Financial Advice for Young Adults

I delivered this talk in 2012 to the 20 under 20 group, but I had a letter to my daughters in mind when I wrote it.

I am not an expert in any of these subjects with the possible exception of investments. However, I do have the advantage of being beholden to no one. This means that the following opinions and thoughts are very much my own and are not coloured in any way by vested interests.

Banking

It is quite possible that the bank you choose now will remain your bank for the rest of your life. This is because switching costs become increasingly onerous as you get older and your financial life becomes more complicated.

While charges for the ATM, debit card etc. may seem trivial, just multiply them by 50 years and see if you still think it doesn't matter. The answer is to shop around now. Even within one bank, it matters a good deal what account you have. For example, my wife and I have checking accounts where we pay no fees on anything as long as we maintain a balance of at least $1,500. You cannot get these types of accounts any more but since we are original account holders, we are grandfathered. The bank is desperately trying to sell us on new accounts with all types of features. When they do that, you know you have the right type of account.

Credit Cards

These are useful because they give you a credit score early in life and are almost essential for many transactions like car rentals and booking flights etc.

If you are under 18, you probably will not be able to get a credit card on your own account. They will probably offer you a joint card with your parents. This may not be worth it since I do not believe it does much for your personal credit score.

The cardinal rule of credit cards is NEVER EVER REVOLVE. This means you MUST always pay off your balance immediately. As you know, interest charged on credit card balances is obscene. Basically if you always pay your balance on time, those that are revolving will subsidize all the points and goodies you get from your card and you know what side of that equation you want to be on.

When selecting a credit card, consider those that pay a cash dividend rather than air miles or other types of points or rewards. I have a card that costs me 100 per year and tends to pay me 500 per year in cash. Needless to say, you will not see any ads for these types of credit cards.

Housing

I am going to spend a good deal of time on this area because with house prices now it is topical and I think that most Canadians lack perspective. The following is a primer from a strictly financial point of view:

If you purchase any residential real estate, whatever you paid is partly for land and partly for structure. If you buy a detached house in Toronto it is about half land value. If you buy a condo it is over 90% structure value. If you don't believe me, an acre of serviced but unimproved land in the Toronto downtown core is worth about 3 mm. Divide the land footprint of a condo building by the number of units to see how much land value you actually purchase with a condo.

Residential structures (as opposed to land) are not an investment. They are depreciating assets like cars. Eventually all structures need substantial repairs (assessments in condo parlance). The typical life of a high rise building is about 40 – 60 years. They actually last much longer but only because enormous sums are invested to extend their lives.

The bottom line is if you are considering buying a condo, evaluate the mortgage and maintenance payments against rent in a comparable building. In the long run, net of assessments, a condo is not likely to appreciate in value.

If you are considering buying a detached house, you have more land value but …

- Do not underestimate costs of ownership including property taxes, insurance, maintenance and constant upgrades
- Be aware of the ladder of consumption that home ownership tends to bring – gardening tools, kitchen appliances, flatware, art etc. etc. If you don't believe me, Google George Carlin Talks about Stuff

Ok, so you bought your detached house anyway, but now you have to move. That means you have to sell. Transaction costs in real estate are enormous. Commissions are at least 4%. In addition, there are often taxes and legal costs as well as moving costs. However, arguably the biggest cost is the one you never see: the bid/ask spread you have to eat. While your house might be worth X, the buyer is only willing to pay 95% of X and you have to move so you take it. This spread can be $25,000 or more.

There is another aspect of selling that you don't think about until you are actually in the process. The real estate agent will tell you there is a showing in an hour. You have to clean up the house, pack up your kids and find somewhere to go for an hour. You have to do this perhaps 20 times before the house is sold. Remember that before you buy.

We are selling our house now. On the surface, given that our listing price is almost three times what we paid for our house, we will have done well. However, at what we are likely to settle for and net of commissions and other costs, the annual return will be about 7% nominal and this does not account for the hundreds of thousands we have put in to it. I am not complaining. We got a place to live and some kind of return.

However, I tell my girls now to go ahead and buy a house if they want. However, do not consider it an investment. In order to realize a return, you would have to sell your house to someone else for more than you paid for it. The sad fact is that there will be fewer people looking to buy their first house in the future than has ever been the case in my lifetime. I would be very surprised if my daughters had a return on their house that was anywhere close to our modest return just because of demographics.

Do consider renting - even for the rest of your life. I know this sounds heretical in our society, but that may, in fact, be its strongest recommendation.

I know a number of well-to-do European families that have never - and never plan to – own their own residence. They may own other properties but are perfectly happy to rent where they live. I will tell you also that my finance professor at Queens had never owned a house and never planned to. Think about it.

Budgeting

You are constantly told that you should keep a running personal statement of income and expenses and then budget down the expenditures to achieve the desired level of saving.

It's a nice theory but I have met very few people who have successfully implemented it. Instead I would take the approach of the Wealthy Barber and "pay yourself first". Just put 10% of your "take home" in some kind of savings account and don't touch it. This will build a nest egg and start you off with a saving mindset.

