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Financial Foundations for the Next Generation

We've all heard stories of individuals (e.g. lottery winners, professional athletes) who have come into sudden wealth and, within a few years, have seen their fortunes disappear. This is often due to the fact that these individuals have little practical experience or training in financial matters. Sadly, this is not an uncommon problem. Our educational system is not designed to teach the next generation how to manage their finances. Outside of business schools, financial literacy is a nearly non-existent component of our academic institutions' curricula, leaving individuals to fend for themselves. Yet, gaining such knowledge and establishing good financial habits are critical for successfully reaching a financial goal whether it be purchasing a home, saving for retirement or managing a windfall from inheritance.

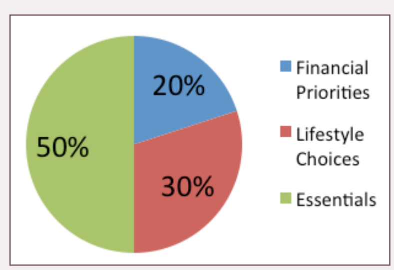
The Boston College Center on Wealth and Philanthropy recently stated that, "An estimated $59 trillion—divided among heirs, charities, estate taxes and estate closing costs—will be transferred from 93.6 million American estates from 2007 to 2061, in the greatest wealth transfer in U.S. history."[1] Coming in the form of financial assets, tangible property, real estate and business interests, this is a staggering amount of wealth, which the next generation is likely ill-equipped to handle.

In our role as advisors, we think it would be useful to offer to our readers some elements of financial wisdom. Understanding that many college students and young adults come home for the holidays, this newsletter is geared toward younger adults, but other generations are likely to find it informative as well.

We believe that creating financial flexibility is essential for a strong financial future. Creating financial flexibility requires careful balance of budget, risks, debt and investing. An understanding of each of these topics will better guide the individual in making financial choices day-to-day.

Good Budgeting is a Reality of Financial Success

Financial flexibility is created by having a proactive plan when it comes to spending and saving habits. Expenses fall into three primary categories: essential, financial priorities and lifestyle. Essential expenses are related to immediate needs and are required to provide for basic necessities like housing and food. Financial priorities include planning ahead by building an emergency fund and saving for retirement. Lifestyle expenses are allocated to having fun (dining out, travelling, hobbies and clubs). Dividing a budget 50/20/30[2] between these expense categories provides a good road map for developing strong saving and spending habits.



Expenses can further be fixed or variable in nature. A primary source of financial stress comes from assuming too many fixed expenses (auto loans, rent) in relation to incoming cash flow. Such expenses ought to be carefully considered before making a commitment. Fixed expenses should fall somewhere between 33% and 40% of one's total income. Remaining cash flow can be dedicated to variable expenses (e.g. savings, travel, clothing, dining out). For a budget worksheet visit
http://www.hmpayson.com/wp-content/uploads/2014/12/HMP-Income-Expenses-Form.pdf

Insurance – Hoping for the Best but Preparing for the Worst

There are certain risks that young adults need to manage. Insurance is a risk management tool that is best suited for low probability but financially costly events. Insurance premiums are simply the cost to obtain financial protection against a particular adverse event or risk; insurance premiums should be considered an essential expense. For example auto insurance and health insurance are critical to prevent financial hardship.

A few tips when exploring your insurance coverage:

• **Health insurance** – understand the relationship between fixed monthly premiums and the variable out of pocket medical expenses, such as co-pays.

• **Life insurance** – typically only necessary for individuals who have financial dependants. Term life insurance provides the greatest benefit coverage per dollar of premium.

• **Long term care insurance** – the risk of a long term care event is low for young adults. Consider insurance coverage later in life as risk increases.

• **Disability insurance** – a younger person's greatest asset is his or her earnings power over his or her lifetime. Protecting this asset is important.

The Emergency Fund

According to the National Foundation for Credit Counseling, 64% of Americans are unable to accommodate unexpected expenses of $1,000. With the average household having $2,000 in unexpected expenses annually, this lack of savings is problematic.

