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HOW THE YOUNG CAN WHITTLE DOWN DEBT

Debt problems plague every generation, but they've hit young adults especially hard. By following a few key tips, however, the young can whittle away at that debt.

According to Demos, a consumer advocacy group, credit-card debt shot up 104 percent from 1992 to 2001 for those age 18–24, and 55 percent for those 25–34. During the same period, debt for all households rose 38 percent. Demos also reports that 25 cents of every dollar that indebted young people earn goes toward debt payments.

Why so much debt? A major factor is the escalating cost of college, much of it paid for by loans. The average student loan debt for graduating four-year students is $19,000, according to Nellie Mae, a college lender. The increased use of credit cards by college students and young adults is another source. Nellie May says students graduate with an average credit card debt of $3,000.

When they enter the workforce, many young are finding stagnant wages for entry-level jobs, and they compound their limited income problems because the word "frugal" is not in their vocabulary. And debt problems are only going to get worse as interest rates continue to rise.

What can you do about all that debt if you're young and struggling on limited income?

Organize and budget. Review all of your debts, regular bills, and income to see where your money is coming from and going to. Are you paying your bills on time and are you paying at least the minimum every month—preferably more?

Establish a simple budget. Prioritize your expenses: rent, groceries, transportation, loans, and other expenses you have to meet every month. See what falls toward the bottom that you can do without or at least cut back.

Get a free credit report. Ask for a free credit report from each of the three major agencies. Check the reports for accuracy and make sure the credit scores don't differ much from each other. The shock of the reports also might motivate you to start cutting debt.

Watch those credit cards. Beyond debt you may already have accumulated on your credit cards, are you adding to that debt with purchases for short-term needs such as groceries, meals out, and clothing? Stop! Switch to a debit card, checks, and cash. It's easier to restrain spending that way.

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Is the interest rate you are paying high? Consider switching to a lower-rate card, even if that rate is offered only for a limited time (at which point you can switch again). Watch for costly transfer fees, however.

Pay costliest debt first. Usually it's best to tackle the costliest debt first. For young people, that typically means making the minimum payments for the lower-rate college debt and perhaps a car loan, while paying down credit card debt faster.

Consider consolidating student loans. The interest rates for consolidating federal student loans dropped to historic lows in mid-2004 and will remain there through June 30, 2005. After that, with overall interest rates rising, rates could start climbing again. But be careful how you consolidate. By extending the loans beyond ten years, you lower monthly payments, which may be necessary, but you will end up paying more interest over the life of the loan.

Avoid bankruptcy. Bankruptcy rates are up 19 percent from ten years earlier for people age 25–34, according to Demos. A major cause is young people with no medical insurance but high medical bills. But bankruptcy stains your credit record for ten years, so avoid it unless you're sinking deeper into debt and see no realistic way out. Negotiate with creditors for lower interest charges and longer repayment terms, or get help from a reputable credit counseling service (the field does have rip-off artists).

Generate more income. If debt is weighing you down badly enough, you may need to moonlight at a second job until you can get it under control. Some experts suggest working with your parents, though you don't want to hinder their ability to meet their own needs such as saving for retirement. Some suggest that parents help out for such things as auto or health insurance but let their children remain responsible for their debts.

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8 FINANCIAL KEYS TO A HAPPIER NEW YEAR

For many people, the New Year signifies a fresh start. The mental and spiritual batteries are recharged after the drain of the hectic holidays. We're more optimistic. We're open to new possibilities, new strategies, new aspirations. Here are eight personal finance tips from the Financial Planning Association that can help you toward a happier new year.

1. Set clear goals. We don't mean only financial goals such as building a larger retirement account or getting out of debt. We're talking any goal you'd like to work toward or achieve in the new year that has financial consequences. For example, perhaps you want to work less so you can spend more time with your family, or you want to change to a career that excites you more but that pays less. How can you afford such goals?

That's why setting specific, realistic goals—and writing them down—is such a powerful financial tool for realizing them. It not only clarifies what you have to do financially to achieve the goals, it *motivates* you to achieve them within a specific timeline. Saving *for* something provides much more financial incentive than merely following the standard advice to save 10 or 15 percent of your monthly pay.

2. Discuss the goals with your family. Include your spouse, your children if they're old enough, or other loved ones who might be affected by your goals. They can help you clarify the goals, motivate you to make changes, and aid in their achievement.

3. Create a financial plan. All financial actions (or inactions) affect other financial actions. If your financial left hand doesn't know what your financial right hand is doing, one may undermine the other. For example, lack of adequate insurance for home, health, and other aspects of your life could decimate your retirement savings and investments if something goes wrong.

You may need professional advice at this stage, or you may feel you can do it yourself. Regardless, the key is creating and following through with the plan.

4. Review the last year. Life is continually in flux and change can have a profound impact on your financial plans. For example, during the past year did you get married or divorced, have a child, suffer a death in the family, change jobs, or change short-term or long-term goals?

