from applicants who have been out of school for years, and that is job skills and the ability to contribute now."<sup>6</sup> That change is fundamental, and it is the reason that getting a good job out of college is now such a challenge."<sup>7</sup>

So, what is the takeaway here? Obtain some relevant work experience while in college. Work experience is where community college junior transfer students have a major competitive advantage over traditional high school to four-

<sup>2</sup> [https://www.burning-glass.com/wp-content/uploads/permanent\\_detour\\_underemployment\\_report.pdf](https://www.burning-glass.com/wp-content/uploads/permanent_detour_underemployment_report.pdf)

<sup>3</sup> <https://www.naceweb.org/talent-acquisition/candidate-selection/employers-prefer-candidates-with-work-experience/>

<sup>4</sup> <https://www.naceweb.org/talent-acquisition/candidate-selection/employers-prefer-candidates-with-work-experience/>

<sup>5</sup> <https://www.naceweb.org/talent-acquisition/candidate-selection/employers-prefer-candidates-with-work-experience/>

<sup>6</sup> Cappelli, P. (2015). *Will College Pay Off?: A Guide to the Most Important Financial Decision You'll Ever Make*. PublicAffairs.

<sup>7</sup> *Will College Pay Off*, p.15

year university students. Your ability to market your own unique work experience along with many of your other unique qualities will put you at a competitive advantage during the job search.

Additionally, according to NACE's 2017 Job Outlook Report, graduates should also highlight their solid GPA, detail their abilities to work as part of a team and solve problems, and offer proof of their strong communication skills. The report also found that between 65 and 70 percent of employers screen graduates by GPA. Among the employers that will screen candidates by GPA, more than 60 percent will use a cutoff of 3.0, which is also the mean and median reported cutoffs for the entire group. Also, 78 percent of respondent employers place a lot of importance on a student's ability to work as part of a team. While problem-solving skills may be difficult to exhibit on a resume, they will be required by more than 77 percent of respondents. Rounding out the top attributes employers are seeking on a candidate's resume are communication skills—both written (75 percent) and verbal (71 percent)—and a strong work ethic (72 percent).<sup>8</sup>

According to a 2017 *Business News Daily* article, 44 percent of employers surveyed think academic institutions put too much emphasis on book learning rather than real-world learning, while 17 percent arguing that colleges don't adequately encourage students to take internships. The survey also discovered 50 percent of those surveyed think graduates lack interpersonal or people skills, 45 percent think they lack problem-solving skills, and 39 percent think they lack sufficient teamwork skills.<sup>9</sup>

## 8.3 Your Brand

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Based on the previous discussion, gaining work experience before you graduate is paramount to finding a job out of college; however, I will reiterate that there are no guarantees in life. That is certainly the case when it comes to finding a good job out of college. So, I will say this again as well, since there are no guarantees, you should strive to do all the things necessary to increase your chances of succeeding. And concerning finding a good job out of college, that means being proactive.

Be proactive in the way you acquire the technical skills needed for your intended career. Excel in the class and highlight those achievements on your resumé. Search for opportunities to get involved in school projects and extracurricular activities and present those in your resumé. Take honors classes when possible and join campus clubs and organizations. Again, highlight these accomplishments and activities on your resumé. Seek out internships related to your intended career. Spend the time drawing the connection between your prior work experience and your intended career. A food server and an accountant have a lot of similarities. They are both service-oriented occupations that deal with the public. Time dealing with customers as a food server could be very valuable to an employer concerned with putting their associates in front of clients. Experience handling angry patrons could be similar to dealing with difficult clients. The point being, you may be surprised when you stop and draw the relationships between “irrelevant” work experience and relevant work experience.

You are a brand, and the more unique you and your brand are, the more attractive it may be to employers.

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<sup>8</sup> <https://www.nacweb.org/talent-acquisition/candidate-selection/the-attributes-employers-look-for-on-a-candidates-resume/>

<sup>9</sup> <https://www.businessnewsdaily.com/4436-degrees-that-will-get-you-hired.html#:~:text=Despite%20their%20willingness%20to%20hire,roles%20needed%20within%20their%20organizations.&text=The%20study%20discovered%20a%20number,college%20graduates%20are%20deficient%20in.>

## 8.4 Marketing Your Brand

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In addition to seeking internships and developing your brand, you need to be sure to spend time marketing yourself in college. The best way to do this is in person at on-campus recruiting events. So, I highly recommend attending as many of those recruiting events as you possibly can. Companies are looking for graduates with soft skills, and the best way to demonstrate those skills is in person. Attending these events and introducing yourself to these companies may not be a hugely enjoyable activity and can feel forced at times. However, the more you attend, the better you will get at it. And the more personable and authentic you are, the more likely it is you will make a good first impression. Do a little research on the company you are contacting so you know a little about who you will be meeting. It is also useful to bring a handful of well-thought-out questions. They shouldn't be questions like: "Where do you see your company in 5 years from now?" They should be questions that really matter to you. Be genuine and authentic as opposed to trying to look smart. Ask questions about the training provided, the open-door policy, or where new hires go to get help when they get stuck on issues. Ask about what's expected of new hires. If you can't imagine what it would be like your first six months on the job, then ask the questions that would help you fill in that picture. It shows you care and allows you the opportunity to collect valuable information that will help you make a good decision about what company to work for until you graduate.

The next bit of marketing involves your resumé. The big issue here is that it cannot contain any mistakes. Employers are looking for things like attention to detail. If you can't pay enough attention to your resumé to make sure there are no mistakes in it, how are you going to make sure to limit the number of mistakes you make on the job? You will make mistakes, but you want to avoid making mistakes on your resumé. Visit your career center and have other people review your resumé and provide you with feedback.

Beyond the networking events and a spotless resumé, the next line of marketing takes place online. Set up a LinkedIn account and begin to grow your professional network. Connect with the company representatives you meet at the recruiting events. Connect with recruiters from companies you would want to work for, etc. Also, clean up your social network activity. You don't want future employers going online and looking up your social accounts only to find things that are not flattering. Essentially, less is more on that front.

## 8.5 The Recruiting Process

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Searching for your first job out of college should begin well before your last year of college. This is true for two reasons: 1) the importance employers place on internships and prior work experience when it comes to finding a full-time job and 2) the fact that you could increase the probability of landing a meaningful career after college if you had an internship in your intended career during college. Therefore, a thoughtful job search should begin with searching for an internship at least by your junior year. However, there are internship opportunities for promising freshmen and sophomores, so there is no reason to wait until your junior year. The sooner you get started, the sooner you can take advantage of the networking opportunities on your campus.

Check with the career center and join clubs on campus to plug into the pipeline of recruiting events at your campus. The on-campus recruiting process usually begins in the fall semester or quarter, so visiting the career center at the beginning of the fall academic calendar makes more sense than the end of spring. It may seem like a long way off to begin thinking about finding a job, but employers like to get on campus and work out their incoming recruitment class. It will usually extend to the spring semester or quarter depending on the industry and company, but it's best to start in the fall to not miss any attractive opportunities.

## CHAPTER 8: The Jump from School to Work

Some of the bigger companies will begin the process by holding information sessions where they will talk about their company and available opportunities. These are usually great opportunities to meet company representatives and introduce yourself (network). There will also be career fairs that serve the same purposes. Visiting both to put yourself in front of more company representatives increases your chances of finding someone who will go to bat for you within the company.

The information sessions and career fairs are typically followed with “on campus” or virtual screening interviews. These are typically short interviews, and those students who impress make it to the official round of interviews that often take place at the company, although this may be changing given the current environment. Again, you will want to visit your career center to see if they provide any interview preparation workshops. The more interviews you attend and the more you practice, the better you will get.



## CHAPTER 9: Student Loans

- 9.1 Borrowing for College is a Personal Decision, Not a National Issue
- 9.2 Types of Student Loans
- 9.3 Rules of Thumb On How Much to Borrow
- 9.4 Determine Your Monthly Payment
- 9.5 Loan Forgiveness

### 9.1 Borrowing for College is a Personal Decision, Not a National Issue

A loan is a legal obligation that requires repaying the amount borrowed with interest. Borrowing money to help pay for college (student loans) is an investment in your future and you should not necessarily be afraid to take out student loans. Student loans can come from the federal government, private banks, or other organizations.

As of December 31, 2020, there was \$1.7 trillion in outstanding student loan debt in the U.S.<sup>1</sup> However, according to Brookings, most undergrads finish college with a small amount of debt. Approximately 30 percent of undergrads graduate with no debt and about 25 percent with less than \$20,000. Only six percent of borrowers owe more than \$100,000 – and they owe about one-third of all the student debt.<sup>2</sup> So why has the total amount of student loan debt ballooned to such a staggering amount?

#### FIGURE 1: Reasons for Large Student Debt

- More people are going to college, and more of those who go are from low- and middle-income families.
- Tuition has risen, particularly among four-year public institutions.
- The federal government has changed the rules to make loans cheaper and more broadly available.
- Parents have borrowed more.
- Borrowing for graduate school has increased sharply.
- Borrowing for for-profit schools skyrocketed as enrollments in higher education soared during the Great Recession.<sup>3</sup>

Statistics about our national student loan program are interesting and may even be troubling, but they are irrelevant when it comes to whether you should borrow money to go to college. That decision is complicated and hugely personal. There are many good reasons to borrow money to go to college. The most obvious one is that you would not be able to pay the costs to go to school without borrowing. If this is the case, then you should research the benefits specific to your decision to go to college relative to how much you intend to borrow and how difficult or easy it will be for you to pay your loans back after you graduate.

<sup>1</sup> <https://www.federalreserve.gov/releases/g19/current/default.htm>

<sup>2</sup> Wessel, D., & Yilla, K. (2020, January 8). *Who owes all that student debt? And who'd benefit if it were forgiven?* Brookings. <https://www.brookings.edu/policy2020/votervital/who-owes-all-that-student-debt-and-whod-benefit-if-it-were-forgiven/>.

<sup>3</sup> Wessel, D., & Yilla, K. (2020, January 8). *Who owes all that student debt? And who'd benefit if it were forgiven?* Brookings. <https://www.brookings.edu/policy2020/votervital/who-owes-all-that-student-debt-and-whod-benefit-if-it-were-forgiven/>.

The U.S. government may forgive, discharge, or cancel some or all your student loan debt under certain circumstances. If you are employed by a government or nonprofit organization, you may be able to receive loan forgiveness under the Public Service Loan Forgiveness (PSLF) Program.<sup>4</sup> If you teach full-time for five complete and consecutive academic years in a low-income elementary school, secondary school, or educational service agency, you may be eligible for forgiveness of up to \$17,500 on your Direct Loan or Federal Family Education Loan (FFEL).<sup>5</sup> There are additional ways to qualify for student loan forgiveness. StudentAid.gov is an excellent resource if you qualify for such forgiveness. Your employer may also have programs directed at paying some or all of your student loan debt.

Every dollar borrowed for education that is not required to be paid back is free money, making your college education that much cheaper. If you anticipate some portion of your loans will be forgiven, then it makes sense to borrow money to pay for your education, even if you don't need to borrow.

It may make sense to take out student loan debt to take advantage of no-interest loans until you graduate. Some schools won't even charge you interest until one year after you graduate, so definitely stay in touch with your school's financial aid department. Of course, there are opportunity costs associated with paying for college with your own money. The most obvious one could be the lost opportunity to earn a return on your investments. If you borrow at no interest until you graduate, then you can continue to earn returns on your investments while you are still in college.

This can apply to credit card debt. Given the high cost of credit card debt relative to the lower cost of student loan debt in many situations, it would make sense to pay down your credit card debt and assume student loan debt. Likewise, it may make more sense to pay off your credit card before making extra payments on your student loan debts.

It may make sense to take out student loans to take advantage of certain tax deductions. Student loan interest is tax-deductible, and can be taken as a deduction even if you do not itemize. The American opportunity tax credit (AOTC) is a credit for qualified education expenses (interest being one of them) paid for an eligible student for the first four years of higher education. A maximum annual credit of \$2,500 per eligible student is available. If the credit brings the amount of tax owed to zero, 40 percent of any remaining credit (up to \$1,000) is refunded to you.<sup>6</sup>

## 9.2 Types of Student Loans

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The Student Loan Bill of 2010 requires all federal student loans to originate directly with the government. Direct federal student loans are now arranged through each college's financial aid department. By arranging federal loans directly through each college's financial aid department, the government eliminated the middleman from the process and estimated it would save \$61 billion over 10 years.

The U.S. Department of Education provides money to students to cover education expenses under the name of the William D. Ford Federal Direct Loan (Direct Loan) Program. The William D. Ford Federal Direct Loan Program offers four types of Direct Loans:<sup>7</sup>

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<sup>4</sup> <https://www.irs.gov/credits-deductions/individuals/aotc>

<sup>5</sup> <https://www.irs.gov/credits-deductions/individuals/aotc>

<sup>6</sup> <https://www.irs.gov/credits-deductions/individuals/aotc>

<sup>7</sup> <https://studentaid.gov/understand-aid/types/loans>

### FIGURE 2: Four Types of Direct Student Loans

- Direct Subsidized Loans are need-based loans. These loan amounts are determined by your cost of attendance less expected family contribution and other financial aid (such as grants or scholarships). The benefit of subsidized loans is that they do not accrue interest while you are in school at least half-time.
- Direct Unsubsidized Loans are not need-based loans. These loan amounts are determined by your cost of attendance less expected family contribution and other financial aid (such as grants or scholarships). Interest is charged while you are in school.
- Direct PLUS Loans are loans made to graduate or professional students and parents of dependent undergraduate students to help pay for education expenses not covered by other financial aid. Eligibility is not based on financial need, so a credit check is required.
- Direct Consolidation Loans allow you to combine all of your eligible federal student loans into a single loan with a single loan servicer.

There are limits to the maximum amount undergraduate students can borrow each year in Direct Subsidized and Unsubsidized Loans. For instance, in 2021 the maximum amount ranged from \$5,500 to \$12,500 per year, depending on what year students were in school and their dependency status. There are maximum amounts graduate students can borrow as well. Those maximum amounts were capped at \$20,500 each year in Direct Unsubsidized Loans as of 2021.<sup>8</sup>

Federal student loans offer many benefits compared to other options you may consider when paying for college:

### FIGURE 3: Benefits of Federal Student Loans

- The interest rate on federal student loans is fixed and usually lower than that on private loans—and much lower than that on a credit card.
- You don't need a credit check or a cosigner to get most federal student loans.
- You don't have to begin repaying your federal student loans until after you leave college or drop below half-time.
- If you demonstrate financial need, the government pays the interest on some loan types while you are in school and during some periods after school.
- Federal student loans offer flexible repayment plans and options to postpone your loan payments if you're having trouble making payments.
- If you work in certain jobs, you may be eligible to have a portion of your federal student loans forgiven if you meet certain conditions.

To apply for a federal student loan, first complete and submit a Free Application for Federal Student Aid (FAFSA) form. Based on the results of your FAFSA form, your school will send you a financial aid offer, which may include federal student loans. The school will also indicate how to accept all or a part of the loan.

There is a wide variety of private student loan lenders, so it's hard to summarize the market in totality. However, the same principles apply to private loans as to federal student loans.

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<sup>8</sup> <https://studentaid.gov/understand-aid/types/loans>

**FIGURE 4: Terms of Private Loans**

- The time in which you will be required to begin paying back the loan
- Understanding the length of the loan
- The interest rate is changed and if interest is applied while you are in school

Private loans may have variable interest rates, require a cosigner, may not be tax-deductible, and are seldom forgiven. There are some private loans that are currently available at interest rates lower than those offered by federal loans and with extended repayment periods. Although a high credit score is required, the benefits could be substantial.

Private loans may be available for consolidation or refinancing. Federal loans are generally eligible for consolidation but not refinancing. Be careful, though, because if a federal loan and a private loan are consolidated, you could lose all the benefits of a federal loan such as flexible repayment plans and loan forgiveness.

## 9.3 Rules of Thumb On How Much to Borrow

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You should give serious thought to the amount of student loan debt you can assume. You should begin thinking about student loan debt early in the process when researching colleges and continue to give the issue serious consideration throughout the process of selecting a major and a career. Consider whether a prestigious school is worth the extra expense, or whether a major has limited marketable skills or might require additional years to complete, and whether it is worth the additional cost. If you do decide to take out student loans, be sure to understand the terms and conditions. Student loans can come from the federal government, private banks, or other organizations. You should consider all of these issues in combination to make sound decisions regarding your financial situation in college and extending through the early portion of your working adult life.

Keep track of how much you are borrowing relative to your anticipated earning power after you graduate. You do not want to be overwhelmed by student loan debt after you graduate. Research starting salaries in your intended field. Ask your school or future school you plan to attend for starting salaries of recent graduates in your field of study to get an idea of how much you are likely to earn after you graduate. You can also use the U.S. Department of Labor's Occupational Outlook Handbook or career search tool to research careers and salaries. If your loan amount and the expected payments after graduation are a substantial portion of your anticipated earnings after graduation, then you need to critically evaluate your plan to determine whether it makes sense to proceed.

It may also be tempting to borrow more than you need, and then use the excess cash that you borrow to pay for spring and summer vacations while you are still in school. However, debt often should only be used to invest in assets and activities that will yield a return. While it would be a ton of fun in theory, a vacation to Mexico likely won't yield any monetary returns, so borrow only what you need.

As a rule, try to limit borrowing to no more than what you expect your annual salary to be upon graduation. So, if you expect your annual salary will be \$45,000, then don't borrow more than \$45,000 for education. Furthermore, if you are a student, your monthly student loan payments should not exceed 10 percent of your expected monthly take-home pay once you graduate. For a parent, total debts ideally should not exceed 36 to 43 percent of gross income, which includes home mortgage, credit cards, car loans, and education loans.

There is a great calculator at NerdWallet.com that is worth reviewing.

<https://www.nerdwallet.com/article/loans/student-loans/is-college-worth-it#calc>

Using the calculator, we can make the following assumptions about starting salaries and student loan terms:

**FIGURE 5: Student Loan Affordability Example**

- An annual salary of \$55,000 a year, a reasonable assumption according to the National Association of Colleges and Employers,<sup>9</sup>
- An annual student loan interest rate of 3.73 percent, the 2021-2022 federal student loan interest rate for undergraduate direct loans, and
- A 10-year payback period.

Assuming a 33 percent federal, state, and payroll tax deduction, an annual salary of \$55,000 results in monthly take-home pay of \$3,071. Thus, the average monthly student loan debt payment should not exceed \$307. A monthly payment of \$307 with 3.73 percent rate of interest over 10 years would allow a student to borrow \$30,710.

The best point of contact for questions regarding your student loans would be the financial aid department of schools to which you are applying or already attending.

## 9.4 Determine Your Monthly Payment

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Student loans are a serious financial obligation that must be repaid even if your financial situation becomes difficult. Understand the loan terms (due dates, interest rates, and payment amounts) and keep copies of loan documents. You will be repaying the loan according to the agreed terms, regardless of the situation you find yourself in after graduation. Therefore, you will have to repay the loan even if you don't complete your education, didn't like it, or can't find a job after graduation.

Make payments on time. Like all bills, you are required to make payments on time even if you don't receive the bill, repayment notice, or a reminder. You will have to pay the full amount required by your repayment plan. Partial payments will most likely not fulfill your obligation to repay your student loan on time. Missing payments, paying late, or making partial payments will harm your credit. Conversely, paying the full amount on time will have a positive impact on your overall creditworthiness and credit score.

Your monthly student loan payment depends on three things: the amount borrowed, the interest rate, and the term. So, the higher the interest rate, the higher your monthly payment, and the fewer the years to pay back your loan, the higher the payment.

There are multiple online student loan monthly payment calculators. For instance, look at Bankrate's online student loan calculator:

<https://www.bankrate.com/calculators/college-planning/loan-calculator.aspx>.

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<sup>9</sup> <https://www.nacweb.org/job-market/compensation/starting-salary-projections-positive-for-the-class-of-2021/>

Assuming a \$20,000 student loan balance, an annual interest rate of 3.73 percent, and a 10-year payback period, the monthly payment would be \$199.93.

## A. Interest Rates

Federal student loan interest rates are set by Congress and tied to the 10-year Treasury note for academic years beginning on July 1st and ending the following June 30th. Rates are fixed for the life of the loans issued during a given academic year. For the academic year beginning July 1, 2021, and ending June 30, 2022, the rates were:

### FIGURE 6: Federal Student Loan Interest Rates

- 3.73% for undergraduate students, 5.28% for graduate students, and 6.28% for Direct PLUS Loans<sup>10</sup>
- The legislation guarantees interest rates will not exceed 8.25% for undergraduates, 9.50% for graduate students, and 10.50% for Direct Plus loans

Using the same calculator from Bankrate's website, look at what happens to the monthly payment if the interest rate jumps from 3.73 percent to 8.25 percent. Assuming a \$20,000 student loan balance, an annual interest rate of 8.25 percent, and a 10-year payback period, the monthly payment would be \$245.31.

## B. Payback Period

There are many options for paying back student loans, depending on the type of loan and the outstanding balance. For maximum flexibility and to derive the lowest monthly payment, many borrowers choose the longest payback period available. As stated above, the longer the term, the lower the monthly payments, but the more you will pay in interest over time.

For instance, let's assume the same outstanding balance of \$20,000 and an annual interest rate of 2.75 percent. Now let's assume your payback terms are 6 months, 5 years, and 10 years. What will it cost you?

### FIGURE 7: Loan Payback Cost Examples

- 6 months – 6 monthly payments of \$3,360.12 and the total interest over those 6 months would be \$160.72.
- 5 years – 60 monthly payments of \$357.16 and the total interest over those 5 years would be \$1,429.37.
- 10 years – 120 monthly payments of \$190.82 and the total interest over those 10 years would be \$2,898.65.

Paying off the loan in 10 years instead of six months results in substantially more interest, but the monthly payment will be significantly less. In the short term, extending to longer periods will lower the monthly payment. And the amount saved every month might be better used in some other fashion. Selecting a longer payback period may allow you to start saving for a down payment on a house, or contributing to a retirement plan, or paying off high-interest credit card debt. In the long term, however, you will pay somewhat more in total interest on this loan. There is no right or wrong answer, as it depends on your circumstances.

According to the Department of Education, "If your outstanding federal student loan debt is higher than your annual income or if it represents a significant portion of your annual income, you may be able to repay your federal student loans under an income-driven repayment plan." An income-driven repayment plan sets your monthly

<sup>10</sup> <https://studentaid.gov/understand-aid/types/loans/interest-rates>



student loan payment at an amount that is intended to be affordable based on your income and family size. The federal government offers four income-driven repayment plans:<sup>11</sup>

**FIGURE 8: Income Driven Repayment Plans**

- Revised Pay As You Earn Repayment – Generally, 10 percent of your discretionary income.
- Pay As You Earn Repayment Plan – Generally, 10 percent of your discretionary income, but never more than the 10-year Standard Repayment Plan amount. This plan also forgives the loan if you make the regular payments for 20 years.
- Income-Based Repayment Plan – Generally, 10 percent of your discretionary income if you're a new borrower on or after July 1, 2014, but never more than the 10-year Standard Repayment Plan amount. Generally, 15 percent of your discretionary income if you're not a new borrower on or after July 1, 2014, but never more than the 10-year Standard Repayment Plan amount.
- Income-Contingent Repayment Plan – The lesser of (1) 20 percent of your discretionary income or (2) what you would pay on a repayment plan with a fixed payment over 12 years, adjusted according to your income.

If you'd like to repay your federal student loans under an income-driven plan, you need to fill out an application.<sup>12</sup> Studentaid.gov is the best and most authoritative place to get more information about these programs. These programs do not apply to private loans.

Be careful of fraudulent student loan debt relief companies that claim to help desperate students deal with overwhelming student loans. These companies usually ask for an upfront fee by promising relief from the current program, debt consolidation, or debt forgiveness, but they tend to cash your check and then disappear. You can do all these things on your own without any cost just by contacting your lender. Always make sure that the URL is legitimate.

**FIGURE 9: If You are Unable to Make Your Payments, there are Generally Three Options**

- Forbearance – You place your monthly payments on hold for several months, but interest accrues and is added to the loan principal.
- Interest-only loans – You defer your principal payments until a later date, but continue to pay the interest.
- Increase the borrowing period – You lower your monthly payments by extending the payment period, though you will end up paying more interest as we discussed above.

**FIGURE 10: What Happens if Your Payment is Late?**

- 1 day late – You will lose any discount for paying on time.
- 21 to 30 days late – The loan becomes delinquent.
- 22 to 37 days late – You will be mailed a notice for collection.
- 60 days late – Your delinquency is reported to the major credit bureaus.
- Over 270 days late – The loan goes into default and you will be subject to possible wage garnishment and other serious penalties.

<sup>11</sup> <https://studentaid.gov/manage-loans/repayment/plans/income-driven>

<sup>12</sup> <https://studentaid.gov/manage-loans/repayment/plans/income-driven>



## 9.5 Loan Forgiveness

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In certain situations, the federal government will forgive student loans. According to the Internal Revenue Service (IRS), “Certain student loans provide that all or part of the debt incurred to attend a qualified educational institution will be canceled if the person who received the loan works for a certain period in certain professions for any of a broad class of employers.” You may be entitled to student loan forgiveness under the following circumstances:<sup>13</sup>

### FIGURE 11: Reasons for Student Loan Forgiveness

- Public Service Loan Forgiveness
- Teacher Loan Forgiveness
- Closed School Discharge
- Perkins Loan Cancellation and Discharge
- Total and Permanent Disability Discharge
- Discharge Due to Death
- Borrower Defense to Repayment
- False Certification Discharge
- Unpaid Refund Discharge
- Eligibility for Parent Borrowers in certain situations
- Total and Permanent Disabled Veterans

If you are seeking public service loan forgiveness, you should repay your federal student loans under an income-driven repayment plan. If you are not under one of these plans, the forgiven amount will become taxable income in the year of forgiveness. For example, if the government forgives a student loan balance of \$20,000, which is not covered by the program, that \$20,000 becomes taxable as ordinary income to the borrower upon which taxes are due in the year received.

For those who pursue a Ph.D. or degrees in business, law, or medicine (outside of these established plans), the forgiven amount could easily generate a large tax obligation. Generally, those who qualify for forgiveness do not have the cash to pay such taxes.

One of your best resources for additional information on federal student loans is the Student Aid website, speaking directly with your lender, and a financial aid expert.

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<sup>13</sup> <https://studentaid.gov/manage-loans/forgiveness-cancellation>

## CHAPTER 10: Managing Your Credit Score

- 10.1 Why Good Credit is Important
- 10.2 Understanding the Credit Score Process
- 10.3 FICO® Scores
- 10.4 Review and Manage Your Credit Report

### 10.1 Why Good Credit is Important

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The title to this chapter should actually be: “Consistently pay your bills on time, keep your debt-to-credit ratio near or below 30 percent, and avoid getting arrested or other character flaws.”

According to USA.gov, credit reports list your bill payment history, loans, current debt, and other financial information. They show where you work and live, and whether you've been sued, arrested, or filed for bankruptcy.<sup>1</sup> Nearly every financial decision you make shows up on your credit report.

Credit reports allow lenders to decide if they'll extend you credit or a loan. The reports also help determine what interest rates they may charge you. Employers, insurers, and property owners may also look at your credit report for various reasons. About 50 percent of employers currently run credit checks as part of their hiring process. The employer, however, must have your written permission to do so. If you believe there to be an issue with your credit score or in the information listed therein, it's wise to address those issues with your potential employer upfront.

You can think of your credit report as your financial report card. It essentially tells lenders whether you make your required payments on time. Obviously, the better you are at managing your credit, the better your credit score. And obviously, the better your credit score, the more likely creditors will lend to you. Maybe not so obvious, the better your credit score, the more likely lenders will extend you better credit terms (i.e., better interest rates). The lower the interest rate, the lower the monthly payments and the lower the total cost of the loan.

For instance, let's imagine you're going to take out a \$20,000 car loan, which you intend to pay off over five years, to buy a used car.<sup>2</sup> Take a look at how the interest rate, your monthly payment, and the total cost of the car increase as your credit score declines.

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<sup>1</sup> <https://www.usa.gov/credit-reports>

<sup>2</sup> Interest rates on used car loans by credit score: <https://www.carsdirect.com/auto-loans/what-is-the-average-interest-rate-for-a-car-loan-with-bad-credit>

**FIGURE 1: How Your Credit Score Can Impact a Loan**

| Credit Score | Car Price | Average Used Car Loan Interest Rate | Monthly Payment | Total Cost |
|--------------|-----------|-------------------------------------|-----------------|------------|
| 781-850      | \$20,000  | 3.80%                               | \$367           | \$21,992   |
| 661-780      | \$20,000  | 5.59%                               | \$383           | \$22,971   |
| 601-660      | \$20,000  | 10.13%                              | \$426           | \$25,573   |
| 501-600      | \$20,000  | 16.56%                              | \$492           | \$29,540   |
| 300-500      | \$20,000  | 20.30%                              | \$533           | \$31,993   |

As can be seen in the example above, the difference between the best credit and the worst credit can be dramatic. In fact, based on the example above, the worst credit score can increase the total cost of the car by more than \$10,000, and the car is only worth \$20,000 to begin with. In isolation it seems innocent enough to miss the due dates on bills. But missed payments, late payments, and too much debt can all come back to haunt you. And a terrible credit score is totally avoidable by simply making good decisions. While paying bills on time is obviously an example of a good decision, there is more to it when it comes to your credit score.

## 10.2 Understanding the Credit Score Process

There are three major agencies that report your credit history and score:

**FIGURE 2: Credit Reporting Agencies**

- Transunion (Empirica score)
- Equifax (Beacon score)
- Experian (Experian model)

Each credit reporting agency manages their own records and, as such, might not have the same information about your accounts. Even though there may be differences between the reports, no one agency is more important than another. Still, the information must be accurate.

Your credit report will show the loans and credit as well as those from the previous 7-10 years even if they have been closed. For each account listed in a credit report, the report will show the account number, balance, credit limit, monthly payment, past due amounts, and late payments. All loans will be included, such as any student loans, rents and mortgages, credit cards, and charge cards. Credit usage, monthly payment records, delinquencies, and items turned over for collection, as well as checking and savings accounts, will all be reported.

A credit report will show the number of accounts applied for recently, as well as the number of recent requests. It will also include employment history, lawsuits, judgments, arrests, DUIs, bankruptcies, and records of credit reports over the previous 7-10 years. It might even include some things you may consider minor, like library fines and parking tickets, and even the frequency of address changes.

Voluntary, or “hard,” credit inquiries are those authorized by you so that a lender, landlord, employer, etc. can legally access your credit report. These hard credit checks remain on your report for up to two years. Involuntary, or “soft,” credit checks, which usually come from lenders interested in soliciting you by mail for a preapproved credit offer,

have no bearing on your score.

## 10.3 FICO Scores

A FICO score is a three-digit score used by lenders to determine whether to extend credit or not. A FICO score is a credit score system created by the Fair Isaac Corporation (FICO). It helps lenders determine how likely someone is to repay a loan. Thus, a FICO score will dictate how much can be borrowed, for how long, and how much it will cost (the interest rate). The more often someone is delinquent in paying off their debt, the lower the score, and therefore the less likely they are to get a good deal, or any deal at all. The following table presents delinquency rates and the corresponding FICO score.

**FIGURE 3: Credit Score and Delinquency Rates**

| Credit Score | Delinquency Rate (%) |
|--------------|----------------------|
| 800-850      | 1%                   |
| 750-799      | 2%                   |
| 700-749      | 5%                   |
| 650-699      | 15%                  |
| 600-649      | 31%                  |
| 550-599      | 51%                  |
| 500-549      | 71%                  |
| 300-499      | 87%                  |

Creditors constantly report your financial activity to the credit agencies. However, the same information may not be sent to all three agencies, so it's not unusual to have slightly different FICO scores. Likewise, credit scores can change daily as creditors submit new information regarding their business with you.

The minimum scoring criteria can be satisfied by a single account or by multiple accounts in a credit report. In order to receive a valid FICO score, your credit report must include:<sup>3</sup>

**FIGURE 4: Credit Report Must Include Three Elements**

- At least one account that has been opened for six months or more,
- At least one account that has been reported to one of the credit agencies within six months, and
- No indication of a deceased individual on the credit report (If you share an account with another person and that person is deceased, then this may affect you).

FICO scores are calculated using many different categories of credit data contained in your credit report. This data is grouped into five categories: payment history, amounts owed, length of credit history, credit mix, and new credit, as shown in the following figure:<sup>4</sup>

<sup>3</sup> <https://www.myfico.com/credit-education/faq/scores/fico-score-requirements>

<sup>4</sup> <https://www.myfico.com/credit-education/whats-in-your-credit-score>

**FIGURE 5: Components of a Credit Score**

| Category                 | Weight |
|--------------------------|--------|
| Payment History          | 35%    |
| Amounts Owed             | 30%    |
| Length of Credit History | 15%    |
| Credit Mix               | 10%    |
| New Credit               | 10%    |

The importance of these categories can be different across individuals. For example, according to myFICO.com, scores for individuals who have not been using credit long will be calculated differently than those with a longer credit history.<sup>5</sup> Likewise, as you would expect, as the information in a credit report changes, so does the evaluation of these factors.

Credit reports and FICO scores evolve over time as your credit history evolves. The number of outstanding accounts changes over time, the balances change, and the delinquency rate may change. Because of this, it's not reasonably possible to measure the impact of a single change in a credit report on a corresponding FICO score. However, it is important to note that paying your outstanding balance each month will not hurt your credit score.

### **A. Payment History (35%)**

According to myFICO.com, the first thing any lender will want to know is whether you pay on time. Lenders use this information to measure the risk of extending credit to you. This is the most important factor in a FICO Score. As such, it's imperative to keep accounts in good standing to establish good credit.<sup>6</sup> This means PAY ON TIME! Some argue to always mail payments at least five days before the due date or pay online at least two days before the due date.

### **B. Amounts Owed (30%)**

Open accounts with outstanding balances do not necessarily mean you are a high-risk borrower. However, lenders will look at open accounts and amounts owned relative to available credit to determine whether you are overextended. If lenders conclude you are overextended, they may decide that you are at a higher risk of defaulting.<sup>7</sup>

The goal should be to stay below a 50 percent debt-to-credit ratio on each credit card, meaning that any outstanding balance should be no greater than 50 percent of the maximum amount owed. A 30 percent ratio is best for higher scores. If you are over the 30 percent or 50 percent thresholds, pay down your debts or call your lenders to increase your credit limits.

Medical bills do not show up in credit reports as long as they are paid. Additionally, most health care providers do

<sup>5</sup> <https://www.myfico.com/credit-education/whats-in-your-credit-score>

<sup>6</sup> <https://www.myfico.com/credit-education/whats-in-your-credit-score>

<sup>7</sup> <https://www.myfico.com/credit-education/whats-in-your-credit-score>

not report to credit bureaus, so a debt would have to be sold to a collection agency before appearing in a credit report.<sup>8</sup> Even then, medical debt won't immediately show up on a credit report. The credit bureaus will allow 180 days to resolve any unpaid medical debt before the collection account appears in a report.<sup>9</sup>

The circumstances surrounding medical bills are quite different than more traditional types of debt. Even if medical insurance covers certain expenses, it may take months for the insurance company to pay the health care provider. The 180-day grace period allows time to correct errors and/or gives the insurance company time to pay.<sup>10</sup>

### C. Length of Credit History (15%)

Longer credit history will lead to higher FICO scores, all else being equal. However, a long credit history may not be required to establish good credit, depending on the rest of a credit report. Lenders will look at how long credit accounts have been established, the age of the newest account and the average age of all accounts.<sup>11</sup>

If you want to increase your average age on all accounts, you can cancel newer cards first. However, canceling a card may increase your overall debt-to-credit ratio, so before you cancel a newer card, be sure your remaining cards result in the desired debt-to-credit ratios.

### D. Credit Mix (10%)

Your credit score depends on the mix of credit cards, retail accounts, installment loans, finance company accounts, and mortgage loans. For example, an individual with several credit cards paying all the minimum balances on time but no installment loans would probably have a lower credit score than an individual with one credit card paying the minimums, and a home mortgage and car loan with no late payments.

It's also not necessary to have one of each, but it helps to have a mix.<sup>12</sup>

### E. New Credit (10%)

Research shows that opening several credit accounts in a short amount of time represents a greater risk—especially for people who don't have a long credit history. If you can avoid it, try not to open too many accounts too rapidly.

For a higher credit score, do not apply for a lot of new credit cards at once. Each application results in a hard inquiry. Creditors view several inquiries for a car loan or a mortgage as a single event, the assumption being that you are looking for the best deal. However, multiple inquiries for credit cards might indicate financial distress and could negatively impact your score. According to [www.myfico.com](http://www.myfico.com), people with several such inquiries have a greater risk of declaring bankruptcy.<sup>13</sup>

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<sup>8</sup> <https://www.experian.com/blogs/ask-experian/medical-debt-and-your-credit-score/#:~:text=Medical%20bills%20will%20not%20affect,appearing%20on%20your%20credit%20report>.

<sup>9</sup> <https://www.experian.com/blogs/ask-experian/medical-debt-and-your-credit-score/#:~:text=Medical%20bills%20will%20not%20affect,appearing%20on%20your%20credit%20report>.

<sup>10</sup> <https://www.experian.com/blogs/ask-experian/medical-debt-and-your-credit-score/#:~:text=Medical%20bills%20will%20not%20affect,appearing%20on%20your%20credit%20report>.

<sup>11</sup> <https://www.myfico.com/credit-education/whats-in-your-credit-score>

<sup>12</sup> <https://www.myfico.com/credit-education/whats-in-your-credit-score>

<sup>13</sup> <https://www.myfico.com/credit-education/whats-in-your-credit-score>

Credit scores are based on all the above criteria. Each financial institution or creditor views credit scores differently, but a generally accepted interpretation of credit scores is as follows:

**FIGURE 6: Fico Score Interpretations**

| <b>FICO Score</b> | <b>Interpretation</b> |
|-------------------|-----------------------|
| 780-850           | Best                  |
| 720-779           | Good                  |
| 661-719           | Ok                    |
| 620-660           | Subprime              |
| 560-619           | Bad                   |
| 500-559           | Worst                 |
| 300-499           | Toxic                 |

FICO score simulators available online can help you understand how future behavior may change your score. They can be helpful at times by showing what bills or loans should be paid first to have the most beneficial impact on your credit score.

Sometimes lenders, landlords, employers, or other creditors will get different FICO scores for you than you would when reviewing your own credit report, since these creditors may be more interested in certain aspects of your credit history than others. They may be interested in the way in which how you handle specific areas like rent and utilities as opposed to credit card debt or types of payments in calculating your score. Some lenders may even look more carefully at where you spend your money. They may pay closer attention to your charges at bars and pawn shops or places that raise risk, such as tire retreading companies.

## 10.4 Review and Manage Your Credit Report

Credit reports are used to generate credit scores. A credit score is the result of a mathematical formula based on the data included in a credit report. Items in a credit report can be disputed, such as a closed account or an account that doesn't belong, but the generated credit score cannot be disputed. So, in order to manage or change your credit score, you need to manage your credit report.

Everyone is legally entitled to one free copy of their credit report per year from each of the three major credit reporting agencies. This means you can legally check your credit report three times a year for free, or once every four months. There is only one federally mandated website for free credit reports: [www.annualcreditreport.com](http://www.annualcreditreport.com). There are others out there, but they typically charge you a fee to provide credit-watching services on your behalf. Even if the service is free, they typically sell your personal information to make money. In some instances, they may be criminals looking to use your information to open accounts in your name, so be aware.

While making these reports available is helpful, there are now firms that will enable you to get free credit reports and scores as frequently as you wish. This includes customers of certain financial institutions, along with independent websites such as [creditkarma.com](http://creditkarma.com), [credit.com](http://credit.com), and [mint.com](http://mint.com). They are free as long as you are willing to view some ads and have your personal information sold to advertisers, and they can provide you with valuable information.

So, if you are concerned about your creditworthiness, or planning to buy a car or a house, you can see it is possible



to get this information, plan ahead, and put a shine on your credit report.

### **A. Review Your Credit Report for Accuracy**

Approximately 25 percent of the total credit reports in existence include some type of error or list old accounts, so you should make it a habit to review your credit report for accuracy. Sometimes people will apply for credit under different spellings of their name, like Steve, Steven or Stephen. Make sure that no other individual with a similar name to yours applied for credit and that credit application mistakenly ended up on your credit report. You may also want to check for an error with the Social Security number or some other clerical error. You may also want to check to ensure payments or changes were reported for the correct account. Finally, check to ensure that previously closed accounts from past years are removed from your credit report.

To correct an error, contact the business that reported the problem or the credit bureau reporting the incorrect information. Sometimes once an unflattering item has been resolved you can ask the company and/or the credit bureau to have the item removed. It's worth a try, and the standard persuasive advice applies: Be nice, don't argue, don't use profanity, and always call more than once.

### **B. Review Your Credit Report for Identity Theft**

According to USA.gov, identity theft occurs when someone steals your personal information to commit fraud. Thieves may use your information to apply for credit, file taxes, or get medical services. Unfortunately, these acts can damage your credit report and score, and cost you time and money to restore your good standing.<sup>14</sup> Typically, identity theft begins when someone steals your Social Security number, password, credit card number, bank account number, or any other information that can be used to open accounts in your name and make purchases.

There are a number of ways thieves gain access to personal information. They can outright steal or come across a lost backpack, wallet, or purse. They can dig through the trash, steal from a mailbox, or forward mail to another address or post office (P.O.) box. Other methods can include "phishing" via email, text, or over the phone with fake messages, sometimes encouraging you to validate or update your personal information. I have had students tell me horror stories about their roommates stealing their identity. Your roommate already has access to a ton of your personal information, and getting just a bit more to open an account is typically easy, so identity theft can even occur right under your own roof.

As a general and OBVIOUS rule, don't give your social security number or other information to a stranger. Do not respond to phone calls or emails from the Internal Revenue Service (IRS).