When you near retirement, the question of how much you need becomes important. Do not bother to estimate future expenses. The surest guide is to start with your current take home income less savings (including mortgage payments if you plan to pay it off before retirement), and then take about 70% of that result and that will be a good approximation of what you will need in retirement after tax.

I have come to believe that the expenditure side of the equation is more important than the income side. The reason is that you have 100% control over spending and your current level of spending defines what you will need in retirement. As a very rough rule of thumb, a dollar of spending in retirement requires over 30 dollars of assets – that's a big multiplier.

Recent research indicates that spending, especially at the higher income levels, is significantly driven by the social milieu in which a person operates. In a sense, this is the "keeping up with the Jones' " phenomenon but it goes well beyond cars and fridges. I have seen people making almost a million dollars a year who had negligible net worth because they spent so much on fancy dinners and trips with their friends. I have seen very wealthy people compete with each other to see who could give the most to a charity. Consider cultivating a circle of friends who are slightly less well off than you and never tell them about your financial situation. I think there is a good chance you will be happier and wealthier.

Saving

At this stage of your life, I assume you have just started saving. I would suggest you put it in a TFSA and keep it liquid. Use a TFSA instead of an RRSP because you can carry forward your RRSP contribution room to a time when the tax deduction is more valuable. Keep liquid in your TFSA because you may need this money for emergencies or buying a car or a down payment on a house. It will not necessarily be used for retirement even if that is your intention right now.

The other reason for remaining liquid is psychological. You won't make much on your savings but you will not be discouraged by a big loss in the stock market. If at this stage of your life you do well in the stock market, it will not have much impact on you eventual wealth because the amounts invested are relatively small. On the other hand, if you take a big loss now, it may discourage you from investing in the market later in life when it is important.

Investing

While now may not be the time in your life to invest in the capital markets, it is a great time to learn about them. Here are some very important statistics that can help you design an investing program whether you do it yourself or through an advisor:

1. Always think of returns in real terms when you are planning. This means think about returns after inflation.
2. Over the very long run, the following real returns before fees and taxes are what you can expect: stocks 5.5%; bonds 1.5%; money market and cash 0%. This means you only invest in money market and shorter term instruments if you need liquidity or are convinced that the other asset classes are going to fall a lot. Because bond interest is taxed at the full marginal rate you are not likely to make anything after tax and inflation if you invest in bonds in a taxable account. In the long run, you are only going to be able to grow the purchasing power of your wealth through investing in equities or similar assets
3. The top 25% of equity managers will outperform the index by about 2% per year before fees and taxes and it costs about 0.15% to buy the index through Exchange Traded Funds (ETFs). This means that buying a mutual fund with a Management Expense Ratio (MER) of over 2% is unlikely to be a good investment relative to an index ETF because in order for that to be the better choice, you have to have selected a manager in the top quartile. If you can reliably pick top money managers you can probably pick good stocks and you will be better off spending your time doing that
4. Investment advertising will trumpet funds that have outperformed by some large number. In order for this to be true they have to be taking on more risk than the market or the time period they are measuring is too short to be meaningful or they are in the top 10% of managers. It is possible they are exceptionally skilled, but review it with a suspicious eye
5. No manager of bonds can meaningfully outperform the index without taking either credit risk, term risk or currency risk. Skill in evaluating credit is worth paying for. Successfully playing terms

and currencies is a trading game and if a manager really has skill in those areas, they don't need your money. If you need to buy bonds through a mutual fund or ETF, be very conscious of fees

Investing for Retirement

All the advertising you see from the financial industry talks about the amount of assets you need to retire and they evaluate that in terms of expected returns, inflation, your withdrawals and how long you expect to live. No one can know any of these variables with certainty and even if you could, the analysis still does not include the effect of tax. Frankly, I think it is a flawed model.

I ask my clients what they really need in retirement. Eventually we come to the conclusion that what they need is a certain level of income after tax that will keep pace with inflation. Given that objective, I think it makes more sense to think of your investments in terms of their ability to generate income rather than the market value.

This insight can make you a better investor. It steers you to dividend paying stocks because these payments tend to grow at a rate well above inflation and they are taxed at half the rate of bond interest. In addition, when equity prices are depressed, you think differently about your investments. For example, during 2009 TD Bank traded down to about 37 per share. It still paid a dividend of 2.44 for a yield of 6.6%. Viewing the investment process through the lens of income rather than market price, the question was will they have to cut their dividend rather than will the stock price drop more. It was pretty clear that the probability of TD having to cut their dividend was remote and so we bought more TD and it now trades for about 83 a share and has raised its dividend 18%.

The goal is to build a portfolio whose income stream will supplement your pension and CPP etc. in retirement such that it meets your spending needs. If you can do this, you do not have to worry about inflation or stock market returns or even how long you might live. Your sole concern is that your stocks keep paying dividends that increase in line with inflation.

A General Approach to Financial Decisions

Try to avoid being sold anything, whether it is an insurance policy or mutual fund or anything else. Paying people to sell is very expensive. In the final analysis, it is the purchaser who ends up paying for the salesperson. Where possible, try to figure out what you need or want and what you are willing to pay for it and then go out and find it. If you can do this, you are likely to be a good investor. It is also the best approach for all transactions in your life.