USING THE "M" WORD HIGHLIGHTS:

Teaching Children About Managing Money

"We teach children to save their money. As an attempt to counteract thoughtless and selfish expenditure, this is a value. But it is not positive; it does not lead the child into the safe and useful avenues of self-expression or self-expenditure. To teach a child to invest and use is better than to teach him to save." **– HENRY FORD**

"With the amount of money I have, it's difficult raising children the way I was raised."

– ADAM SANDLER

While Ford and Sandler, one a Depression-era industrialist and the other a modern-day comedian, have life stories that couldn't appear to be more different, their quotes about children and money reveal a common struggle. Whether a family is preparing to discuss its estate plan with the next generation or introducing a child to her first piggy bank, discussing money and the responsibility for it has long been one of the more difficult conversations parents can have with their children.

In this paper, we take a look at some important dimensions of wealth and responsibility and the strategies parents can use to teach kids of any age, from early childhood to early adulthood, about managing money.

Pass The Wealth…And The Values

During the financial planning process, a considerable amount of time can be spent on estate planning and ensuring that wealth is passed to the next generation in the most tax efficient manner possible. When discussing the subject of wealth transfer with parents and grandparents, the greater concern in passing wealth to the next generation is not avoiding unnecessary taxation, but rather preserving the next generation's work ethic and teaching them to embrace the responsibility of wealth by maintaining charitable giving and community service as core values.

In 2018, U.S. Trust conducted an annual survey, Insights on Wealth and Worth®, which examined wealth management challenges confronting high-net-worth individuals in the United States. The survey included 640 individuals with at least $3 million in investable assets. The findings from this survey indicate that while six in 10 wealthy parents say it is important to leave an inheritance to the next generation, only one in five agree strongly that their children will be able to handle the wealth they receive, and fewer than one in three have discussed details of an inheritance with their children. In fact, only a third of wealthy parents have fully disclosed their wealth to their children, while just under half have disclosed only a little.

The primary reasons for not discussing family wealth are concerns about negative repercussions on work ethic and family privacy and the fact that they were taught to never discuss wealth. Nearly 20 percent of parents with children over the age of 25 haven't discussed family wealth because they think their children aren't old enough or mature enough.

An Expert Says: Parents... Someone's Watching You

University of Illinois economist Dr. Angela Lyons has conducted extensive research about financial literacy and how young people form money management habits. In addition to working with school districts and universities across the United States on financial literacy curricula, she also spends considerable time abroad working with foreign governments and central banks on financial literacy programs for developing countries.

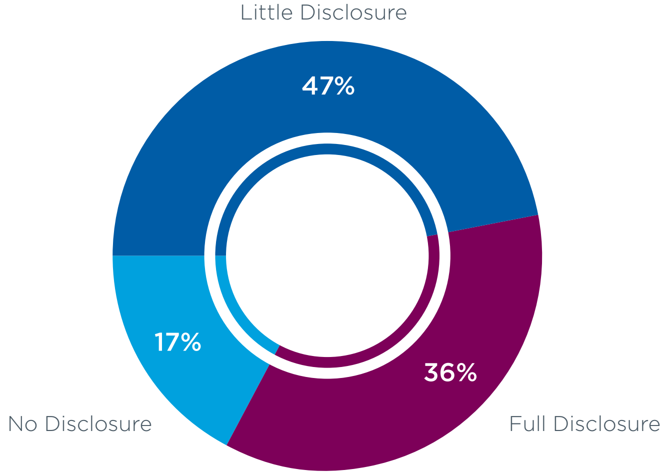
Over the course of her research, Dr. Lyons has found that a child's understanding of money begins at home. And regardless of a parent's level of comfort in discussing financial matters, children form their own impressions based on observation.

"What parents don't realize is how much kids pick up from observation. Kids observe both good and bad behaviors," Lyons said. "If parents are not talking to kids about financial responsibility, kids are forming attitudes regarding money through observation but without any adult context."

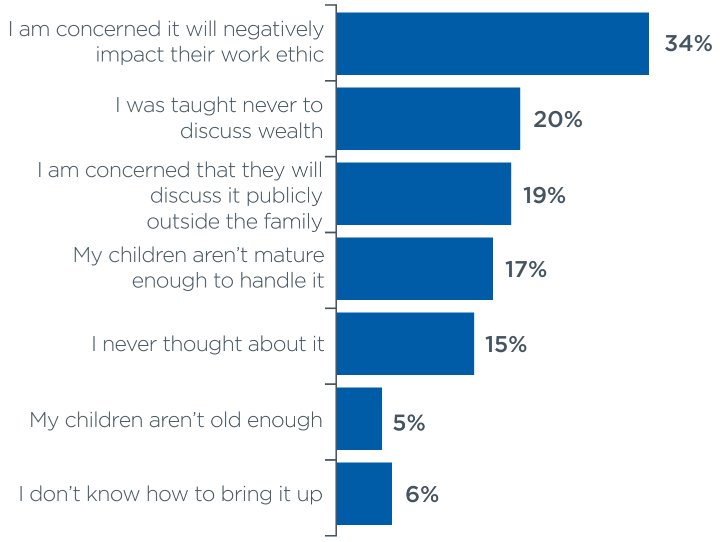
Dr. Lyons has also found that one of the biggest frustrations parents face when teaching their children about financial responsibility is that some lessons may be grasped or embraced by one child but not another. To this point, Dr. Lyons suggests parents try to modify their perspective.