If the IRS is going to contact you, they will do so only by mail and they will have your Social Security number already. A dead giveaway you are being scammed is if the IRS asks you for your Social Security number. I mean come on, didn't they give you your Social Security number in the first place? We have a real problem if the IRS or the U.S. government can't find your Social Security number in their own files.

USA.gov also has a great list of things to do to prevent identity theft:<sup>15</sup>

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<sup>14</sup> <https://www.usa.gov/identity-theft>

<sup>15</sup> <https://www.usa.gov/identity-theft>

- Secure your Social Security number (SSN). Don't carry your Social Security card in your wallet. Only give out your SSN when necessary.
- Don't share personal information (birthdate, SSN, or bank account number) because someone asks for it.
- Collect mail every day. Place a hold on your mail when you are away from home for several days.
- Pay attention to your billing cycles. If bills or financial statements are late, contact the sender.
- Use the security features on your mobile phone.
- Update sharing and firewall settings when you're on a public wi-fi network. Use a virtual private network (VPN), if you use public wi-fi.
- Review your credit card and bank account statements. Compare receipts with account statements. Watch for unauthorized transactions.
- Shred receipts, credit offers, account statements, and expired credit cards. This can prevent “dumpster divers” from getting your personal information.
- Store personal information in a safe place.
- Install firewalls and virus-detection software on your home computer.
- Create complex passwords that identity thieves cannot guess and store them in a password manager app. Change your passwords if a company that you do business with has a breach of its databases.
- Review your credit reports once a year. Be certain that they don't include accounts that you have not opened. You can order it for free from [Annualcreditreport.com](http://Annualcreditreport.com).
- Freeze your credit files with Equifax, Experian, Innovis, TransUnion, and the National Consumer Telecommunications and Utilities Exchange for free. Credit freezes prevent someone from applying for and getting approval for a credit account or utility services in your name.

This last approach (“security freeze”) is of particular note given the large-scale hacking of business and governmental data centers. Thieves may try to open new credit accounts in your name with stolen information. A security freeze denies access to credit information, so that a potential new creditor cannot access your information in order to approve the request. With a credit freeze in place, only certain entities can access your credit report. These entities include existing creditors and any companies you specifically authorize to monitor your credit reports.

Immediately contact the three major credit bureaus if your identity has been stolen. Have them place a “fraud alert” on your account, which requires all creditors to contact you directly before granting any new credit. Close all of your accounts as soon as possible and then reopen new accounts. The goal should be all accounts like Amazon and Netflix, and not just bank and credit card accounts. You will want to contact all of your creditors and file a report with the police. It's also a good idea to keep records of who you contacted and when.

## CHAPTER 11: Credit Cards

- 11.1 Credit Cards Should be Used to Establish Credit
- 11.2 Credit Cards Should Not be Used to Buy Things You Cannot Afford
- 11.3 Things to Consider When Applying for a Credit Card
- 11.4 Why You Should Pay Off Your Credit Card Debt as Quickly as Possible
- 11.5 Make Every Effort to Reduce and Eliminate Your Credit Card Debt as Soon as Possible
- 11.6 Other “Types” of Credit Cards

### 11.1 Credits Cards Should be Used to Establish Credit

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There are obvious benefits to having good credit. Landlords may consider established credit when deciding whether to rent an apartment or home to a potential tenant. A car dealership will consider it when determining whether to offer a car loan and at what interest rate. Banks definitely consider established credit when deciding how much money to lend a customer to buy a home. The list of reasons to maintain good credit goes on.

To establish good credit, borrow money and pay it back according to the terms and conditions of the lending agreement. There are various ways for young people to establish good credit that we explore in Chapter 10, but in this chapter I want to focus on credit cards, since they are so often misused. I understand that credit cards provide an opportunity to establish good credit; however, if you are not careful, they can do more harm than good. So I think it makes sense to talk about both the benefits and risks associated with credit cards.

Generally, you must be at least 18 years old in order to apply for a credit card. However, if you are not yet 21 and have no credit history or have a less-than-ideal credit history, most credit card issuers will require proof that you can independently pay your bills. One way to establish credit between the ages of 18 and 21, under these circumstances, is to become a joint credit card account holder with a parent. Both joint holders of the credit card (parent and child) are equally responsible for making payments. A joint account holder is different than an authorized user. An authorized user simply allows someone other than the account holder to use a credit card, and under this arrangement the child does not establish credit.

A credit card is an unsecured line of credit, meaning the lender has no collateral. This is different from a home loan or car loan, where the lender can repossess the house or car if the borrower doesn't pay. This makes credit card debt more difficult to collect even if the account is turned over to a collection agency. So, when the credit card bill comes in, it's important to pay at least the minimum amount by the due date to establish good credit with that credit card.

If you are unable to make the minimum monthly payments, the credit card company will report these missed payments to the credit reporting agencies and, just like that, your credit is damaged. Other than suing for payment, this is the only real recourse they have, so they are going to use it. And these reports are accessed by other potential lenders, creditors, landlords, employers, etc. However, since these creditors have access to your credit reports, you can build your credit by abiding by the terms and conditions of the credit card agreements.

Again, the main benefit of the card is to establish good credit and not to buy things you can't afford. So the goal is to make purchases using a credit card that you normally would make with cash during the month, and then pay the entire balance due at the end of the month. Nothing more. Credit card companies generally are looking out for their best interests, so you must take personal responsibility and be aware of the risks. However, knowing those risks and using the credit the right way to establish credit can work in your favor.

Another potential advantage to having a credit card has to do with certain types of purchases. Sometimes you need to provide a credit card to check into a hotel or to rent a car. Hotels and rental car companies may place a "hold" on your credit card account to cover any damage or other purchases. It is only after check out or returning the car that the hold on your card will be released. You can do these with your debit card; however, if you do not have sufficient funds to cover the hold amount, sometimes the hotel or car rental agency will decline your business.

Yet another possible benefit to having a credit card relates to the cash back reward programs some cards offer. I have students who use certain cards for gas and groceries to take advantage of the cash back rewards for using the card in those situations. One particular student allows his significant other and daughter to use the same card for gas and grocery purchases. Collectively, the three of them make their gas and grocery purchases with the credit card, and then they pay the outstanding balance in full at the end of each month. By doing this, my student has received \$150 in cash back rewards each month over a six-month period. This is a smart plan, but it requires discipline to pay the outstanding balance each month.

## **11.2 Credit Cards Should Not Be Used to Buy Things You Can't Afford**

It's a lot easier than you think to dig a financial hole early in life. And once in that hole, it's difficult to get out. Simply not saving puts you behind the eight ball, but overspending, buying without thought, and doing so on a credit card is the real danger, especially while in college. It's easy to miss a payment, forget to pay on time, or make partial payments when you are in college. So not only do you subject yourself to expensive debt, you are also likely to damage your credit in the process.

According to Sallie Mae, the average recent college graduate has approximately \$2,351 in credit card debt.<sup>1</sup> It's easy to go from \$0 to \$2,351 without trying really hard – a few dinners here and there, books, maybe a spring break or summer trip, a few nights out on the town, a graduation party, etc.

Unfortunately, most individuals do not pay off that debt after college. According to a few sources, the average credit card debt for families in the U.S. was \$6,270 in 2021.<sup>2</sup> Many recent college grads don't pay their credit card balances. In fact, they often keep spending more than they have, even after college.

Access to credit cards is overwhelmingly high. It seems anywhere you turn you can fill out a credit card application and have the card in your wallet before you know it. The incentives to fill out the applications include low introductory rates and the opportunity to earn points on your credit purchases, to name only a couple. It's incredibly easy to convince yourself it's fine to put things on your credit card. Everyone does it, and access is so easy that surely it must be OK, right? Wrong!

There are benefits to having access to credit, and even credit cards. But spending more than you have and running up a balance on a credit card that you do not pay off in full at the end of the month is not one of them. Nor is

<sup>1</sup> [https://wallethub.com/answers/cc/average-credit-card-debt-for-college-students-2140670817/#:~:text=The%20average%20credit%20card%20debt,twice%20as%20much%20\(%242%2C351\)](https://wallethub.com/answers/cc/average-credit-card-debt-for-college-students-2140670817/#:~:text=The%20average%20credit%20card%20debt,twice%20as%20much%20(%242%2C351))

<sup>2</sup> <https://www.valuepenguin.com/average-credit-card-debt>

borrowing money to support a lifestyle beyond your means or shopping to boost your mood on a bad day. These are all clearly bad reasons to go into debt.

Compounding works wonders when saving for retirement, but the problem with credit card debt is that compounding doesn't work in your favor. It works against you when you borrow money. For instance, let's assume the following:

**FIGURE 1: Credit Card Debt Assumptions**

- \$6,270 credit card balance
- 18% credit card interest rate
- Monthly minimum payment is the lower of (1) 2% of outstanding balance or (2) \$25
- See, <https://www.bankrate.com/calculators/credit-cards/credit-card-minimum-payment.aspx>

Under these assumptions, making only the minimum payment each month, it would cost you approximately \$22,000 and take you almost 34 years to pay off your credit card debt. This is precisely what Albert Einstein was getting at when he said, "He who understands it, earns it ... he who doesn't ... pays it."

In addition to the interest on outstanding credit card balances, if you miss a payment or pay late, you will be subject to late fees and penalties. According to The Balance, "Most credit cards determine the fee based on how often you have let your account become past due. But some credit cards have tiered late fees based on your credit card balance. For example, if your balance is less than \$1,000, your late fee might be \$10, but if it's between \$1,000 and \$2,000, it might be \$20, and if it's more than that, \$25."<sup>3</sup> Late penalties will lower your credit score, which will in turn likely increase the interest other lenders will charge you on the "good" sources of debt. If your late fees and penalties increase your outstanding balance from one month to the next, you may be subject to interest on those fees.

There can be a litany of other charges, fees and penalties that make credit even more expensive and problematic. These can include:

**FIGURE 2: Credit Card Fees and Penalties**

- Annual membership fees
- ATM fees – fees can be as high as five percent per transaction with a minimum charge when using another bank's ATM machine
- Foreign exchange fees of between three and five percent when using your card in other countries
- Overdraft fees
- Duplicate card fees for lost cards
- Cash advance fees
- Balance transfer fees of between two and five percent

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<sup>3</sup> <https://www.thebalance.com/what-is-a-late-fee-960701>

## 11.3 Things to Consider When Applying For a Credit Card

When you are filling out a credit card application, it's important to read the agreement to understand the terms. They may seem long and confusing, but that is no excuse to not read them. You should at least understand the important terms like the maximum amount you can borrow, the interest rates being offered, how the minimum payments will be determined, whether there are any grace periods, and if there are, how they work. The key terms are often summarized at the beginning of the credit card agreement.

### A. Interest Rates

Interest is the money credit card companies charge for the privilege of borrowing their money. It's most commonly presented as an annual percentage rate (APR). So, if you owe \$1,000 and your APR is 18 percent, your monthly interest charge will be approximately \$15, calculated as follows:  $\$1,000 \times 18\% / 12 \text{ months} = \$15$ . The monthly interest amount will actually be slightly higher because this calculation ignores the daily compounding that occurs with credit cards. The bottom line is that the interest rate determines how much it costs to borrow money using a credit card. The higher the APR, the more expensive the interest charge.

Some credit card companies will offer low introductory APRs to entice you into applying for their card and then will raise the APR after the introductory period. There can be no interest rate increase for the first 12 months of your account unless an introductory rate comes to an end. However, if you are more than 60 days late with a payment, the interest rate can be raised to the default rate, which is typically 28 to 35 percent. The original rate won't likely be restored until you make payments on time for at least six months. So when comparing credit cards, be sure to focus on the "normal" APR rather than just the introductory rate. While you shouldn't carry a balance and subject yourself to this interest, it is important to know both rates just in case you are forced to carry a balance on the account. Also, if you decide to carry a balance, your credit card company may charge different rates for different types of uses, such as those related to purchases, cash advances, balance transfers, or convenience checks.

Some companies will also increase the APR if you pay late or miss payments. So be sure to also check these "penalty" rates and make it a point to pay on time to avoid these unnecessary charges. On the other hand, you should expect your interest rates to come down as you pay on time over time.

### B. Minimum Payment

In addition to knowing the APR, you should also know how your credit card company will set the minimum payment each month. Typically, it's the greater of (1) 2.5 to 3 percent of the outstanding balance or (2) a flat rate like \$25.

If you owe \$1,000 and your minimum payment was the greater of (1) 3 percent of the outstanding balance or (2) a flat rate of \$25, your payment would be calculated as follows:

#### FIGURE 3: Minimum Monthly Payment Example

1.  $\$1,000 \times 3\% = \$30$ , or
2. \$25



In the above example, the minimum monthly payment would be \$30, since \$30 is greater than the flat fee of \$25. And it would likely take you forever to reduce your outstanding balance down to \$0 making the minimum payment every month. The monthly statement will show how many months it will take to pay your balance down to \$0, along with the total you will pay in principal and interest over that time making only the minimum payment. Your statement will also show the monthly payment required to pay the entire balance in 36 months.

Again, as a general rule, don't carry a credit card balance month to month. If you do, don't pay just the minimum monthly payment each month. And always make sure the payment is made on time. The payment due date should be the same day each month, so paying on time should be routine. I have made a habit to pay bills the day they come in. That way they don't sit around past the due date by mistake. Some issuers will adjust the due date so that it coincides with pay days or another preferred day of the month if you ask. To ensure that your payment is on time, pay two days before the due date if paying online. If making a payment over the phone, you may be charged a convenience fee, so it is best to avoid this "convenience" and pay online.

Interest is not charged between the statement closing date and the due date. Therefore, if the balance is paid in full by the due date, no interest will be charged. The card issuer has essentially loaned you money for free during that period of time. Unfortunately, this only applies to purchases and NOT to cash advances or the use of convenience checks.

If you carry an outstanding balance from one month to another, you end up losing your grace period. At that point, you pay interest on all outstanding amounts back to the purchase date and on all subsequent purchases.

### C. Other Fees

Don't use "convenience checks" that connect to your credit card account. You can lose your grace period and there is a minimum charge, and generally a high interest rate.

Likewise, don't use your credit card to get cash advances, except in an emergency. Credit card companies typically charge a fee of between three and four percent.

Never agree to overdraft fees, because unless you agree to allow them, credit card companies cannot charge them. Overdraft and late payment fees are added to your balance, which will increase your overall interest charges.

Credit card companies can't charge fees, including activation, annual, and other specified fees greater than 25 percent of the credit limit during the first year. So if your credit card limit is \$1,000, your first-year fees can't exceed \$250. There is no limit on fees after that.



## 11.4 Why You Should Pay Off Your Credit Card Debt as Quickly as Possible

While saving and investing is the number one goal for retirement, most advisors will tell you to pay off your credit card debt before doing anything else. Credit cards have their benefits, but they can seriously damage your credit if you miss payments or pay late. So, from a financial point of view, it's better to never carry a balance. If you have an outstanding balance, pay it off as soon as possible.

Credit card companies generally charge high interest, more in fact than what you can typically earn from available investments. So if you are carrying a balance on your credit card, even though you could begin saving and investing, you will typically lose ground to the interest charges on your credit card balances relative to the gains you would make investing.

Assume you have \$1,000 in credit card debt that has an 18 percent annual interest rate. Let's also assume you have \$1,000 that you could place into an investment opportunity that would yield an eight percent annual return. Ignoring daily compounding and minimum monthly payments, your credit card would charge you \$180 in interest and your investment would only yield \$80 in income. Therefore, at the end of the year you would be down \$100.

**FIGURE 4: Why You Should Pay Off Credit Card Before Investing**

|               | Credit Card | Investment |
|---------------|-------------|------------|
| Principal     | \$1,000     | \$1,000    |
| Interest Rate | 18%         | 8%         |
| Interest      | \$180       | \$80       |

This is an oversimplified example, but it still illustrates the point. You move backwards financially while carrying credit card debt. And if the goal is to move forward, in this situation it makes sense to pay off the credit card to avoid the \$180 in interest charges. While you haven't saved, you also didn't lose ground.

All debt is not bad. There are a number of instances in which it makes sense to borrow money. Generally, it's good to borrow to purchase a car, buy a house, pay for college, or start a well-thought-out business. You can think of these as investments in you. Maybe the car isn't an investment, but it can provide mobility, which for many of us is a basic need. This doesn't mean it's OK to run out and buy a Lamborghini as soon as you graduate from college. However, most would say it's acceptable to borrow in order to pay for something that is an investment in you, since it can set you on a path to financial independence. It could be a school loan to transition to a better line of work or help you run your own business; a new house to provide security for you and your family; a better job or your own business; a car to get to work; or real estate ownership. "Bad debt" is borrowing for nothing more than total consumption.

If it's ok to borrow in some situations, is it better to pay off that "good debt" or invest in retirement savings? For instance, does it make sense to pay off your car loan or student loans before you begin saving for retirement? Or does it make sense to pay down your mortgage before investing? Does it make more sense to save for a house or for retirement?

There are competing views on the answers to all of these questions. Some would suggest it's better to save for a

down payment on a house before you begin saving for retirement. Some would say it's better to pay down your debt rather than to save for retirement. Some might even say it does not have to be all or nothing in response to these questions.

In fairness, the answers to these questions will vary depending on your own set of goals and priorities. I have plenty of friends who do not like the idea of having a house payment and are therefore aggressively paying down their mortgages. I, on the other hand, don't mind the mortgage on my house, so I continue to save for retirement. We are all different and have our own set of priorities.

What has helped me over the years is going back to the interest rate analysis I presented earlier with the credit card vs. saving decision. We can apply the same analysis to the difference between paying off your mortgage (or some other loan) as opposed to saving for retirement. Assume that the after-tax interest rate on your mortgage is four percent and you can earn eight percent in your retirement investments.

**FIGURE 5: Why You Don't Necessarily Need to Pay Off Your Home Loan Before Investing**

|               | Home Loan | Investment |
|---------------|-----------|------------|
| Principal     | \$1,000   | \$1,000    |
| Interest Rate | 4%        | 8%         |
| Interest      | \$40      | \$80       |

Having \$1,000 to apply to one or the other, in this particular example, it looks like it would make more sense to invest your \$1,000, because you would be up by \$40 (\$80-\$40) at the end of the day. This is the rule I generally use to determine where to spend my money.

There are liquidity issues to consider, tax implications, and personal thoughts on debt and money set aside for retirement. Thus, there is no right answer here other than to pay off the credit cards. Stay informed, think about the various returns you can earn, speak to as many people as you think necessary, and then make your decision and don't second guess yourself.

## 11.5 Make Every Effort to Reduce and Eliminate Your Credit Card Debt as Soon as Possible

If you charge on your credit card, you should know in advance how you are going to pay those charges back. Because until you pay off the outstanding balance, your credit card company is going to charge you quite a bit in interest, services fees and penalties. How can you enjoy life if you are beholden to someone or something else?

So, if you have any outstanding credit card debt, the goal should be to pay it down as quickly as possible. As obvious as it may seem, that starts by no longer using the card until the balance reaches \$0. Until then, if you need something, save first and only buy with cash. Take an extra job if need be. Any time you get a gift for a special occasion, a bonus from work, or you find money you didn't know you had, pay down your credit card balances rather than spending that money.

If you have multiple credit cards, make the minimum payment on all cards and then pay more on the card with the highest rate of interest. It might seem like a good idea to pay down a card with the lowest balance, but remember the interest rate analysis we discussed previously. Reduce the highest interest rate cards first. Consider selling

some of your possessions.

Call and ask your credit card company for better terms and conditions. It does not hurt to ask. Also, if your various cards have different interest rates and available balances, try and move high rate balances to lower rate cards. This will result in lower interest charges. And the lower the interest, the more your payment is applied to the carrying amount.

## **11.6 Other “Types” of Credit Cards**

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### **A Charge Card**

Retailers issue charge cards in order to allow you to charge purchases made only in their stores. Retailers will offer you discounts at the register on all purchases made that day in the store to encourage you to open an account. These discounts typically range between 10 and 20 percent.

Store charge cards come with high APRs, typically 20 to 30 percent on unpaid balances, and many of these charge cards have no grace period, so interest begins on the date of purchase. If you want a discount on your purchases, you may be better off asking for the “friends and family” discount.

### **B. Prepaid Card**

Prepaid cards are offered by banks and nonbanks but are not linked to a bank account. Prepaid cards provide some individuals without bank accounts the ability to carry “cash” in a more secure manner. And as usual, banks have found ways to earn significant fees related to activation fees, inactivity fees, fees to load more money, check the balance, etc. If you lose a prepaid card, the “cash” is likely gone for good.

## CHAPTER 12: Purchasing a Car

**12.1** Selecting the Right Car

**12.2** Affording the Right Car

**12.3** When to Visit the Dealership

**12.4** Negotiate the Price of the Car and Not the Monthly Payment, Down Payment or Trade-in-Value

**12.5** Leasing a Car

Buying a car is one of my least favorite things to do in life. Don't get me wrong, a new car is a nice thing, even when it's a new used car. But I hate the idea of finding the right car, visiting a dealership, dealing with salespeople, dealing with the finance department, and then having to make monthly payments. So I usually drag my feet until there is no other option left than to buy a car.

As long as my car is reliable, I don't feel a need to get a new one. Most cars these days can easily be driven for 200,000 miles. The way I see it, as long as the maintenance cost on my current car is less than the monthly payments on a new car, why get a new car? I would rather save and invest or go on vacation than sign up for more hefty car payments.

However, all good things eventually come to an end. The repair bills get to be too much as the car gets older. Eventually, the timing belt, transmission and/or other big-ticket items need to be replaced. Your lifestyle can change and you may need to trade in the convertible for a minivan. Your job may change or require you to travel more and you may need to drive a more reliable car.

At some point, you will be faced with having to decide whether to buy or lease a vehicle.

### 12.1 Selecting the Right Car

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Since everyone's taste in cars is different, there isn't a go-to car for everyone. To begin a search for a car, take note of the make, model and color of cars that appeal to you. Compare new car models to used models. Sometimes, it may be difficult to tell them apart if the used car is only a few years older than the new model. Compare the luxury brands with the economy brands. The difference may not be something that matters to you. For example, a Camry is similar in many ways to a Lexus, and also manufactured by Toyota, but priced much lower. Maybe the same is true between an Audi and a Volkswagen.

Compare prices between the different Internet sites dedicated to new and used car sales. Try sites like Carvana, CarMax, Shift, Vroom, Autotrader, and Craigslist.

According to Allstate, before buying or leasing a used car, be sure to inspect the exterior and interior of the car. Watch out for larger areas of damage to the exterior. Ensure the body panels line up evenly. According to Carfax, uneven panels may indicate the vehicle was in an accident but not repaired well. Open and close the doors, hood and trunk. Inspect the inside of the car by sitting in each seat and looking for unusual wear and tear in the upholstery. If the interior of the car smells musty, that may be a sign of a leak.

Go for a test drive. This may help determine the condition of the car and whether it's a good fit for you. Drive at

different speeds and drive on streets and freeways. Check for dashboard warning lights when you start the car. Give some thought to taking the car to a mechanic you trust.

Look up the Vehicle Identification Number (VIN). Check a VIN decoder chart to see if a used car's VIN information matches up with what's in the vehicle title and records. There are a number of VIN decoders available online. For example, see [myfreevin.com](http://myfreevin.com), [vindecoderz.com](http://vindecoderz.com), or [decodethis.com](http://decodethis.com). The VIN can also be used to see if there are recalls on the vehicle. Also consider reviewing the Vehicle History Report. This can help you see title problems, ownership history, service points and previous accidents. You can get a vehicle history report online or through the dealer if you are buying on a lot.

## 12.2 Affording the Right Car

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Affordability is an important factor to consider, whether buying or leasing a new or used car. Consider affordability before even setting foot in a car dealership. When beginning a car search, put together a budget with affordable monthly payments. Set aside that amount in a separate account for at least a few months while you are looking for a car. This will verify you can meet the budgeted monthly payments and also help you save money toward a down payment. The bigger the down payment, the lower the monthly payment – all else being equal – so saving before buying will save money down the road.

Your monthly budgeted payments should include the car payment, insurance and registration, gas, and maintenance for things like tune-ups, brakes and new tires, not just the monthly payment. This is important so that you don't commit to too high a monthly car payment. Some of your monthly budget should relate to things other than the car payment itself. You should also consider the upfront costs like the down payment and sales tax when you consider the affordability of a new car.

### A. Car Price and Monthly Payments You Can Afford

As a general rule of thumb, some financial advisors suggested new cars shouldn't cost more than 35 percent of your annual income.<sup>1</sup> For instance, if your annual income is \$65,000, then a new car shouldn't cost more than \$22,944 (\$65,000 x 35%).

Some financial experts suggest you follow the 20-4-10 rule. According to this rule, only buy a car with a minimum 20 percent down payment, a maximum loan term of four years, and a total monthly cost (including insurance) of no more than 10 percent of your gross income. Based on some reasonable assumptions, this rule would suggest a car price of about \$20,000 at an annual income of \$65,000. For instance, note the following:

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<sup>1</sup><https://www.businessinsider.com/personal-finance/how-much-should-you-spend-on-a-car>

**FIGURE 1: Car Price Rule of Thumb**

- Vehicle price of \$20,000
- Down payment of \$4,000 (20% of car price)
- Annual interest rate of 4.5 percent
- Sales tax rate of 6 percent
- 48-month term
- Monthly car payment would be \$392
- Monthly insurance of \$150
- Annual car payments and insurance premiums of \$6,504 ( $\$392 + \$150$ ) \* 12 months
- 10% of annual income of \$65,000 is \$6,500

**B. How to Determine Your Monthly Payment**

If you need to finance some portion of a car purchase, you should first check rates and terms with banks and/or credit unions where you have an account. The goal is to see what kind of a car loan you can get through one of those companies first. Dealers want to provide financing, since they earn more money from extending loans in addition to selling cars. Their interest rates may be higher than those available through your bank. However, some manufacturers support zero or low interest loans to help sell certain cars. Having more options always leads to better deals, so shop around and let the dealer know you already have a loan to see if the dealership can beat it.

A car loan is a serious financial obligation that must be repaid even if your financial situation becomes difficult. Understand the loan terms (due dates, interest rates, payment amounts). Make payments on time. Like all bills, you are required to make payments on time even if you don't receive the bill, repayment notice, or a reminder. You will have to pay the full amount required by the repayment plan. Partial payments will most likely not fulfill your obligation to repay the car loan on time. Missing payments, paying late, or making partial payments will all have a negative effect on your credit score. Conversely, paying the full amount on time will have a positive impact on your overall credit worthiness.

Your monthly car loan payments depend on (1) the amount you borrowed, (2) the interest rate, and (3) the term, meaning the length of time you elect to pay back your loan (3, 4, 5 years, etc). All other things being equal, the higher the interest rate and the shorter the term, the higher the monthly payment.

There are car loan monthly payment calculators all over the Internet. For instance, take a look at the following online calculator: <https://www.cars.com/car-loan-calculator/>. Using that calculator and assuming the following, your monthly payment would be \$384.

**FIGURE 2: Estimating Your Monthly Car Payment with an Online Calculator**

- Vehicle price of \$15,000
- Down payment of \$3,000
- Annual interest rate of 4.5 percent
- Sales tax rate of 6 percent and folded into the loan
- 36-month term
- Monthly payments of \$384
- Total payments equate to \$13,814

And as I previously mentioned, lowering the interest rate and term will also lower the monthly payment. Assuming the following, the monthly payment would be \$235.

**FIGURE 3: Lowering Your Monthly Payment by Lowering the Rate and Extending the Term**

- Vehicle price of \$15,000
- Down payment of \$3,000
- Annual interest rate of 3.5 percent
- Sales tax rate of 6 percent
- 60-month term
- Monthly payments of \$235
- Total payments equate to \$14,080

When financing a car, experts argue to limit the length of the loan to 36-48 months. The main reason is that if you decide to sell or trade in the car before the end of the loan period, you will likely get enough money in return to repay the remaining loan balance. Loan repayment is slower with a longer payback period. Therefore, with a longer payback period, you run the risk of not receiving enough money in exchange for the car to pay off the loan. This could force you to come up with additional cash, since the automobile has depreciated faster than the reduction of the loan.

If you decide to make a large down payment at the time you purchase a car, you can choose to accept a longer term. This is because the balance of the loan starts much lower than the value of the car, and the risk of the car value being lower than the loan balance is not as great.

## 12.3 When to Visit the Dealership

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If you are looking for a specific car, you may want to start at the high-volume dealerships with lots of inventory. Small dealerships don't carry a wide selection of cars, so they often buy or trade cars from larger dealers. Therefore, if you buy a car from a smaller dealer and that dealer has to go to another dealer to get the specific car you want, you may end up paying a higher mark-up, since two dealerships are involved and both want their cut of the profit.

The best time to visit a dealership is the last two days of the month. Most salespeople are paid a commission and have a monthly quota of cars they need to sell in a month. If they have not yet reached their quota, they may be more inclined to make a deal in order to meet their quota. Also, monthly sales over quota usually earn bonuses. Both lead to added incentives to move more cars at the end of the month.

The week between Christmas and New Year's Day is also a good time to shop for cars. That is usually a slow period for car sales as many people are enjoying the holidays. It's also the last few days to record sales for the month and the year.

Another good time to shop for cars is when last year's new models are sitting on the floor after next year's models are hitting the lot. Prices on the previous year's cars start to drop as they become harder to move. Check the white label on the driver's side door or the doorpost where it shows the month and year the car was made. The older the car, the longer it has been on the lot. The financial cost of carrying a car for more than 90 days eats into profits. This may be a bargaining plus for you. The dealer may want to get rid of a previous year's model to help make way for the new models.



## 12.4 Negotiate the Price of the Car and Not the Monthly Payment, Down Payment or Trade-in Value

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In my opinion, there is nothing worse than visiting a dealership. I would have owned twice as many new cars if the actual price was the advertised price, the price was the same for everyone, and there were no games to be played by the salesperson. It seems like dealers and auto manufacturers are finally figuring this out. Tesla uses this pricing model, and many other dealers promote similar pricing models these days. Until this is the industry standard, you need to head to the dealership armed with information and a good understanding of the dealership's strategy. Going in blind increases the chances of someone taking advantage of you.

For starters, the salesperson is not on your side working with you to get you the lowest price and best terms on the car. The salesperson is employed by the dealer and gets his or her paycheck from the dealer. The salesperson isn't even the individual you are negotiating with. You are usually negotiating with the sales manager who stays out of sight. The salesperson is the go-between so that you can't actually negotiate with the individual making the decisions. A classic negotiating technique. They play games, and they are good at it. So be prepared for a well-thought-out effort on their part to get you to pay the highest price for the car.

No pun intended, but you are in the driver's seat no matter what game is being played. You have the money; it's your decision to part with it, so you make the calls. You may not be able to deal with the sales manager directly, but try and deal with one person. Throwing multiple people at you is another trick the dealerships employ. If you don't feel comfortable with the situation or you are confronted by aggressive tactics, just leave.

The price of the car you are intending to purchase, your down payment, the monthly payments, and the trade-in value for your current vehicle are at the heart of most dealership negotiations. Don't haggle over monthly payment and down payment; it's the price of the car that matters. It's hard to know how much you are paying for the car when you talk in terms of monthly payments. Check a car payment app if you want to know how much a particular car will cost you in monthly payments. The dealership can hide the true price of the car if they continue to only talk in terms of down payments and monthly payments.

So, I recommend that you get your financing somewhere other than the dealership before you go to the dealership. Try your bank or a credit union. When the dealership knows you don't need financing, they may be more likely to be honest with you because they know they don't need to work on monthly payments with you.

Some, on the other hand, tend to believe it's better to tell the dealership you need financing. They argue that the dealer also wants to sell you financing and insurance for the extra fees and commissions. Let them think you will need financing until you have agreed on a price. These proponents believe that may get the dealership to come down a little more on price because they feel they can make it up in the financing and insurance stage. However, even if you do let them believe you will finance through them, remain steadfast on keeping the negotiation on the price of the car and not the monthly payments.

Sell your used car on your own rather than trading it in at the dealership. You will always get more for your car by selling it on your own rather than trading it in. The dealer does not want your used car and won't pay what you think it's worth. Therefore, if you think you can sell it yourself for much more, you are best to go ahead and do that. The trade-in value will always be less than what you think it's worth because the dealership will most likely auction off your car at wholesale. So here's a tip: take the National Automobile Dealers Association (NADA) or Kelley Bluebook values and subtract about \$2,000. This is typically referred to as the "black book" value. The "black book" values

are published weekly by companies such as Manheim Auto Auctions (<http://www.manheim.com/>), and these show the going price at the auction, that week, for any particular car.

Like it or not, dealerships routinely employ schemes to get people to overpay for a vehicle from them. Removing the financing and the trade-in aspects of the negotiation with the dealership reduces the ways in which the dealership can try to take advantage of you. It's extremely helpful to know what you want before you start negotiating at a dealership. Again, be sure to do your homework. Test drive cars and then leave before deciding to purchase. Be certain to know what alternatives are available to you. Be patient and don't rush into anything. That means both in terms of looking for the right car and then negotiating on price.

### A. The Takeover

At some point late in the sales process, you begin to express objections over the price and other terms of the potential sale. This is when The Takeover occurs. The sales manager or a designated closer to finish off the deal suddenly appears. The idea behind this approach is that introducing a new face to the process can convince you to buy. These individuals are even better salespersons and usually apply more pressure and clever tactics. If you feel uneasy about the price, and the terms and conditions, leave the dealership. You may find that the dealer suddenly meets your expectations when you get up to leave.

Try to limit the number of people you negotiate with to one person. Consider negotiating before you even head to the lot. Many large dealerships have an Internet sales manager and a devoted Internet sales channel. You may be able to get your best deal from the Internet manager if you know exactly what you want and have done your homework. You can request bids from three or more Internet managers from three separate dealerships before you ever set foot in any of the dealerships. You can take the lowest quote from one dealership and go back to the others one by one to see if they will reduce or beat that price. The process is over when they will not go any lower. Once you have the price of your new car worked out from the comfort of your own home, you can head to the dealership to sign the contract.

### B. The Four Square

In this system, the salesperson simply draws four squares on a sheet of paper and asks you for your desired monthly car payments, your trade-in amount, and how much you want to pay for your new car. Each of these figures is placed into one of the individual squares to start the negotiation. This strategy is a clear red flag and you should strongly consider not doing business with this dealership.

The figures you have opened with will be scratched out and re-written over and over, and with each change you will become more confused. The goal is to bombard you with too many changing numbers and shift your focus from one box to another. You begin talking about monthly payments and, all of a sudden, you're talking about trade-in values. The dealer will inevitably throw too much at you, change the numbers too often, and can keep you there for hours while he does it. Worse, you will not win the negotiation. He does this three or four times a day and you do this once every five years.

Stick to negotiating only on the price of the car you want to purchase. That is the heart of the negotiation. You don't have any idea about the price of the car when you are talking about the monthly payment. The monthly payment depends on the price of the car, the length of the loan, the down payment and the interest rate. It's easy for the dealer to get you to overpay for the car when so much about the price is hidden and you are distracted in thinking about the payment. Thus, don't let the dealer move you away from talking about the price of the car.

Do your homework before you visit the lot. Begin by understanding the Manufacturer's Suggested Retail Price (MSRP) of the vehicle. You will always see this on the sticker in the vehicle's window. It is almost never the price you will actually pay if you purchase that car.

The invoice price is the manufacturer's price to the dealership before various rebates, allowances, discounts, and incentives the manufacturer extends to the dealership. The dealer invoice price does not include dealer holdback by the manufacturer of two to three percent. The dealer holdback is the manufacturer's way of ensuring the dealer makes a profit. On a \$40,000 car that would be \$800 to \$1,200.

Manufacturers may offer incentives to consumers to sell slow-moving inventory or models. These incentives can range from \$500 to \$4,500 or more. When you negotiate the price of a new car, it may be worth assuming the dealership is receiving these incentives from the manufacturer. Let them tell you they are not.

Try Kelley Blue Book, Edmunds.com, Consumer Reports and your own online research to get information on the dealer's net price. Keep in mind that you will most likely not pay the listed cost of the car, so be realistic about your reasonable bargaining range.

The base price may not include all the options on the car you are purchasing. Options can easily add five to 10 percent to the price of a car. Some cars on the lot may have various options already installed on the car; therefore, they are included in the purchase price. Sometimes the dealer has already added some options to increase the purchase price and the dealer's profit, and wants you to pay for them. Like everything else, if you do not want them, refuse to pay for them.

The prices for options are definitely negotiable, sometimes by as much as 50%. They too have an MSRP and an invoice price. The dealer may earn a higher commission on options. If you raise your price a little, make it contingent upon the dealer throwing in an option, such as an extended warranty, two to three years of free maintenance, or a better sound system. Do not let them sell you things like rust proofing, fabric protection, etching, or specialized insurance coverage, which you probably do not need and might purchase for less from somewhere else.

### C. The Personalized Note System

Some dealerships have adopted a scheme where the sales manager delivers hand-written notes to you via the salesperson. The notes are personalized and meant to make you feel as if the team is working in your best interest. As a general rule, each note will ask for more and more money from you no matter how amenable you are to each previous note. This system is designed to make you feel as if you have leverage in the process and that the sales manager is helping you get the best deal.

Don't be fooled. You never get a deal at a dealership because they like you.

### D. The Tower

Another dealer selling system resembles a casino tactic. It is like a watchtower, where sales managers sit and watch every move you make from the moment you drive onto the lot. This approach is designed to put pressure on you, and the salespeople, through intimidation, do everything possible to sell you a vehicle. No move you make will go unnoticed. At times, the sales manager may even use binoculars, telephones and walkie-talkies to communicate with staff working with you. This is a tense environment, and you can expect the negotiations to be as tense, if not more. Additionally, it's probably the case that other sales tactics will be used in conjunction with this approach. It's

probably best to steer clear of this dealership and stick with one that takes a less adversarial approach to both their staff and customers.

### E. The One Price System

A number of dealerships and manufacturers are advertising “One Price” or “No Hassle” car shopping. I like this approach because it seemingly eliminates the negotiations, games and headaches associated with haggling over the purchase. You might not have to negotiate the price of the new car, but you won’t get a great deal on the interest rate when financing the car, you won’t get a great price for your trade-in, and they will hit you with all sorts of add-on fees in the finance department.

Again, obtaining financing and selling your used car outside of the dealership will help protect you against this approach. If you decide to go with dealer financing, be prepared so that you continue to get the best deal possible.

To begin with, you should know your credit score before you head to the dealership. You don’t want the dealership to misrepresent your credit score to try offering alternative financing meant for subprime buyers at higher rates or with higher commissions. They will likely charge a higher interest rate than what you could get at a bank. It’s usually between .5 to one percent higher at the dealership. There may be little you can do to bring that rate down other than going to your credit union or bank. However, do not let the dealership charge you a fee for handling any paperwork or for not financing with them. Finally, be certain the interest rate in the contract is the same rate that was verbally quoted to you.

The finance manager may offer you a choice between a cash rebate and a lower interest rate on your loan. I would choose the more valuable option. If your loan is relatively low, say \$15,000 or less, a \$1,000 rebate is probably worth more than the lower interest rate. However, if the loan is greater than \$15,000, the interest rate might be the better deal. Do the math before you make the decision – the difference in monthly payments between two interest rates times the number of payments compared to the cash rebate.

They may try to get you to purchase an extended warranty. Usually these extended warranties are hugely expensive through the dealership. You can get extended warranties through third parties for much less. So don’t feel pressured into purchasing on the spot at the dealership. Likewise, if you find that you overpaid for the extended warranty, there is usually a way to cancel it and get some portion of your money back. You may want to bargain for these extended warranty or maintenance contracts with the dealership as deep discounts of up to 50 percent off are not unusual.

The dealership may try to sell you credit life insurance so they get paid if you die or disability insurance if you cannot work. There is no point to sign up for this through the dealership. Do not let them charge you hundreds of dollars for a VIN check and do not let them add anything that was not agreed upon during the negotiation. If they try to, remember that you always have the right to get up and walk out at any time.

### F. Buying a Used Car on a Dealership Lot

You can find used cars on a dealership lot. These cars are usually in great shape. Dealers will tend to hold on to the cars they believe will sell. And solid used cars can sell. You will find more used cars on the lot when the manufacturers and dealerships offer 0% financing, rebates and other incentives on new cars, since those are good times to buy new cars. Do your homework before heading to the lot. Many of the preowned used cars on dealership lots come with preowned certification, meaning they still meet the manufacture’s specifications. A certified vehicle

comes with a warranty covering at least the major parts for a year or more.

It is not unusual for dealers to make more money on used cars than on new cars. Some of this has to do with the price they paid for the vehicle. Typically, the dealerships pay close to or less than wholesale for the car on trade-in. Furthermore, the mark-up can be steep, because even a heavily marked up pre-owned car is less than a new car. The two factors combined means you should have a lot of room to negotiate a better deal.

## 12.5 Leasing a car

Is it better to lease than to buy? Like most things in life, it depends on the particulars of your situation. We have covered the cost of ownership, so let's focus for a moment on the cost of a lease. In its basic form, the cost of a lease is equal to the depreciation on the car while you are leasing it. For example, if a car is anticipated to depreciate by \$10,000 (become \$10,000 less valuable) over the lease term, then the cost of the lease will be \$10,000.

Depreciation is typically a function of the original cost or value of the car (Capitalized Cost), the value of the car at the end of the lease (Residual Value) and the length of the lease.

At the time of the lease, you and the dealer agree upon the Capitalized Cost just as if you were buying the car. You would negotiate the Capitalized Cost the same way you would negotiate the purchase price of the car. Always negotiate the lowest possible Capitalized Cost first. All else being equal, the lower the Capitalized Cost, the lower the monthly payments.

Residual value is the anticipated value of the car at the end of the lease. The Residual Value is as important as the Capitalized Cost of the vehicle. However, unlike the Capitalized Cost, the higher the Residual Value, the lower your monthly payments. You cannot negotiate the Residual Value. It is determined by the quality, reliability and popularity of the car in the marketplace.

