The Importance of Financial Literacy for Those 25 and Under

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Abstract

This article explains the unfortunate pattern of the lack of personal finance education for young people, what they can do to set themselves up for financial stability, and how to do so. To be financially literate is to have a general understanding of personal finances and how to best run yours. A traditional IRA, Individual Retirement Account, allows individuals to make pre-tax contributions to give you immediate tax benefits only if your contributions are tax-deductible. Another type of IRA is called a 401k which is an account where both you and your employer must contribute to an account in which the employer can match your deposit of income up to a certain percentage. Additionally, A Roth IRA is an account that allows earned income to grow tax deferred and be withdrawn penalty free. An investment portfolio refers to all of the different investments one holds to ensure that all of their money is not in one place. A Roth IRA is an example of an investment in a portfolio, but to diversify risk, it is diligent to invest in assets other than just a Roth IRA. It is also important to save money in an emergency fund, an account where you save 3-6 months' living expenses to create a safety net for yourself in times of uncertainty. Therefore, through amassing an investment portfolio, adding to an emergency fund, converting to a Roth IRA, and becoming financially literate, people under the age of 25 can set themselves up for financial success.

The Importance of Financial Literacy for those 25 and Under

According to a study from Walden University, about four in seven Americans are financially illiterate and report being unable to manage their finances. Some suggest that the catalyst for this problem is the lack of education about personal finance in high schools. The Council for Economic Education explains that only 17 percent of students in America in 2019 were required to take a personal finance course in high school, highlighting the unfortunate fact that there is little education regarding the most basic and important life skills. Although it may seem difficult to educate yourself about personal finance, young adults are not destined for financial illiteracy. There are some basic things that can be done to make a huge difference at a young age. Investing and saving money in accounts such as IRA's and emergency funds can change lives. By the age of 25, people should attain financial literacy and know how to let their money work for them through amassing an investment portfolio to minimize risk so they can set themselves up for a comfortable life and retirement.

So, what exactly is financial literacy? The Swiss Journal of Economics and Statistics defines financial literacy as the understanding of financial concepts and risks as well as the skills that allow this knowledge to be applied to one's own finances. How can one become financially literate? Many people learned from trial and error or from knowledge passed down to them by their parents. But, that isn't the only way. According to the National Endowment for Financial Education, teens who received financial education in high school outperformed those who did not in an independent evaluation intended to measure financial literacy. This shows that financial education in high school can be effective in promoting this skill. However, financial education extends throughout one's lifetime. Alan Greenspan, an economist, explains that financial education is a cumulative, unfixed process that continues throughout life and improves

one's economic well being. If financial education wasn't received in high school, one can still seek out personal finance education and discuss financial ideas with others to broaden their knowledge and increase their financial literacy.

Moreover, it is important that everyone creates an investment portfolio because it can significantly minimize risk and prevent financial discomfort. As defined by the Harvard Business Review, an investment portfolio "refers to all of the different types of financial investments [held] such as bonds, stocks, and real estate." So, an investment portfolio is not a physical portfolio, rather, it is the box that holds a variety of investments. When putting money aside for investing, it is very important to not put all of the "eggs in one basket." While it may seem illogical to invest less money in multiple places, because the growth will seem smaller, it minimizes risk significantly. For example, if one has X amount of dollars to invest and one chooses to invest it all into stocks, but those stocks plummet, all of the money will be lost. But, if the same amount of money is invested into both stocks and real estate, when these same stocks plummet, the money invested into real estate is still growing. Additionally, it is important to have assets that have values that fluctuate based on different drivers. For example, the stock market is driven by public interest, whereas property value may fluctuate based on the political atmosphere. Stocks, bonds, and real estate are not the only assets that can be a part of an investment portfolio. Other types of investments include private equity investments, cryptocurrency, gold, commodities, etc., which, in the proper and balanced amounts, all diversify a portfolio. Creating an investment portfolio is quite simple, and all it takes is knowledge, diversification, and a sum of money for investing.

When it comes to financial stability in rough patches, it is necessary to have an emergency fund. According to an article from the Harvard Business Review, an emergency fund

is "a sum of money that is set aside for unplanned or unexpected events." In addition to this, it is recommended that emergency funds hold enough money to cover up to three to six months worth of living expenses. To create an emergency fund, one can put a small portion of one's paycheck into a designated account and gradually grow the account's balance. The article from Harvard Business Review also explains that the money entering an emergency fund should not come from a savings account, and it should not be so much that it would make living conditions unbearable. Even saving a few dollars per paycheck can make a difference. This may make money a bit tighter in the moment when it comes to splurging and luxuries, but having an emergency fund allows for some peace of mind and provides more stability in unprecedented times.

Furthermore, when it comes to being smart with money for the long-term future, it is essential to open and use an Individual Retirement Account (IRA) to avoid relying solely on social security for retirement funds, as it is set to be insolvent by the year 2033. Therefore, other types of investments are needed to ensure a solid future and retirement. There are different types of retirement accounts, each with their own benefits. It is extremely important to know the differences so that young adults can open the kind that is best for them, and start saving in it as soon as possible.

The first kind of IRA is the Traditional IRA. According to Charles Schwab, it is an account "to which you can contribute pre-tax or after-tax dollars," giving immediate tax benefits to tax-deductible contributions. In this type of account, even though money can grow without being taxed in the process, it will require income tax to be paid on withdrawals once one is 59 ½ years old and able to do so. Additionally, it will require one to begin taking distributions once one reaches age 72. In short, a Traditional IRA allows for money and investments to be put into an

account where they can be bought and sold without paying taxes during the process. This allows the sum to grow, and then when old enough and can begin withdrawals, one will pay their current income tax rate on the money in the account.

Another type of IRA is a Roth IRA, which is ideal for those who believe they will become a part of a higher tax bracket in the future. A Roth IRA is an account that allows earned after-tax income to grow and be withdrawn penalty-free after the account has been open for five years and one is at least 59 ½ years old. While there are no limitations to how much money can be put in a Traditional IRA, Roth IRA's have yearly contribution limits based on earned income and have no required minimum distributions. It is diligent to contribute the maximum allowed amount into a Roth IRA each year because it grows and can be withdrawn without paying taxes at any point in the future.

Yet another important type of retirement account is a 401k plan. Unlike IRA's, a 401k is a joint account between an employee and an employer, meaning that both parties can make contributions to the account. This is a smart way to save for retirement, as one is getting the money for "free" from the employer. However, the exact tax guidelines vary, depending on the employer. The money saved in a 401k enters the account pre-tax and is taken directly out of the employee's paycheck. Then, the employee will have to pay taxes once the money is withdrawn from the account. These plans are very risk-tolerant, as the internal transactions can only be as conservative or as aggressive as the employee and employer agree to have them. They are extremely helpful saving tools because a portion of each paycheck is automatically put into the 401k and impulsive, irresponsible decisions cannot be made with the money if it is going directly into the account.

Traditional IRA's, Roth IRA's, and 401k's are all very valuable means of saving for retirement and using at least one of them will set one up for a stable and prosperous future.

For a comfortable financial future, young adults should become financially literate and learn how to minimize financial risk through amassing an investment portfolio with an emergency fund and a retirement account by the time they reach 25. This allows them to save and grow their money. It is important to be part of the 43% of the country who is forward-thinking and taking the step to make smart financial decisions that allow for money to multiply. Financial literacy ensures peace of mind for the future and today.

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