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Do Your Children Understand How Debt Works?

Wealth Management Insights April 2012

Many people will tell you that the single biggest problem facing the global economy today is debt. Whether it's the daily updates from the eurozone or continued debate in the U.S. Congress, debt and weak financial news have become as intertwined as the housing bubble and the Great Recession in most Americans' minds. But are young people taking away the right message from recent negative experiences with debt? In honor of Financial Literacy Month, our Wealth Management Insights Brief for April is designed to help you have informed discussions with your children on the issue of debt.

What You Should Know:

1. **Not all debt is necessarily bad.**
   Recent events – ranging from risky bets by large financial institutions to individuals taking out home mortgages they couldn't afford – have clearly illustrated how irresponsible debt management can have catastrophic consequences. But living a completely debt-free life is not practical for most American young people unless they are willing to compromise their future quality of life.
   - The cost of a four-year college education – considered by many a prerequisite for securing a well-paying job in today's competitive market – can cost as much as $60,000 per year. That's a significant annual cost that many families simply could not cover with cash on hand.
   - Even though home prices are currently as low as they've been in a decade, most Americans aren't currently in a position to pay cash for the outright purchase of a home.
   - If you want to start your own business and don't have access to investors or don't want partners, the costs could be greater than you can or would want to bear upfront.
2. **"Good" debt can have advantages.**
   In addition to opening doors and creating opportunities, responsibly maintaining "good" debt can boost your credit rating – something that can have a surprising impact on everything from your ability to buy a phone to getting a job. There are also less obvious potential benefits to responsible borrowing, primarily tied to the current low-interest-rate environment.
   - At 4.17% as of April 4, the average 30-year fixed mortgage rate was still near the historic low (3.87% hit during the week ending February 2 of this year). At the same time, home prices are down more than 30% from their 2006 peak and some economists are predicting an equivalent rebound within the next 10 years.

- As of April 4, the Federal Reserve listed average small consumer loan rates between 6% and 8.19%. This fixed cost over the life of a loan could well end up being lower than the potential returns a business owner could see on other investments in that business, assuming that taking out a loan frees up capital for expenditures.

3. **Awareness is the key to good personal financial management.**
   Taking on "good debt" can be viewed as making an investment. And, as with any investment, it is important to be aware of the specific implications as well as how it fits into your broader financial plans.

- Be aware of your options. Compare rates from different lenders when considering a loan and see if there is room to negotiate. The application process is often time-consuming, which can discourage comparison shopping. But lending is a competitive business, and most lenders would rather you borrow from them than someone else.

- Be aware of the circumstances. Making sure you will have the money to pay off a loan is essential. Be sure of your employment and income situation before mortgage shopping. Ask questions like: What's the neighborhood like? How good are the schools? What have similar homes in the area sold for over the past three to six months? If you're starting a business, understand your initial and continuing costs, and do your research on competition and demand so you can have an idea of what kind of payments you can afford. Similarly, when you apply for student loans, try to get an understanding of the value (in terms of employment prospects and salary) of the degree you're seeking to determine how much it makes sense to borrow.

- Be aware of your other spending needs and habits. If loans were the only expenses young people incurred after graduating or buying a home, living debt-free would be a reality for many much sooner in life. But things like food, clothing, utilities, transportation and everyday necessities or impulse purchases add up quickly. Making a monthly budget or balance sheet and conservatively estimating your available income after anticipated expenses is a good place to start when determining how much debt you can responsibly maintain.

- Be aware of the risks. It's highly advisable to set aside money each month for the unexpected – car repairs, medical costs or other emergencies – and to maintain an emergency savings that would cover expenses for at least three months in case you can't work and experience a disruption in income.

What You Should Do Now:

For all but a fortunate few, avoiding debt entirely is not a realistic life goal. But making smart choices where such investments are concerned is something anyone can do with a little research, self-awareness and sound judgment.

Your family's Financial Advisor can help you evaluate your situation, needs and options when it comes to assuming "good debt," and he or she can also help you plan to manage it wisely and responsibly. ■