Car lease payments are based upon the difference between the Capitalized Cost and the Residual Value. As can be seen in the example below, even though Car 1 has a higher Capitalized Cost, its monthly payments are lower than Car 2 because it has less depreciation. The less a car depreciates, the lower the relative lease payment, irrespective of the "value" of the car when you buy it.

**FIGURE 4: Car Lease payments**

|                                 | <b>Car 1</b> | <b>Car 2</b> |
|---------------------------------|--------------|--------------|
| Capitalized Cost                | \$70,000     | \$45,000     |
| Residual Value                  | \$45,000     | \$3,000      |
| Depreciation                    | \$25,000     | \$42,000     |
| Monthly Car Payment (36 months) | \$694        | \$1,167      |

You are financing the depreciation, not buying the car. And since you are financing the depreciation, the monthly payment includes an interest charge. Many dealers won't disclose the actual interest rate being used. If the dealer will tell you, sometimes they will only tell you the interest factor and not the interest rate. You can convert the interest factor to an interest rate by multiplying the interest factor by the number of months in the lease. For example, if the interest factor is 0.0035 and it is a two-year lease (24 months), then the interest rate is 8.4 percent ( $0.0035 \times 24 = 8.4\%$ ).

## CHAPTER 12: Purchasing a Car

When you lease a car, you may need to make a down payment in addition to making the monthly payments over the life of the lease. The higher the down payment, the lower the monthly payment. At the end of the lease, you have the choice of either buying the car at the Residual Value or returning it. If you don't plan on buying the car at the end of the lease period, then getting the lowest capitalized cost and highest residual value will result in the lowest lease payment.

Lease periods typically last two to three years, and during the term of the lease you are responsible for insurance, regular maintenance and repairs not covered by a warranty or maintenance contract. You may need to keep records and have the maintenance done at the dealership. Maintenance and wear and tear like new batteries, brakes, wipers and tires are usually your responsibility.

Leases include a mileage allowance, usually in the range of 10,000 to 15,000 miles per year. The higher the mileage allowance, the higher the monthly payment, all else being equal. This is because the higher the mileage, the more the car will depreciate. If you exceed the mileage allowance, the charge is normally 10 to 25 cents per mile to be paid at the end of the lease when you return the car. There is obviously no mileage charge if you purchase the car. And unfortunately, there is no refund if you drive fewer miles than the allowance.

Leases are attractive because they usually involve less cash up front and a lower monthly cost. In addition, you don't have to sell the car at the end of the period. You simply return it. The downside is that you are constantly making payments. When you purchase a car, once you are done making the payments, the car is yours free of any additional financing payments. Thus, even though lease payments may be lower than car loan payments, the car loan payments stop. So, over the course of a 10-year period, the car loan payments may actually be less expensive than lease payments.

A substantial portion of a car's depreciation usually occurs in the first three years of the life of the car (usually over 40 percent in the first three years). Re-leasing a car that just came off a lease can be a great way to drive a more expensive car than you would otherwise buy, since someone else has already paid for the big depreciation.

Always read the lease agreement carefully. Be sure you understand all the charges and what every written number means. Check to make sure the lease contract explicitly lists the capitalized cost of the vehicle, the down payment, registration fees, trade-in allowances or rebates, the interest cost, the monthly payment including taxes, the residual value of the car at the end of the lease, and all extra charges.



## CHAPTER 13: Auto Insurance

### 13.1 Why Get Auto Insurance

### 13.2 Auto Liability Insurance

### 13.3 Additional Optional Auto Insurance

### 13.4 Keeping Auto Insurance Costs Down

### 13.5 What To Do in Case of an Accident

## 13.1 Why Get Auto Insurance

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For starters, auto insurance is required by law in most states. Auto insurance may potentially save you from financial ruin. There are nearly 100,000 auto accidents a day in the United States. If you are in one and it's your fault, you may be held financially responsible. Costs you may be forced to pay could include the costs to fix someone else's car, legal fees, the injured person's medical expenses and/or their lost income if the individual is unable to work. Auto insurance can help pay for these costs. Without auto insurance, you would likely have to pay these costs yourself.

If you borrow money to buy a new car or you lease a car, your lender will require you to purchase auto insurance. Your lender or lease company bears the majority of the financial risk while you're making your payments. Your lender can repossess your car if you don't make your car payments. They can then sell the car to someone else and get their money back. If the car is damaged in an accident, they no longer have the ability to repossess the car, and at that point are forced to hope you continue making the payments even though you no longer drive the car. That is too much risk for them, so they will require you to obtain insurance to help protect their investment. Auto insurance may help pay to repair or replace the vehicle if it's damaged in a covered loss.

Even if you own a vehicle outright, you may want to have auto insurance for it. Likewise, auto insurance may help pay your medical bills in the event you're injured in an accident. Many people do drive without insurance. In fact, according to a 2021 study by the Insurance Research Council, one in eight drivers are uninsured.<sup>1</sup> Auto insurance may help pay for your car and medical bills if you're hit by an uninsured driver.

## 13.2 Required Auto Liability Insurance

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Liability insurance is a standard component in most insurance policies – maybe the most important type of auto insurance – and is required in most states. Liability insurance does not cover you, your car or your property. However, auto liability insurance can help protect you in two distinct ways. First, if you are at fault in an accident that injures another person and damages their car, liability coverage will help pay for the individual's medical bills and damage to their car. Second, it also protects you when another person drives your car with your permission. You are financially protected if that driver causes an accident while driving your car and injures another person or damages someone else's car.

Liability insurance also pays for legal defense costs if you're sued as a result of a car accident. The insurance will

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<sup>1</sup> <https://www.iii.org/fact-statistic/facts-statistics-uninsured-motorists>



pay for your legal defense, as well as judgments and settlements issued against you.

As I previously mentioned, most states legally require you to have auto liability insurance. Each state has its own state-mandated minimum insurance requirements, so you should be sure to abide by your state's legal requirements.

Although there is no standard policy across states, let's take a look at California's mandatory liability coverage as an example:<sup>2</sup>

#### **FIGURE 1: California's Mandatory Liability Coverage**

- \$15,000 for injury/death to one person
- \$30,000 for injury/death to more than one person
- \$5,000 for damage to property

This is commonly expressed as 15/30/5. These minimum amounts are wholly inadequate, as costs and judgments can easily surpass these amounts. And you would be responsible for paying those costs after you hit the limits of your insurance coverage. That is why it is important that you obtain higher coverage. Medical bills and car repairs can be really expensive, and a car accident that is your fault could lead to the beginning of bankruptcy.

For example, suppose you hit and total another car, and seriously injure two people. If you're at fault, you will be responsible for the market value of the car and the medical bills of the two individuals you hurt in the car. What if it's a \$100,000 Land Rover you total and the resulting medical bills are \$300,000? California's minimum coverage will not cover all of these amounts and the rest could come out of your pocket and life savings.

As a general rule, some financial analysts say you'll want enough liability insurance to cover your net worth. Your net worth is equal to the value of all the cash you have and things you own, less your debt. If you don't own much, there may be less incentive to obtain additional coverage. However, as your wealth continues to grow, so too should your auto insurance coverage. The more to protect, the more coverage you should get. These are things you would want to discuss with your insurance agent and financial advisors. And in the end, the cost of excess liability coverage is not that great considering the protection it provides. I personally carry 500/500/250 with an additional million-dollar umbrella. Umbrella insurance is additional insurance that can provide protection beyond existing coverage of other policies. Umbrella insurance can provide coverage for injuries, property damage, certain lawsuits, and personal liability situations. And on top of that, I drive hella slow.

### **13.3 Additional Optional Auto Insurance**

No-fault insurance, sometimes referred to as personal injury protection (PIP) insurance, can help cover your medical expenses and loss of income in the event of an accident, regardless of who's at fault. It's unlike comprehensive, collision and liability auto insurance, because those coverages reimburse for damage depending on who is determined to be "at fault" in the accident. No-fault insurance is designed to lower the cost of your auto insurance by having an accident victim's minor medical expenses paid for by their own insurance company regardless of who was at fault. No-fault plans do not cover property damage, nor pain and suffering.

Collision insurance helps you pay to repair or replace your car if it's damaged in an accident with another vehicle.

<sup>2</sup> <https://www.dmv.ca.gov/portal/vehicle-registration/insurance-requirements/>

If you're leasing or financing your car, as discussed above, collision coverage is typically required by the lender. If you own your vehicle outright, collision insurance is optional. Collision coverage has a deductible, which means there is an amount that you are required to pay before your coverage helps pay for your claim. You can typically choose the amount of your collision deductible when you buy coverage.

Depending on your insurance provider, you may be able to choose your deductible amounts. Typically, they are between \$0 and \$1,000. Usually, the higher the deductible, the lower the monthly premium payments. Collision coverage also has a limit, meaning there is a maximum amount your policy will pay to fix or replace your car. Your collision coverage limit is typically the actual cash value of your vehicle (its value minus depreciation).

Therefore, your insurance company would pay you for the car's depreciated value, minus your deductible. The depreciated value is often less than the amount required to replace your old vehicle with a newer make and model. Thus, you likely will have to spend some of your own money to replace your vehicle. If your car is fairly old, it may not make sense to have collision insurance. Instead of paying the premium on collision insurance, you could save that money as a down payment on a new car if it ever gets to that point. On the other hand, how much would it cost you to repair or replace your vehicle? If you can't afford to fix your car or buy a new one after a wreck, purchasing collision coverage could ease that burden.

Uninsured and underinsured motorist coverage pays your medical bills and other expenses if you're in a car accident caused by a driver who doesn't carry any or doesn't have enough liability insurance. It also covers you if another driver's insurance company denies coverage or goes out of business. About one in eight drivers doesn't carry car insurance, according to a 2021 report from the Insurance Research Council. So this type of auto insurance could make a lot of sense. Make sure you purchase insurance that covers both uninsured and underinsured claims.

Uninsured motorist insurance can pay for medical bills and lost wages if you can't work because of the car accident, as well as pain and suffering compensation. Uninsured motorist insurance is typically expressed as something like 100/300, or \$100,000 bodily injury coverage per person and \$300,000 bodily injury coverage per accident. So, if you have 100/300 and three passengers are injured, your maximum insurance payout would be \$300,000.

Comprehensive insurance helps pay to replace or repair your vehicle if it's damaged in an incident that's not a collision. Comprehensive insurance typically covers damage from fire, vandalism or forces of nature, like a tree falling onto your car or it getting set on fire. If you're financing or leasing your car, your lender will likely require you to have comprehensive insurance. This insurance typically has a deductible. Again, the higher the deductible, the lower the monthly premiums.

## **13.4 Keeping Auto Insurance Costs Down**

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Don't simply sign up for auto insurance based on the easiest means possible. There are ways to get good insurance at a good price. Prices will vary from company to company depending on your specific situation, so it makes sense to begin by shopping around. A good rule of thumb is to get at least three price quotes.

When comparing quotes between insurance providers, be sure to confirm that each quote is based on the same insurance coverage. For instance, one insurance company may provide you a quote that is \$25 a month less than another insurance company. However, the \$25 lower price may be the result of less coverage. So, if you get a quote for liability insurance with coverage equaling 100/100/50, be sure to get the second and third quotes with the same 100/100/50 coverage.

Before you buy a car, you may want to check into insurance costs. Rates vary, in part, by car as some cost more to replace or repair, cars have different safety records, and some have a greater chance of getting stolen.

You may want to consider asking for higher deductibles. Again, a deductible is the out-of-pocket cost to repair or replace your car. A higher deductible can lower your costs substantially. For example, increasing your deductible from \$200 to \$500 could reduce your collision and comprehensive coverage costs by 15 to 30 percent. Going to a \$1,000 deductible can save you 40 percent or more. Before choosing a higher deductible, be sure you have enough money set aside to pay it if you have a claim.<sup>3</sup>

Furthermore, you might want to drop collision and/or comprehensive coverages on older, less-expensive cars. Many insurers will also give you a break if you buy two or more types of insurance. This means you get a price reduction if you have more than one vehicle insured with the same company, or maybe even having auto and homeowner's insurance through the same company.

Many insurers use your credit score to price your auto insurance policies, as research has shown that people who effectively manage their credit have fewer insurance claims. Some insurers even give discounts to college graduates, teachers and military personnel.

Some companies offer discounts to motorists who drive a lower-than-average number of miles per year. Low mileage discounts can also apply to drivers who carpool to work. Some companies offer discounts if you have not had any accidents or moving violations for a number of years. You may also get a discount if you take a defensive driving course.

Given the above discussion, you will want to inquire about discounts when shopping around for insurance. If they apply, be sure to ask whether the insurance company offers discounts for the following factors:

### FIGURE 2: Insurance Discounts

- Anti-theft devices
- Auto and homeowners coverage with the same company
- College students away from home
- Defensive driving courses
- Drivers education courses
- Good credit record
- Higher deductibles
- Low annual mileage
- Longtime customer
- More than 1 car
- No accidents in 3 years
- No moving violations in 3 years
- Student drivers with good grades
- Teacher or military personnel

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<sup>3</sup> <https://www.iii.org/article/nine-ways-to-lower-your-auto-insurance-costs>

Finally, don't shop for insurance by price alone. Ask friends and relatives for their recommendations. Getting into an accident can be stressful and it may help to know you have an insurance company that at least takes the time to answer your questions.

## **13.5 Automobile Rental Insurance**

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Before renting a car, check the coverage on your auto insurance policy. Your personal auto insurance coverage may extend to a rental car, if you're renting the car for personal use and not for business. Thus, purchasing rental car insurance coverage from the rental car agency may be an unnecessary expense.

In addition to your auto insurance policy, some credit cards offer extra insurance if you pay for a rental car with that card. If you have a credit card that offers extra rental car insurance, be sure to call the toll-free number on the back of your card to better understand your options in detail before you reserve your car. Your credit card's auto insurance is typically secondary, which means it will likely pay your deductible and expenses that exceed what your primary insurance company will pay.

If you don't have your own auto insurance when you rent a car, or if you're driving in another country, you'll need to at least purchase liability coverage from the rental company. Liability coverage for all drivers is required by law in most states.

If your current policy doesn't have comprehensive and collision coverage because you drive an older car, you may want to purchase this insurance from the rental company.

## CHAPTER 14: Employee Benefits and Payroll Deductions

### 14.1 Benefits of Employer-Sponsored Retirement Accounts

### 14.2 Benefits of Employer-Sponsored Health Insurance Plans

### 14.3 Federal Income Tax Withholdings

### 14.4 State Income Tax Withholdings

### 14.5 FICA Tax Withholdings

### 14.6 Other Deductions

I graduated with a business degree from the University of California, Berkeley and went to work for one of the biggest accounting firms in the world. For many years I had a very light understanding of what was being withheld from my paycheck and why. Many of the deductions that were either made or not made had significant implications on my short- and long-term financial goals. Rather than blindly going into your first few years of paycheck deductions like me, let's get you informed so you can actively manage your finances rather than allowing your finances to actively manage you.

Additionally, discussing common paycheck deductions will introduce you to topics we will discuss in greater detail in later chapters, including federal and state income taxes, Social Security, retirement savings and health insurance. Our discussion in this chapter, combined with later chapters, will allow you to make informed decisions when it comes to managing your financial goals.

Your paycheck deductions are (1) mandatory or optional and (2) based on your gross pay or net pay. In most cases, the largest mandatory deductions from your paycheck will relate to federal and state income tax withholdings as well as FICA tax deductions. FICA is a U.S. federal payroll tax program based on a federal law created in 1935 called the Federal Insurance Contribution Act.

In addition to the various mandatory tax deductions, there are optional company-specific deductions relating to benefits your employer may provide. Common employee benefit programs that lead to paycheck deductions include retirement savings programs and health insurance. Some of these deductions can lower your taxable earnings and your overall tax expense at the end of the year. In addition, your employer will often match portions of your payments and/or will pay portions on your behalf, making these programs even more attractive. The paycheck deductions that we will discuss in this chapter include:

**FIGURE 1: Paycheck Deductions**

| Deduction                   | Requirement | Pretax? |
|-----------------------------|-------------|---------|
| Deferred Retirement Account | Optional    | Yes     |
| Medical Insurance           | Optional    | Yes     |
| Federal Income Tax          | Mandatory   | No      |
| State Income Tax            | Mandatory   | No      |
| FICA Taxes                  | Mandatory   | No      |
| Wage Garnishment            | Mandatory   | No      |
| Work Related Expenses       | Optional    | No      |

There are many online net pay calculators that you can use to determine your take-home pay under various scenarios. For example, see the online calculator at <https://smartasset.com/taxes/california-paycheck-calculator#APYsDQCj7j>.

Likewise, Fidelity Investments has a really good net pay calculator at <https://nb.fidelity.com/public/nb/401k/tools/calculators/takehomepay>

Also, see <https://www.taxformcalculator.com/state-tax/california/56000.html>

## **14.1 Benefits of Deferred Employer-Sponsored Retirement Accounts**

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Saving and investing over the long run is a common theme in this book, and retirement saving fits squarely within that discussion. Employer-sponsored retirement plans are the most common way of saving for retirement. There are various plans depending on your employer; however, the most common one is a 401(k) plan. A 401(k) plan is an employer-sponsored defined contribution plan primarily funded by the employee. You tell your employer how much you want taken out of each paycheck and directly deposited into your 401(k) account. The money goes directly to the 401(k) account before any income taxes are paid (pretax). In addition, employees choose which investments the money is put into and they retain total control over the money when at retirement age.

We will cover 401(k) plans at length in Chapter 16. However, these employer-sponsored retirement accounts, like a 401(k), are attractive for several reasons and worth discussing in the context of your paycheck. First, contributions are pre-tax, meaning that they reduce the current income tax due. Secondly, employers often match some portion of contributions so that a one dollar contribution results in the employer putting an additional dollar into the account. And remember, no income tax is currently due on either employee or employer contributions. Finally, studies have shown that participation in savings plans that are directly deducted from paychecks greatly increases the chances of meeting your financial goals. The more automated your savings, the more likely it is you will save.

Below is an example that highlights the benefits and power of a 401(k) plan. This way you can see how it lowers your taxes and how the employer match increases your overall savings. I discuss this example in more detail in Chapter 16. However, for now, let's assume:

**FIGURE 2: 401(k) Input Assumptions and Results**

- Your annual salary is \$56,000.
- Your marginal tax rate for federal and state income taxes is 21 percent.
- Your employer matches 50 percent of your contribution, up to six percent of your salary.
- You elect to contribute \$10,000 to your 401(k) Plan.

**RESULTS:**

- Even though you contribute \$10,000 to your 401(k), since you are making your contribution with pre-tax dollars, it is really only costing you \$7,900. If you had not contributed the \$10,000 to your 401(k), your taxable income would have been higher and you would have had to pay an additional \$2,100 in taxes. Therefore, \$2,100 goes to either your taxes or your 401(k). So you really only need to contribute another \$7,900 in order to contribute a total of \$10,000.
- Since you contributed more than six percent of your salary, your employer matches the maximum amount: \$1,680 ( $\$56,000 \times 3\% = \$1,680$ ).
- As a result, for a \$7,900 after-tax contribution on your part, you now have \$11,680 invested: \$7,900 from you, \$2,100 from the IRS, and \$1,680 from your employer.

In the above example, three parties contributed to your 401(k): you, your employer, and the U.S. government. On an after-tax basis, you now have \$11,680 in your account, but only \$7,900 of it came from you.

**FIGURE 3: Example of the Tax Benefits of a 401(k)**

|                       | SCENARIO 1:<br>No 401(k)<br>Contribution | SCENARIO 2:<br>\$10,000 401(k)<br>Contribution | DIFFERENCE |
|-----------------------|--|--|------------|
| Gross Income          | \$56,000                                 | \$56,000                                       |            |
| 401(k) Deduction      | \$0                                      | (\$10,000)                                     |            |
| Taxable Income ("TI") | \$56,000                                 | \$46,000                                       | \$10,000   |
| Taxes (21%) of TI     | (\$11,760)                               | (\$9,660)                                      | (\$2,100)  |
| Earned Income         | 44,240                                   | \$36,340                                       | \$7,900    |

*Even though you contribute \$10,000 to your 401(k), your take-home pay (Earned Income) is only \$7,900 less.*

It may not seem like it, but the automatic payroll deductions to your account are an extremely important factor to saving money. The money is taken out before you even see it in your bank account, so it's not like you would even miss it. Fidelity Investments found that one of the biggest hurdles to achieving financial goals is the lack of actually setting money aside to save. Therefore, the more you can automate the savings process, like automatic deductions to your paycheck, the more likely you are to achieve your financial goals.

New laws enable employers to automatically enroll employees in a 401(k) plan, unless the employee "opts out" of the plan. In other words, the employee would have to ask to not participate. Historically, it's been the opposite – the employee would have to ask to participate in a 401(k) plan. One law currently being considered would make 401(k) participation mandatory. This would have the effect of reducing the number of individuals who would become a burden on society when they retire.



## 14.2 Benefits of Employer-Sponsored Health Insurance Plans

Employer-sponsored health insurance is another common voluntary paycheck deduction that can lower taxable income. Usually employers and employees share the cost of health insurance. If your employer deducts your portion of your healthcare premium from your pre-tax earnings, your actual cost of health care goes down by the tax savings from the deduction. In addition, the portion paid directly by the employer is never taxed even though it is just like income to you.

**FIGURE 4: Example of the Tax Benefits of Employer Sponsored Health Insurance**

|                            | No Health Insurance<br>Deduction | Health Insurance<br>Deduction | Difference |
|----------------------------|----------------------------------|-------------------------------|------------|
| Gross Income               | \$56,000                         | \$56,000                      |            |
| Health Insurance Deduction | \$0                              | (\$2,800)                     |            |
| Taxable Income (TI)        | \$56,000                         | \$53,200                      | \$2,800    |
| Taxes (21%) of TI          | (\$11,760)                       | (\$11,172)                    | (\$588)    |
| Net Pay                    | 44,240                           | \$42,208                      | \$2,212    |

You will usually pay your portion of the insurance premium by having it withheld from your paycheck. We will have a more thorough discussion of health insurance in Chapter 18. For now, it's important to realize that by joining an employer-sponsored plan and having your portion of the premiums withheld from your paycheck, you can lower your tax withholdings and tax expense. Likewise, obtaining health insurance through your employer will often be less expensive since your employer can negotiate discounts.

In addition to health insurance premiums, employees can make pretax deductions to set up savings accounts for qualified medical costs. These are called flexible spending accounts or health savings accounts that we will learn more about in Chapter 18.

Some employees choose to pay for life insurance through a company-sponsored program. Such premium payments are commonly withheld from your paycheck and are typically post-tax deductions. You will also see that many employers offer relatively inexpensive (\$5 a month) disability insurance. You should highly consider participating in these since they are so inexpensive.

## 14.3 Federal Income Tax Withholdings

In most cases, the largest deduction from your paycheck will be for Federal Income Tax (FIT). The U.S government wants its money as soon as possible and it doesn't get any more "as soon as possible" than taking it straight out of your paycheck each time you get paid. In fact, your employer is required by law to forward a certain amount from each paycheck directly to the U.S. Treasury in a timely fashion. I'm sure the government worries about collection risk as well. There were many years earlier in my life when I would have been too irresponsible to set aside money throughout the year in order to pay a large lump-sum tax payment when I filed my taxes. So, taking it straight out of our paychecks solves these issues and likely many others.

It's important to note that the FITs withheld from your paychecks are estimated tax payments and *not* your actual tax expense. You calculate your actual tax expense when you file your annual tax return. Thus, if the cumulative FIT withheld from each of your paychecks throughout the year is greater than the actual tax expense based on your

annual tax return, then you are entitled to a tax refund. Conversely, if the cumulative FIT withheld throughout the year is less than your actual tax expense at the end of the year, then you will be required to pay the difference when you file your tax return. And in some instances, if the difference is substantial, you may be required to pay fines and penalties for paying too little throughout the year.

**FIGURE 5: Example of Refund or Payment**

|                  | Cumulative FIT Withholdings | Tax Expense Per Your Tax Return | Refund / Payment                       |
|------------------|-----------------------------|---------------------------------|--|
| Refund Scenario  | \$5,600                     | \$5,000                         | Refund of \$600 (\$5,600-\$5,000)      |
| Payment Scenario | \$4,600                     | \$5,000                         | Tax Payment of \$400 (\$5,000-\$4,600) |

### A. Estimating FIT Withholding

Not every individual pays the same amount of federal income taxes based on the same level of income. There are a host of reasons for this that we will address in Chapter 19, but some of the main reasons include:

**FIGURE 6: Some Reasons for Different Tax Rates for Different Individuals**

- There are different tax rates applied to the same level of income depending on filing status (single, married filing jointly, or head of household).
- Some individuals choose to take a standard tax deduction, whereas others choose to itemize their tax deductions.
- Not everyone's itemized deductions are the same amount.
- Individuals with children and/or other dependents earn tax credits for each of those dependents. A dependent can be you, a spouse, a child, a qualifying relative, or another individual sharing your household. To qualify as a dependent, the taxpayer must provide **over half** of the dependent's support.

When beginning any new job, your employer will have you fill out IRS Form W-4 (Employer's Withholding Certificate). Your employer will use the information included in the W-4 to help determine how much FIT to deduct from your paychecks. Generally speaking, the more exemptions you claim, the lower your taxable income and the lower your taxes. The W-4 worksheet attempts to account for this. As can be seen from the W-4 worksheet on the next page, your FIT withholdings are generally based upon:

**FIGURE 7: Federal Income Tax Withholdings Based On:**

- Filing status,
- Number of jobs held at one time,
- Annual income,
- Number of children and/or any other dependents,
- Other income,
- Itemized deductions or standard deduction, and
- Any election to withhold more from your paycheck.

FIGURE 8: Form W-4

| <b>W-4</b><br>Form (Rev. December 2020)<br>Department of the Treasury<br>Internal Revenue Service  |   | <b>Employee's Withholding Certificate</b><br>▶ Complete Form W-4 so that your employer can withhold the correct federal income tax from your pay.<br>▶ Give Form W-4 to your employer.<br>▶ Your withholding is subject to review by the IRS. |                                      | OMB No. 1545-0074<br><br><b>2021</b>  |
|--|---|---|--------------------------------------|---|
| <b>Step 1:</b><br><b>Enter Personal Information</b>  | (a) First name and middle initial   | Last name   |                                      | (b) Social security number  |
|  | Nikita  | Bilyk   |                                      | 111-11-1111   |
|  | Address   |   |                                      | ▶ Does your name match the name on your social security card? If not, to ensure you get credit for your earnings, contact SSA at 800-772-1213 or go to <a href="http://www.ssa.gov">www.ssa.gov</a> . |
|  | 795 Folsom St.<br>City or town, state, and ZIP code<br>San Francisco, CA 94107  |   |                                      |   |
| (c)  | <input checked="" type="checkbox"/> <b>Single or Married filing separately</b><br><input type="checkbox"/> <b>Married filing jointly or Qualifying widow(er)</b><br><input type="checkbox"/> <b>Head of household</b> (Check only if you're unmarried and pay more than half the costs of keeping up a home for yourself and a qualifying individual.)  |   |                                      |   |
| <b>Complete Steps 2–4 ONLY if they apply to you; otherwise, skip to Step 5.</b> See page 2 for more information on each step, who can claim exemption from withholding, when to use the estimator at <a href="http://www.irs.gov/W4App">www.irs.gov/W4App</a> , and privacy. |   |   |                                      |   |
| <b>Step 2:</b><br><b>Multiple Jobs or Spouse Works</b>   | Complete this step if you (1) hold more than one job at a time, or (2) are married filing jointly and your spouse also works. The correct amount of withholding depends on income earned from all of these jobs.<br>Do <b>only one</b> of the following.<br><b>(a)</b> Use the estimator at <a href="http://www.irs.gov/W4App">www.irs.gov/W4App</a> for most accurate withholding for this step (and Steps 3–4); <b>or</b><br><b>(b)</b> Use the Multiple Jobs Worksheet on page 3 and enter the result in Step 4(c) below for roughly accurate withholding; <b>or</b><br><b>(c)</b> If there are only two jobs total, you may check this box. Do the same on Form W-4 for the other job. This option is accurate for jobs with similar pay; otherwise, more tax than necessary may be withheld . . . . . ▶ <input type="checkbox"/><br><b>TIP:</b> To be accurate, submit a 2021 Form W-4 for all other jobs. If you (or your spouse) have self-employment income, including as an independent contractor, use the estimator. |   |                                      |   |
| <b>Complete Steps 3–4(b) on Form W-4 for only ONE of these jobs.</b> Leave those steps blank for the other jobs. (Your withholding will be most accurate if you complete Steps 3–4(b) on the Form W-4 for the highest paying job.)   |   |   |                                      |   |
| <b>Step 3:</b><br><b>Claim Dependents</b>  | If your total income will be \$200,000 or less (\$400,000 or less if married filing jointly):<br>Multiply the number of qualifying children under age 17 by \$2,000 ▶ \$ _____<br>Multiply the number of other dependents by \$500 . . . . . ▶ \$ _____<br>Add the amounts above and enter the total here . . . . . <b>3</b> \$ _____   |   |                                      |   |
| <b>Step 4 (optional):</b><br><b>Other Adjustments</b>  | <b>(a) Other income (not from jobs).</b> If you want tax withheld for other income you expect this year that won't have withholding, enter the amount of other income here. This may include interest, dividends, and retirement income . . . . .   |   |                                      | <b>4(a)</b> \$ _____  |
|  | <b>(b) Deductions.</b> If you expect to claim deductions other than the standard deduction and want to reduce your withholding, use the Deductions Worksheet on page 3 and enter the result here . . . . .  |   |                                      | <b>4(b)</b> \$ _____  |
|  | <b>(c) Extra withholding.</b> Enter any additional tax you want withheld each pay period . . . . .  |   |                                      | <b>4(c)</b> \$ _____  |
| <b>Step 5:</b><br><b>Sign Here</b>   | Under penalties of perjury, I declare that this certificate, to the best of my knowledge and belief, is true, correct, and complete.<br>▶ <b>Employee's signature</b> (This form is not valid unless you sign it.) ▶ <b>Date</b>  |   |                                      |   |
| <b>Employers Only</b>  | Employer's name and address   | First date of employment  | Employer identification number (EIN) |   |
| For Privacy Act and Paperwork Reduction Act Notice, see page 3. <span style="float: right;">Cat. No. 10220Q <b>Form W-4</b> (2021)</span>  |   |   |                                      |   |

It is important to note that you control the amount of money taken out of each paycheck and whether you want a refund when you file your tax return. There are two ways to think about this issue:

**FIGURE 9: Do You Want a Refund or Do You Want More Current Take-Home Pay?**

1. Reduce FIT withholdings to maximize current take-home pay. This results in more money in your budget during the year, more to save and invest, more to pay off debts, etc. Under this approach, your tax refund is very small and you owe taxes when you file your tax return.
2. Increase FIT withholdings from each paycheck to maximize federal tax refund at year end. You can use the tax refund to cover your taxes on interest, dividends, profits, or other amounts you received for which no taxes were withheld.

Some people prefer the first option since it gives them more money in each paycheck throughout the year. Many who choose this option also argue they are not interested in giving the government an interest-free loan. That is what happens when you pay the government more than you owe throughout the year.

Others prefer the second option, where the government takes more money out of each paycheck to avoid having to pay at the end of the year, or to get a refund check. Many who choose this option argue it's kind of like a forced savings plan.

I always opted to have my employers withhold more from each of my paychecks. I did this in order to get a tax refund at the end of the year. Like others, I viewed it as a forced savings plan. After a number of years, I was able to do something nice with the tax refund, which also coincided with my year-end bonuses from work.

If you prefer to have a tax refund when you file your tax return, consider making the following adjustments to your W-4:

**FIGURE 10: Ways to Create a Refund Using Your W4**

- Reduce the number of dependents in Step 3.
- Add an extra amount to withhold in Step 4, line 4(c).

If you prefer to have less FIT withheld from each of your paychecks, consider making the following adjustments to your W-4:

**FIGURE 11: Ways to Create a Larger Take-Home Paycheck**

- Increase the number of dependents in Step 3.
- Reduce the number in Step 4, on line 4(a) or 4(c).
- Increase the number in Step 4, on line 4(b).

If you prefer to have the precise amount of FIT withheld from your paycheck to ensure you have a very small refund or are required to pay very little when you file your annual return, consider making the following adjustments to your W-4:

### FIGURE 12: Ways to Ensure an Accurate Withholding Amount Using Your W4

- Ensure your filing status hasn't changed since the last time you filled out a W-4. Did you get married, divorced, etc.?
- Ensure your family situation hasn't changed since the last time you filled out a W-4. Did you have a baby or did one of your kids turn 18 this year?
- Be sure to accurately estimate your other sources of income, such as capital gains, interest on investments, rental properties etc. This information is included on line 4(a) of your W-4.
- Be sure to accurately estimate your deductions. The W-4 automatically assumes you're taking the standard deduction. If you intend to itemize, you will want to estimate and include those incremental deductions on line 4(b).

The IRS recommends that if you had a major life change, such as marriage, the birth of a child, a child turned 18, adoption, or bought a home, you should consider making changes to your W-4.

The IRS also encourages everyone to use its Tax Withholding Estimator to perform a “paycheck checkup.” This can be found at <https://www.irs.gov/individuals/tax-withholding-estimator>.

The IRS calculator will help make sure you have the right amount of tax withheld from your paycheck. According to the IRS, there are a couple reasons to check your withholding:

### FIGURE 13: Reasons to Check Your Withholding Amount

- It can help protect against having too little tax withheld and facing an unexpected tax bill or penalty at tax time next year.
- You may prefer to have less tax withheld upfront, so you receive more in your paychecks and get a smaller refund at tax time.

Prior to using the IRS Tax Withholding Estimator, be sure to gather recent pay statements, including those for your spouse. Gather information for other sources of income. And finally, have your most recent income tax return handy.

## 14.4 State Income Tax Withholdings

At least as of 2017, only Alaska, Florida, Nevada, South Dakota, Texas, Washington, and Wyoming did not require their residents to pay state income taxes. (Technically, New Hampshire and Tennessee also do not have a state income tax; however, residents are required to pay state taxes on interest and dividends.) Like the federal government, state governments that require their residents to pay income taxes want their money sooner rather than later. Like the federal government, those states require employers to deduct state tax withholding from employee paychecks.

Given all of the different state tax laws across the U.S., we can't possibly talk about state tax withholding with any meaningful specificity. Most states base their withholding amounts on the same information that is listed in the employee's federal Form W-4, although some have their own versions of this form that are used instead. Likewise, some states, like California, require residents to fill out both the federal Form W-4 and the state income tax

withholding form. Employers in these states use publications similar to the federal Publication 15 to figure the amount to be withheld for state income taxes.

The best place to check for the most up-to-date information regarding your state's income tax withholding requirements would be with your state of residence and your employer.

## A. California State Taxes

Since all of my students reside in California, I thought I would provide a brief discussion of California state income tax withholdings. California employees are required to submit both a federal Form W-4 and California state Form DE 4 (Employee's Withholding Allowance Certificate) when beginning new employment or changing their state withholding allowances. New hires and existing employees changing their California income tax withholding elections must submit both Form W-4 and Form DE 4.

If a new employee does not submit Form DE 4, the employer will withhold California state income tax as if the employee is single and claiming zero withholding allowances, which is the minimum number of withholding allowances. The fewer the withholding allowances, the more your employer will withhold from your paycheck. Conversely, the more withholding allowances, the less your employer withholds from your paycheck.

You can work towards a California state tax refund or reduce the California state tax withholdings by changing the number of withholding allowances claimed on your California Form DE 4.

In addition to California state income tax withholdings, most employees in California also have State Disability Insurance (SDI) taxes automatically taken out of their paychecks. SDI gives you a cash benefit if you have paid payroll taxes into it and can't work for one of the following reasons:

### **FIGURE 14: Reasons for SDI Cash Benefits**

- You have a disability not related to your job.
- You need to take Paid Family Leave, which replaces part of your income when you miss work to care for a sick relative or to bond with a new child.
- You are pregnant.

The SDI tax deduction from your paycheck is 1.1 percent of your gross pay.<sup>1</sup> As of 2022, SDI taxes are paid on income of up to \$145,600 a year, meaning once you hit that amount of income in a year, you no longer have to pay SDI taxes.<sup>2</sup>

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<sup>1</sup>[https://ca.db101.org/ca/programs/income\\_support/sdi/program2.htm#:~:text=If%20you're%20like%20most,are%20also%20called%20SDI%20contributions.](https://ca.db101.org/ca/programs/income_support/sdi/program2.htm#:~:text=If%20you're%20like%20most,are%20also%20called%20SDI%20contributions.)

<sup>2</sup>[https://ca.db101.org/ca/programs/income\\_support/sdi/program2.htm#:~:text=If%20you're%20like%20most,are%20also%20called%20SDI%20contributions.](https://ca.db101.org/ca/programs/income_support/sdi/program2.htm#:~:text=If%20you're%20like%20most,are%20also%20called%20SDI%20contributions.)



## 14.5 FICA Tax Withholdings

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Employers must also withhold FICA taxes from our paychecks in addition to withholding federal, and most likely state, income taxes. FICA taxes are composed of the Old-Age, Survivors, and Disability Insurance taxes (OASDI or Social Security), and the hospital insurance tax (Medicare).

The OASDI program, or for most Americans, Social Security, provides monthly benefits designed to replace, *in part*, the loss of income due to retirement, disability, or death. The program is financed through OASDI tax withholdings in our paychecks. As of 2022 the current tax withholding rate for Social Security from your paycheck is 6.2 percent of gross earnings, up to a maximum gross earnings amount of \$147,000. This means you do not have to pay Social Security for any amount you earn above \$147,000.

As of 2022, the current tax withholding rate for Medicare is 1.45 percent on all gross earnings. All gross earnings are subject to Medicare tax. Each individual is also required to pay an additional Medicare tax of 0.9 percent on wages that exceed \$200,000 in a calendar year.

## 14.6 Other Deductions

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Courts, or certain agencies, and/or the IRS may order employers to withhold a portion of your wages to cover unpaid taxes, child support, alimony or defaulted loans. The order garnishing wages will typically specify an exact withholding amount or percentage of withholding and where to send the payment.

If you are part of a union through work, you will likely have to pay membership dues and taxes on any taxable benefits offered through the union. These will commonly be deducted from your paycheck. Other types of job expenses that can be deducted from your paycheck include uniforms, meals, and travel.



## CHAPTER 15: Planning for Retirement

- 15.1 Estimating Your Financial Needs in Retirement
- 15.2 Determine the Amount You Need to Save for Retirement
- 15.3 How to Invest your Retirement Savings
- 15.4 Understanding Your Social Security Benefits Will Be Modest at Best

### 15.1 Estimating Your Financial Needs in Retirement

Since you are in college, it might be a little early to begin dreaming of retirement. However, who doesn't dream of relaxing under a beach umbrella staring at a deep blue sea? That's certainly my retirement dream. Regardless of what your ideal retirement life looks like, or how far away it is, it's never too early to start planning for it. You need to begin planning earlier rather than later because Social Security will not be enough for retirement.

Social Security is not and never was intended to be a federally funded pension plan for U.S. citizens. It was designed only to supplement each individual's pension plan and lifetime savings. And now that most company-sponsored pension plans have vanished, Social Security is the only thing that will supplement your savings. This fact has apparently been lost on most people today, as most individuals believe Social Security is their pension plan and will adequately support them. It will not, and it will not to a greater extent as the years go by.

Given that you have to pay for your own retirement, how do you know how much will you need and how much you should save each year? The list of factors that affect the amount of money needed in retirement is seemingly endless. And to make matters worse, the further you are from retirement, the more difficult it will be to determine the answers to some of the basic questions. And not really knowing how much you will need in retirement makes it difficult to determine how much to save each year for it, not to mention how or what to invest in.

Factors that go into how much money you will need in retirement include, but are not limited to:

#### FIGURE 1: Factors to Consider When Determining Your Retirement Needs

- Your needed income level and intended lifestyle in retirement
- The age you intend to retire
- Your life expectancy (the number of years you will be retired)
- Whether your income needs will change throughout retirement
- Whether you intend to work in retirement
- Your health and medical needs in retirement
- Whether your spouse will help contribute to your retirement needs
- Your tax bracket in retirement and how much of your retirement distributions will be taxable
- Whether you will have any non-taxable retirement distributions
- The return on your investments in retirement and inflation

Given the complexity of the analysis, Fidelity Investments analyzed enormous amounts of national spending data to determine the average retirement needs and the average amount to save during one's working life to meet those needs. Fidelity found that those with between \$50,000 and \$300,000 in annual income should plan for their savings (including pensions if they have one) to replace between 55 and 80 percent of their preretirement income to maintain their lifestyle in retirement, depending on their unique circumstances. They also found that the average individual should plan to replace approximately 45 percent of their pretax, preretirement income.

Why only 45 percent and not 100 percent? For starters, people usually stop making contributions to retirement savings plans once they are retired. In addition, most people will be in a lower tax bracket, with less need for certain forms of life insurance and lower overall expenses. For example, many people will have paid off their home mortgage by the time they retire. Fidelity also took into account that most people will collect Social Security in retirement (which we will discuss later in this chapter). So, after considering Social Security and these other factors, Fidelity found that most people will need to generate about 45 percent of their retirement income (before taxes) from savings.<sup>1</sup>

The age at which you stop working is another big factor in how much of your preretirement income must be replaced in retirement. Most people are eligible to receive Social Security benefits as early as age 62, but those benefits increase if you wait until your full retirement age (usually 67), and rise even more if you delay until age 70. Thus, the later you delay retirement, the less savings are needed to meet your income needs because your Social Security payments will be greater.

### **A. Determine the Amount You Need to Save for Retirement**

I'll cut straight to the chase. If you are 25, you are not going to be able to figure out how much you will need in retirement. So my advice is to start saving 15 percent of your pretax income for retirement. Then, as you get older, monitor your savings relative to when you plan to retire. The closer you get to retirement, the more you can refine your strategy. And throughout the years, measure your savings against U.S. averages and benchmarks to help you determine whether you are on track.

