Teaching Children Personal Finance

Craig L. Israelsen, Ph.D.
School of Family Life
Brigham Young University
July 2007

What are the basic personal finance principles that we need to teach our children? I've listed five suggestions below. There are undoubtedly more we could add, but this list gets us started. I'm assuming that we're talking about "children" between the ages of five to fifty! If your children are young, you will want to adapt this list accordingly.

1. Pay a full **tithing** and be generous in your offerings.
2. **Save** at least **10 percent** of your income.
3. Develop and maintain a **record-keeping system.**
4. **Keep track of expenditures** by using a budget**.**
5. **Start investing now!**

With these five core habits in place your children will have a solid foundation. But, there is one more vitally important element. It is **perspective**. Financial stewardship is more than teaching money skills. More importantly, **we are sharing a value system with our children**. Without a value system in place, financial skills lack meaning.

Now, let's discuss each item in a bit more detail.

<u>*Tithing and Offerings*</u>

And all the tithe of the land, whether of the seed of the land,
or of the fruit of the tree, is the LORD's: it is holy unto the LORD.
(Leviticus 27:30)

Tithing is 10 percent of our increase (Leviticus 27:32, D&C 119:4). Tithing is the Lord's law of finance. Paying tithing to the Lord is a privilege. Moreover, it is an important step toward living a consecrated life. Those who faithfully tithe can know that they have kept one of the Lord's commandments with exactness. Offerings should be generous. President Spencer W. Kimball gave the following counsel:

> Each member should contribute a generous fast offering for the care of the poor and the needy. This offering should at least be the value of the two meals not eaten while fasting. Sometimes we have been a bit penurious and figured that we had for breakfast one egg and that cost so many cents and then we give that to the Lord. I think that when we are affluent, as many of us are, that we ought to be very, very generous. . . . I think we should . . . give, instead of the amount saved by our two meals of fasting, perhaps much, much more—ten times more when we are in a position to do it.[i]

Children love the opportunity to share and can be naturally generous if simply shown the pattern by their parents.

Save At Least 10 Percent of Income

If you wish to get rich, save what you get.
A fool can earn money; but it takes a wise man to save and
dispose of it to his own advantage.[ii]
(Brigham Young)

Tithing, the Lord's law of finance, is meant to teach us a valuable lesson, namely that a portion of our income is dedicated to Him. It also suggests that a portion of our income should be dedicated to ourselves—in the form of savings. If a ten-year-old girl were to save 10 percent of her annual income (assuming modest income figures throughout the lifecycle), when she is sixty-five she will have over $225,000 in her savings account—and that's assuming no interest earnings! If all the saved money earned 6-percent interest per year there would be nearly $830,000 in the account. At 10-percent annual interest, she would have over $2,500,000 by age sixty-five. Retiring with a comfortable nest egg is more a function of our persistence in saving than the size of our income. Time is the key element in building up a savings account. The more time the better. So, start now!

Young children usually respond well to tangible processes. In other words, they are more likely to save money if they have a cool piggybank or snappy trappy box. For older children, starting a savings account at a local bank can be motivating. One of our children, for example, started an investment account in a mutual fund with money earned from his paper route. The key is to help the child by finding something that motivates them to save. Be creative.

Saving money is a bit different from investing money. Money "saved" is typically put in a bank account. There is no stock market risk, but also no chance of earning stock market returns. Investing generally involves opening several mutual fund accounts (more about that later).

Develop and Maintain a Record Keeping System

Nobody was ever meant
To remember or invent
What he did with every cent.
(Robert Frost)

Record keeping is vitally important, but Robert Frost has a good point. Clearly, not all information is equally important. Moreover, record keeping should not turn us into neurotic zealots who track every penny like an FBI agent gone mad. Record keeping is creating and maintaining a system for preserving or documenting anything of financial, personal, or familial importance. If it's important, keep it—and keep it organized.

You can help your child by purchasing some folders that they can label. A folder for Pokemon cards, a folder for their report cards from school, a folder for treasured letters or e-mails they want to save, a folder for pictures, and so on.

