Money and You: Subjects your kids won't be studying, part 2

by Carrie_Schwab_Pomerantz

Last week I wrote about putting personal finance on your teen's curriculum this fall by teaching them about the basics of money management: budgeting, saving, and the pros and cons of credit cards. But I also believe teens should at least start to learn about investing for the long term. One of the more eye-opening findings of the survey about teens and money I mentioned last week, co-sponsored by Schwab and the Boys & Girls Clubs of America, was that 22 percent of teens surveyed know how to invest their money to build wealth; however, just 13 percent knew what a 401(k) plan is.

Now's the time to teach them about the general principles - the wealth-building power of compound growth and the basics of portfolio investing - and one very specific, but very important lesson: the power of tax-advantaged retirement plans like 401(k)s and IRAs.

Naturally, I realize that "long term" for most teens means a month from now and that it's hard to think about building wealth when your "income" comes from allowances and part-time jobs. But they're going to need to know this stuff someday, so why not give them a head start?

I've already mentioned the importance of instilling the savings habit in your kids. Saving should be a key part of everyone's financial foundation. Kids like having money in the bank, but learning about compound growth can really get them interested in saving and, ultimately, investing. Explain to them how investments grow, including interest payments for savings accounts, dividend payments and capital growth for stocks. And run through a couple of examples with them; online calculators for future value are easy to find.

Here's a typical scenario. If your 16-year-old could put $4,000 into a Roth IRA every year, starting now and continuing until she is 60, and that nest egg grew an average of 8 percent each year, she would end up with almost $2 million (on under $200,000 of contributions).

In other words, the savings habit is particularly valuable for the young because if they start early, they'll have to save a lot less for long-term goals like retirement. In fact, if they start saving 10 percent of their income when they enter the workforce in a few years, they'll probably never need to save a larger percentage. Someone who waits until he is in his 30s will need to save about 20 percent of his income, and the percentage just keeps rising the older he gets.

Asset allocation trumps stock picking. Some schools do teach personal finance, and one popular approach is to sponsor stock market-related games and contests; however, for most investors, stock picking and short-term trading is not the key to building long-term wealth. The key is understanding and applying the principles of asset allocation and diversification.

As you know, but as your kids probably don't, asset allocation refers to the mix of equities (U.S. and international stocks), bonds, and cash that match an investor's goals, time frame and risk tolerance. Diversification refers to the fact that owning many securities, within and across the different asset classes, can help you ride out market volatility. Owning just a few securities would cause a sharp decline and have a larger impact on your overall portfolio.

You can achieve this without ever picking an individual stock by taking advantage of the vast array of low-cost, highly diversified index and actively managed mutual funds or exchange-traded funds. So when your kid comes home talking about a stock-picking competition, use that as an opportunity to talk about the stuff that really matters, such as building a strategic, diversified portfolio. Recent stock market volatility also gives you a perfect opportunity for discussing risk and the importance of building a portfolio that can weather the ups and downs.

The power of the 401(k): You may think I'm crazy for wanting to teach high school kids about 401(k) plans, but I am convinced that bringing up the subject early will help them embrace the opportunities of tax-advantaged retirement plans when they do enter the workforce. I already mentioned the long-term impact of compound growth, but because so many 401(k) plans include a company match and contributions are made with pretax dollars, their wealth-building potential is even more dramatic. Talk it up now so they're ready to use it when they land that first job.

You may find it difficult to engage your kids with topics that have a long-term time frame, like investing and retirement planning. If you can afford it, consider giving them a sum to invest now while they're young. You could open a small custodial account for them, help them select investments, and then monitor its ups and downs.

If they have a job for which taxes are withheld, they're probably eligible to open a custodial IRA or a Roth IRA. Since the tax deduction for most teens will be meaningless, take the Roth IRA route. Again, they'll need your help in constructing a portfolio, but there are plenty of low-cost, well-diversified possibilities. You'll be giving them a real stake in the markets and their own futures as well as the chance to get some hands-on learning that will pay dividends for a lifetime.

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