### **B. Begin Saving 15 Percent of Your Pretax Income for Retirement**

Most financial advisors will tell you to begin saving 15 percent of your annual pretax earnings when you are 25 and continue until you are 67. So if you are far off from retiring but saving for retirement is a long-term goal, try to get to that 15 percent goal as quickly as possible.

Based on the Fidelity analyses of nationwide spending data and retirement savings, Fidelity further suggests that individuals between the ages of 25 and 67 should save at least 15 percent of their pretax income each year for retirement to reach a point where their savings will replace 45 percent of their pretax preretirement income in retirement. Fidelity also argues that the 15 percent goal should include contributions from your employer through 401(k) matching or a pension.<sup>2</sup> For instance, employer 401(k) matching contributions of three percent of your annual salary means you only need to save 12 percent (12 percent + 3 percent) of your income each year.

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<sup>1</sup> <https://www.fidelity.com/viewpoints/retirement/retirement-roadmap>

<sup>2</sup> <https://www.fidelity.com/viewpoints/retirement/retirement-roadmap>

Your target savings rate will vary depending on a variety of factors, including when you plan to retire, your desired retirement lifestyle, when you started saving, and how much you have already saved. However, 15 percent is what most financial advisors will recommend.

Fidelity's 15 percent savings rule of thumb assumes that you retire at age 67, when you will most likely be eligible for full Social Security benefits. If you don't plan to work that long, you may want to consider saving more than 15 percent. If you plan to work longer, then less savings are required.

The most important thing you can do is to start saving as early as you can. The earlier you start, the more time you have for your investments to grow.

### C. Plan to Have Saved 10x Your Annual Income by the Time You Reach Retirement

Based on a similar Fidelity analysis, Fidelity also created a guidepost to help you measure whether you are on track to retire with enough money saved. The following are the assumptions that go into Fidelity's guidepost analysis:

#### FIGURE 2: Fidelity Retirement Savings Guidepost

- Individuals save 15 percent of their annual pretax income beginning at age 25
- Individuals invest more than 50 percent, on average, of their savings in stocks over their lifetime
- Individuals at age 67 plan to maintain their preretirement lifestyle in retirement

Based on those assumptions, you should have an amount equal to your annual pretax earnings saved by the time you are 30, and 10 times your preretirement income saved by age 67. Fidelity also provides guideposts between the age of 30 and 67 to help you determine whether you are on track to have enough money saved for retirement. The table below applies Fidelity's multipliers to various income levels.<sup>3</sup>

#### FIGURE 3: Fidelity Retirement Savings Guidepost Example

| Age | Fidelity<br>Income<br>Multiplier | Assumed<br>Income Example | Retirement Savings based on<br>Fidelity Income Multiplier are<br>Assumed Income |
|-----|----------------------------------|---------------------------|---|
| 30  | 1                                | \$64,310                  | \$64,310  |
| 40  | 3                                | \$88,000                  | \$264,000   |
| 50  | 6                                | \$93,520                  | \$561,120   |
| 60  | 8                                | \$89,200                  | \$713,600   |
| 67  | 10                               | \$100,000                 | \$1,000,000   |

Fidelity advises that these rules of thumb be used as a starting point to help build a savings plan and assess your progress. The age you plan to retire can have a big impact on the amount you need to save and your milestones along the way. The longer you can postpone retirement, the lower your savings factor can be. That's because delaying retirement means that savings have a longer time to grow, the length of retirement will be shorter, and Social Security benefits will be higher.

<sup>3</sup> <https://dqydj.com/income-percentile-by-age-calculator/>

Fidelity has a helpful calculator that measures the specific savings needed at different points in time based on when you plan to retire and the lifestyle you want to have in retirement. The calculator can be found at the following link:

[https://www.fidelity.com/products/retirement/widget/xfactor/retire\\_xfactor.html](https://www.fidelity.com/products/retirement/widget/xfactor/retire_xfactor.html)

What if you're behind? If you're under age 40, the simple answer is to save more and invest for growth through a diversified investment mix. Of course, stocks come with more ups and downs than bonds or cash, so you need to be comfortable with those risks. If you're over 40, the answer may be a combination of increased savings, reduced spending, and working longer, if possible.

No matter what your age, focus on the goals ahead. Don't be discouraged if you aren't at your nearest milestone. There are ways to catch up to future milestones through planning and saving. The key is to take action, and the earlier the better.

Here is the deal: It's easier to follow this advice when you get into the workforce than when you are in college, so make sure you start as soon as you graduate and begin working. If you are five years away from retirement and want to spend your twilight years traveling the world, and you have nothing saved, it's time to start saving A LOT more than 15 percent every year.

Once you settle on a target savings percentage, the next thing to consider is how you will get there. You will need to determine the following:

**FIGURE 4: Determining How Much to Save for Retirement**

- How much you will receive in Social Security benefits
- Whether you will get an employer pension
- How much you can actually save in any given year, and how that will change between now and when you retire
- The return on your investments
- Inflation

It may be impossible to answer these questions at age 25. The closer you get to retirement, the more in focus these issues will become. However, that doesn't mean you should put off saving until your retirement needs begin to come into focus. Begin to save for retirement as soon as possible and refine later.

## 15.3 How to Invest Your Retirement Savings

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### A. Select Your Retirement Plan

There are various retirement plans available and no one solution is for everyone. The right solution for you depends on your preferences and strategies. In general, the best plan will provide tax advantages, and, in some instances, an employer matching program through a 401(k) plan.

A 401(k) plan is a tax-advantaged, defined-contribution retirement account offered through employers (if your employer chooses to do so). It is named after a section of the U.S. Internal Revenue Code. Contributions to 401(k) accounts are typically made through automatic payroll withholding, as we discussed in Chapter 14. Employers will often match some or all of your contributions. In general, 401(k) contributions are not taxed until withdrawn in

retirement. That is why a 401(k) with an employer match is the best place to start for many people. I discuss 401(k) plans at length in Chapter 16.

Individual Retirement Accounts (IRAs) can also be used in addition to a 401(k) plan, or instead of a 401(k) if your employer doesn't offer one. IRAs can be opened at an online broker or other account provider. I discuss IRA plans at length in Chapter 17.

## **B. Select Your Retirement Investments**

401(k) and IRA accounts provide a range of investment options, including stocks, bonds, and mutual funds. The investments you choose will depend on your time horizon, meaning how long until you need the money, and how much risk you are willing to take. It is typically the case that the more risk you take on, the more you hope to earn in return.

Generally, the younger you are, the more risk you can take. As you get older and closer to retirement, you should transition into safer investments. Early in life you have more time for your investments to work through fluctuations in value. A few bad years won't destroy your investments in the long run, and overall, your retirement investments should benefit from the stock market's history of long-term growth.

Retirement investments don't necessarily require constant monitoring. You can manage your retirement savings on your own by selecting a handful of low-cost mutual funds or exchange traded funds (ETFs). You can also solicit professional guidance from a financial advisor.

## **C. Managing Your Retirement Accounts on Your Own**

According to the Schwab Center for Financial Research, you might be taking on too much investment risk if a single stock accounts for 10 percent or more of your total stock investments.<sup>4</sup> If you own too much of one stock and that stock price declines rapidly with no foreseeable way to bounce back, you could lose a substantial portion of your retirement. For example, if you own only one stock and it falls 32 percent, the value of your investments will drop by 32 percent. By folding in even one additional stock that could rise at the same time (or at least doesn't go down as much) when the other one falls, it will improve your portfolio returns. Thus, most retirement account investment options will be limited to diversified investments such as mutual funds or index funds.

Mutual funds and index funds typically invest in a mix of different company stocks and bonds. It's not uncommon for a mutual fund to own stock in at least 50 different companies. Diversification means lowering your investment risk by spreading money across and within different asset classes, such as stocks, bonds and cash. It's one of the ideal ways to maneuver through market ups and downs while still maintaining the potential for growth.

Most retirement plans rely on diversification to balance risk and ensure retirement income that meets your expectations. This is why most plan managers invest in bonds, individual stocks and mutual funds, among other investment types. There are likely to be many diversified funds to choose from within your retirement account.

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<sup>4</sup> [https://www.schwabmoneywise.com/public/moneywise/essentials/the\\_advantages\\_of\\_diversification](https://www.schwabmoneywise.com/public/moneywise/essentials/the_advantages_of_diversification)

## **D. Actively Managed Mutual Funds**

These funds have been around for decades and are still the most popular kind of security among investors. They hold a variety of stocks or bonds, and sometimes both, in one investment vehicle. Mutual funds are ideal for people who don't want to choose their own stocks. Instead, a professional fund manager can do it for you. If you want to own a bunch of international stocks but don't want to pick individual companies, then buy an international stock fund. The same goes for tech stocks, U.S. stocks and corporate bonds — there's a fund for everything. The main drawbacks are fees and flexibility. Because someone else is doing the stock picking, fees are higher on actively managed mutual funds than on other kinds of investment vehicles. You also can't buy or sell them during the day as they're only priced after the market closes.

## **E. Target Date Funds**

One of the most popular 401(k) investments these days are target date funds, which are a class of all-in-one mutual funds or Exchange Trade Funds (ETFs) that adjust their asset class mix automatically as you age. For instance, someone in their 30's in 2020 might hold a Target Date 2055 fund, which might hold 90 percent stocks and 10 percent bonds. As the individual ages, the stock and bond mix will self-adjust, so that by the time they're 65, the fund will have a 30 percent allocation to stocks and a 70 percent allocation to bonds. By becoming more conservative, there's less of a chance of losing money in the market in the few years leading up to retirement. In many employer-sponsored retirement plans, target date funds are now the default investment choice if investors don't actively make investment selections.

## **F. Index Funds**

Index funds are like actively managed mutual funds; however, there's no advisor picking stocks for the fund. These funds track a benchmark index, like the S&P 500 or the broad-based indexes. One of the main drawbacks to a traditional mutual funds is that most do not beat their benchmarks, especially when you factor in the higher fees. The returns on mutual funds (after fees) are usually not much better, if at all, than the index they are investing in. Index funds were therefore developed to avoid underperformance, which means their returns are the same as the index they follow. There is still a management fee, but much less than what you would pay on a traditional mutual fund.

## **G. Exchange-Traded Funds (ETF)**

There is not much difference between ETFs and Index Funds. ETFs are like traditional mutual funds in that they hold a mix of stocks and bonds, and they're like index funds since many also track a benchmark. The difference is that they trade on a stock exchange, which means they're priced in real-time and can be bought and sold at any point during the day. Not really an issue for someone investing over the long run for retirement. Most importantly though, index ETFs are really inexpensive. In fact, many even come with no management expense fees.

## **H. Think About Fees**

Mixed into all of these considerations are fund management and trading fees since they can eat into your returns. Active mutual funds tend to be more expensive than index funds and ETFs. However, management fees on active funds have come down due to the pressures from index funds and ETF pricing structures. The average equity



mutual fund fee is now roughly 0.5 percent. Most index ETFs and index mutual funds remain even less expensive. Lower-fee investments are gaining a lot of momentum, so expect more actively managed funds to drop their prices in the coming years.

## I. Managing Your Retirement Account Using a Financial Advisor

Many individuals find that they are more than capable of managing their retirement accounts on their own. However, it's not a bad idea to work with a financial advisor who can provide insight into your situation that you may not be able to glean on your own. Here are a few factors to consider when searching for the right financial advisor.

### FIGURE 5: Factors to Consider When Searching for a Financial Advisor

- **Qualifications:** Check their credentials. A Certified Financial Planner (CFP) is the most widely recognized financial advisor designation.
- **Services they provide:** Check to ensure they specialize in retirement planning.
- **Compensation:** Some advisors get paid directly from the mutual funds, others may charge an upfront fee or an hourly rate. Be sure to shop around for the right advisor at the right cost.
- **Track record:** Definitely speak to references (i.e., former and present clients). You are not necessarily looking for the advisors who produce the highest returns. Rather, you want to make sure your advisor will have your best interests in mind, understand your needs, can create solid plans, is attentive and timely to your requests, and knows how to help you invest.
- **Communication:** You may be the type to panic when the markets get bad and your investments begin to decline. You may also get concerned if your advisor doesn't reach out to you. Before that happens, be sure to determine how often your advisor wants to meet and how they will reach out to you. It's not unusual to speak to your financial advisor at least twice a year or if you experience a major life change, such as purchasing a home or starting a new job.

Early in the relationship, the first conversations with your advisor will revolve around your willingness to take risk and your estimated time horizon.

As a general rule, you will tend to take on more risk at a younger age and become more conservative as you get older, since there's less time for your investment to recover from a drop the closer you get to retirement. That doesn't mean you need to hold 100% in stocks early in life and no stocks the year prior to retiring. If at age 30 your investment portfolio consists of 80% stocks and a 20% bonds, you may want to consider moving closer to 50-50 as you near retirement. This is a rule of thumb, though many people reach retirement with a big nest egg and still can keep a good portion of their assets in stocks. Just make sure that any money you need for day-to-day living is not subject to market ups and downs.



## 15.4 Your Social Security Benefits will be Modest at Best

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According to the Social Security Administration (SSA), Social Security financially helps older Americans, workers who become disabled, and families in which a spouse or parent dies. As of 2021, approximately 180 million people worked and paid Social Security taxes and about 65 million people received monthly Social Security benefits.<sup>5</sup>

### A. Current Social Security Benefit Amounts

Social Security benefits are much lower than most people realize, as they were never intended to be the only source of retirement income. It is intended to replace only a *percentage* of your preretirement income based on your lifetime earnings. According to the SSA, the average Social Security retirement benefit in 2021 is \$1,544 a month, or \$18,528 a year.<sup>6</sup>

For someone at full retirement age in 2021, the maximum monthly Social Security benefit is \$3,113. For someone filing at age 70, the maximum monthly amount is \$3,895.<sup>7</sup> The longer you wait to receive benefits, the more you will get each month when you do begin to receive benefits.

For someone who worked all of their adult life at average earnings and retires at age 65 in 2021, Social Security benefits replace roughly 40 percent of their preretirement earnings.<sup>8</sup> Moreover, most retirees enroll in Medicare's Supplementary Medical Insurance (Medicare Part B) and have their premiums deducted from their Social Security checks. So, if you elect to have Medicare Part B, you could expect your Social Security benefits to be even lower. As healthcare costs continue to outpace general inflation, those Medicare Part B premiums will take out a greater amount from your Social Security benefits.

Social Security retirement benefits are available as early as age 62. However, benefits will be reduced if you retire before your full retirement age. For example, if you turn age 62 in 2021, your benefit would be about 29.2 percent lower than it would be at your full retirement age of 66 and 10 months.<sup>9</sup>

By taking early retirement at age 62, the monthly retirement benefit is reduced by 25 percent. Also, if one applies for early retirement and is still working, Social Security deducts \$1 from the benefit payment for every \$2 earned above an annual limit. Upon reaching full retirement age, they will receive their benefits regardless of income.

Furthermore, 85% of Social Security benefits are currently taxable to the individual; however, lower-income people are able to exclude more of their benefits from federal taxes. Benefits are usually adjusted each year for inflation as calculated by the government. Which method of calculation should be used has been an ongoing source of discussion.

Need an estimate of how much you could get from Social Security? Use the SSA's Retirement Estimator to project your Social Security benefit amount at <https://www.ssa.gov/benefits/retirement/estimator.html>.

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<sup>5</sup> <https://www.ssa.gov/news/press/factsheets/basicfact-alt.pdf>

<sup>6</sup> <https://www.ssa.gov/news/press/factsheets/basicfact-alt.pdf>

<sup>7</sup> <https://www.kiplinger.com/retirement/social-security#:~:text=There%20is%20a%20maximum%20Social,maximum%20monthly%20amount%20is%20%243%2C895>

<sup>8</sup> <https://www.cbpp.org/research/social-security/top-ten-facts-about-social-security#:~:text=For%20someone%20who%20worked%20all,40%20percent%20of%20past%20earnings>

<sup>9</sup> <https://www.ssa.gov/pubs/EN-05-10035.pdf>

The Retirement Estimator gives you a benefit amount based on your actual Social Security earnings record. According to the SSA, the calculator only provides estimates. Estimated and actual amounts may differ due to:

**FIGURE 6: Differences Between Actual and Estimated Social Security Benefits**

- Future increases or decreases in your earnings
- Social Security annual cost-of-living adjustments
- Changes to U.S. laws and policies
- Your military service, railroad employment, or pensions earned through work for which you did not pay Social Security taxes

**B. Social Security Estimated to Run Out in 2037**

The SSA currently estimates that benefits are expected to be payable in full on a timely basis until 2037, when the trust fund reserves are projected to become exhausted. At that point, the SSA estimates that taxes will be enough to pay only 76 percent of scheduled benefits.

Thus, Congress will need to make changes to the scheduled benefits and revenue sources for the program to avoid reductions in benefits. The Social Security Board of Trustees projects that changes equivalent to an immediate reduction in benefits of about 13 percent, or an immediate increase in the combined payroll tax rate from 12.4 percent to 14.4 percent, or some combination of these changes, would be enough to allow full payment of the scheduled benefits for the next 75 years.<sup>10</sup>

Analysts and media pundits also suggest the full retirement age may increase to 68, 69, or 70. This would increase tax revenue, as individuals would be required to work longer, and would lower the total payout to retirees, since their time in retirement would be shortened.

Another possible adjustment could have to do with the Social Security wage base. Currently, you are not required to pay Social Security taxes over \$142,800. However, President Biden has proposed expanding the wage base so that wages above \$400,000 are also subject to Social Security taxes. The theory is that higher-income earners contribute more so that the program could be solvent for longer.

Nobody knows what aspects of Social Security will actually end up changing. Likewise, benefits probably won't completely run out. However, Social Security will look a lot different by the time you reach retirement. By all accounts, either you will get less in retirement benefits than individuals receive today, or you will have to work longer and/or pay more in taxes to maintain current levels of benefits.

Politicians find it difficult to take action against senior citizens, as they vote in large numbers. Many imagine that a fear of a reduction of benefits may motivate senior citizens to push for changes in order to fully fund Social Security. For most, Social Security and Medicare are lifelines such that they cannot afford a cut in benefits or an increase in cost.

Given the low payouts today and the thought that the amount paid when you retire will likely be even less, I would make saving for retirement a high priority.

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<sup>10</sup> <https://www.ssa.gov/policy/docs/ssb/v70n3/v70n3p111.html>

### C. Qualifying for Social Security Benefits

To be eligible for most types of benefits, you must earn an average of one work credit for each calendar quarter between age 21 and the year in which you reach age 62, or become disabled or blind, up to a maximum of 40 credits.<sup>11</sup> You receive one work credit for each \$1,470 of earnings in a quarter, up to the maximum of four credits per year. Furthermore, a minimum of six work credits are required, regardless of age. In short, you need to earn at least \$1,470 for 10 years by the time you reach retirement (40 quarters / four quarters per year)

Divorcées are entitled to the higher of their own benefit or half of their ex-spouse's benefit, whichever is greater, but only if they were married for 10 years or more. If they were married for less than 10 years, then they are not entitled to that option.

The full retirement age is 66 if you were born between 1943 and 1954. The full retirement age increases gradually if you were born between 1955 and 1960 until it reaches 67. For anyone born 1960 or later, full retirement benefits are payable at age 67.<sup>12</sup>

There is no means test for Social Security. If you satisfy the criteria above, you automatically qualify for benefits. Anyone, regardless of income level, can receive Social Security benefits. Even very wealthy individuals can and do collect Social Security. Given the current challenges the Social Security fund faces, it could be the case that in your lifetime, there will be a means test applicable to your receiving retirement benefits. This risk is even more reason to begin planning, saving, and investing in your retirement.

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<sup>11</sup> <https://www.ssa.gov/ssi/text-entitle-ussi.htm>

<sup>12</sup> <https://www.ssa.gov/pubs/EN-05-10035.pdf>

## CHAPTER 16: 401(k) Plans

- 16.1 Benefits of a 401(k) Plan
- 16.2 401(k) Regulations and Rules
- 16.3 Vesting
- 16.4 Roth 401(k)s
- 16.5 401(k) Withdrawals
- 16.6 Plans for the Self-Employed

### 16.1 Benefits of a 401(k) Plan

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Investing in retirement should be high on the list of financial goals for most young working adults. This assumes you have no credit card debt and sufficient savings in case of an emergency. I also understand that there are competing mid-range and long-term goals, like saving money to put towards the down payment on a first home purchase or saving for a child's college education. I address multi-goal planning in Chapter 2. However, for now, let's assume you simply want to invest for retirement. A common first choice would be through an employer-sponsored 401(k) retirement plan.

According to the IRS, a 401(k) plan is a qualified plan that allows you to elect to have your employer contribute a portion of your wages to an individual retirement account under the plan. It is a defined contribution plan, which means the contribution, not the benefit, is defined. Generally, amounts contributed to a 401(k) retirement account are not subject to federal income tax on your income tax return.<sup>1</sup> Essentially, the tax law gives you a special tax break for saving primarily for your retirement. Additionally, your investments in the plan can grow without being taxed. Then, in retirement, your withdrawals from the account are taxed, usually at ordinary income rates.

The two scenarios below demonstrate the benefits of the tax deferral in the year you contribute to your 401(k). The first assumes you do not contribute to a 401(k) and the second assumes you contribute \$10,000.

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<sup>1</sup> <https://www.irs.gov/retirement-plans/plan-sponsor/401k-plan-overview>

**FIGURE 1: Tax Benefits of 401(k) Contributions**

|                             | <b>Scenario 1:<br/>No 401(k)<br/>Contribution</b> | <b>Scenario 2:<br/>\$10,000 401(k)<br/>Contribution</b> | <b>Difference</b> |
|-----------------------------|---|---|-------------------|
| Gross Income                | \$56,000  | \$56,000  | \$0               |
| 401(k) Deduction            | \$0   | (\$10,000)  | N/A               |
| Taxable Income (TI)         | \$56,000  | \$46,000  | N/A               |
| Taxes (21% of TI)           | (\$11,760)  | (\$9,660)   | (\$2,100)         |
| Additional Savings Required | (\$10,000)  | \$0   | N/A               |
| <b>After-tax Total</b>      | <b>34,240</b>                                     | <b>\$36,340</b>   | <b>(\$2,100)</b>  |

The two scenarios above are identical, except that in scenario 1, you save \$10,000 in a regular (after-tax) savings or investment account, while in scenario 2 you save the same \$10,000, but in a 401(k) account. Thus, you have the same amount saved/invested for retirement in both scenarios, but you pay \$2,100 less in federal income tax in scenario 2. The federal government is simply providing an incentive for you to save through a 401(k), so at the end of the day you have an extra \$2,100 in your pocket.

A 401(k) plan can be attractive for reasons beyond simply lowering your taxes. In addition to paying less in taxes, your employer may also match all or some portion of your contribution. For example, if you contribute \$1,000, your employer may match your contribution by contributing another \$1,000 to your account.

Your employer can match all of your contributions or just a portion of your contributions. It is their decision. A common employer match is 50 percent of your contributions up to six percent of your salary – meaning your employer will match half of whatever you contribute but not more than three percent of your total salary ( $50\% \times 6\% = 3\%$ ). Assuming these terms, you would have to contribute six percent of your salary to get the maximum amount of match. If you put in more, say 10 percent, your employer will stop contributing once they contribute three percent of your salary, because that is their max under this assumption.

You should always contribute enough to earn the maximum employer match. Come on, it's free money. Some employers will play games to keep matching contributions to a minimum, like tying future 401(k) matching to the company's profits. Another strategy involves delaying their matching contributions until the end of the year, so that if you decide to leave during the year, you will not take any partial employer matching funds with you. Unfortunately, you have little say in these matters.

Looking back at our example where you contribute \$10,000 to your 401(k), let's now assume your employer matches 50 percent of your contributions up to six percent of your salary. Since you contributed \$10,000 of your \$56,000 annual salary to your 401(k) plan, your employer would match the maximum amount. Based on the example in which your annual salary is \$56,000, your employer would contribute \$1,680 to your retirement savings ( $\$56,000 \times 3\% = \$1,680$ ).

Therefore, combining the tax savings and the employer contribution, you come out ahead by \$3,780 (\$2,100 tax savings + \$1,680 employer matching contribution) just for saving in a 401(k) account rather than an after-tax savings or investment account. That "profit" of \$3,780 means you have already earned a 37.8 percent return on your retirement savings ( $\$3,780 / \$10,000 = 37.8\%$ ).

Actual amounts will be different based on what you earn, what you can afford to save, and your specific tax situation.

But the concepts remain the same. Your contributions are pretax, which makes them less expensive than after tax, and if your employer matches, the matched amount is free money.

The automatic paycheck deduction that goes straight into your 401(k) may not seem like something worth highlighting, but in fact it's a big benefit of these plans. Fidelity Investments found that one of the biggest hurdles to achieving your financial goals is the lack of setting money aside to save. Fidelity's research also showed that the more you can automate the savings process, like automatic deductions from your paycheck, the more likely you are to achieve your financial goals. Making the process automatic overcomes one of the most common barriers to saving – actually saving.

New laws enable employers to automatically enroll you in a 401(k) plan, unless you “opt out” of the plan by requesting not to participate. Historically it's been the opposite – you would have to ask to participate in a 401(k) plan. Another law being considered would make 401(k) participation mandatory. This would obviously also have a positive impact on retirement savings overall.

## 16.2 401(k) Regulations and Rules

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Employers are required to designate investments available in their 401(k) plans. This often limits the available investment options within the plan. Employers will provide information about each investment, and then employees select from the list of options. So, you get to manage the account, but only within the mix of investments offered by your employer.

Evaluate your investment choices thoroughly, both in terms of quality and variety. You can be moderately aggressive or conservative; it's your choice. You can diversify and allocate your contributions even when using monthly payroll deduction. I discuss investment strategies in Chapters 3-6.

For your employer to retain the tax shelter benefit, a 401(k) plan must adhere to certain rules, including:

### FIGURE 2: Employer 401(k) Tax Shelter Rules

- The employer's plan may not discriminate against lower-paid employees. This means that no matter what level of the organization you are in, if you are an employee, you should be able to participate in the plan.
- Your contributions to a 401(k) are tax-deductible.
- Growth within the 401(k) is tax-sheltered and tax-deferred until the funds are withdrawn.
- Your withdrawals in retirement become taxable income subject to ordinary tax rates in the year of withdrawal.
- You cannot withdraw funds without penalty before age 59½, except under special circumstances.

The IRS sets limits, adjusted periodically for inflation, on how much can be contributed to a 401(k) each year. The limit on employee elective deferrals (for traditional and safe harbor plans) is \$20,500 in 2022. If permitted by the 401(k) plan, participants age 50 or over at the end of the calendar year can also make catch-up contributions. You may contribute additional elective salary deferrals of \$6,500 in 2022.<sup>2</sup>

The IRS amounts and regulations change periodically, so be sure to check as you plan your level of contribution.

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<sup>2</sup> <https://www.irs.gov/retirement-plans/plan-participant-employee/retirement-topics-401k-and-profit-sharing-plan-contribution-limits>

According to current law, if the plan owner dies, the beneficiary of a 401(k) plan is the spouse, regardless of who is the named beneficiary. The only exception is if the spouse has waived, in writing, his or her rights. If the plan owner is single, it goes to the named beneficiary regardless of a will.

A 401(k) beneficiary is the person (or persons) who will receive the money left in a 401(k) money upon the owner's death. If the owner is married, 401(k) beneficiary rules typically consider the spouse as the default beneficiary. If you are married and don't want to list your spouse as the beneficiary, your spouse will usually have to sign a spousal waiver agreeing to it. (You probably don't want to do this if you want to stay married.) If you are single, you can name anyone as your beneficiary. This could be your children, your parents, your siblings, a friend, a favorite charity, or me.

Under the current law, your retirement plan must disclose fees, expenses, and past performance. Typical fees fall within a range of 0.60 to 0.75 percent of assets; and the total should not exceed 1.00 percent of assets. Employers may pay these fees or choose to pass them on to employees.

401(k) plans are typically for traditional for-profit companies. There are similar plans at non-profits and government entities, depending on the type of organization you work for. Those plans are covered by a different section of the IRS tax law. The additional plans are:

#### FIGURE 3: Alternative Employer Sponsored Retirement Plans

- **403(b) plan:** a retirement plan for certain employees of public schools, employees of certain non-profit tax-exempt organizations, and certain ministers. A 403(b) plan allows employees to contribute some of their salary to the plan. The employer may also contribute to the plan for employees. A 403(b) plan is similar to a 401(k), except it relates to different types of organizations.
- **457 plan:** a defined contribution plan established for governmental agency employees. It is similar to a 401(k) but is funded only by employee contributions, since the government does not match contributions.

## 16.3 Vesting

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You will always have access to every dollar you contribute to your own 401(k) plan. It is your money and no one can take it or prevent you from spending it. If you take it out before you are 59½, the IRS will penalize you for it, but it's still your money. The portion your employer contributes to your 401(k) may not necessarily be yours unless you meet certain employment milestones. This is called vesting.

Vesting refers to when you will actually own your employer's contributions to your 401(k) plan. Your employer does have the right to put conditions on their contributions. Typically, these conditions relate to your continued employment with the company. The conditions your employer places on vesting is one method they have to reduce employee turnover and save money. If you decide to leave the company, any unvested employer contributions remain with your employer.



**FIGURE 4: Three Types of Vesting**

- **100% Vesting:** You own 100% of these contributions, including your contributions and your employer's matching contributions. You can take all of your 401(k) money when you leave your company.
- **Cliff Vesting:** You take ownership of your employer's matching contributions from a given year all at once but only after you have worked for the company for a certain period of time. The maximum vesting period is three years. For example, if you have employer matching contributions in 2021 and they Cliff Vest in three years, you will have access to these funds at the end of 2024. If you choose to leave at the end of 2024, you will not have access to employer matching contributions from 2022, 2023, or 2024, since you have not met the three-year vesting period for these years.
- **Graded Vesting:** You take ownership of a percentage of your employer's match each year. It is usually one-third of the employer's contribution per year for three years, but it could be 20% over five years or some other schedule.

When considering a job change, remember to include the impact vesting might have on your 401(k) plan so you are aware of the money you may be leaving behind. Lost 401(k) employer contributions can be used to negotiate for a signing bonus or higher salary from your new employer.

Furthermore, 401(k) plans are portable, which means the funds can be moved into a new account when you leave your employer. Specifically, with respect to all vested amounts:

**FIGURE 5: Portability of 401(k) Plans**

- You can transfer your funds, tax free, into a traditional IRA, where the fees may be less and many more investment choices may be available.
- You can transfer your funds, tax free, into a new employer's plan if the new plan allows you to do this.
- You can leave your account with your former employer if you have more than \$5,000 invested. However, you cannot add to the plan.
- You can withdraw the funds, but if you are under 59½, taxes will be withheld and you will have to pay a 10% early-withdrawal penalty.

## 16.4 Roth 401(k)s

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A Roth 401(k) is an employer-sponsored investment savings account that is funded with *after-tax* dollars, so there is no tax deduction associated with your contributions. This may sound like a negative at first. However, in a Roth 401(k), withdrawals are tax-free in retirement. This type of investment account may be preferable if you think you will be in a higher tax bracket in retirement than you are at the time of your contributions. Moreover, all the earnings on a Roth 401(k) are never taxed. The traditional 401(k) plan, as we have been discussing, is funded with pre-tax money, and your withdrawals are taxed in retirement when most people are in a lower tax bracket. So, essentially, one is taxed now (Roth) and the other is taxed later (traditional).

Companies that have a 401(k) plan are allowed to add a Roth 401(k) plan, but they are not required to do so. If your company has a Roth 401(k) option, you can contribute to it if you are eligible to contribute to the company's 401(k) plan. The contribution limit for a Roth 401(k) in 2021 is \$20,500. If you are age 50 or older, you may make catch-up contributions of up to \$6,500, for a potential total annual contribution of \$26,000.

There is no difference in contribution limits between a traditional 401(k) and a Roth 401(k). You can contribute the maximum amount every year and spread those contributions between the two plans. But you cannot exceed the total maximum contributions between the two types of accounts. For example, if you contribute the maximum of \$20,500 in 2022 to a Roth 401(k), you cannot contribute anything in your traditional account. There is also no difference in the matching contribution percentage.

You can transfer your Roth 401(k) funds into a new employer's Roth 401(k). You can also transfer your Roth 401(k) funds into a Roth IRA without regard to the Roth IRA contribution limits or phaseouts.

## 16.5 401(k) Withdrawals

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The IRS allows penalty-free withdrawals from retirement accounts after age 59½. There are some exceptions to these rules.

Depending on your specific circumstances, you might qualify for an early withdrawal, such as a hardship withdrawal. The IRS defines a hardship as having an immediate and heavy financial need, such as a foreclosure, tuition payments, or medical expenses. However, if you're under age 59½ and take a hardship withdrawal, the withdrawal will be subject to a 10 percent penalty in addition to the income taxes that you will be required to pay. Some plans may allow a non-hardship withdrawal, but all plans are different, so check with your employer for details.

You can also choose to borrow from your 401(k) plan. Depending on your plan, you could take out as much as 50 percent of your savings, up to a maximum of \$50,000. The loan will be subject to interest and must be paid back within five years. Generally, the interest rate is one to three percent over the prime rate but will depend on your specific plan. Unlike early 401(k) withdrawals, you don't have to pay taxes and penalties when you take a 401(k) loan. Plus, the interest you pay goes to you rather than someone else. Missing payments or a default on your loan from a 401(k) won't impact your credit score. However, if you leave your current job, you might have to repay your loan (to yourself) upon departure. If you can't repay the loan for any reason, it's considered defaulted and you'll owe both taxes and a 10% penalty if you're under 59½.

The IRS requires withdrawals after age 72 (these are called Required Minimum Distributions or RMDs). The RMD for any year is the account balance as of the end of the immediately preceding calendar year divided by your remaining life expectancy. If your sole beneficiary is 10 or more years younger than you, then you could choose to use your spouse's remaining life expectancy.

If you die with available funds in your 401(k), current tax law requires the entire balance of your account be distributed within 10 years. There is an exception for a surviving spouse, a child who has not reached 18, a disabled or chronically ill person, or a person not more than 10 years younger than you. This 10-year rule applies regardless of whether you die before, on, or after the required beginning date, now age 72. There is no required minimum distribution at any age for a Roth 401(k), but there is for the heirs.

## 16.6 Plans for the Self-Employed

Self-employed individuals, those working alone or with only a few employees, have additional retirement savings options available to them.

Solo 401(k) plans are for sole proprietors who have no employees, except possibly a spouse, and who may sometimes want to contribute to a retirement plan with income from the business. As it relates to the 401(k) plan, the business owner wears two hats, one for the employee and one for the employer. Contributions can be made to the plan in both capacities. The owner can contribute both:

### FIGURE 6: Self-Employment Contributions

- **Elective deferrals** up to 100% of compensation (“earned income” in the case of a self-employed individual) up to the annual contribution limit of \$19,500 in 2021, or \$26,000 if age 50 or over
- **Employer nonelective contributions** up to 25 percent of compensation as defined by the plan, or for self-employed individuals

Total contributions to a participant’s account, not including catch-up contributions for those age 50 and over, cannot exceed \$58,000 in 2021.

Here is an example from the IRS: Ben, age 51, earned \$50,000 in W-2 wages from his S Corporation in 2020. He deferred \$19,500 in regular elective deferrals, plus \$6,500 in catch-up contributions to the 401(k) plan. His business contributed 25% of his compensation to the plan, \$12,500. Total contributions to the plan for 2020 were \$38,500. This is the maximum that could be contributed to the plan for Ben for 2020.<sup>3</sup>

A SEP-IRA is a Simplified Employee Pension Individual Retirement Account for self-employed individuals and small-business owners with only a few employees. In 2021, business owners can contribute up to the lesser of 25 percent of income or \$58,000 to the plan. Contributions do not have to be made every year, but if you choose to contribute, you must contribute to your own SEP-IRA plan and the SEP-IRA plan of every eligible employee, which is defined as any employee at least 21 years of age who has worked for the company in three of the last five years and received at least \$500 during the year.

<sup>3</sup> <https://www.irs.gov/retirement-plans/one-participant-401k-plans>

## CHAPTER 17: Individual Retirement Accounts

### 17.1 Types of Individual Retirement Accounts

### 17.2 Opening an IRA and Getting Started

### 17.3 IRA Contribution Limits

### 17.4 IRA Withdrawals

### 17.5 Plans for the Self-Employed

## 17.1 Types of Individual Retirement Accounts

Like a 401(k) Plan, an individual retirement account (IRA) allows you to save money for retirement in a tax-advantaged way. However, unlike a 401(k), an IRA is not employer-sponsored and can just be set up at a financial institution.

IRAs are currently protected from bankruptcy up to about \$1.2 million. Few accounts are this large, which makes IRAs attractive in addition to the tax benefits they provide.

Always seek professional advice on all of these issues. Tax laws and personal circumstances change. Your employer, accountant, or investment professional can update you on IRA tax laws and help you make decisions (see IRS Pub 590).

There are four main types of IRAs and each offers a unique tax advantage:

### FIGURE 1: Four Types of IRAs

- **Traditional IRA** – This is like a traditional 401(k). Contributions are made on a pretax basis, meaning that no current income tax is paid on the contributions. Any earnings can potentially grow tax-deferred until withdrawn in retirement. In addition to deferring current income taxes and allowing investment growth tax free until retirement, IRAs also benefit most investors because their tax rates in retirement are usually lower in retirement.
- **Roth IRA** – This is like a Roth 401(k). Contributions are made with money you have already paid taxes on (after-tax), and the money grows tax-free. Most importantly, withdrawals in retirement are tax-free, provided that certain conditions are met.
- **Rollover IRA** – Money is “rolled over” from a qualified retirement plan into this traditional IRA. Rollovers involve moving eligible assets from an employer-sponsored plan, such as a 401(k) or 403(b), into an IRA.<sup>1</sup>
- **SEP-IRA** – Self-employed individuals or a small-business owners have other types of IRA plans available, such as SEP-IRAs. SEP-IRAs allow you to save more than the traditional or Roth IRA. Before opening a SEP-IRA, you should consult with your financial advisor or tax accountant to ensure you follow all the required guidelines and procedures.

<sup>1</sup> <https://www.fidelity.com/retirement-ira/inherited-ira/overview>

All else being equal, the tax benefits of a traditional or Roth IRA will allow your savings to potentially grow, or compound, more quickly than in a taxable account. There are no annual taxes due on dividends, interest or capital gains within your IRAs. Many financial experts argue that you may need up to 85 percent of your pre-retirement income in retirement. If you have an employer-sponsored savings plan, such as a 401(k), it may not be enough to accumulate the savings you need. In some situations, you can contribute to both types of accounts. And if you do not have an employer-sponsored savings plan, then an IRA makes a lot of sense.

There are reasonable and sound debates about whether it is better to contribute to a traditional IRA, a Roth IRA or a combination of both. There is no one right answer, as everyone's situation is different. Many argue it is better to contribute to a Roth IRA, since no income tax is ever paid on investment returns in a Roth IRA and tax rates will likely increase over time. Given that your qualified distributions in retirement are tax-free for a Roth IRA, you would avoid paying taxes at those higher tax rates. This may be especially true for individuals just getting out of college with relatively low levels of income. Likewise, there are no required minimum distributions beginning at age 72.

While all of this may be the case, your total retirement income may be lower than where it is today and thus subject to a lower tax rate. This would suggest that it's better to invest in a traditional IRA. However, the traditional IRA has a required minimum distribution, which forces you to withdraw taxable funds from your account.

Many also believe that it's always better to take advantage of tax-reduction strategies now and worry about the future when you get there. Contributing to a traditional IRA and getting the tax deduction now may be more valuable than the possibility of getting an unknown tax break 40 years from now.

Your situation will change throughout the years, as do tax laws. Examine your situation and the corresponding tax laws before you begin contributing to either a traditional or Roth IRA. It's important to do one or the other, rather than spending years doing nothing.

## 17.2 Opening an IRA and Getting Started

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IRAs are self-directed retirement accounts that give you complete control to manage your money as you see fit. You can open an IRA through several different institutions, including but not limited to Fidelity Investments, Vanguard, Betterment, Schwab, Motif Investing, Personal Capital, and All Invest Select. Each has its own strengths and weaknesses. Spend time researching these companies to determine which would be best for your specific situation. Fortunately, you can have more than one IRA and you can transfer funds from one account to another, assuming you follow the guidelines. Be sure to know what the fees are for account maintenance and brokerage services before signing up for an account with an institution.

Funding your IRA is simple. You can fund most IRAs with a simple transfer from a bank. Automatic transfers can also be set up so you do not have to make manual transfers or deposits. As emphasized throughout this text, the more you can automate your savings, the more likely you are to reach your financial goals.

You can also place existing retirement funds into your IRA. You can transfer funds from an IRA at one institution to an IRA at another. You can move funds from a 401(k) to a traditional or Roth IRA, and you can move funds from a traditional IRA to a Roth IRA. To convert a traditional IRA to a Roth IRA, you will need to pay the tax due on the withdrawal from the traditional IRA at your ordinary tax rate, but subsequent withdrawals from the Roth IRA will not be taxed. Money converted into a Roth IRA can only be withdrawn tax-free if held in the account for at least five years.

Once your IRA is funded, you can begin investing in assets that meet your financial objectives. You can invest in stocks, bonds, mutual funds, exchange-traded funds (ETFs), sector funds, certificates of deposit (CDs), and money market funds.

## 17.3 IRA Contribution Limits

The IRS limits traditional IRA tax deductions on contributions of up to \$6,000, or \$7,000 for those age 50 or older in 2021. The IRS may also further limit traditional IRA tax deductions, depending on whether you participate in an employer pension, profit sharing, 401(k) or 403(b) retirement plan, your marital and tax filing status, and whether your spouse is covered by an employer-sponsored retirement plan.

The IRS adjusts the contribution limits and phase-out amounts for inflation over time, so it is a good idea to check the amounts annually before making a contribution. Any excess contributions that you deduct from your taxable income above the maximum allowed are subject to six percent penalty plus taxes.<sup>2</sup>

The IRS allows you to contribute to a separate taxable IRA if your income exceeds these limits. However, you would not be able to take the tax deduction for those excess contributions.