Keep Track of Expenditures by Using a Budget

For young children this will be a very simple project with a very profound impact. On a piece of paper (or better yet, in a notebook) help them write down the money they have to spend and how they plan to spend it during the month. As they spend money, encourage them to record their expenditure on the “budget sheet.” If the child wants to use a computer to keep track of his or her spending, that works too.

It’s not uncommon for young children (up to age twenty-five) to have no clue regarding the cost of running a household. One helpful exercise is to sit everyone down and with the use of play money (for example, Monopoly money) start out with a stack of money representing the total monthly net income (take-home pay). Then, with all eyes on the stack of money, start physically allocating it to the various budget categories (in little sub-stacks): house payment, utilities, tithing, food, insurance, medical, and so on. Kids get the point real quick. This lesson has a half-life of about two weeks, so it has to be repeated every now and then. But, don’t do it too often because the object of the lesson is not to create a neurotic obsession with expenses. It can be discouraging to children if we fixate on money too much. So, we have to walk a fine line here.

Start Investing Now

For which of you, intending to build a tower,
sitteth not down first, and counteth the cost,
whether he have sufficient to finish it?
(Luke 14:28)

Most people invest in stocks and bonds by choosing several mutual funds. A stock mutual fund is a portfolio (or collection) of stocks. Some stock mutual funds have as little as 30 stocks, some as many as 3,500 stocks. The average stock mutual fund holds about 200 different stocks in its portfolio, while the average bond mutual fund has about 350 different bonds in its portfolio. As of early 2007, there were about 4,000 mutual funds that invest in U.S. stocks (both large and small . . . and medium!), about 1,000 mutual funds that invest in non-U.S. stocks, and about 1,000 mutual funds that invest in bonds (government or corporate bonds). So, there are a lot of mutual funds to choose from.

An investor needs several different mutual funds to be “diversified.” Diversification helps avoid a large loss if one particular mutual fund (say, the one that invests in large U.S. stocks) has a bad year. By spreading investment dollars across four different mutual funds, the chance of a big loss in any particular year is minimized. Understanding that an investor needs three to four different mutual funds is the first step in building an investment portfolio.

Example Portfolio #1: The Vanguard Portfolio

Vanguard is a mutual fund company in Pennsylvania. Their Web site is http://vanguard.com and their phone number is 1-800-662-7447. They have about 150 different mutual funds. Below are four of their funds that meet the “diversification” objectives when building an investment portfolio. One fund invests in large U.S. stocks, one in small U.S. stocks, one in non-U.S. stocks, and one invests in bonds.

The average return of the Vanguard portfolio (using four different funds) over this eight-year period was 7.1 percent. In 1999, this portfolio had an overall return of 18.3 percent, but you notice that one of the funds (the one that invests in non-U.S. stock) had a 29.9-percent return, while the bond fund lost nearly 1 percent. In 2000, the tables were turned—the international fund lost 15.6 percent, while the bond fund gained 11.4 percent. That's why an investment portfolio needs several different mutual funds—it balances the returns of the overall portfolio. The eight-year risk score for the portfolio was 14.1 percent. The lower the risk score the better.

Here's the challenge: to invest in Vanguard mutual funds requires a $3,000 investment to open each mutual fund account. (There is one exception, the Vanguard STAR fund can be opened for $1,000. It is a fund that invests in other Vanguard funds). To start this four-fund Vanguard portfolio would require $12,000. After starting the accounts, a person can start an automatic monthly investing plan to add more money to each mutual fund. The minimum automatic monthly investment at Vanguard is $50.