It is critical to create an emergency fund to cover three to six months of expenses. Building an emergency fund is a financial priority, therefore an important piece of your budget.[3]

Not All Debt is Treated Equally

Debt plays a meaningful role in personal finance and can be both good and bad, depending on the type. Good debt is borrowing money to pay for a long term investment, such as education or home purchase. Incurring student loan debt is an investment in future earning potential. The burden of student loans, however, can overwhelm one's cash flow, particularly in early low-earning years after college. Fixed loan repayment expenses decrease financial flexibility. With the high cost of college education, it is no wonder that students are considering the economics of different academic degrees much more than in generations past.

Mortgages are another example of good debt. Real estate often appreciates in value over time, so incurring debt to capitalize on this potential growth can be wise. Because buying and selling real estate is costly, it should only be considered when planning to live there for at least five years. Deciding how much mortgage debt to assume should depend upon how the fixed monthly mortgage payments will affect one's budget rather than how much a lender is willing to loan. It is important to remember that real estate is a cash consuming asset that comes with a host of variable expenses (maintenance, utilities, capital improvements) that are necessary to maintain its value and functionality.

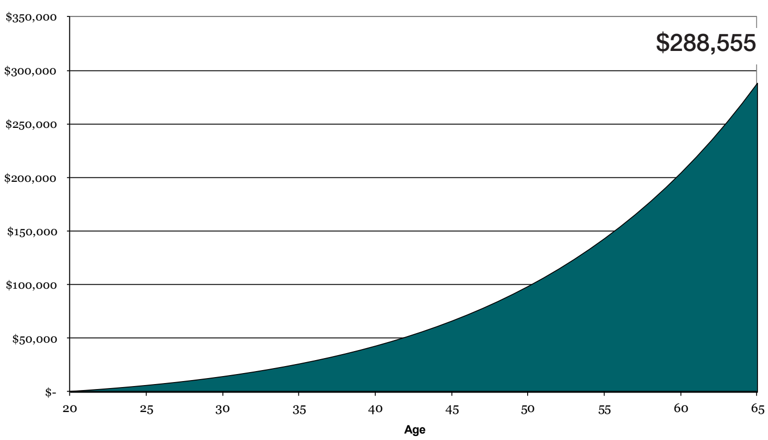
Bad debt is expensive. This type of debt includes auto loans and credit cards, which often result in satisfying immediate desires that have little lasting economic value. Social pressures can tempt people to spend money they do not have on unproductive pursuits. According to *Kelley Blue Book*, the average car depreciates 44% over 5 years[4], causing auto loans to lack significant investment value. At the same time, credit cards, while very convenient, often charge the highest interest rates. If the credit card balance is not paid fully each month, compounding interest on the outstanding balance can cause this debt to increase substantially. Credit cards can be convenient and a useful credit building tool, but it is important to cultivate a budget and make diligent spending decisions to avoid the effects of compound interest.

"Social pressures can tempt people to spend money they do not have on unproductive pursuits."

Saving and Investing - Time is One's Greatest Asset

One of the greatest quotes relating to finance comes from the famed scientist Albert Einstein who once said, "Compound interest is the eighth wonder of the world. He, who understands it, earns it ... he who doesn't ... pays it." Compound interest becomes so powerful when time is on one's side. Compounding refers to the ability of an asset to generate earnings on previous earnings. While compounding can cause credit card debt to grow exponentially (which is great for the credit card company), compounding can also benefit the savings and investing side of the ledger in the same manner.

Latte Savings



20 yr old saves the equivalent of $4 everyday - cost of a latte - until reaching age 65.
Assumes 6.0% annual return and 2.5% cost of inflation.

Saving for the future feels challenging, especially when we hear the recommended savings rate of 15% for retirement. Conversely, many think that a $4/day coffee habit is such a small dollar amount that it does not make a difference whether the $4 is saved or spent. Yet, these choices do make a difference. The graph above illustrates what we call the 'Latte Effect'. This simply shows how a 20-year old that saves $4 every day until age 65 can accumulate $288,555.

Saving small amounts can have a profound effect on wealth, but *when* an individual starts saving has an equally, if not greater, impact on how much wealth is accumulated.

"Compound interest is the eighth wonder of the world. He, who understands it, earns it... he who doesn't... pays it."

Albert Einstein

Consider the following three examples:

- A 25 year old saves $5,000/year for 40 years (until age 65), earning 6%/year on his or her investments, will see his or her portfolio grow to $773,000 by age 65.