### A. Traditional IRA Deductions Covered By Employer Retirement Account

If you participate in your employer's sponsored retirement plan, your 2021 IRA deductions are impacted as follows:<sup>3</sup>

**FIGURE 2: Single**

| Modified Gross Income                     | Deduction |
|---|-----------|
| \$66,000 or less                          | Full      |
| More than \$66,000 but less than \$76,000 | Partial   |
| \$76,000 or more                          | None      |

**FIGURE 3: Married Filing Jointly or a Qualifying Widow(er)**

| Modified Gross Income                  | Deduction |
|--|-----------|
| \$105,000 or less                      | Full      |
| More than \$105,000 but less \$125,000 | Partial   |
| \$125,000 or more                      | None      |

**FIGURE 4: Married Filing Separately**

| Modified Gross Income | Deduction |
|-----------------------|-----------|
| Less than \$10,000    | Partial   |
| \$10,000 or more      | None      |

<sup>2</sup> <https://www.investopedia.com/articles/retirement/04/042804.asp>

<sup>3</sup> <https://www.irs.gov/retirement-plans/2021-ira-deduction-limits-effect-of-modified-agi-on-deduction-if-you-are-covered-by-a-retirement-plan-at-work>

## B. Traditional IRA Deductions Not Covered by Employer Retirement Account

If you do not participate in your employer's sponsored retirement plan, your 2021 IRA deductions are impacted as follows:<sup>4</sup>

**FIGURE 5: Single or Married Filing Separately**

| Modified Gross Income | Deduction |
|-----------------------|-----------|
| Any amount            | Full      |

**FIGURE 6: Married Filing Separately with a Spouse Who is Covered**

| Modified Gross Income                       | Deduction |
|---|-----------|
| \$198,000 or less                           | Full      |
| More than \$198,000 but less than \$208,000 | Partial   |
| \$208,000 or more                           | None      |

**FIGURE 7: Married Filing Jointly with a Spouse Who is Covered by a Plan**

| Modified Gross Income | Deduction |
|-----------------------|-----------|
| Less than \$10,000    | Partial   |
| \$10,000 or more      | None      |

## C. Roth IRA Contributions

The IRS does not allow tax deductions in the year you contribute to a Roth IRA. However, as previously mentioned, your withdrawals are not subject to taxes in retirement. There is also an income test to determine if you qualify to contribute to the Roth IRA.

For instance, your 2021 IRA contributions are impacted in the following ways:<sup>5</sup>

**FIGURE 8: Married Filing Jointly or a Qualifying Widow(er)**

| Modified Gross Income                                      | Contribution |
|--|--------------|
| Less than \$198,000  | Full         |
| Greater than or equal to \$198,000 but less than \$208,000 | Partial      |
| \$208,000 or more  | None         |

**FIGURE 9: Married Filing Separately and Lived with Spouse at Any Time During the Year**

| Modified Gross Income | Contribution |
|-----------------------|--------------|
| Less than \$10,000    | Partial      |
| \$10,000 or more      | None         |

<sup>4</sup> <https://www.irs.gov/retirement-plans/2021-ira-deduction-limits-effect-of-modified-agi-on-deduction-if-you-are-not-covered-by-a-retirement-plan-at-work>

<sup>5</sup> <https://www.irs.gov/retirement-plans/amount-of-roth-ira-contributions-that-you-can-make-for-2021>



**FIGURE 10: Single, Head of Household, Married Filing Separately and Did Not Live With Spouse at Any Time During the Year**

| Modified Gross Income                                      | Contribution |
|--|--------------|
| Less than \$125,000  | Full         |
| Greater than or equal to \$125,000 but less than \$140,000 | Partial      |
| \$140,000 or more  | None         |

Note that the phase-out amounts differ for traditional and Roth IRAs.

#### **D. Income Levels Too Large To Participate in an IRA Plan**

If you are not able to receive a tax deduction for contributing to a traditional IRA, and your income levels are too high to qualify for Roth IRA contributions, you have a few choices.

First, consider putting money into a personal investment account. They are not tax sheltered, but money can be contributed and invested, and you will still benefit from the power of compounding. Funds from these accounts can be used to pay off a loan, cover educational expenses, invested into a small business, etc. All options are better than blindly spending the money instead.

If your income levels are too high to contribute to a Roth IRA, there are alternatives. You can contribute to a traditional IRA at any income level. You will not receive a tax deferral on your contributions, but you can still contribute to the traditional IRA. Then, on the next day, you can transfer your traditional IRA funds to a Roth IRA. If you transfer your funds the next day, they will likely not have any earnings on which to pay taxes. You may want to discuss this step with a tax accountant or financial planner before taking action.

## **17.4 IRA plan Withdrawals**

According to the IRS, distributions can be taken from your IRA at any time (including your SEP-IRA or SIMPLE-IRA). However, distributions will be includable in taxable income and may be subject to a 10 percent penalty if you're under age 59½. The penalty is 25 percent if the distribution is from a SIMPLE-IRA in the first 2 years that you participate in the SIMPLE-IRA plan.<sup>6</sup> If you inherit an IRA or Roth IRA, check the current rules and regulations regarding withdrawals from the account before doing anything with the money.

There are exceptions for early withdrawals without penalty in extenuating circumstances. However, the withdrawals are still subject to income tax. Some exceptions include:

<sup>6</sup> <https://www.irs.gov/retirement-plans/retirement-plans-faqs-regarding-iras-distributions-withdrawals>

**FIGURE 11: Exceptions to Taxable Withdrawals**

- Total and permanent disability of the participant/IRA owner
- Unreimbursed medical expenses that are greater than 10 percent of adjusted gross income in 2021
- Health insurance premiums paid while unemployed
- Certain distributions to qualified military reservists called to active duty
- Qualified higher education expenses
- Qualified first-time homebuyers, up to \$10,000

Before taking a distribution prior to age 59½, carefully review the IRS rules and/or speak with a financial advisor.

The IRS requires that you begin taking yearly withdrawals from your IRA at age 72½. The IRS also sets the minimum amount to be withdrawn each year. The required minimum distribution for any year is the account balance as of the end of the immediately preceding calendar year divided by the remaining life expectancy of the account holder. This is designed to ensure the IRS receives the taxes you owe on your deferred income before you or your beneficiary dies.

If you do not take out the required minimum distribution, the IRS will claim 50% of the amount you failed to withdraw.

**A. Roth IRA Plan Withdrawals:**

Roth IRAs include the original contributions and the earnings on those contributions over time. You can always withdraw *contributions* from a Roth IRA tax-free and with no penalty at any age.<sup>7</sup> However, the withdrawal rules surrounding the earnings in your Roth IRA are not nearly as straightforward. Your earnings may be taxed and subject to a 10 percent penalty depending on your age and the age of the account at the time of the withdrawal.

After age 59½ and after the account has been open for five years, you can take *earning* distributions tax- and penalty-free. The following table summarizes the consequences of taking withdrawals prior to age 59½ and/or prior to the account being five years old:

**FIGURE 12: Early Withdrawal Consequences**

| Your Age         | Roth IRA Age   | Earnings Taxed? | Earnings Subject to 10% Penalty? |
|------------------|----------------|-----------------|----------------------------------|
| Older than 59½   | Older than 5   | No              | No                               |
| Older than 59½   | Younger than 5 | Yes             | No                               |
| Younger than 59½ | Older than 5   | Yes             | No                               |
| Younger than 59½ | Younger than 5 | Yes             | Yes                              |

<sup>7</sup> <https://www.schwab.com/ira/roth-ira/withdrawal-rules>

Before making a Roth IRA early withdrawal, consider the following factors to avoid a potential 10 percent early withdrawal penalty:<sup>8</sup>

### Figure 13: Avoid the 10 Percent Penalty

- Early distributions of earnings for these reasons are considered qualified (not subject to taxes or the 10 percent early withdrawal penalty):
  - You're permanently and totally disabled.
  - As a beneficiary of the Roth IRA after death of the account owner to use up to \$10,000 for a first-time home purchase.
  - You use the withdrawal (up to a \$10,000 lifetime maximum) for a first-time home purchase.
- Early distributions of earnings for these reasons are considered exceptions (taxable as income but not subject to the 10 percent penalty):
  - You use the withdrawal to pay for qualified education expenses.
  - You use the withdrawal for qualified expenses related to a birth or adoption.
  - You become disabled or pass away.
  - You use the withdrawal to pay for unreimbursed medical expenses or health insurance if you're unemployed.
  - The distribution is made in substantially equal periodic payments.

Remember that unlike a traditional IRA, there are no required minimum distributions with a Roth IRA. However, beneficiaries are required to take minimum distributions after your death.

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<sup>8</sup> <https://www.schwab.com/ira/roth-ira/withdrawal-rules>

## CHAPTER 18: Health Insurance

- 18.1 Never Go Without Health Insurance
- 18.2 How to Obtain Health Insurance
- 18.3 Selecting the Right Health Insurance
- 18.4 Health Savings Accounts and Flexible Savings Accounts
- 18.5 Using Your Health Insurance

### 18.1 Never Go Without Health Insurance

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There is no longer a penalty for not having health insurance coverage in 2022, although California, Rhode Island, the District of Columbia, Massachusetts, New Jersey, and Vermont have their own health insurance mandates. The penalty for not having coverage the entire year within California is at least \$750 per adult and \$375 per dependent child under the age of 18 in the household in 2021. A family of four that goes uninsured for the whole year would face a penalty of at least \$2,250. However, this really isn't the reason why you should get health insurance.

Nobody plans to get sick or hurt, but bad things happen – even to healthy people. A ski trip with friends can lead to a \$7,500 bill to treat a broken leg. Three days in the hospital can cost \$30,000. For someone making \$65,000 a year, \$30,000 is almost 50 percent of their annual earnings. Having those kinds of medical bills or debt can really set you back financially. Furthermore, if you're paying for every medical service yourself, you are more likely to make health care decisions based on your finances rather than what is best for your health.<sup>1</sup>

A 2019 American Journal of Public Health study found that 66.5 percent of bankruptcies in the U.S. were due to medical issues, such as being unable to pay high medical bills or due to time lost from work.<sup>2</sup> Therefore, always make sure you have medical insurance to ensure you meet your financial goals by staying out of financial trouble. At a minimum, make sure to have medical insurance that would cover major expenses. If you are single and in good health, you might look for low-cost, high-deductible plans that cover major medical procedures. On the other hand, if you have small children and are making frequent visits to the pediatrician, look for a plan with low or no co-payments.

Health insurance is not cheap. A decent comprehensive individual healthcare insurance plan for my family of four would cost me approximately \$1,400 a month, according to Covered California.<sup>3</sup> Fortunately, I pay for my family's healthcare insurance through an employer-sponsored group healthcare plan, where I am required to pay approximately \$400 a month for my portion of the insurance premium. My employer pays the rest.

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<sup>1</sup> <https://www.healthcare.gov/young-adults/ready-to-apply/>

<sup>2</sup> <https://www.eurekalert.org/news-releases/825782>

<sup>3</sup> <https://www.coveredca.com/#quick-calculator>

## 18.2 How to Obtain Health Insurance

According to USA.GOV, you can obtain health care coverage through the following:<sup>4</sup>

### FIGURE 1: Ways to Obtain Health Insurance

- Your parents' insurance plan, if you are under 26 years old
- A group coverage plan at your job or your spouse/partner's job
- Continuing employer coverage from your former employer on a temporary basis under the Consolidated Omnibus Budget Reconciliation Act (COBRA)
- A plan you purchase on your own directly from a health insurance company or through the Health Insurance Marketplace
- Government programs such as Medicare, Medicaid, or Children's Health Insurance Program,
- The Veterans Administration or TRICARE for military personnel
- Your state, if it provides a health insurance plan

### A. Employer-Provided Group Plans

The least expensive option to obtain health care coverage is to remain on your parents' plan. When you reach the age of 26, though, you will have to acquire your own insurance. A group coverage plan through your employer or spouse's employer will most likely be your least expensive option. First of all, since it's a group plan, you and your co-workers can take advantage of group rates. Second, your employer will likely cover some portion of your monthly premium. A Kaiser Family Foundation survey found that employers on average pay 82 percent for single coverage and 70 percent for family coverage.<sup>5</sup> Finally, the monthly health insurance premium payments deducted from your paychecks are tax-deductible, as we discuss in Chapter 19 on Employee Benefits.

If you leave your job or no longer qualify for insurance through your employer, you may want to consider COBRA coverage. In certain circumstances, COBRA allows you to continue to participate in your former employer's group plan for up to 18 months. However, your employer will no longer be paying a portion of your monthly premiums, so COBRA coverage may cost substantially more than what you were paying while you were employed.

### B. Individual Plans

There are several options available to obtain individual health insurance. Most people get their own health insurance through the government's Health Insurance Marketplace, sometimes referred to as the health insurance "exchange." You can purchase an individual policy through the marketplace, even if you are eligible for insurance through your employer.

You can apply for a marketplace policy online, by phone, or in person. You must be a U.S. citizen or lawfully present in the country to buy a marketplace plan. You can start your search for a marketplace policy at [healthcare.gov](https://healthcare.gov) by entering your state and zip code. If your state has its own marketplace, you'll be redirected to your state's website.

<sup>4</sup> <https://www.usa.gov/finding-health-insurance>

<sup>5</sup> <https://files.kff.org/attachment/Report-Employer-Health-Benefits-2020-Annual-Survey.pdf>

## CHAPTER 18: Health Insurance

For instance, in California we are directed to Coveredca.com.

Individual health insurance plans in the marketplace are presented in four “metal” categories: **Bronze**, **Silver**, **Gold**, and **Platinum**. Metal categories are based on how you pay for your health insurance and have nothing to do with the quality of care you would receive.

**The Bronze Category** has the lowest monthly premiums but the highest costs when you need care. Bronze plan deductibles can be thousands of dollars a year. A Bronze plan is a good choice if you are young and healthy and want a low-cost way to obtain health insurance to protect yourself against worst-case medical scenarios.

**The Silver Category** has moderate monthly premiums and moderate costs when you need care. Deductibles under Silver plans are usually lower than the deductibles in Bronze plans. The standard Silver plan covers 70 percent of your out-of-pocket costs. If you qualify for cost-sharing reduction, you may qualify for cost sharing of between 73 percent and 94 percent coverage. Those who qualify for cost-sharing reductions at the upper end of the range should rarely purchase a Gold plan because they would be paying higher premiums for less benefits. The Silver plans are a great option if you qualify for “extra savings” or if you’re willing to pay a slightly higher monthly premium than Bronze to have more of your routine care covered.

**The Gold Category** has high monthly premiums but low costs when you need care, as deductibles are usually low. Gold plans are a good choice if you’re willing to pay more each month to have more costs covered when you get medical treatment. It makes sense to lean toward a Gold plan if you use a lot of care.

**The Platinum Category** has the highest monthly premium and the lowest costs when you get care. Deductibles are very low, so it’s a good choice if you usually use a lot of care and are willing to pay a high monthly premium, knowing nearly all other costs will be covered.

Some individuals may qualify and benefit from Catastrophic health insurance sold in the marketplace. These plans only cover three primary care visits per year before the plan’s deductible is met. The premiums are generally lower than for other plans but the out-of-pocket costs for deductibles, copayments, and coinsurance are generally higher. To qualify for a Catastrophic plan, you must be under 30 years old or get a “hardship exemption.”

There are other options available to you to purchase an individual health insurance plan beyond the marketplace. You can work with an agent or broker and rely on their experience evaluating an insurance plan. You can purchase directly from an insurer, since the marketplace doesn’t offer every plan available. You can buy through an online health insurance brokerage that can help you compare different plans. And you can buy through a membership organization like a union, alumni association, professional organization, or any other large group that you belong to that offers insurance plans at group rates.

### C. Medicare

Medicare is the federal health insurance program primarily for individuals 65 or older, certain younger individuals with disabilities, and individuals with End-Stage Renal Disease (ESRD), permanent kidney failure requiring dialysis or a transplant. Medicare helps cover specific services within Medicare Parts A, B, and D.

**Medicare Part A**, also known as Hospital Insurance, covers inpatient hospital stays, care in a skilled nursing facility, hospice care, and some home health care. Generally, you do not pay a monthly premium for Part A if you or your spouse paid Medicare taxes for a certain amount of time while working. This is sometimes called “Premium-free

Part A.”

**Medicare Part B**, also known as Medical Insurance, covers certain doctors’ services, outpatient care, medical supplies, and preventive services. Everyone pays for Part B and most will pay a standard premium amount. The amount you pay is based on your prior year’s adjusted gross income. The standard Part B premium amount in 2022 is \$170.<sup>6</sup> You pay your premiums directly and most of the time they are deducted from Social Security checks. Benefits are the same regardless of what you pay per month.

**Medicare Part D**, also known as Prescription Drug Coverage, is optional and helps cover the cost of prescription drugs (including many recommended shots or vaccines). Monthly premiums vary widely depending on the coverage and may be different in every state. Some states have over 40 different plans just for residents of that state. Some individuals with higher-than-average adjusted gross income pay a monthly surcharge in addition to their insurance cost. The monthly surcharge ranges from about \$12 to \$67 per month.

Once you enroll in Medicare, you will need to decide how you’ll get your Medicare coverage. There are two main ways: Original Medicare and Medicare Advantage.

Original Medicare includes Medicare Part A (Hospital Insurance) and Medicare Part B (Medical Insurance). You pay for services as you get them. When you get services, you’ll pay a deductible at the start of each year, and you usually pay 20% of the cost of the Medicare-approved service. If you want drug coverage, you can add a separate drug plan (Part D).

Original Medicare pays for much, but not all, of the cost for covered health care services and supplies. A Medicare Supplement Insurance (Medigap) policy can help pay some of the remaining health care costs, like copayments, coinsurance, and deductibles. Some Medigap policies also cover services that Original Medicare doesn’t cover, like medical care when you travel outside the U.S.<sup>7</sup>

Medicare Advantage is an “all in one” alternative to Original Medicare. These “bundled” plans include Part A, Part B, and usually Part D. Most plans offer extra benefits that Original Medicare doesn’t cover — like vision, hearing, and dental. Medicare Advantage Plans have yearly contracts with Medicare and must follow Medicare’s coverage rules. The plan must notify you about any changes before the start of the next enrollment year.<sup>8</sup>

Each Medicare Advantage Plan can charge different out-of-pocket costs. They can also have different rules for how you get services.

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<sup>6</sup> <https://www.medicare.gov/what-medicare-covers/your-medicare-coverage-choices/whats-medicare>

<sup>7</sup> <https://www.medicare.gov/what-medicare-covers/your-medicare-coverage-choices/whats-medicare>

<sup>8</sup> <https://www.medicare.gov/what-medicare-covers/your-medicare-coverage-choices/whats-medicare>



## 18.3 Selecting the Right Health Insurance

There is a basic set of factors to consider when selecting medical insurance coverage, whether through an employer or on your own. The annual cost of the plan is a critical factor. Many medical insurance plans include the following key cost-related elements:

### FIGURE 2: Cost-Related Elements of Health Plans

- **Premium** – The amount you pay for health insurance every month. In addition to the premium, you usually have to pay other costs, including a deductible, copayments, and coinsurance. When shopping for a plan, keep in mind that the plan with the lowest monthly premium may not be the best match for you. If you need a lot of health care, a plan with a slightly higher premium but a lower deductible may save a lot of money.<sup>9</sup>
- **Deductible** – The amount you pay for covered health care services before insurance starts to pay. With a \$2,000 deductible, for example, you pay the first \$2,000 of covered services. After you pay the deductible, you usually pay only a copayment or coinsurance for covered services. Your insurance company pays the rest.<sup>10</sup>
- **Copayment or Coinsurance** – A fixed amount (\$20, for example) you pay for a covered health care service after you've paid the deductible. Let's say your health insurance plan's allowable cost for a doctor's office visit is \$100. Your copayment for a doctor visit is \$20. If you've paid your deductible: You pay \$20, usually at the time of the visit. If you haven't met your deductible: You pay \$100, the full allowable amount for the visit. Copayments (sometimes called "copays") can vary for different services within the same plan, like drugs, lab tests, and visits to specialists. Generally, plans with lower monthly premiums have higher copayments. Plans with higher monthly premiums usually have lower copayments.<sup>11</sup>
- **Out-of-Pocket Maximum/limit** – The most you have to pay for covered services in a plan year. After you spend this amount on deductibles, copayments, and coinsurance for in-network care and services, your health plan pays 100% of the costs of covered benefits.

If you do have coverage through your employment, your employer's contributions to your health care are not taxed as income to you. Likewise, your premium payments deducted from your paycheck are pretax, so they lower your taxable income.

### A. HMOs vs. PPOs

There are two major types of healthcare insurance providers: Health Maintenance Organizations (HMOs) and Preferred Provider Organizations (PPOs). Each has its own set of benefits and drawbacks. Understanding the differences between the two will allow you to make a more informed, and hopefully better, decision regarding your healthcare.

With an HMO plan, you pay a flat monthly fee to the HMO for coverage, regardless of usage, with little or no deductible or copayment at the time of service. You choose one primary care doctor and all your health care services go through that doctor. That means that to see any other health care professional you will first need a

<sup>9</sup> <https://www.healthcare.gov/glossary/premium/>

<sup>10</sup> <https://www.healthcare.gov/glossary/deductible/>

<sup>11</sup> <https://www.healthcare.gov/glossary/co-payment/>

referral from your primary doctor. Visits to health care professionals outside of your network are typically not covered by your HMO insurance. One exception is that women do not need a referral to see an obstetrician/gynecologist (OB/GYN) in their network for routine services such as Pap tests, annual well-woman visits and obstetrical care.<sup>12</sup>

Kaiser Permanente is one example of an HMO. HMOs were among the first to encourage periodic checkups and other preventative measures. Rather than being paid for individual services, HMOs maintain lower costs by keeping their members healthy, thus requiring less care by the clinic. It would make sense that preventative care is far cheaper than treating illnesses and conditions. The new Health Care Reform Act now requires all medical providers to subsidize annual checkups in an effort to catch—and hopefully prevent—serious conditions early on.

PPOs allow more flexibility in selecting your medical providers, but it is important to make sure they fall under your insurance plan. Some plans require your primary care physician (PCP) to refer you to a specialist within your network; other plans allow you to bypass your PCP and go directly to a specialist.

Whether you choose an HMO or a PPO, you always have the option to visit an out-of-network provider, but you will likely need to pay out-of-pocket. Moreover, certain procedures are “elective,” meaning that it is not imperative for your well-being and thus will not be covered by any insurance. In most cases, cosmetic surgery, infertility treatment, weight loss surgery, and acupuncture are not covered.

### **18.4 Health Savings Accounts and Flexible Savings Accounts**

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Health Savings Accounts (HSA) and Flexible Savings Accounts (FSA) allow you to save pretax dollars to pay out-of-pocket medical expenses, thereby making qualified medical expenses tax-deductible. These medical expenses include copayments, coinsurance, deductibles, and other services, but exclude medical insurance premiums.

To be eligible to contribute to an HSA, you cannot be claimed as a dependent on someone else’s tax return. HSA plans can be set up through your employer or purchased individually with a qualified trustee, such as a bank, investment firm, insurance company or Healthcare Exchange Plan. HSAs must also be used in conjunction with high deductible health plans (HDHPs). HDHPs have higher annual deductibles than typical health plans.

For 2021, the IRS defines a HDHP as any plan with a deductible of at least \$1,400 for an individual or \$2,800 for a family. An HDHP’s total yearly out-of-pocket expenses (including deductibles, copayments, and coinsurance) can’t be more than \$7,000 for an individual or \$14,000 for a family.

In connection with a HDHP, you can contribute up to \$3,600 to your HSA in 2021. With family coverage, you can contribute up to \$7,200. If you are 55 or older, additional catch-up contributions of \$1,000 per year are allowed. These limits tend to change annually based on cost-of-living adjustments. You can contribute more money to your HSA than is needed to cover your deductible, since it may also be used to cover other non-insured out-of-pocket medical expenses such as vision or dental care. Your employer may also contribute to your HSA plan.

HSAs are triple tax-sheltered accounts for qualified medical expenses.

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<sup>12</sup> <https://www.bcbsm.com/index/health-insurance-help/faqs/topics/how-health-insurance-works/difference-hmo-ppo.html>

**FIGURE 3: HSA Tax Benefits**

- Contributions are tax-deductible and you do not also pay FICA or Medicare tax on your contribution.
- HSA contributions can be invested and the investment income grows tax-free, similar to an IRA or 401(k). Monies in the account can be invested in mutual funds, fixed rate assets, Exchanged Traded Funds (ETFs), or Real Estate Investment Trusts (REITs). Once in a lifetime you can roll over money from an IRA to an HSA up to the annual maximum.
- The money in the account can be withdrawn tax-free if used to pay qualified out-of-pocket medical expenses that are not covered by insurance.

You can withdraw funds from your HSA for non-qualified medical expenses at any time. But those funds will be taxed as ordinary income, and the IRS will impose a 20% penalty. After you reach age 65 or if you become disabled, you can withdraw HSA funds without penalty, but the amounts withdrawn will still be taxable as ordinary income. This makes HSA plans a great alternative to a 401(k) or traditional IRA plan, since withdrawals from these accounts for medical expenses would still be subject to ordinary income taxes.

If you leave your employer, you can transfer your HSA plan to a new administrator without losing any of the tax benefits. However, you cannot make additional contributions without signing up for a new HDHP through your new employer.

If you are married when you die, money in the account can transfer to your spouse tax-free to be used for medical care. Otherwise, any balance would go to your beneficiary and be taxed.

Flexible Spending Accounts (FSAs) are like HSAs but are sponsored by employers only. Money is deducted from your paycheck on a pre-tax basis and contributed to your FSA account to pay for out-of-pocket health care expenses. Funds in the account can be used to pay for copayments, coinsurance, deductibles, or other qualified medical expenses that are not covered by your insurance.

Also, like HSAs, contributions are not subject to federal or state income taxes, Social Security or Medicare taxes. In the past, unlike HSA accounts, you lose any money left in an FSA account at the end of the year (use it or lose it). However, under the temporary rules, employers can allow you to carry over unspent contributions. You should check with your employer about your deadlines and whether these rollovers still apply to you before considering how much to contribute.

At the beginning of the year, you need to estimate the amount of expected medical expenses you will incur during the year to determine the contribution to the plan during the year. In 2021, the dependent care FSA annual pretax contributions limits are \$10,500 for single taxpayers and married couples filing jointly, and \$5,250 for married individuals filing separately. The contribution limit for health care FSAs is \$2,750.

## 18.5 Using Your Health Insurance

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When you enroll in health insurance, the plan might send you a catalog of all medical providers within your network. Make sure you know which emergency clinic is closest to you, as well as the fastest route to it.

An estimated 70% of hospitals overcharge for visits, prescriptions, and treatments. You must expect to spend a significant amount or be prepared to negotiate.

## CHAPTER 18: Health Insurance

Do not pay your hospital bill at the time of the visit. Stay in touch with the billing department and insist upon itemized bills; clinics are required to provide this to their patients. Read your medical bills carefully.

There are ways to reduce costs if you face excessive medical bills. Before paying anything, make sure they are entirely correct, then build a case. If your insurance provider contests a claim, you may appeal the decision. Ask your doctor for a letter and any other documentation that might legitimize the care or procedure.

Medical billing specialists are also available to help. Some charge by the hour, some collect a percentage of your case winnings. You can also contact your state insurance department. Some have ombudsmen—legal representatives—to either advise you or to negotiate for you. Otherwise, you're on your own.

## CHAPTER 19: Federal Income Taxes

### 19.1 Basics About Filing Your Federal Income Tax Return

### 19.2 Understanding Taxable Income, Line 15, Page 1 of Your Form 1040

### 19.3 Calculating Your Taxes Owed or Refund, Page 2 of Your Form 1040

### 19.4 Ways to Avoid Penalties and Audits

As Benjamin Franklin said, “In this world, nothing is certain except death and taxes.” And unfortunately, when it comes to paying taxes, it’s likely to be one of the biggest expenses over your lifetime. You are going to pay federal income tax, state income tax (most likely), Social Security tax, Medicare tax, sales tax, property tax, estate tax, fuel tax, automobile registration tax, airfare tax, and – my favorite – hotel room tax. This list isn’t even all-encompassing as there are all sorts of other taxes. According to an article published by the New York Society of CPAs, an analysis performed by a CPA in New York found that the average American will pay about \$525,000 in taxes over the course of a lifetime.<sup>1</sup>

Since the greatest portion of taxes we will pay as individuals will be paid to the Federal Government, this chapter focuses on federal income taxes. Many of us will also pay state income taxes, unless you live in a state that does not impose state income taxes on its residents. However, the tax laws are different in each of the states that impose state income taxes, so it’s impossible to have a discussion of state income taxes in one chapter.

As of 2019, collectively, individual taxpayers paid about two-thirds of all federal tax revenue collected. You would think that most U.S. tax revenue would come from multi-billion-dollar companies like Facebook, Apple, and Google, but it actually comes from individuals when you factor in Social Security and Medicare. The 2019 percentage of tax revenue collected by the Federal Government was as follows:

**FIGURE 1: Breakdown of 2019 U.S. Tax Revenue**

|  |     |
|--|-----|
| Individual income taxes                              | 50% |
| Social Security / Medicare taxes paid by individuals | 17% |
| Social Security / Medicare taxes paid by employers   | 17% |
| Corporate income taxes                               | 7%  |
| Excise taxes   | 3%  |
| Other taxes  | 5%  |

Not only is the corporate tax revenue significantly lower compared to the individual amounts, it also has been trending downward since the 1950s.<sup>2</sup> Given this ridiculous dichotomy, I encourage you to take advantage of all the legal tax-saving opportunities available to you. To do so begins with a basic understanding of the system within which we operate. With that in hand, the goal will be to take advantage of special tax breaks that may exist for items such as home ownership, retirement accounts, medical care, child care, college expenses, and electric cars.

<sup>1</sup> <https://www.nysscpa.org/news/publications/the-trusted-professional/article/study-average-american-will-pay-525-000-in-taxes-over-lifetime-ny-and-nj-residents-will-pay-much-more-022521>

<sup>2</sup> <https://www.taxpolicycenter.org/briefing-book/what-are-sources-revenue-federal-government>

## 19.1 Basics About Filing Your Federal Tax Return

No matter what the Federal Government does, you need to keep up with the tax rules that impact your life. Understanding the basic tax laws will allow you to make more informed financial decisions. Your best resource when it comes to taxes is [www.irs.gov](http://www.irs.gov).

Every April 15th, you are required to file a federal income tax return for the prior year ending December 31st using Internal Revenue Service (IRS) Form 1040. If the 15th falls on a weekend or holiday, then the filing date moves to the next business day. A six-month extension can be filed, but you still have to pay all of the taxes due by the April 15th deadline.

IRS Form 1040 is available online at <https://www.irs.gov/pub/irs-pdf/f1040.pdf>. There are also several different software packages to help file your taxes. I have been completing my own tax returns for years and now use TurboTax online. In fact, many software providers allow you to use their product for free if your 2021 adjusted gross income is \$39,000 or less, you are active-duty military in 2020 with an AGI of \$72,000 or less, or you qualify for the Earned Income Tax Credit. For more information, check <https://www.irs.gov/filing/free-file-do-your-federal-taxes-for-free>. You can also check to see if there are any community-based tax preparation programs in your area. For example, the College of San Mateo offers services to certain San Mateo residents during tax season. You can also seek professional help from a tax preparation firm like H & R Block, Jackson Hewitt, or a qualified tax accountant or attorney.

If you decide to do it yourself, make sure you are up to date on the most current tax laws. For basic returns, this information is not difficult to find on the Internet. But you will want to check as certain requirements change every year for no other reason than inflation. For instance, tax brackets, standard deductions, and personal exemptions all change each year due to inflation. Major tax law changes do not occur frequently, but when they do, they can cause confusion in the first tax year affected. It may make more sense to take advantage of available resources in those years to ensure you are following the most up-to-date rules. Finally, there may be temporary tax law modifications in your specific area due to natural disasters or tax-related economic stimulus provisions.

### FIGURE 2: Two Ways in Which We Make Estimated Tax Payments During the Year

1. As we discussed in Chapter 14, the government requires your employer to withhold money from your paycheck to forward to the U.S. Treasury on your behalf.
2. You may be required to pay an additional quarterly estimated tax based upon income for which no tax has been withheld, such as self-employment, commissions, rental income, and income from dividends, interest, capital gains, and royalties.

If you do not pay enough in withholding and estimated taxes throughout the year, you may be subject to a penalty from the IRS. In most instances, if your primary source of income comes from your employer, you have enough withheld from your paychecks to avoid paying penalties. If you find yourself in a situation where you have substantial self-employment income, commissions, rental income, and income from dividends, interest, capital gains, and royalties, it is probably best to discuss your specific situation with a tax professional to avoid penalties and ensure you are paying as little in taxes as legally possible.

Filing out a Form 1040 can be relatively straightforward if you aren't self-employed and don't generate income through a side business (e.g., rental income). If you primarily earn a paycheck from an employer, I encourage you to file your own 1040 every year. Consider completing your return through TurboTax or some other tax preparation



software.

I am certainly not offering tax advice in this chapter; I am simply providing an overview of the more common situations related to federal taxes and your tax return. If your financial situation evolves from the straightforward situation I just described, or you don't feel comfortable with taxes in general, consider speaking with a tax professional before completing your return. However, you should also at least understand the various rules to better make decisions regarding your finances that will result in favorable tax treatment.

Before filling out a 1040, you need to indicate your filing status, as the IRS will use it to determine the tax brackets that apply to your income level.

**FIGURE 3: Five Basic Filing Status Categories**

1. Single
2. Married filing jointly
3. Married filing separately
4. Head of household
5. Widow(er) with dependent child

The 1040 consists of two pages. The goal of the first page is to determine how much taxable income you earned during the year. The goal of the second page is to determine your Total Tax and whether you must write a check when you file your return to pay some portion of that, or whether you are entitled to a tax refund.

## 19.2 Understanding Taxable Income, Line 15, Page 1 of Your Form 1040

Not all income is taxable, not all taxable income is taxed at the same rate, and certain expenses and deductions may lower your Taxable Income. That is essentially what you are reconciling on Page 1, with the goal being to determine Taxable Income by Line 15.

**FIGURE 4: 2020 Form 1040, page 1, lines 1-15**

|   |           |  |                          |          |  |
|---|-----------|--|--------------------------|----------|--|
| Attach<br>Sch. B if<br>required.  | <b>1</b>  | Wages, salaries, tips, etc. Attach Form(s) W-2                                     | <b>1</b>                 |          |  |
|   | <b>2a</b> | Tax-exempt interest  | <b>2a</b>                |          |  |
| <b>Standard<br/>Deduction for—</b><br>• Single or<br>Married filing<br>separately,<br>\$12,400<br>• Married filing<br>jointly or<br>Qualifying<br>widow(er),<br>\$24,800<br>• Head of<br>household,<br>\$18,650<br>• If you checked<br>any box under<br>Standard<br>Deduction,<br>see instructions. | <b>3a</b> | Qualified dividends  | <b>3a</b>                |          |  |
|   | <b>4a</b> | IRA distributions  | <b>4a</b>                |          |  |
|   | <b>5a</b> | Pensions and annuities   | <b>5a</b>                |          |  |
|   | <b>6a</b> | Social security benefits   | <b>6a</b>                |          |  |
|   | <b>7</b>  | Capital gain or (loss). Attach Schedule D if required. If not required, check here | <input type="checkbox"/> | <b>7</b> |  |
|   | <b>8</b>  | Other income from Schedule 1, line 9   |                          | <b>8</b> |  |
|   | <b>9</b>  | Add lines 1, 2b, 3b, 4b, 5b, 6b, 7, and 8. This is your <b>total income</b>        | <b>9</b>                 |          |  |
|   | <b>10</b> | Adjustments to income:   |                          |          |  |
|   | <b>a</b>  | From Schedule 1, line 22   | <b>10a</b>               |          |  |
|   | <b>b</b>  | Charitable contributions if you take the standard deduction. See instructions      | <b>10b</b>               |          |  |
|   | <b>c</b>  | Add lines 10a and 10b. These are your <b>total adjustments to income</b>           | <b>10c</b>               |          |  |
|   | <b>11</b> | Subtract line 10c from line 9. This is your <b>adjusted gross income</b>           | <b>11</b>                |          |  |
|   | <b>12</b> | <b>Standard deduction or itemized deductions</b> (from Schedule A)                 | <b>12</b>                |          |  |
|   | <b>13</b> | Qualified business income deduction. Attach Form 8995 or Form 8995-A               | <b>13</b>                |          |  |
|   | <b>14</b> | Add lines 12 and 13  | <b>14</b>                |          |  |
|   | <b>15</b> | <b>Taxable income.</b> Subtract line 14 from line 11. If zero or less, enter -0-   | <b>15</b>                |          |  |

For Disclosure, Privacy Act, and Paperwork Reduction Act Notice, see separate instructions. Cat. No. 11320B Form **1040** (2020)



**Earned Income** – Line 1 reports wages, salary, bonuses, commissions, royalties, tips, and other money earned in exchange for providing personal services. It's essentially all the income you earned while working. Your employer will send you an IRS Form W-2 at the end of the year detailing all the income you earned while working for that employer. You use the W-2 to fill out the Earned Income when completing the tax return. If you are self-employed, you may receive an IRS Form 1099 from someone you worked for, and you may report income on Schedule C of the 1040 tax return.

For example, I work for the College of San Mateo and I also work on various consulting projects over the summer for various firms. At the end of the year, the College of San Mateo sends me a W-2 summarizing all the income I earned while teaching. I report that income at Line 1 of Form 1040. Additionally, I receive 1099s from clients I worked for throughout the year that summarize the money I made working on their engagements. I report that income on Schedule C and at Line 8 of my 1040.

**Unearned Income** – Lines 2-8 come from investments and other sources unrelated to employment. Unearned Income can include interest from savings accounts, bond interest, alimony payments, dividends from stock, Social Security payments, retirement distributions from IRA or 401(k) accounts, rental income, or capital gains from the sale of your home or stock that you may have owned.

**Total Income** – Line 9 adds all Earned and Unearned Income from Lines 1-8 and is sometimes referred to as **Gross Income**.

**Adjusted Gross Income** – Fortunately, we do not pay taxes based on our Total Income. As we have been discussing throughout this book, there are deductions we can take to reduce our overall tax liability. The first set of deductions we can take advantage of are referred to as “above the line” deductions because they appear above the line (Line 11) that reports Adjusted Gross Income. Most of these deductions occur on Schedule 1 to Form 1040 and are then presented in Lines 10a-10c.

Several adjustments are related to contributions you can make to certain tax-deductible accounts, such as IRAs, 401(k)s and 403(b)s, as well as health savings accounts and flexible spending accounts that we discussed in previous chapters.

Additionally, if you are self-employed, you can deduct half of the Social Security and Medicare taxes that you are required to pay. As a self-employed individual, you must pay both your share and the “employer’s” share of the tax. The “employer’s” share of the tax is an above-the-line deduction you can take. Self-employed individuals can also deduct the cost of health insurance and for contributions to self-employed retirement plans, such as a simplified employee pension or a personal 401(k). These adjustments are included at Line 10b.

Above-the-line deductions can also include educator expenses, moving expenses, certain business expenses for reservists, penalties paid for an early withdrawal of savings (e.g., from a certificate of deposit), and alimony paid. Subject to certain requirements, as of 2021 you can deduct up to \$2,500 of your student loan interest and up to \$4,000 in tuition and fees for yourself, a spouse, or a dependent.

On occasion, you will see references to “Modified” Adjusted Gross Income, which is used to determine whether you qualify for certain tax deductions. One of the most notable involves whether your IRA contributions are deductible. If your “Modified” Adjusted Gross Income is too high, then the IRS may disallow a tax deduction related to your IRA contributions.

To determine “Modified” Adjusted Gross Income, certain deductions such as tax-exempt interest, foreign income,

student loan deductions, and portions of Social Security benefits are added back to Adjusted Gross Income. The items added back can depend on the type of calculation you are performing. Also, when you use TurboTax to prepare your taxes, TurboTax will calculate “Modified” Adjusted Gross Income for you based on your answers to some simple questions.

## A. Standard and Itemized Deductions, Line 12

Once Adjusted Gross Income has been determined, below-the-line tax deductions need to be addressed to determine taxable Income. Deductions are expenses that are subtracted from Adjusted Gross Income to reduce taxes. You deduct the greater of the Standard Deduction, a fixed deduction allowed by the IRS, or the total of all your specific allowable tax deductions, called Itemized Deductions. The Standard or Itemized Deductions, whichever is greater, are included at Line 12.

The Standard Deduction in the 2020 tax year for married couples filing jointly was \$24,800. For single taxpayers and married individuals filing separately, the standard deduction was \$12,400 in 2020, and for heads of households, the standard deduction was \$18,650.<sup>3</sup> The Standard Deduction may change from year to year due to inflation adjustments, so be sure to check the most current amounts before preparing your Form 1040.

If you believe your eligible Itemized Deductions are more than the Standard Deduction, you can itemize them on Form 1040, Schedule A and use them rather than the Standard Deduction. The Standard Deduction will often be greater than your Itemized Deductions, unless you own a home. The following is an overview of some of the more common types of **Itemized Deductions**:

### FIGURE 5: Common Types of Itemized Deductions

- Out-of-pocket medical and/or dental expenses not covered by insurance that exceed 7.5 percent of Adjusted Gross Income (AGI).
- Long-term care premiums to the extent the premiums exceed 10 percent of AGI.
- Home mortgage interest is deductible on the first \$750,000 of outstanding loans. Lenders send Form 1098, which details the exact amount of deductible interest and fees paid over the year. Interest on home-equity loans/lines of credit is deductible as long as the money was borrowed to buy, build, or substantially improve the home that secured the loan.
- Personal property taxes, including real estate taxes and state/local taxes paid are also deductible up to \$10,000. However, refunds received from the state in the previous year are treated as income if you itemized deductions in the previous year.
- Donations made to a qualified charity are deductible within certain limitations. Between 2018 and 2025, the deductible amount is limited to no more than 60 percent of your AGI.
- Casualty or theft loss incurred as a result of a federally declared disaster. However, you can only deduct losses in excess of 10 percent of AGI after subtracting \$100 from the loss amount.
- Unreimbursed job-related expenses and certain miscellaneous deductions.
- Certain job-related expenses that exceeded two percent of your AGI. To qualify, you must be either an armed forces reservist, a qualified performing artist, a state or local government official working on a fee basis, or an employee with impairment-related work expenses.