Vanguard Mutual Funds

Name of Vanguard Mutual Fund	This mutual fund invests in…	1999 Return	2000 Return	2001 Return	2002 Return	2003 Return	2004 Return	2005 Return	2006 Return	8-Year Average Return	8-Year Std Dev of Return
Vanguard 500 Index	Large US Stocks	21.1%	-9.1%	-12.0%	-22.2%	28.5%	10.7%	4.8%	15.6%	3.3%	17.6%
Vanguard Small Cap Index	Small US Stocks	23.1%	-2.7%	3.1%	-20.0%	45.6%	19.9%	7.4%	15.7%	10.0%	19.5%
Vanguard Total Bond Index	Bonds	-0.8%	11.4%	8.4%	8.3%	4.0%	4.2%	2.4%	4.3%	5.2%	3.9%
Vanguard Total International Stock Index	Non-US Stocks	29.9%	-15.6%	-20.2%	-15.1%	40.3%	20.8%	15.6%	26.6%	8.0%	23.7%
VANGUARD PORTFOLIO Annual Percentage Gain/Loss		18.3%	-4.0%	-5.2%	-12.2%	29.6%	13.9%	7.5%	15.6%	7.1%	14.1%
Growth of $100 invested in the portfolio at the start of 1999		$118	$114	$108	$95	$123	$140	$150	$173	$100 invested in 1999 grew to $173 by the end of 2006	

Past performance is not a guarantee of future performance. Mention of these funds does not constitute an endorsement.

The Vanguard portfolio above is an excellent set of mutual funds. They have solid track records and very low annual fees (average of less than 0.25 percent). But, they require a lot of money to start. For those who don't have $12,000, there is a solution. It costs $12 per month, or sometimes less.

Example Portfolio #2: The Homestead Portfolio

Homestead is a mutual fund company in Virginia. Their Web site is http://homesteadfunds.com, and their phone number is 1-800-258-3030. They have eight different mutual funds. Below are four of their funds that meet our "diversification" objectives.

Just because they have lower investment requirements, do the Homestead funds have inferior performance to the respected Vanguard funds? No. In fact, their performance has been superior. These four mutual funds offered by Homestead outperformed the Vanguard funds over this eight-year period, 7.9 percent to 7.1 percent. The Homestead portfolio also had a lower risk score, 9.4 percent vs. 14.1 percent. Homestead mutual funds can be opened for $500 (or $200 if it is an IRA account) if making a one-time lump sum investment.

Homestead Mutual Funds

Name of Homestead Mutual Fund	This mutual fund invests in…	1999 Return	2000 Return	2001 Return	2002 Return	2003 Return	2004 Return	2005 Return	2006 Return	8-Year Average Return	8-Year Std Dev of Return
Homestead Value	Large US Stocks	-3.2%	9.6%	5.9%	-11.6%	26.2%	14.7%	10.9%	17.8%	8.2%	11.9%
Homestead Small Company Stock	Small US Stocks	-0.6%	15.2%	11.2%	-0.6%	32.4%	13.2%	9.5%	16.7%	11.7%	10.5%
Homestead Short-Term Bond	Bonds	3.2%	7.8%	7.1%	5.3%	1.9%	1.7%	2.3%	4.1%	4.2%	2.4%
Homestead International Value*	Non-US Stocks	24.8%	-16.4%	-23.6%	-17.6%	35.9%	17.9%	14.3%	25.8%	5.3%	23.2%
HOMESTEAD PORTFOLIO Annual Percentage Gain/Loss		6.1%	4.1%	0.1%	-6.1%	24.1%	11.9%	9.3%	16.1%	7.8%	9.4%
Growth of $100 invested in the portfolio at the start of 1999		$106	$110	$111	$104	$129	$144	$157	$183	$100 invested in 1999 grew to $183 by the end of 2006	

Past performance is not a guarantee of future performance. Mention of these funds does not constitute an endorsement.

* The inception date of the Homestead International Value fund was on 1/22/2001. From that date until October 2005 it tracked the MSCI EAFE Index. The returns for 1999, 2000, and 2001 are estimated returns using the EAFE Index return minus 220 bps (where 220 bps equals the average difference between the fund's actual return and the EAFE Index return in 2002, 2003, and 2004).

But, there is another way to invest in Homestead funds—an automatic monthly investment of as little as $1 per fund. With their automatic investing plan, Homestead waives the normal initial investment of $500 (or $200 for IRAs). You can literally create the four-fund portfolio shown above for **$12 per month** ($3 each month into each fund) if you automate the monthly investment. An automatic monthly investment is when you authorize Homestead to electronically withdraw your monthly investment from your checking or savings account. There is no fee for that service.