5. Establish a spending plan. Achieving financial goals is built on a single principle: spend less money than you earn. And it's difficult to spend less than you earn if you don't know where your money is coming from and going to.

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First, list your regular, dependable sources of income. Then track how much and where you spend money every month (including cash). Average out on a monthly basis periodic expenses such as car insurance or property taxes.

Subtract monthly expenses from monthly income and…do you have a surplus, are you in balance, or are you spending more than you're taking in? Are you skimming 5 or 10 percent right off the top of your income for savings and investing? If not, what expenses can you reduce or income increase in order to save toward goals? Automate savings to make it less painful.

6. Reduce debt. Resolve to lower debt this year. As interest rates rise, every dollar of accumulated debt becomes a heavier and heavier drag on your entire financial life.

7. Diversify your household assets. You know not to put all of your investment eggs in one basket (such as high-tech stocks). Apply this advice to your overall financial household. If possible, working spouses should be employed in separate companies in separate industries in order to reduce the possibility of both of you losing jobs at the same time. Go easy on company stock and industry stock where you work. If your employer or the industry suffers hard times, you might lose not only your job but also much of the value of your investments. Avoid investing in a single business or industry that dominates the economy where you live. If the company or industry suffers, so might your home values along with your investments.

8. Educate yourself financially. The more you understand about finances—from budgeting to investments to insurance—the more confident and motivated you'll be to take the right financial steps this year.

And the happier you'll be for it.

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HOW TO MAKE YOUR 401(K) ACCOUNT WORK LIKE A PENSION PLAN

They are not the headlines workers want to see splashed across the business section of their newspaper: traditional employer-funded pension plans outperformed worker-funded 401(k) plans during the 2000–2002 bear market.

The headlines, based on a recent study conducted by the employee-benefit consulting firm of Watson Wyatt Worldwide, bolster critics' arguments that 401(k) and similar retirement plans are not up to the task, compared with defined-benefit pension plans, of preparing Americans for a financially secure retirement. Regardless of the merits of the criticism, 401(k)-type plans—in which workers do the bulk of the funding and make the investment decisions—remain a fact of life for workers. And fortunately, within the findings of the Watson Wyatt study and from outside experts, lie keys to what workers can do to improve the performance of their 401(k) accounts.

The study found that while both types of plans lost money during the three-year bear market, 401(k) plans fared worse by an average of 3.86 percent a year compared with professionally managed pension plans. Although 401(k) plans outperformed pension plans during the three years preceding the bear market, pension plans still averaged better returns than 401(k) accounts over a 12-year period ending in 2002, according to Watson Wyatt: 7.42 percent annually for pension plans versus 6.86 percent for 401(k) accounts. That may not seem like a lot of difference, but over decades of investing for retirement, it can add up to tens or even hundreds of thousands of dollars.

So what can employees managing their own 401(k) or similar retirement account do to bridge the gap and ensure that their account helps provide adequate income for their retirement?

Rebalance your assets. One of the key findings of the study was that most workers failed to rebalance their 401(k) accounts. Pension plans, however, following a disciplined investment plan, regularly rebalance their assets to reduce risk and maintain their various asset categories, such as stocks, bonds, and cash, in the desired ratios described in the plan.

The consequences of not rebalancing periodically became apparent in the wake of the boom market years of 1995–1999. Because workers typically didn't rebalance, the stock portion of their portfolios grew disproportionably large compared with other types of assets. By 1999, stocks comprised 72 percent of 401(k) account values, according to the Federal Reserve Board, while defined-benefit pension plans held only 59 percent in equities. Thus, when the stock market tumbled in 2000–2002, stock-heavy 401(k) accounts suffered steeper losses.

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Diversify. As the rebalancing issue illustrates, it's important to maintain a diversified portfolio. When some assets are down, others may be up to help offset losses. For example, while stocks suffered during the bear market, bonds and real estate did well.

The Watson Wyatt study found that large-company 401(k) plans performed better than plans run by small companies. The study attributed the difference to the fact that plans of larger employers typically offer more investment options, thus allowing for greater diversification.

Many investors don't take advantage of this, however. According to a 2003 study by Hewitt Associates, while the average 401(k) plan offered 13 mutual fund choices, participants held only 3.6 funds. More important, four in ten employees held only one or two asset classes, such as stock or conservative stable-value funds. They weren't spread out into bonds, or perhaps international funds if they were offered.

Easy on the company stock. The Hewitt study noted that the average 401(k) participant who held employer stock devoted 42 percent of his or her account to that stock—despite recommendations from many financial planners to limit company stock to no more than 10 or 15 percent of the portfolio's value. As Enron and other major corporate bankruptcies illustrated, overweighting company stock can be very risky.

Contribute and make the match. The bear market scared many workers from even making contributions to their 401(k) plan. Yet 401(k) plans will be the main source of income for many retirees. At least contribute enough to maximize any company contribution matches, and ideally increase contribution amounts every year. And you can always shift account assets into less-risky investment options in the plan. You don't have to only be in growth stocks, for example.

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