<sup>3</sup> <https://www.irs.gov/newsroom/irs-provides-tax-inflation-adjustments-for-tax-year-2020>

Self-employed individuals may be able to take the qualified business income deduction at Line 13. This allows eligible self-employed and small-business owners to deduct up to 20% of their qualified business income. In general, total taxable income in 2020 must be under \$163,300 for single filers or \$326,600 for joint filers to qualify. If you're over that limit, the rules to determine whether your business income qualifies for a full or partial deduction get fairly complicated. As such, you should consult with a qualified tax professional before claiming the deduction.

Finally, Taxable Income, Line 15, is the difference between Adjusted Gross Income (Line 11) and the deductions included on Lines 12 and 13.

## 19.3 Calculating Taxes Owed or Refund, Page 2 of Your Form 1040

Page 2 of the 1040 is a calculation of the Total Tax liability for the year, and whether tax payments made throughout the year are greater than or less than the Total Tax. If you have already paid more than the Total Tax, you are owed a refund. If you have underpaid, you will owe taxes. Page 2 contains three main sections that, when combined, determine your ultimate situation – tax payment required or tax refund owed by the government.

**FIGURE 6: Three Main Sections of Form 1040 page 2, and Tax Payment or Tax Refund Example**

- Calculating your taxes
- Applying credits to those taxes
- Subtracting taxes already paid either by paycheck withholdings or estimated tax payment

|                                    | Refund Example      | Payment Example            |
|------------------------------------|---------------------|----------------------------|
| Taxes                              | \$5,400             | \$5,400                    |
| Credits                            | -\$1,000            | -\$1,000                   |
| Withholdings / Estimated Payments  | -\$5,100            | -\$3,200                   |
| <b>Remaining Payment or Refund</b> | <b>\$700 Refund</b> | <b>\$1,200 Tax Payment</b> |

Page 2 gets complicated when you have a lot going on in your financial life. Take my situation, for example:

**FIGURE 7: Types of Factors That Can Make Page 2 Complicated**

- I am married with children.
- I have multiple sources of Earned Income and self-employment income.
- I have taxes withheld from paychecks.
- I make quarterly estimated tax payments on my self-employment income.
- I occasionally have short- or long-term capital gains and/or losses.
- My income levels begin to phase out certain retirement plan contributions and available tax credits.
- I own my own home and can deduct mortgage interest, property and state taxes. However, I am usually unable to take 100 percent of those tax deductions due to limits placed on those types of deductions.
- I have business expenses to deduct from my consulting business in the summer.

Trying to discuss all the nuances line by line of Page 2 goes beyond the goal of this chapter. Simply look at Page 2 in relation to my situation and you can appreciate just how complicated the discussion could get.

FIGURE 8: Form 1040, page 2, Lines 16-38

| Form 1040 (2020)                                   |  | Page <b>2</b> |
|--|--|---------------|
| <b>16</b>  | <b>Tax</b> (see instructions). Check if any from Form(s): 1 <input type="checkbox"/> 8814 2 <input type="checkbox"/> 4972 3 <input type="checkbox"/> . . .               | <b>16</b>     |
| <b>17</b>  | Amount from Schedule 2, line 3 . . . . .   | <b>17</b>     |
| <b>18</b>  | Add lines 16 and 17 . . . . .  | <b>18</b>     |
| <b>19</b>  | Child tax credit or credit for other dependents . . . . .  | <b>19</b>     |
| <b>20</b>  | Amount from Schedule 3, line 7 . . . . .   | <b>20</b>     |
| <b>21</b>  | Add lines 19 and 20 . . . . .  | <b>21</b>     |
| <b>22</b>  | Subtract line 21 from line 18. If zero or less, enter -0- . . . . .  | <b>22</b>     |
| <b>23</b>  | Other taxes, including self-employment tax, from Schedule 2, line 10 . . . . .   | <b>23</b>     |
| <b>24</b>  | Add lines 22 and 23. This is your <b>total tax</b> . . . . . ▶   | <b>24</b>     |
| <b>25</b>  | Federal income tax withheld from:  |               |
| <b>a</b>   | Form(s) W-2 . . . . . <b>25a</b>   |               |
| <b>b</b>   | Form(s) 1099 . . . . . <b>25b</b>  |               |
| <b>c</b>   | Other forms (see instructions) . . . . . <b>25c</b>  |               |
| <b>d</b>   | Add lines 25a through 25c . . . . . <b>25d</b>   |               |
| <b>26</b>  | 2020 estimated tax payments and amount applied from 2019 return . . . . .  | <b>26</b>     |
| <b>27</b>  | Earned income credit (EIC) . . . . . <b>27</b>   |               |
| <b>28</b>  | Additional child tax credit. Attach Schedule 8812 . . . . . <b>28</b>  |               |
| <b>29</b>  | American opportunity credit from Form 8863, line 8 . . . . . <b>29</b>   |               |
| <b>30</b>  | Recovery rebate credit. See instructions . . . . . <b>30</b>   |               |
| <b>31</b>  | Amount from Schedule 3, line 13 . . . . . <b>31</b>  |               |
| <b>32</b>  | Add lines 27 through 31. These are your <b>total other payments and refundable credits</b> . . . . . ▶   | <b>32</b>     |
| <b>33</b>  | Add lines 25d, 26, and 32. These are your <b>total payments</b> . . . . . ▶  | <b>33</b>     |
| <b>34</b>  | If line 33 is more than line 24, subtract line 24 from line 33. This is the amount you <b>overpaid</b> . . . . .   | <b>34</b>     |
| <b>35a</b>   | Amount of line 34 you want <b>refunded to you</b> . If Form 8888 is attached, check here . . . ▶ <input type="checkbox"/>  | <b>35a</b>    |
| Direct deposit?<br>See instructions.               | ▶ <b>b</b> Routing number <input type="text"/> ▶ <b>c</b> Type: <input type="checkbox"/> Checking <input type="checkbox"/> Savings                                       |               |
| ▶ <b>d</b> Account number <input type="text"/>     |  |               |
| <b>36</b>  | Amount of line 34 you want <b>applied to your 2021 estimated tax</b> . . . ▶ <b>36</b>   |               |
| <b>Amount You Owe</b>                              | <b>37</b> Subtract line 33 from line 24. This is the <b>amount you owe now</b> . . . . . ▶   | <b>37</b>     |
| For details on<br>how to pay, see<br>instructions. | <b>Note:</b> Schedule H and Schedule SE filers, line 37 may not represent all of the taxes you owe for 2020. See Schedule 3, line 12e, and its instructions for details. |               |
| <b>38</b>  | Estimated tax penalty (see instructions) . . . . . ▶ <b>38</b>   |               |

Despite how complicated your tax situation is or how uncomfortable you may feel about completing a return, you should still understand some of the more common tax situations to properly plan and take advantage of tax-saving strategies throughout the year.

There are a few types of taxes we pay when it comes to our 1040 returns. The two most common taxes included in Line 16 are Income Tax and Capital Gains Tax. Income taxes are paid on our wages from employment, interest, certain dividends, royalties, and self-employment income. Capital gains taxes are paid on income derived from the sale or exchange of an asset, such as a stock or investment property, and certain dividends. And there are additional taxes we may be required to pay.

## B. Income Tax at Line 16

The income tax rate on taxable income depends on your tax bracket, which in turn depends on how much income you make throughout the calendar year. As we discussed earlier, tax brackets also depend on your filing status. The U.S. employs a progressive tax system, meaning lower-income individuals are taxed at lower rates than higher-income taxpayers. The underlying presumption is that those with higher income levels have a greater ability to pay. Then why, you may ask, don't multi-billion-dollar corporations pay more in taxes? Why do individuals pay so much more than corporations?

Our progressive tax system means that segments of income are taxed at different rates. The rates for the 2020 tax year, for example, were as follows:

**FIGURE 9: 2020 Progressive Tax Rates**

| Rate | Single                 | Married Filing Jointly | Head of Household      |
|------|------------------------|------------------------|------------------------|
| 10%  | \$0 to \$9,875         | \$0 to \$19,750        | \$0 to \$14,100        |
| 12%  | \$9,876 to \$40,125    | \$19,751 to \$80,250   | \$14,101 to \$53,700   |
| 22%  | \$40,126 to \$85,525   | \$80,251 to \$171,050  | \$53,701 to \$85,500   |
| 24%  | \$85,526 to \$163,300  | \$171,051 to \$326,600 | \$85,501 to \$163,300  |
| 32%  | \$163,301 to \$207,350 | \$326,601 to \$414,700 | \$163,301 to \$207,350 |
| 35%  | \$207,351 to \$518,400 | \$414,701 to \$622,050 | \$207,351 to \$518,400 |
| 37%  | \$518,401 or more      | \$622,051 or more      | \$518,401 or more      |

Say you were single and your Taxable Earned Income was \$95,000 in 2020. You would calculate your Total Income Tax in the following way:

**FIGURE 10: 2020 Progressive Tax Example**

| Cumulative Income | Income in Tax Bracket | Tax Rate               | Total Income Tax |
|-------------------|-----------------------|------------------------|------------------|
| \$9,875           | \$9,875               | 10%                    | \$988            |
| \$40,125          | \$30,250              | 12%                    | \$3,630          |
| \$85,525          | \$45,400              | 22%                    | \$9,988          |
| \$95,000          | \$9,475               | 24%                    | \$2,274          |
| <b>\$95,000</b>   | <b>N/A</b>            | <b>17.8% (average)</b> | <b>\$16,880</b>  |

As you can see from the example above, if your Taxable Earned Income was \$95,000 and you were single, your Total Income Tax, before credits, would be \$16,880 and your effective (or average) tax rate would be 17.8 percent of your Taxable Income. The IRS also provides tax tables at <https://www.irs.gov/pub/irs-pdf/i1040gi.pdf> (beginning at page 66).

### C. Capital Gains at Line 16

The **Capital Gains Tax** is reported on Form 1040, Schedule D. This is a tax on the profit from the sale of an asset. It includes capital gains or losses from the sale of stocks, bonds, real estate, art collections, and other assets. If, for example, you purchase stock for \$150 and then you sell it for \$400, your profit (or capital gains) would be \$250 and would be subject to capital gains tax.

Capital gains tax rates first depend on whether you held the asset for more than a year. Capital gains are considered short term if the asset is held for less than a year. Short term capital gains are taxed at ordinary income tax rates. However, if you held the asset for more than a year, the capital gains are considered long term and have preferential tax rates. This does not include taxes on profits from the sale of a home, which is reported elsewhere and taxed differently.

The current long-term capital gains tax rates are 0, 15, or 20 percent, depending on your level of income. If you were single and earned between \$40,401 and \$473,750 in 2020, you would be at the 15 percent rate. If your income was less than that range, you would not pay capital gains tax, and if it were above that range, you would be subject to the 20 percent rate. Similarly, if you were married filing jointly and earned between \$80,801 and \$502,600 in 2020, you would be at the 15 percent rate. If your income was less than that range, you would not pay capital gains tax, and if it were above that range you would be subject to the 20 percent rate.

Capital losses can usually be used to offset capital gains for tax purposes. For example, if you purchase stock for \$150 and then sell it for \$100, your loss (or capital loss) would be \$50 and would offset \$50 of capital gains in that year. First you will need to apply short-term losses against short-term gains, then long-term losses against long-term gains. Excess losses in any year can be applied to either type of gain. If in the same tax year you had a short-term gain of \$3,000 and a short-term loss of \$1,000, you would report both transactions and end up with a \$2,000 net short-term capital gain for tax purposes.

As of 2020, if you had more capital losses than gains, you may be able to use up to \$3,000 a year to offset ordinary income on federal income taxes and carry over the rest to future years. You will want to check with a tax professional as usual before making the calculation.

## **i Real Estate Capital Gains**

Up to \$250,000 for an individual (\$500,000 for married couples filing jointly) in capital gains on the sale of a primary residence is excluded from tax altogether. A primary residence is a home you lived in for at least two of the last five years. The two years that you live in your home do not need to be consecutive. You also don't need to own your home for at least five years to claim an exemption from the capital gains tax. However, you do need to have owned your home for at least two years. Generally, you can't claim this exemption if you've already claimed an exemption during the last two years.

It's important to note that this exemption does not apply to investment property. If you were to sell your second home or investment property, you would have to pay full capital gains tax. You can minimize your capital gains tax burden by selling the home strategically.

First, keeping careful track of how much money you made can help you find the best time to sell your home. For example, let's say you and your spouse earn a combined income of \$80,000 a year. Then, let's say that your spouse stops working, and as a result your household income drops to \$50,000. This would be the ideal time to sell the home because your new income puts you in the 0 percent capital gains bracket. Thus, you could avoid capital gains tax altogether. This could even apply to your primary residence.

Second, you could consider a 1031 exchange, which is a swap of one investment property for another that allows capital gains taxes to be deferred. In effect, you can sell one property at a gain and use all the funds from the sale to purchase a second property, essentially delaying the recognition of the capital gain until you sell the second property. You can do this a third, fourth, fifth time, etc. There are specific rules and guidelines you must follow when attempting a 1031 exchange, so it's important to speak to a tax professional to successfully defer the tax on the sale of your investment property.



## ii Dividends Capital Gains

Qualified stock dividends are taxed at the long-term capital tax rates discussed above. If the stock has been held for at least 61 days, it meets the qualified stock dividend criteria.

Nonqualified dividends are received from stocks held less than 61 days, stocks in Real Estate Investment Trusts and certain other dividends which are called “ordinary dividends.” These are reported on Form 1040 and are taxed as ordinary income at your individual tax rate. The year-end statement from your investment broker will itemize which are qualified and nonqualified dividends for tax purposes.

## iii Other capital gains

You cannot declare a tax loss on a security that you sold if you purchase the identical security within 30 days before or 30 days after the sale. For example, if you sold a stock on Friday at a \$1,000 loss, you could not buy the same stock back on Monday and still treat the Friday loss of \$1,000 as a capital loss on your tax return at the end of the year.

## D. Tax Credits, Withholdings, and Quarterly Payments

You can offset your total tax with available tax credits. Tax credits are directly subtracted from your tax liability. Tax credits are worth more than tax deductions because tax deductions reduce taxable income only, whereas tax credits reduce the amount of tax you owe dollar for dollar.

Tax credits are generally for special situations, such as installing energy-saving materials in your home, child care, and education.

### **FIGURE 11: Some of the More Common Tax Credits**

- Child tax credit
- Credit for other dependents
- Child and dependent care credit
- Earned income tax credit
- The retirement contribution savings credit
- American Opportunity Tax Credit
- Lifetime learning credit
- Alternative energy credits
- Obama opportunity tax credit for post-secondary education
- Adoption tax credit
- Teacher's classroom credit

Be sure to check the 1040 instructions or speak with a tax professional to ensure you are properly considering all the available tax credits. Since some of the tax credits are subject to income thresholds, you may not qualify for the tax credit if you earn too much in a year.

Remember, if you work for an employer, they have been withholding taxes from your paychecks throughout the



year. Likewise, the IRS requires those who have a significant amount of income that is not subject to adequate withholding for tax purposes to file and pay quarterly estimates of additional federal taxes. The estimates are due April 15, June 15, September 15, and January 15 for the previous quarter. Such income might come from the sale of a house, business or other asset, dividends, interest, capital gains, a sole proprietorship, Social Security and pension payments, alimony, or some other source.

## **E. Other Tax Considerations**

**Alternative Minimum Tax** (AMT) is designed to impose greater taxes on high-income earners who were paying little or no income tax by taking advantage of tax loopholes. AMT ignores certain tax deductions otherwise allowed under regular tax law, and applies special tax rates. AMT essentially places a floor on the taxes a filer must pay. AMT requires you to recalculate your taxes by adding back normal deductions such as state income and property taxes, tax-free interest on certain state and local bonds, and gains on certain stock options.

In 2021, if your adjusted gross income is over \$73,600 for a single filer, or \$114,600 for married filing jointly, you must recalculate your tax using the AMT rules. In the future, the AMT exemption level will be adjusted for inflation. The AMT tax rates are between 26 and 28 percent. If after you calculate your AMT and the tentative minimum tax is higher than your regular tax liability for the year, you will pay the tentative minimum tax.

**Federal Gift Tax and Estate Tax** - For 2020 and 2021, the annual gift-tax exclusion is \$15,000 per donor, per recipient. Thus, you can give anyone else up to \$15,000 in assets a year, free of federal gift taxes. You do not need to be related to the recipient. If you are married, you and your spouse can each give \$15,000 to the same person for a total of \$30,000. This is in addition to the lifetime exemption of \$11.7 million.

You can also pay medical bills or school tuition for someone else free of gift tax, as long as it is paid directly to the medical provider or educational institution.

On top of the \$15,000 annual exclusion, in 2021 you also get an \$11.7 million lifetime exclusion. And because it is per person, married couples can exclude double that.

So how does this work? Say you give a friend \$50,000 this year, you will first use up your \$15,000 annual exclusion. However, you still won't likely pay a gift tax because the extra \$35,000 (\$50,000 – \$15,000) counts against your lifetime exclusion. You do need to file a gift tax return. The gift tax return keeps track of that lifetime exemption.

I'm pretty sure I will never get to the lifetime exclusion. But if you're lucky enough and/or generous enough to use up your exclusions, you will likely need to pay a gift tax. The rates range from 18 to 40 percent, and you as the giver generally pay the tax. There are, of course, exceptions and special rules for calculating the tax, so you should probably speak to a tax professional before being crazy enough to give away more than \$11.7 million.

**Excise Tax** - This is a tax on purchases of specific products or certain activities. Often excise taxes are included in the price of the product or activity.

## 19.4 Ways to Avoid Penalties and Audits

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There is never a good reason to not file a tax return. And yes, that also goes for not being able to pay your taxes. If you cannot pay your taxes, you should still file and then explore your options surrounding your ability to pay. You may be able to arrange for late installment payments by filing Form 9465. The IRS also has a First Time Abatement program for those who file or pay late. The IRS may provide administrative relief from a penalty that would otherwise be applicable under its First Time Penalty Abatement policy. You can contact the IRS for more information and to plead your case at 1-800-829-1040. It can't hurt to call as you may be able to work out some payment options and they will certainly let you know what they are willing to do. As a last resort, you can file an Offer in Compromise with the IRS, but those are rarely accepted.

If you do not have the cash to pay your taxes, you can consider borrowing money or selling some of your assets to raise the necessary cash in order to pay. You can consider using your credit card. The interest expense on your credit card may be lower than the interest and penalties you would owe the IRS. You might even get miles or cash back on the credit card.

The IRS has the absolute power to audit or review your tax returns for accuracy, avoidance, fraud, or other issues. The IRS doesn't always audit you because there is a problem or red flag. The IRS uses several different methods to determine which tax payers to audit. Those methods include random selection, benchmarking, where your tax return is compared to "norms" of similar returns. Sometimes the IRS will select your return based on transactions you were involved with, with other taxpayers, such as business partners or investors, whose returns were selected for audit.

The IRS argues that filing an amended return does not affect the selection process of the original return. However, amended returns also go through a screening process and the amended return may be selected for audit. If you are one of the lucky chosen individuals who gets to live through an IRS audit, the IRS will notify you by mail. They will not initiate an audit by telephone.

If you do get audited, the first step involves understanding the reason for the audit. If the audit relates to a computational error on your part, a math error, a misplaced or omitted number, or a return not signed or filled out correctly, you may feel comfortable making the correction and being done with it.

If the audit elevates to something more substantial, you should consider whether you need professional assistance and representation. Certain tax preparers, such as H&R Block and Jackson Hewitt, may be willing to attend the audit with you without charge if they prepared your return. TurboTax has audit protection options when you sign up for their services. Sometimes it pays to have a professional on your side who looks at issues similar to yours more than once in a lifetime.

If you go it alone, address only the matter that has been raised by the IRS and nothing more. The more you say or write, the more it can be used against you, or it can raise additional issues. Approach every conversation or meeting prepared. Have all your information and documents you used to support your position. Be respectful and avoid anger and yelling.

Finally, no matter what the reason, if you do owe more tax, try to get the interest and penalty waived.

## CHAPTER 20: Buying a Home

- 20.1 Understanding the Basics
- 20.2 Assess How Much Home You Can Afford
- 20.3 Understanding the Different Types of Mortgages
- 20.4 The Buying Process
- 20.5 Miscellaneous Elements of Homeownership
- 20.6 Tax Issues Surrounding Your Primary Residence

### 20.1 Understanding the Basics

Buying a home is a huge decision and involves multiple factors that reach far beyond the contents of this book. The decision to buy a house is a personal choice and will not necessarily be covered here; I'm going to stick to laying out the financial aspects of buying and owning a home.

Buying a home will be one of the biggest financial commitments you will make. To buy a home, most individuals take on a large home loan requiring a payment every month, most commonly over 30 years. Do not underestimate what can happen over the course of 30 years, such as fluctuations in the home's value, your ability to make the monthly payments, and unexpected repair costs that could be in the many thousands of dollars.

Whether it be a house, condo, or townhome, a *home* has three common financial terms you should understand: value, mortgage, and equity. The value of a home is the price someone would theoretically be willing to pay to buy the home. A mortgage is a loan used to buy a home. The mortgage pledges a piece of property (in this case, the house itself) to the lender as security for repayment of the loan by the borrower. If the borrower stops making the monthly payments, the lender can take (repossess) the home and sell it to get the money owed. Equity is the portion of the home's value over and above the outstanding mortgage on the home. It's the amount of money you would walk away with if you were to sell the home and pay off the loan. For example:

**FIGURE 1: Home Equity Calculation**

|                      | <u>Total</u> |
|----------------------|--------------|
| Home Value           | \$1,000,000  |
| Home Loan (Mortgage) | \$800,000    |
| Equity               | \$200,000    |

Reasonable swings in a home's value can lead to significant swings in equity due to the mortgage, so if the property's value increases, the loan amount does not change, and the entire increase in the home's value goes straight to equity. For instance, assume the value of the \$1,000,000 home we were discussing above increases by 10 percent. That 10 percent increase in value equates to a 50 percent increase in equity. Equity increases from \$200,000 to \$300,000.

**Figure 2: Change in Home Equity Value from Change in Home Price**

|                      | Initial Purchase | 10% increase in Home Value |
|----------------------|------------------|----------------------------|
| Home Value           | \$1,000,000      | \$1,100,000                |
| Home Loan (Mortgage) | \$800,000        | \$800,000                  |
| Equity               | \$200,000        | \$300,000                  |

However, if the house goes down in value, the losses will come straight out of equity. Therefore, leverage (borrowing to buy a home) magnifies both increases and decreases in the owner's equity. This is not a problem if you intend to live in your home for a long time. For example, I purchased my home for \$765,000 and put approximately \$165,000 of my cash towards the down payment. Shortly after, the home's value declined substantially to where it was less than the mortgage, but since we had no intention of moving, we kept making our mortgage payments and enjoyed living in the home. Today, the home is worth about \$1,800,000. Assuming the same \$600,000 mortgage, my equity jumped from \$165,000 to \$1,200,000 (\$1,800,000 - \$600,000 mortgage).

People try to measure the better investment: buying a home or investing in the stock market. In many of those studies, stock market returns are compared to home price increases. If you are contemplating whether or not to buy a house, I encourage you to speak with an investment advisor, but remember that a home is much more than an investment, so non-financial considerations also apply.

## 20.2 Assess How Much Home You Can Afford

Buying a home starts with a review of your financial situation. First, determine how much cash you have available for a down payment, and then the amount you can borrow from the bank. The amount you can borrow depends on how much the bank is willing to lend you, as well as your honest assessment of how much you want to borrow. The more you borrow, the higher your monthly payments will be.

### A. Determine How Much Down Payment You Will Need

A down payment on a home is the upfront payment you must make to secure a loan for your home. Most mortgage lenders require that you make a cash down payment of three to 20 percent of the home's price. The down payment percentage will differ depending on your credit score, mortgage type, and home value. The most common down payment is usually 20 percent of the home's price.

#### FIGURE 3: Down Payment Examples

- A 20% down payment on a \$500,000 home would be \$100,000 ( $\$500,000 \times 20\%$ ).
- Another way of looking at it would be if you have \$75,000 for a 20% down payment on a home, then you could afford to buy a home worth \$375,000 ( $\$75,000 / 20\%$ ).

Most first-time home buyers overlook the closing costs associated with buying a home. Closing costs include all the fees for the services and expenses required to finalize a home loan. Typically, they can include appraisal fees, title and mortgage insurance, and broker fees. Unfortunately, there is no getting around most of those fees, and they

add up fast. According to NerdWallet, average closing costs for the buyer can run between two percent and five percent of the loan amount on the home. NerdWallet also has an online calculator to estimate closing costs:

<https://www.nerdwallet.com/article/mortgages/closing-costs-calculator>

Here is an example:

**FIGURE 4: Down Payment Determination**

|                                |           |   |
|--------------------------------|-----------|---|
| Home Price                     | \$500,000 |   |
| Down Payment %                 | 20%       |   |
| Down Payment                   | \$100,000 | ← |
| Resulting Loan                 | \$400,000 |   |
| Closing Costs                  | \$12,934  | ← |
| Down Payment and Closing Costs | \$112,934 | ← |

The more cash up front you have, the more house you can afford to buy. Some are lucky enough to get a family loan or gift to help with the down payment. Unfortunately, here in the Bay Area, most people struggle to come up with the down payment for even the least expensive homes. The down payment and closing costs to purchase a home are huge barriers to homeownership. So, the pursuit of homeownership usually begins with that long, steady march to save up for the down payment.

## B. Tips to Help with Your Down Payment

There are options available to lower the down payment below the typical 20 percent. Keep in mind that while it does lower the amount of cash needed to buy the home, a lower down payment may result in a higher interest rate, and will certainly mean higher monthly payments. I encourage you to speak with a reputable mortgage broker to understand the available options. Also, federal programs can help first-time buyers and/or low-income individuals.

**FIGURE 5: Federal First Time Homebuyer Programs**

- The US Department of Veterans Affairs (VA) helps service members, veterans, and surviving spouses purchase homes. VA loans provide competitive interest rates and lower down payments. Although there is no official minimum credit score, most VA-approved lenders require scores of at least 640.
- Federal Housing Administration (FHA) programs help first-time homebuyers with lower credit scores. The FHA allows down payments as low as 3.5% for those with credit scores of 580 or higher. The FHA will insure loans for borrowers with scores as low as 500 but requires a 10% down payment in those instances.
- The U.S. Department of Agriculture (USDA) home loan program is a zero-down-payment mortgage for eligible rural and suburban homebuyers. There are income limitations that vary by region.

Again, I recommend speaking with a mortgage broker or researching these programs for more information to see if you qualify. Some states also offer first-time homebuyer assistance. For instance, California has two programs:

**Figure 6: California First Time Homebuyer Programs**

- MyHome Assistance Program for assistance with down payment and closing costs
- CalHFA Zero Interest Program for closing cost help on CalPLUS Conventional and CalPLUS FHA loans

California residents seeking more information regarding these programs should visit the CalHFA website at: <https://www.calhfa.ca.gov/homebuyer/programs/index.htm>

If these options aren't possible, look for a less expensive home, or consider a home that needs remodeling so improvements can be made as finances permit. Also consider taking advantage of remote work to buy in a lower cost area, but remember that some employers will reduce your compensation if you move to a lower cost area.

**C. How to Determine How Much You Can Afford to Borrow**

It's helpful to know how much house you can afford before getting started on your search. That way you can filter out houses that are out of your price range. There's no point in falling in love with a house or neighborhood that you just can't afford. Speaking directly with lenders to get pre-approved is the best way to go, but you can also estimate it yourself. Start with an honest personal budget as we discussed in Chapter 1. This will help determine the monthly payment you can afford. Then use that monthly payment, along with a few other assumptions, to estimate the amount a bank would be willing to lend you. The money you ultimately get from the bank, combined with your down payment, will give you an idea of how much you can pay. Some rules of thumb include:

**FIGURE 7: Borrowing Rules of Thumb**

- **28% Rule:** Some argue that monthly mortgage payments should not exceed 28% of gross monthly income (income before taxes). For example, if you have annual income of \$100,000, your monthly payment should not exceed \$2,333. ( $\$100,000 / 12 \times 28\%$ )
- **32% Rule:** Others argue that total housing payments (mortgage, insurance, property taxes, etc.) should not exceed 32% of gross monthly income. Assuming \$100,000, your monthly housing payment should be no more than \$2,666 per month. ( $\$100,000 / 12 \times 32\%$ )
- **40% Rule:** Finally, total debt payments, including house, auto, student loans, and minimum credit card payments, should not exceed 40% of gross monthly income. Assuming the same annual income of \$100,000, total monthly debt payments should not exceed \$3,333.

These rules of thumb are just the beginning, since they focus only on the monthly payment. From there, the loan amount must still be estimated. To do so, estimates for the interest rate, term of the loan, down payment, and your credit score are needed. There are mortgage payment calculators online that can help with this calculation. Bankrate.com has a great one at: <https://www.bankrate.com/calculators/mortgages/mortgage-calculator.aspx>. An example is provided below:

**FIGURE 8: Home Value and Loan Assumptions:**

- \$750,000 Home price
- \$150,000 Down payment ( $\$750,000 \times 20\%$ )
- 3% Interest rate



**Figure 9: Detail of Payment**

|                              | <u>Total</u>   |
|------------------------------|----------------|
| Principal and Interest       | \$2,529        |
| Homeowner's Insurance        | \$66           |
| Property Tax                 | \$494          |
| <b>Total Monthly Payment</b> | <b>\$3,089</b> |

Based on the above example, we are between the 32% Rule and the 40% Rule for an individual or couple making \$100,000 per year. This may be OK if you have no other debt. With additional debt, you might not be able to qualify for the loan before paying off the other debt. As previously stated, the rules of thumb and online calculators can help set preliminary expectations, but you will ultimately need to work with a bank or mortgage broker directly.

There are two aspects to the monthly payment I want to highlight. First, the amount of the monthly payment that goes toward paying down the outstanding balance on the mortgage is your money. You are essentially pulling money from one pocket and putting it in another. For instance, assume you own a home worth \$500,000 and have an outstanding mortgage of \$300,000. Your equity in the home would be \$200,000 (\$500,000 - \$300,000). Now assume that over 15 years, the outstanding loan balance decreases by \$150,000 through your continued monthly mortgage payments. If the home value remained \$500,000, equity would have increased by \$150,000 as a result of the loan pay-down. This is a nice benefit of homeownership over renting since you don't build equity by renting.

**FIGURE 10: Loan Paydown Example**

|                      | <u>Initial Purchase</u> | <u>15 Years Later</u> |
|----------------------|-------------------------|-----------------------|
| Home Value           | \$500,000               | \$500,000             |
| Home Loan (Mortgage) | \$300,000               | \$150,000             |
| Equity               | \$200,000               | \$350,000             |

Second, you will receive a tax deduction on some or all of the mortgage interest and property taxes you pay. Given the tax deduction, your overall tax liability may be lower than if you were to rent a home. This suggests that you can afford higher mortgage payments versus rent payments because of the tax deduction. I would avoid increasing your mortgage based on this argument unless you can accurately estimate the tax benefits.

#### **D. Monthly Maintenance and Repair Costs**

There are several recurring monthly expenses associated with owning a home. The most common is the principal and interest payments on the home mortgage, as well as homeowner's insurance and property taxes. These were all included in the mortgage calculator we used in the previous section. Furthermore, there are additional maintenance and repair costs that you should consider before deciding how much you can afford. There is never a shortage of projects to complete or maintain a home. My home is pretty well-maintained, yet over the past 12 months I spent an average of \$225 per month on general maintenance and upkeep. The list of things to maintain throughout the year can include but are not limited to:



**FIGURE 11: Examples of Repair and Maintenance Costs**

- Maintaining your yard
- Cleaning your siding
- Power-washing your deck or patio
- Cleaning or replacing carpet
- Sealcoating your driveway
- Cleaning out your gutters and vents
- Clearing out your sewer line
- Replacing filters on your heating and air conditioning units
- Fixing leaky faucets
- Swapping out rusted fixtures
- Having kitchen or laundry appliances serviced
- Painting a room

There are many ways to estimate the cost of monthly maintenance. Some suggest that the maintenance on a home can be approximately one percent of the home's value. Another way would be to estimate home maintenance based on a \$1 per square foot of your home per year. For my 1,600-square-foot property, that would put me at approximately \$1,600 in maintenance annually or approximately \$133 per month. ( $\$1,600 / 12$  months).

These rules of thumb don't take the age or location of your home into account, so adjust these estimates accordingly. These maintenance estimates also don't include large one-time expenses like replacing a sewer line or repairing a roof. So when you consider purchasing a home, be certain to properly estimate and include home maintenance in your budgeted monthly expenses.

If you are considering a condominium, townhome, or home in a gated community, you may have to pay Homeowners Association (HOA) fees. These are monthly payments to the organization that is managing your community property. The dues go toward maintaining the common areas of the properties. Depending on the specific property, HOA dues can be as low as a few hundred dollars and up to thousands of dollars. The listing of the property and information online should list the HOA dues for a property you are interested in purchasing.

## **E. Qualifying for a Home Loan**

Your credit score will, in part, determine the amount and interest rate of your mortgage, so check your credit report and FICO scores well in advance of applying for a loan. Like right now! We covered the importance of managing your credit score in Chapter 10-11. You may need time to correct errors, so checking your credit score months in advance makes a lot of sense. You may also be able to use rapid rescore, which is a program available through mortgage lenders and brokers only. It enables you to pay down debt or correct errors and get accurate information updated in your credit report in just a few days rather than months. You will pay a fee for the service, but it may be worth it if it helps you qualify for a loan or lowers your interest rate.

Reach out to banks, credit unions, mortgage brokers, or savings and loans to start the process of borrowing money. I found a mortgage broker decades ago that I use every time I purchase a property or refinance a loan on the current property. And I always reach out well in advance to research my options. You do not need to be an existing customer with any of these institutions, lenders or brokers. As with all big-ticket shopping, get three bids, and make sure they

include the costs of all fees and expenses in addition to maximum loan amounts and stated interest rates. Bids should always be free and without obligations.

Beyond your credit score, lenders will want to know your annual income, other debts (e.g., credit cards, cars), estimated down payment, and employment history. They will likely ask for recent pay stubs and your most recent tax returns from the past three years to get started.

The lender will usually get three credit reports and scores on each applicant. The interest rate quoted will usually be based on the lowest credit score within the bunch. If you are applying jointly, the applicants' incomes and debts will be combined. All else being equal, a good credit score can yield a lower rate of interest and reduce the time to get a loan approved. Given the amount you are contemplating borrowing, a small change in the interest rate can lead to tens of thousands of dollars in interest over the life of the loan.

References to interest rates are almost always based on an annual percentage rate (APR). You've probably heard someone in an advertisement talk about "interest rates of 3 to 3.3% APR" or something similar. The APR generally includes all of the fees you are required to pay. The 3% is to get your attention, but it is almost certainly going to increase over time. Always pay attention to the fine print.

## **20.3 Understanding the Different Types of Mortgages**

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The standard home mortgage is the 30-year fixed-rate. The term "fixed-rate mortgage" means that the interest rate remains the same for the entire 30-year life of the loan regardless of what happens to interest rates in the market. This means the mortgage payment will never change either. While the monthly payment doesn't change, the portion going to principal versus interest does change over the life of the loan. Only a small portion of the monthly payment goes to paying down the principal at the beginning, but almost all of the payment will go toward the principal amount near the end of the loan term. There are 10-year and 15-year loans as well. If you only have 15 years left on your original 30-year loan, it may make sense to refinance your loan to a 15-year loan if you can get a better interest rate on the new loan. You can also match the term of your loan with your expected year of retirement to avoid having to make mortgage payments in retirement.

### **A. Fixed Versus Variable Rate Loans**

There are many types of mortgages available. Some are a bit risky, as they can quickly get expensive. When discussing loan alternatives with a lender, make sure they are offering terms and conditions that will work for you. The 30-year fixed-rate mortgage with 20 percent down is the benchmark against which all other loans are compared.

Adjustable-rate mortgages set the initial interest rate at a fixed amount for a certain time, usually between one and five years. After the initial period, the lender "adjusts" the interest rate to the prevailing rates in the industry. This interest rate adjustment will change your monthly payment, usually to something higher. Low introductory "teaser" rates are often offered to entice borrowers. I highly encourage you to think carefully before getting an adjustable-rate mortgage. The risk is that the new payment amount, after being adjusted, may be more than you can afford, which can ultimately lead to losing your home. Rate increases are commonly limited to a maximum increase each adjustment period, as well as a maximum total interest rate cap that cannot be exceeded during the life of the loan. Even then, it's a risky proposition.

Interest-only loans sound appealing but are equally risky. You are required to only pay the interest, with no part of the payment going toward the principal. The upside is that you have a lower monthly payment, but the interest-only

options generally expire at five years. Because you are not paying principal, your loan never gets smaller during this first five-year period. Plus, when the “interest-only” period expires and the loan converts to a fixed-rate mortgage, the monthly payment will increase substantially and may become unaffordable. This is not only because the interest rate may be higher but also because the entire principal must be paid over a shorter period.

Some interest-only loans may require you to only pay the interest on the loan for a certain amount of time, with the entire loan amount due at the end of the term. This is called a “balloon payment” and common terms can be between two and five years. You should not use this type of loan to buy a home if you intend to keep the home beyond five years. This is because if you can’t afford to refinance or pay off the loan at the time of the balloon payment, you could lose or be forced to sell your home.

A negative amortization loan is a loan where the amount owed increases over time. If you borrow \$500,000 under a negative amortization loan, after five years your outstanding balance on the loan will be greater than \$500,000. This is because you are paying less interest than you are ultimately required to pay. This usually occurs when low introductory interest rates are used to entice you to buy a home. Low rates always come with baggage. The difference between the initial rate and the rate you should be paying is added to the amount of the loan. When the introductory rate ends in two or three years, the interest rate increases to the prevailing market rate, sometimes substantially. At that point, you have a higher interest rate on a larger loan to be paid over a shorter period. Not ideal and I highly encourage you to avoid these loans.

## **B. Conforming and Jumbo Loans**

Conforming loans generally have lower interest rates because they represent a smaller risk and at times can offer lower down payments of three to five percent.<sup>1</sup> Generally, the points (prepaid interest) and fees on conforming loans can’t exceed three percent of the loan, and the term of the loan can’t be longer than 30 years.

The Federal Housing Finance Agency (FHFA) sets the limits for conforming loans. If you have excellent credit and the amount you borrow is under the conforming limits, you can qualify for one of these loans and obtain a loan at a lower interest rate. The 2021 maximum conforming loan limits for mortgages to be acquired by Fannie Mae and Freddie Mac in most of the U.S is \$548,250. However, in certain high-cost areas, like the San Francisco Bay Area, it may be upwards of \$625,000. You should check with the FHFA to get the most up-to-date amounts. To qualify for a conforming loan:

### **FIGURE 12: Conforming Loan Guidelines**

- You will generally need a credit score of at least 620 or better.
- You will need a debt-to-income ratio below 50%.
- You cannot have a loan-to-value ratio greater than 97% (meaning a minimum 3% down payment).

Jumbo loans are larger loans that do not conform to the loan sizes set by Fannie Mae and Freddie Mac. As such, they are likely not eligible for government agency purchase in a secondary market. They usually come with higher interest rates and may require larger down payments.

<sup>1</sup> <https://www.fhfa.gov/Media/PublicAffairs/Pages/FHFA-Announces-Conforming-Loan-Limits-for-2021.aspx>

### **C. First, Second, HELOCS, and PMI**

The primary mortgage is referred to as the First Mortgage. The First Mortgage lender has the first claim on the property in the event of a default or the sale of the property. Once the house is sold, the First Mortgage lender gets its money first before anyone else, including you.

If the down payment is less than 20 percent of the purchase price, the lender may charge a higher interest rate and require private mortgage insurance (PMI). PMI protects the lender from potential financial loss in the event of default on the loan. The cost of PMI is generally one percent of the amount of the loan per year.

PMI usually will be terminated once the loan balance drops below 80 percent of the property's value. This occurs when the home increases in value and/or you have paid back enough of the principal amount. PMI may or may not be a tax-deductible item, so you will need to check with the Internal Revenue Service (IRS) for the latest information.

In some cases, a Second Mortgage can be obtained if the lender of the First Mortgage will not lend more than 80 percent of the home's value. So, if you cannot come up with a 20 percent down payment, you may be able to finance the down payment through a Second Mortgage. A Second Mortgage is then second in line and is considered riskier than a First Mortgage since the First Mortgage always gets paid first. If there isn't any money left after the First Mortgage gets paid, the Second Mortgage lenders do not get paid. Therefore, the Second Mortgage usually has a higher rate of interest and a shorter term of either three, five, or sometimes 10 years.

A Home Equity Line of Credit (HELOC) is a revolving line of credit that works similarly to a credit card but at much better interest rates. A HELOC will allow you to borrow, pay down, and re-borrow funds up to a maximum amount. But, unlike a credit card, a HELOC is secured by the property. If you cannot pay off the HELOC, the HELOC lender can force you to sell your property to be paid back.

While it might be tempting to run up a large balance on your HELOC, it may not always be the best idea. Your house's value will change over time, and it won't always go up. If you are unable to make the required payments and are forced to sell your home, and the sale price of the home isn't high enough to pay off your HELOC loan, you may be forced into bankruptcy. As with all other large financial decisions, be sure to speak with advisors and professionals and consider all the risks before making the decision.