So, if you decide that you can invest $12 (or more) per month, you could set up an account for each of the four Homestead funds shown above and then your monthly investment would be automatically deducted from your checking account. When the $12 is received by Homestead, they would divide it up among the four funds according to your instructions. You might consider allocating $3 into each fund. So, for $12 per month, you have a diversified investment portfolio of four excellent mutual funds. If you decide to increase the monthly investment amount, you just contact Homestead. There is no commission charged by Homestead for your monthly investment. The annual fees they charge are modest, averaging about 1 percent per year. Vanguard has lower annual fees, but Homestead has lower investment requirements.

If you can't afford $12, no problem. You could invest as little as $1 per month into each fund. Now, the fine print. In most states, you need to be at least eighteen years old (referred to as the "age of majority") to start a mutual fund investment account. But, if a person you know (usually a parent) includes their name along with yours on the account application (they are acting as a "custodian"), an account can be established for anyone of any age. If this is confusing, don't sweat it. Just call the folks at Homestead or Vanguard, and they can help you sort it all out.

The most important aspect of investing is starting. **You can open an account for yourself, for your child(ren), or both!** Don't wait until you have a lot of money, start small now. And don't attempt to find the perfect mutual fund, simply build a sensible portfolio using three or four different mutual funds. You will learn a lot about the process of investing by actually doing it! As your income grows, you will be able to invest more. What starts out, for example, as a $12 per month investment will grow over time as your income grows.

Here's the battle plan:

1) Carefully examine your monthly budget to determine how much you can invest. Remember, consistent and honest budgeting is your most important financial habit.

2) Select several mutual funds to invest in. If you can afford only one fund, that's fine. Start with a fund that invests in large U.S. stocks, such as Homestead Value. Or, if you have $1,000 you might consider the Vanguard STAR fund. Over the same eight-year period (1999-2006), its average return per year was 7.4 percent and its risk rating was 9.5 percent (both figures very similar to the Homestead portfolio of four funds).

3) Contact the mutual fund companies by phone and ask them to mail you the necessary forms and applications to open your accounts. You can also go to their Web sites and download the needed forms. You'll have to decide how to set up the accounts—either as regular accounts or as IRA accounts. Or, you can set up some of each.

4) Decide how you want to start the account(s). You have the choice of a single large investment ($3,000 at Vanguard regardless of whether it is a regular account or an IRA account, except for the STAR fund, which requires only $1,000) or $500 at Homestead ($200 if an IRA) **OR** a smaller automatic monthly investment (as little as $1 if using Homestead funds). If you're opening an account for young children (under age eighteen) the account will be established as a

Uniform Transfers to Minors Act account. Just use the regular account forms and include both the child's name and the name of the custodian (usually a parent).

5) Fill out the forms and send them in! Once your accounts are opened, you will receive updates periodically regarding your total account balances. If you have questions or concerns, simply call the mutual fund company. You can also use their Web sites to check on your accounts.

6) Be patient. Have reasonable expectations. Don't panic when your accounts temporarily lose money. Mutual funds that invest in stocks and bonds have positive yearly returns about 70 percent of the time. So, during those occasional years when the returns are negative becomes a perfect time to invest a little extra!

After setting up your investment accounts (ideally with "auto-pilot" automatic monthly investments), get back to what you do. Focus on your family and friends, your hobbies, your meaningful work, your church and community. **Don't focus on your investments, focus on your children.** Always seek balance—physically, mentally, socially, emotionally, and spiritually. Don't become a neurotic investor. Investing is like planting a tree. It doesn't double in size in two months or even two years. It is a long process. No one in their right mind would plant a tree and then check on it every six hours. So, don't do that with your investment accounts. **If you want to reduce the volatility of your investments, check them less often!**

Finally, help others with what you've learned here. Teach others—ideally your children—about investing so that they might better prepare for their future. After all, our greatest investments will be in each other.

[i] Spencer W. Kimball (1974, October), in Conference report, 184.

[ii] Brigham Young, *Journal of Discourses*, 11:301.