- If that same person waits just 10 years to start saving at age 35, he or she will need to save $9,800/year (almost twice as much per year) for 30 years to reach the same $773,000 level.

- If that person waits 20 years and begins saving at age 45, then he or she will need to save $21,000/year (four times as much per year) for the next 20 years to reach the $773,000 level at age 65.

These examples clearly illustrate the beneficial impact of saving early. The results above, however, would not be possible if the funds were not invested in assets which earned an investment return of 6% per year. If the funds were left in cash for the duration, which is currently earning <1%, the results would be dramatically lower.

Understanding Timelines and Whether to Save or Invest

Whether money is being managed for a pension fund, an endowment or an individual, the amount of time that will pass (known as time horizon) before funds are needed is critical in deciding how to invest them. We refer to this relationship between time horizon and investment options as "matching the duration of assets and liabilities."

For short term needs, meaning those needs occurring within the next year or two (such as a down payment on a car or home), it is far more important to preserve money than to earn a high return on that money. Savings accounts, money market funds and short term CDs are the preferred place to store and preserve the money needed for short term expenses. Investing money that will be needed in the short term in the stock market puts that money at risk.

For goals with longer time horizons, capital growth and improving purchasing power should be a higher priority than short term capital preservation. Investing in long term assets, such as stocks and investment real estate, is appropriate for investors with similarly long term time horizons. Investing in long term assets has a distinct trade-off by sacrificing predictability in the short term to gain higher returns over time.

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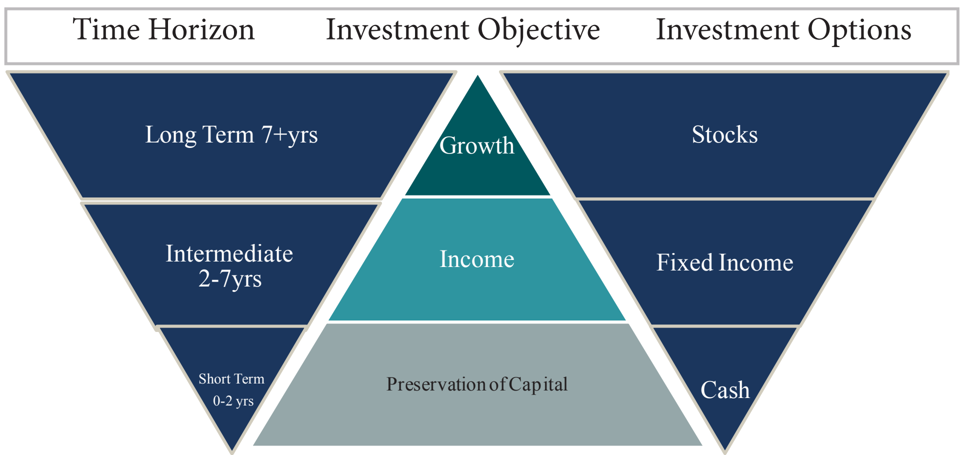
There are no guarantees when it comes to investing in stocks, but the probability of earning a higher return than cash increases meaningfully the longer an asset is held.

The chart below is a guideline for how to align investment objective and time horizon with appropriate investment options.



Conclusion

The choices we make today will impact us, either positively or negatively, in the future. Simple ideas such as how excessive spending increases financial stress, how to manage catastrophic risk and how to use time to our greatest advantage are all powerful tools that come with wisdom. Combined, they can be used to make day-to-day decisions about income and wealth in a manner that increases financial flexibility, thus paving the way for a strong financial future.

This newsletter is intended for educational purposes only. For financial planning advice specific to your needs or for further information, please consult your Portfolio Manager.

Foot Notes:

[1]Center of Wealth and Philanthropy. Boston College. 28 May 2014. Web. 8 Dec. 2014

[2]*How to Budget Your Money With the 50/20/30 Guideline.* Laura Shin. Learnvest. 30 Jan 2014. Web. 8 Dec. 2014. http://www.learnvest.com/knowledge-center/your-ultimate-budget-guideline-the-502030-rule/

[3] *A Modern Girl's Guide to Personal Finance.* Thakor, M. & Kedar, S (2014) Avon, MA: Adams Media p22

[4]*Kelley Blue Book* n.d. Web. 8 Dec. 2014. http://www.kbb.com/new-cars/total- cost-of-ownership