## **20.4 The Buying Process**

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Most of the time, sellers and buyers enlist the help of real estate agents or brokers. Sometimes sellers will opt to sell their house by themselves to avoid having to pay commission. If you decide to sell without a real estate professional, you'll need to take extreme caution and will likely need the help of an attorney. The attorney might ask for a cut, in which case you might as well use a real estate agent. Make sure you ask friends and family members for a referral for an agent, broker or attorney.

In most real estate transactions, the selling agent lists the property on a multiple listing service (MLS) for viewing purposes. When the property sells, the seller pays a commission that is split between the seller's and buyer's agents. In the past, the commission was approximately six percent of the sale price. Today, it is common to negotiate for a lower commission, especially on particularly expensive homes.

Make sure that the agent or broker you are working with isn't representing both the buyer and the seller. This is known as dual agency, which is illegal unless it is properly disclosed to both buyer and seller and everyone is OK

with it. When dealing with a bigger brokerage with several agents, you may be asked to sign a waiver permitting your agent to deal with another agent from the same firm representing the other side of the transaction.

Since agents only get paid if a transaction closes, the pressure is usually on the seller to lower the price and the buyer to raise the price, so that the agents' commissions are earned. Sometimes the agents will agree to reduce their commissions to help close the gap. Real estate transactions are always negotiable.

Since real estate brokers and agents are licensed to work throughout the entire state, make sure to interview your prospective agents for knowledge of the area in which you want to buy. This is a big deal and a huge life decision, so get as many references as you need. Once you have an agent, you are ready to start searching for a home. The most important factor is location – specifically the neighborhood – and its ability to meet your needs. The price is only one facet. You must also consider schools, climate, neighbors, crime rates, transportation, zoning, and the general upkeep of the neighborhood. Look at commute time and cost of transportation. Check Megan's Law or similar sites. Make a pros and cons list. Do not focus on one feature.

The art of buying a home is finding one you will be happy in, and it's your job to lay out what that looks like. Getting the legal and financial aspects to fit your needs is also imperative. Rather than having a perfect price in mind, have a range in mind. Prices are negotiable. If you cannot afford exactly what you want, exactly where you want it, it's more important to sacrifice something inside the house rather than location. You can make changes to the house later, but you cannot change the neighborhood or the climate.

Tour the house and make several visits at different times of the day to any house you are seriously considering. Since you will be home mainly at night and on the weekends, visit the prospective neighborhood, making certain it isn't too loud, too busy, or too sketchy for your preference. Check with police regarding the crime rate in the area. Bring a notepad, tape measure, and maybe take photos.

Check the square footage of the lot and the house. Some listings might be exaggerated. Take note of the age of appliances and major mechanical systems and ask about the property taxes you will have to pay, along with assessments and utility bills. Sometimes promised facilities and/or memberships, such as golf, pool, parking, or storage privileges, might not live up to their description.

Sellers and their agents are required to disclose material defects. Professional inspections aren't expensive and are worth every penny. Make sure the inspection covers roof, gutters, exterior finish, furnace, electrical, plumbing, foundation, termites, soil assessment, leaks, dry rot, mold, water stains, and cracks in walls or concrete. The seller often pays for repairs, but you can negotiate them into the home price.

At this point, you can make an offer. Start low. Compare the house you're interested in with other homes that sold in the last six months in the same area. Your agent will present your offer with your price and conditions, and you'll want to get everything in writing. One condition may be your ability to get financing or to sell your current house. Another condition should cover the inspection (for which the buyer pays) and repairs (which the seller pays) on the property. Counteroffers from the seller are standard. Don't forget to keep looking. A lot of homes will sell for thousands of dollars over the asking price.

The lender you have chosen will get an independent appraisal of the property, and you will likely pay for that. The lender must also give you an itemized estimate of closing costs once you complete the loan application. Lender fees may include running credit reports, appraisals, filing fees, and mailing costs. Closing costs are usually between \$1,000 and \$5,000 but can sometimes cost more. Some lenders offer loans with zero closing costs, but be careful because they'll sometimes make up for it by charging a higher interest rate. Don't forget how competitive the market

can be.

An escrow is when a neutral third party holds the documentation and money involved in the transaction until the transaction is completed, and then distributes the funds and executes the instructions. The escrow company charges a fee for their service and the typical escrow period in California is between 30 and 60 days (sometimes shorter, sometimes longer).

A title search verifies the property's legal owner. You don't want to buy a house from a party who does not own the house. About 25 percent of titles need cleaning up. You can shop around for the lowest cost service, which varies by state. Expenses may include FedEx delivery fees, surveying, and recording deeds and mortgages.

Before closing the deal, figure out how you want to take title to the property. If you are buying a house with someone else, you might want to look into:

- Joint Ownership with Rights of Survival: If one dies, the other automatically inherits the property.
- Tenants in Common: Each of you owns half of the house.

Make sure there is some kind of legal agreement between you and the person with whom you're buying. Figure out what will happen if the relationship ends, and how to split up the property ahead of time.

You might end up buying a condo or an apartment, in which case there are special issues that may affect the price or your ability to resell. You may want to ask yourself:

#### **FIGURE 13: Condo or Apartment Considerations**

- Are common areas such as hallways, elevators, pools, exercise rooms, and laundry facilities kept clean and operational?
- Are the walls and ceilings soundproof?
- What are the monthly fees to cover repairs, maintenance, and other shared expenses?
- Are all the units owner-occupied?
- Are any units in foreclosure?
- Is there a right to sublet units?
- Is there a reserve fund for major repairs?
- Are there any upcoming special assessments?

## **20.5 Miscellaneous Elements of Homeownership**

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### **A. Remodeling Costs**

Remodeling a home can be daunting, especially since costs of remodeling are impacted by shortages of materials and skilled workers. Large projects often require architects, contractors, and subcontractors, as well as local building permits, inspections, and neighbors' approval. It is important to make sure that the contractor you have chosen is licensed and insured, and familiar with local permits, codes, and inspectors. As always, it's wise (and necessary, in my opinion) to get a second, third, and sometimes fourth estimate. Some workers will do it cheaper and faster, but the finished product can end up looking shabby.



It's also imperative that you make sure the renovations are justified in terms of resale value. Updated kitchens and bathrooms are usually the best investments. Just assume it will cost 10 to 20 percent over the bid price, and that it will take 20 to 50 percent longer than planned to complete the project. It is rarely the case that a project will end up being cheaper and faster than the initial estimate.

Cheap means cheap, so it's not always a good idea to haggle or pressure the contractor into using crappy material. Get it done properly so you don't have to redo it the following year due to poor workmanship. Always stay open to professionals' opinions, since they know what they're doing and will rarely risk their reputation to cut corners.

Always discuss scheduling and progress payments with the professional. Establish a written contract with the contractor, which includes start and completion dates; plans that you have agreed to; and scheduled progress payments. Obtain a written warranty on workmanship and materials for the longest possible period.

A contractor, laborer, or service provider may employ mechanics liens through the county recorder's office. Liens are essentially guarantees of payment. If liens are left unpaid, they can negatively impact your ability to borrow against, refinance, or sell your property. Once the worker has been paid, make sure they sign a lien release.

Smaller jobs don't often require permits or any extra hoops on your behalf. Here are some approaches:

## **B. Refinancing Your Loan and Selling Costs**

Refinancing is a way of negotiating with your lender for a new loan on your home or even switching to an alternate lender. There are a few reasons people refinance their homes – the main reasons being a lower interest rate or monthly payment or changing the term of the loan. Consolidating the first and second mortgages is another reason to refinance. Borrowing money via your equity can fund other projects or business endeavors.

Refinancing isn't always as easy as it sounds. Homeowners who are struggling financially or are worried about eviction might refinance their homes, so their interest rates reflect the current market value.

Some mortgage contracts may contain a clause stating that if the borrower prepays the mortgage before a specific date, a penalty will be assessed. Usually, the penalty is equal to a certain number of months of interest or a percentage of the outstanding loan. Try to avoid borrowing from a lender demanding a prepayment penalty, since if interest rates decline you may want to refinance your loan and would not want to pay a penalty to do so.

## **C. Foreclosure**

If you are in financial distress and foresee a problem making your mortgage payments, ask your lender for help. If you have already missed payments, explain your situation to the lender and see if they can work with you. They often recognize that life happens and might be able to help you reduce the payments or set up some other arrangement. You can contact the Department of Housing and Urban Development, or if you are worried about foreclosure, contact the Homeownership Preservation Foundation.

Foreclosures happen when either the bank or the secured lender takes a house after the owner has failed to meet the loan agreement. The lender then sells the property and puts the proceeds towards its loan, its legal costs, and to satisfy any liens on the property such as overdue property taxes. They will then distribute anything that might be left to the borrower.



A lien, as mentioned earlier in the chapter, is a process whereby the property becomes security for the payment of a debt. This doesn't mean that the person who files the lien has the power to sell the house, but they can use it as leverage. If contractors or subcontractors work on your home, they might file a lien in case the owner fails to pay.

## 20.6 Tax Issues Surrounding Your Primary Residence

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Depending on the amount, you can deduct some or all of your mortgage interest, not principal, on federal and state tax returns. In general, you can deduct the mortgage interest paid during the tax year on the first \$1 million of mortgage debt for your primary home or a second home. If you bought the house after December 15, 2017, you could deduct the interest you paid during the year on the first \$750,000 of the mortgage.

If you obtained a \$1,000,000 mortgage to buy a house in 2017 (big yikes), and you paid \$25,000 in interest on that loan during 2020, you can probably deduct all \$25,000 of that mortgage interest on your tax return. However, if you got a \$1,000,000 mortgage in 2020, that deduction might be a little smaller. The 2017 Tax Cuts and Jobs Act limited the deduction to the interest on the first \$750,000 of a mortgage.

Homeowners can also deduct points and origination fees paid on loans at closing. "Points" are prepaid interest and paid to the lender at closing. One point equals one percent of the loan amount. Each point will buy down, or lower, your interest rate by about 0.25 percent, thus lowering the monthly payment. Also, if you work from home, you can claim part of your house as an "office," and therefore write even more off.

Depending on the amount, you can deduct some or all of your property taxes. You may deduct up to \$10,000 (\$5,000 if married and filing separately) for a combination of property taxes and either state and local income taxes or sales taxes.

If you sell your home at a profit, you can exempt some portion of the capital gain from taxes. You can exempt up to \$250,000 for a single person or \$500,000 for a married couple, if you've lived in the house any two of the prior five years as your primary residence.

The amount of profit from the sale of your home begins with the original cost of the property and fees. Add to that what you spent on permanent improvements, such as additional rooms or floor space, new decks, fences, landscaping, fitted draperies, wall-to-wall carpets, shelves, storm windows, and air conditioning. This includes having prepared the house for sale. These expenses all count as the initial cost of the house, which becomes your adjusted cost basis. When sold, this may reduce your capital gains tax. If you sell the house for more than the adjusted cost basis, you have a profit that may or may not be taxed depending on the limits I just laid out.

## CHAPTER 21: Real Estate Investing

**21.1** Introduction to Real Estate Investing

**21.2** The Tax Considerations of Owning Real Estate

**21.3** “Run the Numbers” Before Buying the Property

**21.4** Real Estate Investment Trusts

### 21.1 Introduction to Real Estate Investing

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Investing in real estate most commonly involves buying your primary residence. (I cover home purchasing and ownership in Chapter 20.) Real estate investing can go well beyond just buying a home. It can include buying rental property with the aim of generating monthly rental income, buying a property to fix up and sell (flip), or buying property in the hope that it appreciates in value. Real estate investments can also be used to diversify an investment portfolio and to try and take advantage of various tax laws.

However, investing in real estate usually takes place later in life because it usually requires a substantial amount of capital. Typically it requires enough cash for the down payment with an additional cash cushion to pay the monthly carrying costs on the property (mortgage, insurance, maintenance, and taxes) during periods when the property is vacant or needs repair.

Borrowing money for an investment property can be more expensive (higher fees and interest rates) than for a primary residence. And having a substantial amount of capital tied up in real estate can create liquidity problems. If you need cash for an emergency, it's much easier to sell some of your stock than it is your investment property. Finally, there is no certainty that a real estate investment will increase in value over time, especially if the property isn't properly maintained and renovated on an appropriate schedule (every 7 to 10 years). Future value is dependent on a host of factors, including the condition of the property, interest rates, the local economy, and the neighborhood in general.

While there are many risks, investing in real estate has its benefits. As we discuss in Chapter 20, there can be tax benefits associated with selling your primary residence. A primary residence can be sold at a profit tax-free if you lived in the property at least two of the previous five years. Therefore, you could buy a fixer-upper and, while living in it, do many of the home improvements yourself while contracting out certain projects that are beyond your capabilities. When completed, you can sell it for profit or rent it out and refinance it to pull the equity out for a down payment on another property. You could even buy a foreclosed property to get a better deal on the original purchase price.

Beyond trying to profit from your primary residence, buying rental property is another real estate investment strategy. The goal with rental property is to use rental income to pay for the mortgage, insurance, taxes, and maintenance. At the same time, owning rental property comes with tax benefits and you can invest with borrowed funds. Ultimately, the goal also involves creating additional equity in the property as prices and cash flow increase.

Both aspects can even be combined, purchasing a primary residence to fix up while renting at the same time. You can buy a small residential rental property, like a duplex, and live in one unit while renting out the other.

As is often said about real estate, the name of the game is location, location, location. Do you ever wonder why similar homes a few blocks apart can sell for significantly different amounts? One factor could be that the zip code for one of the homes is in a school district with high test scores, whereas the other home is in a zip code in a school district with lower test scores. Other factors could include safety or whether the property is prone to natural disasters like floods, tornadoes, or hurricanes. There could be erosion or pollution issues and/or highway sound or diversion issues. The home could be in the flight path of a local airport. The home could be conveniently located near a local attraction or public transportation.

Other location-related factors could include delays for construction permits or zoning restrictions that prevent you from using the property in a way in which you intend. Rent control or tenants' rights issues can be factors, and proximity to schools, transportation, and other local services can impact the property's value.

## 21.2 The Tax Considerations of Owning Real Estate

Profits from real estate investments are taxable just like any other income. For example, taxes are payable on any rental income generated, and capital gains taxes are due on any gains realized from the sale of rental property. However, certain tax laws allow for the deferral of some taxes.

### A. Taxes on Rental Income

Rental income is the difference between all the rent payments you receive and all the expenses you incur to own and maintain the property during the year. As the owner or "landlord," you would declare all the rent payments as income and deduct all the allowable operating expenses, such as repairs, maintenance, utilities, insurance, interest, and property taxes, to determine your rental income.

**FIGURE 1: Rental Income**

#### **Rent Payments and Income**

- All rent payments received
- Advanced rent payments
- Expenses paid by your tenant
- Services provided by your tenants
- Portions of the security deposit that you keep

#### **Rent Expenses Deducted from Income**

- Mortgage interest payments
- Cleaning, utility, and maintenance payments
- Insurance payments
- Advertising expense payments
- Property management fees paid
- HOA or condo dues paid
- Property tax payments
- Professional / legal fees paid

Principal payments on any loan or mortgage on the property are not considered an allowable expense to deduct from rental income. Only the interest expense on the loan or mortgage is deductible. Rental income is then taxable as ordinary income. I cover ordinary income taxes in Chapter 19.

Using depreciation expense to lower taxable rental income is a huge benefit to real estate investing. Depreciation is the decline in a physical asset's value due to normal wear and tear. The most well-known type of depreciation relates to cars. For example, if you were to put 25,000 miles on your car in a year, your car would be worth less at

the end of that year. The other thing to keep in mind is that depreciation is a non-cash expense.

Like a car, rental property will depreciate over time. And even though there is no direct or corresponding cash payment, the IRS requires, for tax purposes, that you deduct depreciation from your rental income as if it were an actual cash expense. Therefore, like any other allowable expense, it reduces the operating profit of your property. The amount by which it depreciates in a particular year is the amount that you can use to offset your rental income in that year. In turn, this would lower your overall tax expense. For example:

**FIGURE 2: Depreciation is a Non-Cash Expense that Reduces Taxable Income**

|                               | Without Depreciation | With Depreciation |
|-------------------------------|----------------------|-------------------|
| Cash Rental Payments          | \$60,000             | \$60,000          |
| Allowable Cash Expenses       | (\$14,000)           | (\$14,000)        |
| Non-Cash Depreciation Expense |                      | (\$36,364)        |
| Taxable Income                | \$46,000             | \$9,636           |
| Assumed Income Tax Rate       | 20%                  | 20%               |
| Assumed Income Taxes          | (\$9,200)            | (\$1,927)         |
| Cash Profit                   | \$36,800             | \$44,073          |

Cash profit is the cash rental payments minus the allowable cash expenses and the income taxes. The depreciation expenses are a non-cash expense and, therefore, lowers your taxable income but does not impact your cash flow.

According to the IRS, residential rental properties placed in service after 1986 depreciate over 27.5 years,<sup>1</sup> which means that every year a residential rental property depreciates by  $1/27.5$  or 3.6364% of the total purchase price less the value of the land. Because the land on which real estate is built doesn't wear out, no depreciation can be taken on the value of the land. So if you purchase a rental property for \$1,000,000, and the land is estimated to be worth \$500,000, then your annual depreciation expense would be \$18,182 every year ( $\$1,000,000$  purchase price –  $\$500,000$  Value of Land / 27.5 years).

Keep in mind two things regarding depreciation expense. First and foremost, rental properties typically require significant maintenance and renovations over time. Therefore, while depreciation is an estimate of wear and tear, it is not an actual cash expense. However, real estate requires significant cash outlays to offset the actual impact of wear and tear on a property. Second, when selling a rental property, the IRS requires payment of a depreciation recapture tax which is payable on the portion of the gain attributable to the depreciation deductions taken while the property was rented. The rules regarding depreciation recapture tax are beyond the scope of this text, but it effectively means that the taxed saved each year due to depreciation is not avoided altogether, but just delayed until the property is sold.

## B. Capital Gains

I cover capital gains taxes in Chapter 19. Real estate investment properties are subject to short-term capital gains (or losses) if the property is sold one year or less from the date it was purchased. Alternatively, long-term capital gains taxes are due when a property is sold later than a year after it was purchased. Capital gains taxes are adjusted

<sup>1</sup> <https://www.irs.gov/publications/p946>

for the depreciation recapture tax discussed above.

In general, the gain (or loss) is calculated as the difference between sale price and cost basis, where cost basis is the price originally paid for the property, plus capital improvements made during ownership, minus depreciation expensed during ownership.

$$\begin{aligned}\text{Capital Gains} &= \text{Sale Price} - \text{Cost Basis, where} \\ \text{Cost Basis} &= \text{Purchase Price} + \text{Capital Improvements} - \text{Depreciation}\end{aligned}$$

While depreciation decreases the cost basis of property, significant improvements to the property (capital improvements) increase the cost basis of the property. Capital improvements generally relate to structural improvements which increase the property's value or extend its useful life. Capital improvements could include adding a bedroom or bathroom, or increasing the square footage of the property.

Treating expenditures as either a capital improvement or general repair and maintenance can be complicated, as the IRS codes dealing with real estate, depreciation and capital improvements are extensive. You should solicit the advice of a qualified tax consultant to make sure the improvements you intend to make to the property qualify as capital improvements.

A final factor to keep in mind is that the \$250k-\$500k primary residence capital gains tax exemption does not apply to residential rental property. To qualify for a primary residence, you would have to live in the property at least two of the preceding five years upon the date of sale. So theoretically, you could move into the property two years prior to selling it in order to qualify for the \$250k-\$500k primary residence capital gains tax exemption.

### C. 1031 Exchanges

Capital gains upon the sale of your rental property can be deferred if the guidelines presented in IRS Code Section 1031 are followed. Under this section, the capital gains tax is deferred if another rental property is purchased to replace the one sold. The IRS allows deferral of capital gains in the sale of the first property, assuming the following is done:<sup>2</sup>

#### **FIGURE 3: Ways to Defer Capital Gains**

- Purchase another “like-kind” investment property.
- Replacement property must be of equal or greater value.
- Invest all the proceeds from the sale in the new property.
- It must be the same title holder and taxpayer.
- Identify new property within 45 days.
- Purchase new property within 180 days.

The tax will eventually come due when the rental property is sold and the funds are not reinvested. The cost basis in the old property becomes the cost basis in the new property. Solicit the advice of a qualified tax consultant to make sure you follow the rules surrounding a 1031 like-kind exchange and follow the regulations regarding

<sup>2</sup> <https://trustabcapital.com/1031-exchange-california/>

depreciation on the new property.

## **D. Passive or Active Income**

You may be able to use some of your real estate property losses as a tax shelter that extends beyond your rental income in certain circumstances. The process is complicated and subject to tax laws applied to your unique situation, so you should solicit the advice of a qualified tax consultant to make sure you follow all of the appropriate tax laws. The process begins with understanding the difference between passive and active real estate income.

### **i Passive: Income From Rentals**

The income you earn from real estate investments generally is considered passive income. Passive income is unlike the money you earn from a job, which is active income, since you get compensated for the work that you perform. Passive income generally does not require any active participation on your part. You report your real estate investing income on the Schedule E, which then gets carried forward to line 17 of your 1040 Income Tax Return. Your real estate investment income is then included with your other income and is subject to regular taxes.

### **ii Active: Working in Real Estate**

You can have your real estate investment income treated as active income if you meet the IRS' definition of a real estate professional. To qualify, you must spend at least 750 hours per year working in the real estate industry. The IRS will also consider you a professional if you are a paid employee who owns at least five percent of a real estate business. Likewise, the IRS will consider you a professional if you are a full-time real estate agent paid only on commission. In these two instances, you can use losses from your investments to offset income you make in other real estate business activities.<sup>3</sup>

### **iii Offset Income with Passive Loss**

If you oversee rental real estate investments, you still may be able to claim a portion of any real estate losses against your active income. Currently, if your Adjusted Gross Income (AGI) is \$100,000 or less, you can deduct up to \$25,000 a year in rental real estate losses. The IRS will phase out your allowable deduction for every dollar in AGI above the threshold.

### **iv Use Passive Losses Against Passive Income**

If you do not meet any of the above criteria, the IRS usually allows you to carry your real estate investment losses forward to offset real estate income in the future.

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<sup>3</sup> <https://www.gma-cpa.com/blog/real-estate-investing-passive-vs-active-income>

## 21.3 “Run the Numbers” Before Buying the Property

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The time to determine how much rent to charge and whether it's enough to cover the monthly carrying costs is before buying a property rather than when offering the property for rent. There are resources available to determine the monthly rental rates on similar properties in the area. You can find this data from Zillow, Redfin, and other real estate websites, as well as local property managers and real estate agents. When measuring annual rental income, assume the property will be vacant 5-10 percent of the year (one month per year on average).

Carrying costs include mortgage payments, taxes, insurance, maintenance, and repairs. Although the mortgage principal payments are not allowable deductions for tax purposes, they should still be considered in the monthly carrying costs. The intent of the analysis is to determine whether the property rent will cover all the monthly cash payments. From a cash flow perspective, you should know whether the property will have positive or negative cash flow, irrespective of your taxable income.

Be sure to get inspections before buying any property. Termite damage, water damage, mold, asbestos, and general deferred maintenance can get very expensive very fast. It is in your best interest to do the due diligence to ensure you can afford the property and the costs to get it ready to rent. Then moving forward, the longer you own and rent the property, the more likely you will incur larger one-time repair, maintenance, and improvement expenditures. On the plus side, repairs and maintenance are tax-deductible, so be sure to keep all receipts. Also keep in mind that if the renovations move beyond general repairs and maintenance, they could be considered capital improvements and are depreciated not expensed.

There are obviously costs, risks, and a great deal of effort involved to successfully invest in real estate. However, the benefits include using rental income to pay off the mortgage, using leverage to increase your equity, and taking advantage of the deferred tax benefits afforded real estate investors. All of these factors should be considered at the time of purchase. Even though you may only break even monthly, it doesn't mean you aren't earning a return. If your mortgage includes principal payments, every principal payment increases your equity. Likewise, if you maintain and own the property long enough, the value is almost certain to appreciate.

## 21.4 Real Estate Investment Trusts

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Owning rental property involves a lot of capital upfront to buy the property, and the risk of not being able to cover the monthly cash expenses with monthly rental income. There is also the lack of liquidity – you can't simply sell the property in a day. It will take time and cost money.

In addition to the financial risks and obstacles, there are also the headaches of being a landlord. You will likely have to screen potential tenants by checking references and running credit reports. Then you will have to answer to tenant complaints, sometimes late at night, and possibly collect past due rents. The stress associated with declining rental rates, costly repairs, and nasty evictions can become overwhelming.

You will also need to be familiar with local laws and regulations in your community relating to rent control and tenant's rights, building codes, zoning requirements, and disability access, including ramps and elevators. You cannot discriminate on the basis of race, religion, sex, gender, age, disability, or sexual orientation.



For those who can't afford to buy a property or do not have the time and energy to be a landlord, there are alternatives.

A real estate investment trust (REIT) is an entity that holds a portfolio of commercial real estate or real estate loans very similar to a mutual fund. Congress created REITs in 1960 to provide small investors access to income-producing commercial real estate.<sup>4</sup> REITs are ideal if you are looking to profit in real estate without directly owning or having the responsibility of managing a property or subjecting yourself to capital constraints or liquidity issues. REITs work just like mutual funds; you can buy and sell shares in a REIT on the open stock market like you would buy and sell mutual funds or index funds.

**FIGURE 4: Investing in REITs Has Several Benefits, Including:<sup>5</sup>**

- They can pay above-average dividend yields compared to other stocks.
- They provide diversification from the stock market.
- They don't pay federal corporate income tax.
- Total return is the function of stock price appreciation plus dividend income.
- They offer greater liquidity compared to owning real estate outright.
- They cost less compared to buying commercial real estate outright.

**FIGURE 5: REITs Also Have Some Drawbacks, Including:<sup>6</sup>**

- They pay nonqualified dividends, so it is best to hold them in a tax-advantaged account such as an IRA.
- They are sensitive to changes in interest rates.
- They have property-specific risks such as vacancies.
- They can accumulate too much debt.

**FIGURE 6: REITs Can Be Classified into Three Separate Asset Types:<sup>7</sup>**

1. Equity REITs – Own and operate income-producing real estate.
2. Mortgage REITs (mREITs) – Provide financing for real estate by purchasing or originating mortgages and mortgage-backed securities and earning income from the interest on these investments.
3. Hybrid REITs – Invest in a combination of income-producing real estate and real estate-backed loans.

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<sup>4</sup> <https://www.fool.com/investing/stock-market/market-sectors/real-estate-investing/reit/>

<sup>5</sup> <https://www.fool.com/investing/stock-market/market-sectors/real-estate-investing/reit/>

<sup>6</sup> <https://www.fool.com/investing/stock-market/market-sectors/real-estate-investing/reit/>

<sup>7</sup> <https://www.fool.com/investing/stock-market/market-sectors/real-estate-investing/reit/>

According to The Motley Fool, REIT can be categorized by sector or property type as follows:

#### FIGURE 7: REIT Types

- Office REITs own and manage office real estate such as skyscrapers and office parks. Many office REITs focus on a specific region (New York City or the West Coast) or a type of tenant (technology companies, government agencies, or biotech).
- Industrial REITs own and manage industrial facilities such as warehouses, distribution centers, light manufacturing, and cold storage. Many of these properties are crucial for e-commerce. Most industrial REITs focus on a specific industrial property type or region.
- Retail REITs own and manage retail real estate such as regional malls, shopping centers, and freestanding retail buildings. Most retail REITs will focus on a specific property type such as grocery-anchored shopping centers or free-standing retail properties triple net leased to essential retailers like convenience stores and pharmacies.
- Lodging/resort REITs own hotels and resorts, usually managed by a third-party hotel brand. They rent space in these properties to guests on a nightly or weekly basis.
- Residential REITs own and manage residential real estate such as apartment communities, single-family homes, and manufactured home parks that they rent out to residents. Residential REITs focus on a specific property type.
- Timberland REITs own and manage timberland. They specialize in harvesting and selling timber. Some Timberland REITs also own wood product manufacturing facilities and sell portions of their real estate for higher and better uses like a housing development.
- Healthcare REITs own and manage healthcare-related real estate such as senior living facilities, hospitals, medical office buildings, and skilled nursing facilities.
- Self-storage REITs own and manage self-storage facilities that they rent to individuals and businesses.
- Infrastructure REITs own and manage infrastructure such as fiber cables, telecommunications towers, and energy pipelines. They lease capacity on this infrastructure to mobile carriers or energy companies.
- Data center REITs own and manage data storage facilities. They lease space in these facilities to technology companies to house servers and other equipment. These REITs also provide an uninterruptable power supply, a regulated temperature, and physical security.
- Diversified REITs own and manage a diversified portfolio of commercial real estate. For example, they might have a portfolio of office properties and industrial real estate. Some diversified REITs focus on specific markets, owning a mix of residential, retail, and office properties in one city.
- Specialty REITs own and manage unique properties such as movie theaters, casinos, farmland, outdoor advertising, or ground leases.

## CHAPTER 22: Homeowner's Insurance

### 22.1 Homeowner's Insurance is Usually Required

#### 22.2 Insurance Basics

#### 22.3 Standard Policy

#### 22.4 Filing a Claim

## 22.1 Homeowner's Insurance is Usually Required

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It's hard to get excited talking about insurance, especially homeowner's insurance. However, in most instances mortgage lenders require homeowner's insurance. Before lending money for a mortgage or refinancing, mortgage companies will typically ask the buyer to provide proof that the home is sufficiently insured. This is because your lender wants to be sure its financial investment in your home is protected in the event it is damaged or destroyed by a fire or some other insurable event.<sup>1</sup> After all, the home is collateral for their loan.

In addition to homeowner's insurance, mortgage companies may require other types of insurance. For instance, if a home is located in a high-risk flood zone, flood insurance may be required.<sup>2</sup>

The Consumer Financial Protection Bureau states that lenders can purchase insurance on a property and force the borrower to pay the premiums in the event the borrower doesn't get insurance or allows it to lapse. The insurance policy the lender obtains will most likely be more expensive than what could have been purchased in the market. Not only that, the insurance may offer less coverage.<sup>3</sup>

## 22.2 Insurance Basics

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Homeowner's insurance is a package policy providing financial protection to you and your property, as well as your liability or legal responsibility for injuries or property damage you or your family cause to other people. Some policies may exclude or limit certain coverages, so review the policy carefully. Certain risks like floods, hurricanes, tornadoes, and earthquakes may need to be insured separately, which usually means additional premiums and deductibles. Specifically, as it relates to California, the insurer is legally obligated to offer you earthquake coverage for an additional premium.

Homeowner's insurance can be purchased directly from the insurance company, through an insurance broker, or from an independent agent. When shopping for insurance, ask the agent what is and is not covered in your policy, but definitely read the policy and ask questions so that you understand what you are getting.

Homeowner's insurance premiums vary widely from one company to another, so it makes sense to take the time to get multiple offers to get the best value. The cost of homeowner's insurance depends on many factors, including:<sup>4</sup>

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<sup>1</sup> <https://www.allstate.com/tr/home-insurance/why-do-i-need-home-insurance.aspx>

<sup>2</sup> <https://www.allstate.com/tr/home-insurance/why-do-i-need-home-insurance.aspx>

<sup>3</sup> <https://www.allstate.com/tr/home-insurance/why-do-i-need-home-insurance.aspx>

<sup>4</sup> <http://www.insurance.ca.gov/01-consumers/105-type/95-guides/03-res/res-ins-guide.cfm#shoppingforinsurance>

**FIGURE 1: Factors Impacting the Cost of Homeowner's Insurance**

- The location of the property
- The local fire protection
- The age and construction of building
- Choice of deductibles
- Application of discounts
- The scope and amount of insurance coverage purchased

Many insurance companies have their own methods of premium installment or payment plans, so ask for the details regarding insurance premium installments or payments available.<sup>5</sup> On a similar note, sometimes insurance companies will offer discounts for burglar alarms and fire protection devices like smoke detectors, and fire sprinklers. Ask about the discounts available when shopping for quotes. Also consider combining one or more of your insurance policies (homeowner's, auto, life, health, and disability) through the same insurance company to get better deals.

There are many homeowner's insurance companies that offer dissimilar policies, making it complicated to compare and pick the right company and plan. Policies are usually full of legal jargon subject to "interpretation." It is not uncommon for the insurance company to inspect your property to ensure it is well-maintained, up to current codes, and free of hazards that could cause problems. Therefore, prepare your property for insurability. Some requirements will be the result of local codes and regulations, the insurance company may add requirements, and a lender may add even more in order to obtain a mortgage. Some of these requirements may include:

**FIGURE 2: Prepare Your Property for Insurability**

- Installing smoke and carbon monoxide detectors
- Installing all sprinkler systems
- Installing a burglar alarm and even one that links to your local police station
- Bringing roofing material up to code to prevent water damage from storms
- Clearing vegetation around the property to protect against potential wildfires
- Putting a fence around your pool to prevent drowning

## 22.3 Standard Policy

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The standard homeowner's insurance policy contains two main sections. Section I provides property coverage (items A, B, C and D below), while Section II provides liability coverage (items E and F below). A brief description of the individual coverages follows:<sup>6</sup>

**Coverage A** – Dwelling Coverage: This pays to repair or rebuild your home if it is damaged or destroyed by a covered event. Multiply the square footage of your home by the cost per square foot to build a new house in your area to determine how much insurance you should buy. You can usually find the cost per square foot to build a new house in your neighborhood online or by contacting a local real estate agent, insurance agent, or contractor. It is important to keep in mind that you are obtaining insurance to cover the property, not the land that it sits on.

<sup>5</sup> <http://www.insurance.ca.gov/01-consumers/105-type/95-guides/03-res/res-ins-guide.cfm#shoppingforinsurance>

<sup>6</sup> <http://www.insurance.ca.gov/01-consumers/105-type/95-guides/03-res/res-ins-guide.cfm#shoppingforinsurance>

As a general rule, try to insure at least 80 percent of the value of your home, otherwise you may not be fully covered. Also consider insuring 100 percent of the estimated replacement value if the difference in cost between 80 percent of the value and 100 percent of the replacement cost is minimal. In the event of a loss, you may be glad you opted for more insurance given the difference in cost. If you have a relatively older home, new building codes requiring upgraded roofing materials or sprinkler systems may add to the cost to repair or rebuild, so it may be a good idea to add a feature to the policy that pays for these required code upgrades.

**Coverage B** – Other Structures: This covers other structures on the property that are not attached to the dwelling, such as a detached garage or tool shed. Coverage B is normally limited to 10 percent of the Coverage A limit. However, you can purchase more coverage for an additional premium.

**Coverage C** – Personal Property: This covers the contents of your home and other personal belongings owned by you and other family members who live with you. It usually covers items like furniture, clothes, jewelry, and sports equipment. Coverage C is normally 50 percent of Coverage A, or is subject to an established amount agreed upon by you and your insurance company. Again, you can buy additional coverage above the specified amount for specific items of higher value.

It is a good idea to take pictures of each room of your home, including everything within it to determine the amount of loss you could incur. When doing so, be sure to open all your closets, drawers, and cabinets. Save the pictures to the cloud where they will be safe *outside* of the home. These pictures will be helpful in the event you need to submit a claim.

Coverage on expensive items like jewelry, antiques, collectibles and silverware is usually limited, especially if they are susceptible to loss. Additional amounts of insurance may be purchased. You may want to consider appraising these items separately. In some cases, your insurer may require an independent appraisal of an expensive or rare item you seek to insure.

**Coverage D** – Loss of Use: This coverage will help with additional living expenses if your home is damaged and you cannot live in it. These expenses include, but are not limited to, housing, meals and warehouse storage. Coverage D is normally limited to 20 percent of Coverage A. Be sure to keep all receipts for all additional living expenses and submit them to your company for reimbursement consideration.

**Coverage E** – Personal Liability: This section of your homeowner's policy will provide coverage in the event you or a resident of your household is legally responsible for injury to someone else. The liability coverage will not protect you in all situations though, such as an intentional act. Your policy will list all of the exclusions and specific language surrounding a potential claim.

**Coverage F** – Medical Payments to Others: This coverage pays for reasonable medical expenses for persons accidentally injured on your property. For example, if a neighbor's child is injured while playing in your home, the medical payments portion of your homeowners' policy may pay for necessary medical expenses. Medical payments coverage does not apply to your injuries or injuries of those who reside in your household. It is not a substitute for health insurance.

## 22.4 Filing a Claim

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When contemplating filing an insurance claim, look up the terms and conditions of the policy to see if your particular event is covered. Rest assured that your insurance company will review the policy. You may believe you are covered under the policy, but the insurance claims departments may be looking for ways to deny or reduce their exposure to your loss.

In reality, what is or is not covered can be hard to agree on. For example, you could sustain water damage to your property. But what caused the water damage? It could have been caused by a leak under your sink, bad plumbing, a flood, wind or rain. Some of those causes may or may not be covered. A common issue in California is fire that follows an earthquake. Even though you have fire insurance, the fire was technically caused by the earthquake and you may not have earthquake insurance.

Insurance companies are always looking to pay up to the limits of their policy and nothing more. Where negligence or inadequate coverage exists, you may become personally and financially responsible.

## CHAPTER 23: Life and Disability Insurance

### 23.1 Life and Disability Insurance

### 23.2 Disability Insurance

### 23.3 Life Insurance

## 23.1 Life and Disability Insurance

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Life insurance and disability insurance are both important elements to a sound financial plan for most families. Are they important factors for single individuals in their mid-20s? Maybe not, but they are still worthy of discussion and consideration.<sup>1</sup>

On average, most Americans are more likely to obtain life insurance than disability insurance at some point in their life. However, there is a greater chance that most people will need disability insurance rather than life insurance. This is especially true if you are young and single.<sup>2</sup>

The chances of becoming disabled at some point are much greater than meeting an untimely death. Furthermore, most individuals believe only serious catastrophic accidents cause disabilities. But in fact, according to the Life Insurance Marketing and Research Association (LIMRA), disabilities are most commonly caused by chronic conditions such as back problems and muscle pain. While life insurance will not cover disability claims, disability insurance covers disability claims.<sup>3</sup>

Life insurance and disability insurance cover very different life events. Life insurance will pay the beneficiaries in the event the insured dies, whereas disability insurance will pay part of your salary if you are too sick or injured to work. Disability insurance typically pays 60-70 percent of your annual income. Most policies will require a certain period of time to elapse before they begin paying benefits, and then they will only pay benefits for a certain period of time.

## 23.2 Disability Insurance

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According to Guardian Life, more than 25 percent of today's 20-year-olds will likely be out of work for at least a year before they retire because of a disabling condition. Also, according to Guardian Life, illness causes 90 percent of disabilities, while injuries account for the other 10 percent.<sup>4</sup> Disability insurance will replace some portion of your income if you are unable to work because of an accident or illness. A disability can be a mental or physical injury or illness that prevents you from performing your regular or customary work. Unfortunately, disability insurance does not cover you if you are unemployed. It replaces a portion of your income, so if you have no income from work, theoretically there is nothing to replace.

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<sup>1</sup> <https://www.nerdwallet.com/article/insurance/life-insurance-no-substitute-disability-insurance>

<sup>2</sup> <https://www.nerdwallet.com/article/insurance/life-insurance-no-substitute-disability-insurance>

<sup>3</sup> <https://www.nerdwallet.com/article/insurance/life-insurance-no-substitute-disability-insurance>

<sup>4</sup> <https://www.businessinsider.com/personal-finance/buying-life-and-disability-insurance-at-the-same-time>



### A. Disability Insurance

In most instances, your full-time employer will provide sick leave benefits. Your employer may also provide some type of short-term plan or informal policy that covers a disability that lasts only 30 to 90 days. Some larger employers may even provide long-term disability coverage from as little as two years, and in some instances up until the age of 65. Not common, but some employers may even offer long-term benefits for life. It's typically the case that the longer the benefit period, the more it will cost you, and most benefits will only pay up to 70 percent of your salary. If your employer does not offer a disability plan, or offers a plan that you do not like, or you are self-employed, you can purchase your own disability insurance.<sup>5</sup>

If you choose to purchase your own disability insurance, it generally will be classified as short-term or long-term. Short-term disability insurance usually has a waiting period of 0 to 14 days before the insurance company will begin to pay benefits, and the maximum benefit period of short-term disability insurance usually is no longer than two years. Long-term disability insurance usually has a waiting period measured in weeks or months before benefits begin. The maximum benefit period of long-term disability insurance is several years, to age 65, or lifetime. You may want to integrate your policy and its waiting period with your employer's plan or your state plan, if applicable, to avoid duplication of coverage.

Every disability policy has its own definition of disability that must be met to qualify for benefits. Some policies may identify specific levels of disability (e.g., partial disability) with the corresponding amount of benefit you can receive under that definition. These definitions can look as follows:<sup>6</sup>

**Own-occupation** – You are not able to perform the duties of your occupation. For example, a roofer who becomes disabled and can't climb a ladder to get onto a roof would likely qualify, even if they were healthy enough to do other work. A long-term disability benefit through work would typically apply to the first 24 months of using the benefit under the "own-occupation" definition.<sup>7</sup>

**Any-occupation** You would only qualify for benefits if you are unable to work in any other occupation for which you are suited based on your education, training and/or experience. This could even apply to a lower-paying job. If you have a long-term disability benefit through work, the "any-occupation" definition would typically apply after you have been on long-term disability for more than 24 months.<sup>8</sup>

Disability insurance proceeds are taxed as ordinary income if your employer provides your disability insurance. However, the disability benefits are not taxed if you pay the premiums.

Because disability insurance benefits replace your income, you need to be employed to receive the benefits. In most instances, your insurer will only replace 50 to 70 percent of your income, since they want you to be motivated to return to work.

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<sup>5</sup> <https://www.businessinsider.com/personal-finance/buying-life-and-disability-insurance-at-the-same-time>

<sup>6</sup> <https://www.guardianlife.com/disability-insurance/definitions-and-terms-you-should-know>

<sup>7</sup> <https://www.guardianlife.com/disability-insurance/definitions-and-terms-you-should-know>

<sup>8</sup> <https://www.guardianlife.com/disability-insurance/definitions-and-terms-you-should-know>

An individual policy purchased separately from your employer may be noncancelable or guaranteed renewable.

### FIGURE 1: Noncancelable or Guaranteed Renewable

- With a noncancelable policy, you have the right to renew the policy without the premium payments increasing.
- With a guaranteed renewable policy, you have the right to renew, but the rate may go up depending on your classification. Your classification can be your age group or your occupation.

The average cost of disability insurance is typically between one percent and four percent of your annual income. Another general rule is that your disability insurance premium payment could be between two percent and six percent of your policy's monthly benefit. Your specific situation will ultimately dictate how much you will pay and depends on personal factors, including your job occupation, age, sex, health and policy choices.<sup>9</sup>

## B. Social Security

Social Security includes a component related to disability insurance. To qualify, you must first have worked in jobs covered by Social Security. Then you must have a medical condition that meets Social Security's definition of disability. Furthermore, these benefits apply to people who are unable to work for a year or more because of a disability.<sup>10</sup>

Benefits usually continue until you are able to return to work on a regular basis. There are also a number of special rules, called "work incentives," that provide continued benefits and health care coverage to help with the transition back to work.<sup>11</sup> To qualify for Social Security Disability Insurance (SSDI) benefits, you must have worked for a certain period of time. For more information on whether you qualify, refer to the Social Security website.

The definition of disability under Social Security is different than other programs. To receive Social Security benefits, you must be totally disabled. No benefits are payable for partial disability or short-term disability. You are considered disabled under Social Security rules if all of the following are true:<sup>12</sup>

### FIGURE 2: Disabled Under Social Security Rules

- You cannot do work that you did before because of your medical condition.
- You cannot adjust to other work because of your medical condition.
- Your disability has lasted or is expected to last for at least one year or to result in death.

## C. Workers' Compensation

Workers' Compensation insurance provides benefits, including disability, if an injury or illness is job-related. Your employer pays into the system, but you do not. Benefits usually cover the cost of medical care and lost worker's pay for a certain number of weeks or months. In some instances, there could be a lump sum settlement if the

<sup>9</sup> <https://www.meetbreeze.com/disability-insurance/how-much-does-disability-insurance-cost/>

<sup>10</sup> <https://www.ssa.gov/benefits/disability/qualify.html>

<sup>11</sup> <https://www.ssa.gov/benefits/disability/qualify.html>

<sup>12</sup> <https://www.ssa.gov/benefits/disability/qualify.html>

disability is permanent or the accident results in death.

### D. State Disability Insurance

California and a few other states have their own disability insurance programs. These state fund programs compensate workers who suffer a loss of wages when they are unable to work due to a non-work-related illness or injury.

California has a mandatory state disability plan. The California State Disability Insurance (SDI) program provides short-term Disability Insurance (DI) and Paid Family Leave (PFL) wage replacement benefits to eligible workers who need time off work.<sup>13</sup>

You may be eligible for DI if you are unable to work due to a non-work-related illness or injury, pregnancy, or childbirth. You may be eligible for PFL to:<sup>14</sup>

#### **FIGURE 3: PFL Eligibility**

- Care for a seriously ill family member.
- Bond with a new child.
- Participate in a qualifying event because of a family member's military deployment to a foreign country.

Your plan is paid entirely by you through payroll deductions. The current cost is one percent of your annual earned income up to a certain maximum. The weekly maximum benefit was \$1,357 in 2021.<sup>15</sup>

## **23.3 Life Insurance**

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You may luck out and never become disabled for any meaningful length of time. That would be something to be very grateful for. But unfortunately, you are not going to escape the dying thing. If you're lucky, that won't be for many years from now. At some point as you begin to mature and have kids, or if you have dependents that rely on you in some fashion, you will worry about their well-being in your absence. Life insurance is one way to manage that worry.

If you are single, in your 20s, and no one depends on you for financial support, you probably do not need life insurance. On the opposite end of the spectrum, if you and your significant other both work to make ends meet and have young children, you fit the classic definition of "high need" insurance situation. This is because if the entire family is dependent on the breadwinners for support, and if one of those breadwinners dies, there could be serious financial consequences for the surviving members of the family. In the event of an untimely death, life insurance can replace the income in whole or in part to help with the costs of raising children, making continuing rent or mortgage payments, paying other household bills, paying for education, medical bills, and/or health care.

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<sup>13</sup> <https://www.edd.ca.gov/disability/>

<sup>14</sup> <https://www.edd.ca.gov/disability/>

<sup>15</sup> [https://ca.db101.org/ca/programs/income\\_support/sdi/program2a.htm](https://ca.db101.org/ca/programs/income_support/sdi/program2a.htm)

## A. Factors That Affect the Price of Your Life Insurance

You will want to shop around for life insurance, as the cost from one insurance company to another will vary. Larger insurance companies can often provide lower rates than smaller companies because they can spread the costs of insuring groups across a larger set of individuals.

Your life insurance risk classification is based on the probability that you will die during the policy period. What are your odds of dying in the next year, or 10 years, or even 20 years? Your risk of dying is dependent on your age, health, and family history. So when signing up, you will likely be asked to provide your family's medical health history. You might even be asked to take a medical exam and blood test.

Women live longer than men on average, so there are separate estimates for males and females. The standard estimates are regularly updated to account for improvements in life expectancies, medical advancements, etc. You will be asked if you smoke given all the health-related issues associated with smoking. It's not uncommon for life insurers to use different estimates to determine mortality risk for smokers versus non-smokers. All else being equal, smokers tend to die five to 10 years earlier than non-smokers.

## B. Insurance Needs Analysis

The process to estimate the financial impact of your death on others is often referred to as "insurance needs analysis." To determine how much life insurance to obtain, first estimate your dependents' total financial needs, and then compare that with the financial resources your family currently has available to meet those needs.

### FIGURE 4: Financial Needs

- Your immediate needs typically include all the payments made by the deceased's income. This could include mortgage payments or rent; car loans, credit card debt, and/or any other debts; your children's education costs; medical bills, and funeral costs.
- Your immediate needs could also include obtaining insurance to replace all the non-financial support the deceased spouse provided to the family that would need to be replaced in the event of an untimely death. It's common to overlook all the valuable things a non-working spouse does for the family. Childcare is the most obvious example.
- Your future needs might include the surviving spouse's retirement and children's college education.

### FIGURE 5: Financial Resources

- Social Security survivor's benefits, employer paid benefits, and any other death benefits.
- Assets that can be sold in the event of an untimely death. This could be certain investments or vacation property, a second vehicle, or any other asset with monetary value.
- Alternatively, if the non-working spouse dies, the survivor will still have income from continuing employment but may also need additional help from insurance proceeds. Once children are grown and have moved out of the house, and if you have enough retirement income, you will probably not need as much life insurance as you once did.

I highly recommend speaking with a financial advisor and life insurance agent to determine the amount of life insurance you should obtain, if any.

### C. Term and Whole Life Insurance

Term insurance means that you only receive benefits if the insured individual dies while the policy is in place. It is often referred to as “death insurance.” Many financial advisors say that term insurance is probably the best choice for most people.

As described above, term insurance premiums are based on the amount of coverage you obtain, your age, health, gender, lifestyle (smoking), and occupation. The younger you are when you purchase your insurance, the lower the premiums, since you have more time to pay into the system for the same insurance. With term life insurance, there are no ongoing health requirements to keep the policy in force.

Whole life insurance includes a savings component referred to as the cash value. The cash value is paid and accumulated by you and managed and invested by the insurer. The cash value is an investment account that compounds and earns returns tax-free. The premiums you pay for whole-life insurance are much higher due to the savings component associated with them. The commissions are higher as well.

The nice thing about whole life insurance is that you can borrow your policy’s accumulated cash value. You may need to pay interest on the amount borrowed. Any outstanding loans at the time of death will be deducted from the benefit proceeds of the policy. If you decide to discontinue your insurance, you can get back your accumulated cash value, less any outstanding loans.

I personally chose to buy term insurance rather than a whole life policy, so that I could invest the difference in my own retirement accounts. This way I can manage my own investments.

### D. Tax Implications of Life Insurance

Life insurance proceeds can become part of your estate if your spouse or your estate is the beneficiary. If life insurance proceeds do become part of your estate, they may become subject to estate taxes. One possible way to avoid this from happening would be to name someone else, such as your children, as the owners and beneficiaries of the policy. You could then gift them the money to pay the premiums. Upon your death, the proceeds of the policy would go directly to your children. This way, according to the Internal Revenue Service (IRS), “Generally, if you receive the proceeds under a life insurance contract as a beneficiary due to the death of the insured person, the benefits are not includable in gross income and do not have to be reported. Any interest you receive is taxable and you should report it just like any other interest received.”

## Appendix: Knowledge Checks

1-9 Chapters 1-9

10-21 Chapters 10-23

## Chapters 1-9

1 1 point

Slow and steady steps towards generational wealth and financial independence include

- ☐ (1) Become a saver not a spender; start now and make it a lifelong habit, (2) Invest your money to take advantage of compound interest; again, start now and make it a lifelong habit, (3) Diversify your investments, rather than putting all your eggs in one basket, (4) AND MOST IMPORTANTLY, DO THESE THINGS, DON'T JUST TALK ABOUT DOING THESE THINGS
- ☐ (1) Become a saver not a spender; start now and make it a lifelong habit, (2) Invest your money to take advantage of compound interest; again, start now and make it a lifelong habit
- ☐ Become a saver not a spender; start now and make it a lifelong habit
- ☐ Diversify your investments, rather than putting all your eggs in one basket

2 1 point

Use the future value calculator at <https://www.calculator.net/future-value-calculator.html> to determine how much you would have if you invested \$1,000 every year for 10 years and earned an 8% interest. Complete set of assumptions:

- Number of Periods = 10
- Starting Amount = \$0
- Interest Rate = 8%
- Periodic Deposit = \$1,000
- Payment Made = Beginning of the Year

- ☐ \$10,000
- ☐ \$15,645
- ☐ \$10,800
- ☐ \$3,109



3

1 point

How much cash would you have at the end of the second month if you If had \$3,000 at the beginning of the first month and then received a financial aid check for \$4,000, and then for the next two months incurred the following

- (1) Paid rent of \$400 each month.
- (2) Paid for food of \$700 each month.
- (3) Paid your cell phone bill of \$60 each month.
- (4) Spent \$200 on entertainment each month.
- (5) Paid \$200 on transportation each month.
- (6) Paid \$300 for book in the first month only.

- ☐ \$580
- ☐ \$7,000
- ☐ \$3,420
- ☐ \$3,580

4

1 point

Mark the expenses that would be considered need based expenses?

- ☐ Starbucks coffee in the morning
- ☐ Cellphone
- ☐ Food for dinner
- ☐ Rent

5

1 point

If you only save rather than save and invest, you will actually lose ground with respect to wealth due to inflation?

- ☐ True
- ☐ False

6

1 point

Rank the following financial priorities in order in terms of priority. Rank them in terms of highest priority first. Assume that you have recently graduated from college and have just entered the workforce.

⋮ Contribute to a Roth IRA

⋮ Payoff credit card balances

⋮ Save 3 to 6 months of living expenses

⋮ Contribute to your 401(k) up to the point of your employer match

7

1 point

When setting financial goals, your goals should be:

☐

Attainable

☐

Specific

☐

Easy to achieve

☐

Measurable

☐

Realistic

☐

Time-specific

8

1 point

When setting out to achieve a financial goal, you should wait to the end of the month to see what you have available to contribute to that goal, rather than paying yourself first in order to achieve your goal.

☐

True

☐

False

9 1 point

If you are saving for a car that you want to purchase within a year, you should invest your savings in the stock market?

- ☐ True
- ☐ False

10 1 point

If you choose to invest in the stock market over the long run, you should continue to invest in the market even when the value of your investments is declining?

- ☐ True
- ☐ False

11 1 point

Constantly investing during the ups and downs is a sound investing strategy referred to as Dollar-Cost-Averaging.

- ☐ True
- ☐ False

12 1 point

You can make money by investing in stocks when:

- ☐ the stock pays a dividend.
- ☐ the stock increases in value.
- ☐ the stock pays interest.
- ☐ the stock decreases in value.

13 1 point

Bonds are generally considered safer investments than stocks?

- ☐ True
- ☐ False

14 1 point

You can invest in a mutual fund that owns:

- ☐ stocks
- ☐ cryptocurrency
- ☐ bonds
- ☐ only growth stocks
- ☐ junk bonds

15 1 point

If you wanted to buy stocks, you would use a brokerage firm to help you purchase those stocks?

- ☐ True
- ☐ False

16 1 point

In your mid-20s, your allocation of stocks, bonds and cash would most likely look like:

- ☐ 80% stocks, 15% bonds, and 5% cash
- ☐ 60% stocks, 30% bonds, and 10% cash
- ☐ 30% stocks, 50% bonds, and 20% cash
- ☐ 80% cash, 20% stocks

17 1 point

What are examples of diversification?

- ☐ Within asset classes so you're not too concentrated in any one market sector (e.g., technology or health care), company, company size (e.g., large cap, mid cap, small cap), or country.
- ☐ By mixing investing styles through a combination of value and growth stocks. This will help reduce the risks associated with investing strategies that perform better or worse in certain markets.
- ☐ Across asset classes with a long-term asset allocation plan that combines different categories of major types of investments, such as stocks, bonds, commodities (e.g., gold, other precious metals), and cash.
- ☐ Across cash, treasury bonds and cds.

18 1 point

Mutual fund managers typically outperform the market which is why you should invest in mutual funds over ETF or index funds.

- ☐ True
- ☐ False

19 1 point

If you are just getting started, investing in index funds over actively managed funds is likely the preferred investment strategy. You obviously won't beat the market by investing in index funds, but at least you won't perform much worse than the market as a whole, and by investing in funds, you will earn returns similar to the more expensive actively managed mutual funds.

- ☐ True
- ☐ False

20 1 point

Order the following investment from most risky to least risky

- 
- ⋮ treasury bonds
- 
- ⋮ growth stocks
- 
- ⋮ memestocks
- 
- ⋮ Large company stocks
- 
- ⋮ cryptocurrency
- 
- ⋮ corporate bonds

21 1 point

Which characteristics describe active investing?

- ☐ lots of time and energy to research particular investments
- ☐ since you are actively investing you will outperform the market
- ☐ your emotions will allow you to make sound investment decisions
- ☐ you can avoid unnecessary tax consequences from selling appreciated stock

22 1 point

Identify all of the factors that impact a company's stock price

- ☐ Reported and/or expected earnings
- ☐ The economy
- ☐ Future expectations
- ☐ Investor emotions and social media influence

23 1 point

If employed correctly, fundamental and technical analyses can perfectly predict a stock's future price movements

- ☐ True
- ☐ False

24 1 point

You can make more profit by buying a stock that is priced at \$1 rather than \$100?

- ☐ True
- ☐ False

25 1 point

Incurring investment losses is worse than paying taxes on profits.

- ☐ True
- ☐ False

26 1 point

Cryptocurrencies do not generate cash flow on their own, so the price of the currency is being driven entirely by supply and demand related factors.

- ☐ True
- ☐ False

27 1 point

If you are in your mid-20s, you can afford to invest all of your money into cryptocurrency to take advantage of potentially high returns?

- ☐ True
- ☐ False

28 1 point

Ways to limit your exposure to potentially huge losses when investing in meme stocks and cryptocurrency would be to:

- ☐ Buy more when the price begins to increase.
- ☐ Invest only what you can afford to lose.
- ☐ Hold on to the investment until it returns to its all-time highs.
- ☐ Do not sell your investment until it returns to the price you purchased it at in order to avoid taxes.

29 1 point

Most financial advisors suggest investing only 5-10 percent of your overall portfolio into any one security.

- ☐ True
- ☐ False

30 1 point

You can use fundamental and/or technical stock analyses to predict movements in meme stock prices?

- ☐ True
- ☐ False



31 1 point

Developing an academic plan involves determining the right set of classes to take in order to become eligible for admission at a particular school within a particular major?

- ☐ True
- ☐ False

32 1 point

Colleges will generally place more emphasis on transfer applicant coursework, since transfer students have much less flexibility to meander through insignificant courses once they get into a university?

- ☐ True
- ☐ False

33 1 point

Which of the following examples are reasons to develop relationships with your instructors:

- ☐ Schools tend to place a good amount of weight on professor recommendations in transfer applications.
- ☐ Studies have shown that developing a good relationship with your professor has an extremely positive effect on your performance in the course.
- ☐ Taking advantage of your teacher's office hours (or even send them a quick email) can mean the difference between a good grade and a poor grade.
- ☐ Professors may often have information regarding scholarships you may qualify for.

34 1 point

If the total cost to attend a particular private university is \$73,000 a year and the school is willing to provide you with need based free aid of \$37,000, what would be the annual cost to attend that particular school?

- ☐ \$73,000, because you ultimately need to pay back the free aid.
- ☐ \$37,000 as the free aid is referred to as the actual cost of college within the FASFA application.
- ☐ \$36,000, the difference between the list price of the school and the free aid.

35 1 point

Based on the Gallup Poll, which of the following factors should you consider when measuring the benefit of a particular school you would want to attend after community college:

- ☐ The mentoring programs at the 4-year university.
- ☐ Whether you would be provided the opportunity to work on projects directly related to your field of study.
- ☐ Whether there were internships available to you before you graduated.
- ☐ The landscape of the campus.

36 1 point

According to the National Association of Colleges and Employers (NACE), employers aren't too concerned with work experience and relevant work experience when hiring new graduates, as long as the candidate has a college degree.

- ☐ True
- ☐ False

37 1 point

According to Will College Pay Off, "What employers want from college graduates now is the same thing they want from applicants who have been out of school for years, and that is job skills and the ability to contribute now. That change is fundamental, and it is the reason that getting a good job out of college is now such a challenge.

- ☐ True
- ☐ False

38 1 point

Which of the following factors relate to the way in which you can market your personal brand:

- ☐ Attending career fairs
- ☐ Developing a high quality resume
- ☐ Connect with company representatives through sites like LinkedIn
- ☐ Clean up your social networking sites to make sure there is no information you would be embarrassed about

39 1 point

The job search for college students should begin when?

- ☐ Once you graduate since you need to demonstrate you were able to obtain a degree
- ☐ At least by your junior year since internships are so important
- ☐ Freshman year
- ☐ Your senior years since you won't be graduating until then.

40 1 point

In terms of finding a good job out of college, going to college the "right way" can be as or more important than going to a particular school?

- ☐ True
- ☐ False

41 1 point

Benefits of student loans include all of the following except:

- ☐ The interest rate on federal student loans is fixed and usually lower than that on private loans—and much lower than that on a credit card.
- ☐ You need a credit check or a cosigner to get most federal student loans.
- ☐ You don't have to begin repaying your federal student loans until after you leave college or drop below half-time.
- ☐ If you demonstrate financial need, the government pays the interest on some loan types while you are in school and during some periods after school.
- ☐ Federal student loans offer flexible repayment plans and options to postpone your loan payments if you're having trouble making payments.
- ☐ If you work in certain jobs, you may be eligible to have a portion of your federal student loans forgiven if you meet certain conditions.

42 1 point

To apply for a federal student loan, you must first complete and submit a Free Application for Federal Student Aid (FAFSA) form. Based on the results of your FAFSA form, your college or career school will send you a financial aid offer, which may include federal student loans. Your school will tell you how to accept all or a part of the loan.

- ☐ True
- ☐ False

43 1 point

As a general rule, if you anticipate your annual salary to be \$65,000 after graduation, you should not borrow more than:

- ☐ The annual tuition times the number of years you anticipate graduating
- ☐ \$65,000 times the number of years you intend to go to college
- ☐ \$65,000
- ☐ You should generally not borrow more than \$50,000

44 1 point

If you are a student, your monthly student loan payments should not exceed 10 percent of your expected monthly take-home pay once you graduate.

- ☐ True
- ☐ False

45 1 point

Assuming a \$20,000 student loan balance, an annual interest rate of 3.73 percent, and a 10-year payback period, your monthly payment would be?

<https://www.bankrate.com/calculators/college-planning/loan-calculator.aspx>.

- ☐ \$224
- ☐ \$746
- ☐ \$166.67
- ☐ \$199.93

## Chapters 10-23

1 1 point

According to USA.gov, credit reports list all of the following except:

- ☐ Bill payment history
- ☐ Loans and current debt
- ☐ Your marital status
- ☐ Where you work and live
- ☐ Whether you have been sued, arrested, or filed for bankruptcy

2 1 point

Good credit can be the difference between getting a loan and not getting a loan, and it can be the difference between getting a loan with a low interest rate and a loan with a high interest rate?

- ☐ True
- ☐ False

3 1 point

Your credit report will show loans and credit you have opened over:

- ☐ The previous 7-10 years
- ☐ The current period and accounts you have open
- ☐ Since you were 18
- ☐ Your entire credit history

4 1 point

Identify all the relevant components of your credit score:

- ☐ Length of credit history
- ☐ Amounts owed
- ☐ Your income levels
- ☐ Payment history
- ☐ New Credit

5 1 point

Identify all the relevant actions you should take to prevent identity theft:

- ☐ Don't carry your Social Security card in your wallet
- ☐ Don't share personal information (birthdate, SSN, or bank account number) because someone asks for it
- ☐ Create complex passwords that identity thieves cannot guess
- ☐ Review your credit reports once a year

6 1 point

Use the calculator at <https://www.bankrate.com/calculators/credit-cards/credit-card-minimum-payment.aspx> to answer the following:

How long and how much money would it take to pay off a credit card balance of \$6,270, assuming an 18% interest rate, and making only the minimum monthly payment of the lower of 2% or \$25?

- ☐ Approximately 10 years and \$7,400
- ☐ Approximately 34 years and \$22,000

7 1 point

In addition to the interest on your outstanding credit card balance, if you miss a payment or pay late, you will be subject to late fees and penalties?

- ☐ True
- ☐ False

8 1 point

If your outstanding balance was \$1,000 and your minimum monthly payment was the greater of (1) 3% of the outstanding balance or (2) \$25, what would be your payment?

- ☐ \$25
- ☐ \$30
- ☐ \$1,000
- ☐ \$30 plus the interest expense for the month

9 1 point

What should you do with an extra \$1,000 at the end of the month?

- ☐ Apply it to your high interest credit card.
- ☐ Save it in case of an emergency.
- ☐ Invest it in order to earn a return.

10 1 point

If you have multiple credit cards, make the minimum payment on all cards and then pay more on the card with the highest rate of interest?

- ☐ True
- ☐ False

11 1 point

As a general rule of thumb, some financial advisors suggested your new car shouldn't cost more than 35% of your annual income. So, if your annual income is \$65,000, then your new car shouldn't cost more than?

- ☐ \$65,000
- ☐ \$22,944



12 1 point

Some financial experts suggest you follow the 20-4-10 rule. According to this rule, you should only buy a car when you can make a 20 percent down payment, you plan to finance the car for four years or less, and the total cost of your monthly vehicle expenses (including insurance) does not exceed 10 percent of your gross income. If you had \$3,000 to apply towards the down payment, how much car could you afford?

- ☐ \$18,000
- ☐ \$15,000
- ☐ \$3,000

13 1 point

Determine your monthly car payment using the following calculator and assumptions:  
<https://www.cars.com/car-loan-calculator/>

- Vehicle price of \$15,000
- Down payment of \$3,000
- Annual interest rate of 4.5 percent
- Sales tax rate of 6 percent and folded into the loan
- 36-month term

- ☐ \$416
- ☐ \$333
- ☐ \$384

14 1 point

When buying a car, negotiate on price and not the monthly payment, down payment or trade-in value

- ☐ True
- ☐ False

15 1 point

You are obligated to buy a car from a dealership, even if it's not too much more than what you wanted to spend, because you have been working with the salesperson for hours and it's not ethical to waste their time?

- ☐ True
- ☐ False

16 1 point

True or False? [Auto](#) liability insurance can help protect you in two distinct ways: 1) If you cause an accident that injures another person, your liability coverage may help pay for the individual's medical bills and may also help pay for repairs to another person's property if you damage it with your car. 2) It also protects you when another person drives your car with your permission. That way you are financially protected if that driver is at fault in your car and injures another person or damages someone else's car.

- ☐ True
- ☐ False

17 1 point

In terms of liability auto insurance, what would 15/30/5 refer to?

- ☐ 15 days, 30 days, or 5 months to file a claim?
- ☐ \$15,000 for injury/death to one person, \$30,000 for injury/death to more than one person, and \$5,000 for damage to property
- ☐ \$15,000 for your injury/death, \$30,000 for injury/death to more than one person in your car, and \$5,000 for damage to the other party's property
- ☐ In case you get into an auto accident and the other party does not have insurance.

18 1 point

If your car is fairly new and worth a lot of money, it may not make sense to have collision insurance. Instead of paying the premium on collision insurance, you could save that money as a down payment on a new car if it ever gets to that point.

- ☐ True
- ☐ False

19 1 point

Identify the various ways to keep auto insurance costs down

- ☐ Get multiple quotes before signing up for insurance.
- ☐ Cancel your insurance and drive safely a few months out of every year.
- ☐ Go with a higher deductible.
- ☐ Drop collision if it makes sense.
- ☐ Buy a car that is less expensive to insure.



20 1 point

Before you rent a car, you should check the coverage on your auto insurance policy. Your personal auto insurance coverage may extend to a rental car, if you're renting the car for personal use and not for business.

- ☐ True
- ☐ False

21 1 point

Medical insurance and employer sponsored paycheck deductions are pretax deductions which have the effect of lowering your overall tax liability?

- ☐ True
- ☐ False

22 1 point

Assuming all else equal and based on the assumptions below: How much less would your take home annual pay be:

- Your annual salary is \$56,000.
  - Your marginal tax rate for federal and state income taxes is 21 percent.
  - Your employer matches 50 percent of your contribution, up to six percent of your salary.
  - You elect to contribute \$10,000 to your 401(k) Plan.
- ☐ Only \$7,900 because if you did not contribute to your 401(k) you still would have paid \$2,100 in additional taxes.
- ☐ \$10,000
- ☐ \$5,000 since your employer contributes 50% up to 6% of your annual salary.

23 1 point

Assume your employer deducted \$6,500 from your paychecks during the year. Also assume you filled out your 1040 Tax Return and based on that form, your actual tax expense is \$6,000. Would you be getting a refund?

- ☐ You would get a \$500 refund since your employer deducted too much from your paycheck.
- ☐ No, but you could request that your employer pay you back.
- ☐ No, you would still owe another \$500 in taxes.
- ☐ Yes, you would get \$500 back plus interest.

24 1 point

Reduce your FIT withholdings to maximize your take-home pay. This way you will have more money in your budget during the year, more to save and invest, more to pay off debts, etc. Under this approach, your tax refund is very small and sometimes you actually have to pay taxes when you file your tax return.

- ☐ True
- ☐ False

25 1 point

Use the following online calculator and assumptions to determine your bi-weekly net pay: <https://smartasset.com/taxes/california-paycheck-calculator#APYsDQCjZj>.

- Single
- Live in San Mateo
- You are paid bi-weekly (every two weeks)
- 1 Federal, 1 State, and 1 Local allowance. No additional State allowance
- Fixed medical insurance of \$65 per paycheck
- 401(k) deduction of 15% of Gross Pay

- ☐ \$1,340
- ☐ \$1,607
- ☐ \$2,154

26 1 point

If you work most of your adult life, Social Security will likely be enough for you to live comfortably in retirement.

- ☐ True
- ☐ False

27 1 point

Based on the Fidelity analyses of nationwide spending data and retirement savings, Fidelity further suggests that individuals between the ages of 25 and 67 should save at least 15 percent of their pretax income each year for retirement to reach a point where their savings will replace 45 percent of their pretax preretirement income in retirement.

- ☐ True
- ☐ False

28 1 point

Fidelity argues that by age 30 you should have 1 times your annual salary saved for retirement and by age 40 you should have 3 times your annual salary saved. If you were earning \$85,000 at age 30 and are earning \$155,000 at age 40, how much should you have saved for retirement (again, general rule of thumb) by 40?

- ☐ \$465,000
- ☐ \$255,000
- ☐ \$85,000
- ☐ \$155,000

29 1 point

Fidelity argues that you should tentatively assume that you will need at least 45 percent of your pre-retirement annual income in retirement. For starters, you likely won't be making contributions to retirement savings plans. You might also be in a lower tax bracket, with less need for certain forms of life insurance and lower overall expenses. You may also decide to pay off your mortgage. Fidelity also concluded that some of that money will likely come from Social Security.

- ☐ True
- ☐ False

30 1 point

Which of the following factors will determine your retirement savings needs?

- ☐ Whether you will have any non-taxable retirement distributions
- ☐ Your life expectancy (the number of years you will be retired)
- ☐ Your tax bracket in retirement and how much of your retirement distributions will be taxable
- ☐ The return on your investments in retirement and inflation
- ☐ Whether you intend to work in retirement
- ☐ The age you intend to retire
- ☐ Whether your spouse will help contribute to your retirement needs
- ☐ Whether your income needs will change throughout retirement
- ☐ Your health and medical needs in retirement
- ☐ Your needed income level and intended lifestyle in retirement

31 1 point

According to the IRS, a 401(k) plan is a qualified plan that allows you to elect to have your employer contribute a portion of your wages to an individual retirement account under the plan.

- ☐ True
- ☐ False

32 1 point

A common employer match is 50 percent of your contributions up to six percent of your salary. How do you interpret that?

- ☐ Your employer will match half of whatever you contribute but not more than three percent of your total salary ( $50\% \times 6\% = 3\%$ ).
- ☐ At the end of your 401(k) contributions, your employer will contribute 6% of your salary to your 401(k) plan.
- ☐ If you contribute 3% of your annual salary, your employer will also contribute 3% of your salary.

33 1 point

A Roth 401(k) is an employer-sponsored investment savings account that is funded with after-tax dollars, so there is no tax deduction associated with your contributions. In a Roth 401(k), your withdrawals are tax free in retirement.

- ☐ True
- ☐ False

34 1 point

The IRS requires withdrawals after age 67 (these are called Required Minimum Distributions (RMD)). The RMD for any year is the account balance as of the end of the immediately preceding calendar year divided by your remaining life expectancy.

- ☐ True
- ☐ False

35 1 point

A 401(k) plan can be attractive for reasons beyond simply lowering your taxes. In addition to paying less in taxes, your employer may also match all or some portion of your contribution. For example, if you contribute \$10, your employer may contribute another \$10.

- ☐ True
- ☐ False

36 1 point

Many argue it is better to contribute to a Roth IRA, since Given that your qualified distributions in retirement are tax-free for a Roth IRA, you would avoid paying taxes at those higher tax rates. This may be especially true for individuals just getting out of college with relatively low levels of income. Likewise, there are no required minimum distributions beginning at age 72

- ☐ Tax rates will likely increase over time.
- ☐ Given that your qualified distributions in retirement are tax-free for a Roth IRA, you would avoid paying taxes at higher tax rates.
- ☐ Individuals just getting out of college with relatively low levels of income can pay taxes now and no taxes on distributions later.
- ☐ There are no required minimum distributions beginning at age 72
- ☐ You can contribute as much as you like to your Roth IRA.

37 1 point

Once your IRA is funded, you can begin investing in assets that meet your financial objectives. You can invest in stocks, bonds, mutual funds, exchange-traded funds (ETFs), sector funds, certificates of deposit (CDs), and money market funds.

- ☐ True
- ☐ False

38 1 point

You can only contribute to a 401(k) or an IRA during the year. You can not contribute to both in the same year..

- ☐ True
- ☐ False



39 1 point

SEP- IRA or SIMPLE-IRA). However, your distribution will be includable in your taxable income and it may be subject to a 10 percent penalty if you're under age 59½. The penalty is 25 percent if you take a distribution from your SIMPLE-IRA in the first 2 years that you participate in the SIMPLE-IRA plan. If you inherit an IRA or Roth IRA, you should check the current rules and regulations regarding withdrawals from the account before you do anything with the money. There are exceptions for early withdrawals without penalty in extenuating circumstances. However, the withdrawals are still subject to income tax. Some exceptions include:

- ☐ Qualified first-time homebuyers, up to \$10,000.
- ☐ Qualified higher education expenses.
- ☐ Certain distributions to qualified military reservists called to active duty.
- ☐ Health insurance premiums paid while unemployed.
- ☐ Unreimbursed medical expenses that are greater than 10 percent of adjusted gross income in 2021.
- ☐ Total and permanent disability of the participant/IRA owner.

40 1 point

You should contribute to a Roth IRA before paying off your credit card debt because the tax benefits of a Roth outweigh paying off your credit card.

- ☐ True
- ☐ False

41 1 point

A 2019 [American Journal of Public Health](#) study found that 66.5 percent of bankruptcies in the U.S. were due to medical issues, such as being unable to pay high medical bills or due to time lost from work. Therefore, always make sure you have medical insurance to ensure you meet your financial goals by staying out of financial trouble.

- ☐ True
- ☐ False

42 1 point

List the tax advantages of an Health Savings Account in connection with a High Deductible Health Plan

- ☐ Your contributions to your HSA are tax-deductible and you do not also pay FICA or Medicare tax on your contribution.
- ☐ You can invest the money in your HSA and your investment income can grow tax-free, similar to an IRA or 401(k). Monies in the account can be invested in mutual funds, fixed rate assets, Exchanged Traded Funds (ETFs), or Real Estate Investment Trusts (REITs). Once in a lifetime you can roll over money from an IRA to an HSA up to the annual maximum.
- ☐ The money in the account can be withdrawn tax-free if used to pay qualified out-of-pocket medical expenses that are not covered by insurance.

43 1 point

Your premium is the amount you pay for covered health care services before your insurance plan starts to pay. With a \$2,000 deductible, for example, you pay the first \$2,000 of covered services yourself. After you pay your deductible, you usually pay only a [copayment](#) or [coinsurance](#) for covered services. Your insurance company pays the rest.

- ☐ True
- ☐ False

44 1 point

If you are young enough, its a good idea to take the chance and not obtain health insurance to save money. The money you save you can invest in.

- ☐ True
- ☐ False

45 1 point

Assume the following:

- Your medical bills for an unplanned procedure were \$17,000,
- Your monthly premium is \$367, and
- Your deductible is \$2,7000

How much would you pay for the unplanned proceduer?

- ☐ \$14,300
- ☐ \$17,000 since it was unplanned.
- ☐ You only pay the deductible.

46 1 point

Allowable deductions to Total Income to determine Adjusted Gross Income can include which of the following expenses:

- ☐ Certain business expenses
- ☐ Moving expenses
- ☐ Retirement account contributions
- ☐ Educator expenses
- ☐ Childcare
- ☐ Health savings account contributions

47 1 point

Allowable below the line deductions to Adjusted Gross Income to determine Taxable Income can include either a Standard Deduction or Itemized Deductions, whichever is lower.

- ☐ True
- ☐ False

48 1 point

Allowable below the line Itemized Deductions to determine Taxable Income can include which of the following expenses:

- ☐ [Out-of-pocket](#) medical and/or dental expenses that are not covered by insurance expenses and that exceed 7.5 percent of your Adjusted Gross Income.
- ☐ Long-term care premiums to the extent that the premiums exceed 10 percent of your Adjusted Gross Income.
- ☐ The interest you pay on your home mortgage and some home-equity debt. Home mortgage interest is deductible on the first \$750,000 in outstanding loans.
- ☐ [Personal property](#) taxes, which include real estate taxes along with state and local taxes that you paid in relation to the previous year.
- ☐ Donations you made to a qualified charity are deductible within certain limitations.
- ☐ Unreimbursed job-related expenses and certain miscellaneous deductions.

49 1 point

What would be your Income Tax If your Taxable income was \$40,000 and your progressive tax rates were as follows:

| Income Levels      | Tax Rate |
|--------------------|----------|
| \$0 - \$9,875      | 10%      |
| \$9,876 - \$40,125 | 12%      |

- ☐ \$4,800
- ☐ Depends on how much was deducted from your paycheck during the year.
- ☐ \$4,602.5

50 1 point

Capital gains tax rates first depend on whether you held the asset you are selling for more than a year. Your capital gains are considered short term if you held the asset for less than a year and are taxed at ordinary income rates. However, if you held the asset for more than a year, your capital gains are considered long term and have more preferential tax rates.

- ☐ True
- ☐ False

51 1 point

Assume you took out an interest only loan of \$500,000 to purchase a home for \$750,000. Also assume your home increased in value by 15% the first year you owned your home. What would your equity be in your home after the first year?

- ☐ \$287,500
- ☐ \$250,000
- ☐ \$862,500
- ☐ \$362,500

52 1 point

Assume a home price of \$750,000, a down payment of \$150,000 and a 30-year fixed rate mortgage at 3.0%. Also assume our monthly property tax would be \$494 and your monthly home owner's insurance would be \$66 . What would be your monthly housing payment?

<https://www.bankrate.com/calculators/mortgages/mortgage-calculator.aspx>

- ☐ \$1,500
- ☐ \$3,500
- ☐ \$3,089
- ☐ \$2,529

53 1 point

Assume you follow the 32% Rule of Thumb on how much of a house you can afford where your total housing payments (including mortgage, homeowner's insurance, property taxes, etc.) should not exceed 32 percent of your gross monthly income. Assuming an annual income of \$100,000 and the conclusions from the previous questions, would you satisfy the 32% Rule of Thumb?

- ☐ Yes
- ☐ No

54 1 point

When trying to determine how much house you could afford to buy, you should consider the monthly maintenance on the property and also consider all the closing cost fees associated with actually buying a home?

- ☐ True
- ☐ False

55 1 point

Mortgage interest and principal payments are deductible on your 1040 tax return?

- ☐ True
- ☐ False

56 1 point

Investing in Real Estate is risk for which of the following factors?

- ☐ Its expensive and ties up a lot of your capital.
- ☐ It can create negative cash flow on a monthly basis.
- ☐ The value of the property can decline to an amount that is lower than the outstanding mortgage on the property.
- ☐ It can create liquidity issues.

57 1 point

The benefits of investing in Real Estate include which of the following:

- ☐ Buying a house, possibly in foreclosure, living in it for at least two years as a primary residence, and then selling it for a tax-free profit due to rising home prices in the area, with little maintenance or expense.
- ☐ Buying and financing a fixer-upper and, while living in it, contracting or doing much of the work yourself. This is frequently done by a couple with one or both having a full-time job to help generate cash flow for the mortgage, taxes, labor, and materials. When completed, it may be rented and refinced for a down payment on another property.
- ☐ Buying a small residential rental property, living in one unit, and renting out the other unit(s) without major repairs.
- ☐ Purchasing rental property, living in one unit, and over time making capital and cosmetic improvements, increasing rents, then selling it and using tax-deferred profits as a down payment on a larger piece of rental property.

58 1 point

The goal in real estate is to use the rental income to help pay for the mortgage, insurance, taxes, and maintenance, while taking advantage of the tax benefits and the use of borrowed funds. Ultimately, you will build up your equity or ownership of the property, as prices and cash flow appreciate.

- ☐ True
- ☐ False

59 1 point

Cost Basis = Purchase Price + Capital Improvements – Depreciation + Outstanding loan

- ☐ True
- ☐ False

60 1 point

Potential landlords look closely at the numbers to see if their investment will pay off. Specifically

- ☐ Make sure rental income will cover out-of-pocket costs such as mortgage payments, taxes, insurance, maintenance, repairs with at least a 5% to 10% vacancy rate.
- ☐ Know the terms and conditions of existing leases on the property so the ability to raise rents is not overestimated.
- ☐ Factor in that repairs and maintenance are tax deductible.
- ☐ Factor in that mortgage interest, depreciation, and property taxes are tax deductible.
- ☐ Factor in that capital improvements are depreciated per the schedule, not expensed in the amount of the cash outlay. They are added to the cost basis, the amount you paid for the property.
- ☐ Be aware that the \$250K to \$500K primary residence tax exemption does not apply to residential rental property.

61 1 point

The standard homeowner's insurance policy includes the following essential types of coverage:

- ☐ Liability protection.
- ☐ The structure of the home.
- ☐ Your personal belongings.
- ☐ Additional living expenses.
- ☐ Car insurance when you bundle home and auto.

62 1 point

To determine the amount of insurance you need, multiply the square footage of the house by the approximate cost per square foot to build a new house in your area, such as, \$250/square foot. Do not include the cost of land since land is usually not covered by the insurance.

- ☐ True
- ☐ False



63 1 point

To prepare your property for insurability, you should do which of the following?

- ☐ Install smoke alarms.
- ☐ Install burglar alarm.
- ☐ Paint the property.
- ☐ Put a fence around the pool.

64 1 point

To reduce the cost of home owner's insurance, consider:

- ☐ Increasing the deductibles.
- ☐ Go without insurance during those traditionally "safe" few months out of the year.
- ☐ Paint the exterior to make it look nice.

65 1 point

Some homeowner's insurance policies may limit coverage, exclude coverage, or omit coverage for certain risks. So, you should review them carefully. Acts of nature such as floods, hurricanes, tornadoes, and earthquakes may need to be insured separately, and usually involve additional premiums and deductibles.

- ☐ True
- ☐ False

66 1 point

If you are single you probably need lots of life insurance.

- ☐ True
- ☐ False

67 1 point

How much life insurance you need depends on a number of factors such as:

- ☐ Future needs
- ☐ Sources of funds
- ☐ Immediate needs

68 1 point

Whole life insurance combines the cost of death or term insurance with a savings component called the cash value, an amount which is accumulated by you, managed and invested by the insurer. The cash value builds up tax-free and compounds in your account. Sometimes the insurer will even guarantee a minimum rate of return on the cash.

- ☐ True
- ☐ False

69 1 point

An Individual Disability Income Insurance Policy provides you income in the event you are disabled. Because it provides income replacement, you must be employed to receive benefits. The insurer would not replace all your income because they want you to be incentivized to go back to work. The policy usually replaces 50% to 70% of your income up to a stated maximum.

- ☐ True
- ☐ False

70 1 point

Regardless of the definition of your disability insurance, if the coverage is through your employer and you leave your job, you can usually take your insurance with you.

- ☐ True
- ☐ False