"What worked for you, the parent, in learning money management habits may not work for how you are teaching your kids. We all learn differently," Lyons said. "Think about how to package the ideas differently. Be observant and be willing to adjust. Parents need to be self-aware and look for opportunities to talk about financial responsibility on an everyday basis. People can get very busy as parents and miss the everyday opportunities to teach children about being responsible with money in ways that are easy for children to understand."

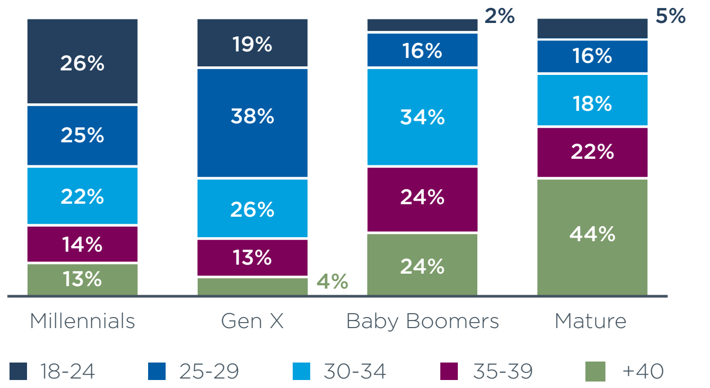
Extent of Disclosure of Level of Wealth to Children



Reasons Parents Have Not Fully Disclosed Level of Wealth



Age at Which Parents Think Children Will Reach the Maturity Necessary to Handle Family Wealth



Source: https://www.investopedia.com/articles/financial-advisors/071015/what-highnetworth-clients-value-and-need.asp

Milestones = Opportunities

Start Early With the Piggy Bank

With those things in mind, there is no question that different developmental milestones present opportunities to connect with a child in ways that are meaningful and lasting.

For parents just beginning to talk to a youngster about financial matters, a piggy bank is an ideal way to introduce the concepts of money and savings. Beyond teaching children about the different types of money, be it coins or bills, the piggy bank can also demonstrate the importance of putting money in the appropriate place. This is often the starting point for children to learn how to treat money responsibly.

Managing an allowance is another way. Many parents provide an allowance as payment for chores or as a reward of some kind; others provide it without attaching specific requirements. A child is ready to receive an allowance if he or she can count small sums of money, demonstrates an interest in it and understands the concept of saving. There is no single correct philosophy— what matters most is creating a learning experience.

From Piggy Bank to Community Bank

A child in elementary school may be ready for the next step: a savings account. Many banks still offer the traditional savings account that allows children to record their balance and transaction history in their own passbook.

A savings account can be a good and versatile tool, for several reasons. First, it can be useful in teaching children about the transactional aspects of saving and the power of compounding interest. What's more, a trip to the bank is a great opportunity to reinforce the importance of saving. It's also a chance for kids to hone existing skills, such as math and learn some new ones, such as interacting with the teller and completing necessary forms. These types of experiences can help a child develop a sense of ownership in the savings process — and a sense of pride and accomplishment in their ability to manage it well.

Setting the Right Example: Charitable Giving and Community Service

Charitable giving and community service are also important lessons that can be taught early. Children remember what they see and live, so although talking to them is a good beginning, including them in actual community service helps them to learn firsthand about philanthropy — what it is and how it works. Whether it's volunteering to read at nursing homes or collecting cans for a food drive, the direct experience of serving those in need is a powerful way to teach children. It's also an indelible lesson that will likely make a significant impact on their future financial decisions.

Parents, Know Thy Students

In their non-fiction bestseller, Freakonomics (2005), economists and authors Steven D. Levitt and Stephen Dubner look at a collective of unusual facts—everything from teachers who cheat to why most drug dealers live with their mothers—and explore the hidden economics behind them to understand the human behavior within them. In the movie adaptation, Steven D. Levitt tells a story about his daughter that serves as both humorous anecdote and cautionary tale for parents attempting to teach young kids about matters of finance.

Economist Steven D. Levitt wants to say one very important thing to parents who are just starting to talk to their kids about money: never underestimate a young child's capacity to grasp economic ideas. It's fairly common for children as young as three years old to have the ability to understand the concepts of earning, bartering and saving.

In the film Freakonomics (2010), Levitt describes an incentive he devised to introduce his daughter, Amanda, to toilet training. In exchange for using the toilet, Amanda would receive a handful of her favorite candy, M&Ms. In the beginning, the strategy worked well. But after only three days, Amanda had figured out a way to use the incentive to her advantage. The three-year old, who just days before had expressed no interest in using the toilet, began going every five minutes as a way to maximize her reward… and her M&M stash. While Levitt muses at the thought of a three-year old gaming an economist's incentive strategy, it serves as a good example, and a fair warning to parents about a child's innate ability to understand how certain behaviors can lead to perks.

Three Envelopes…Budgets Explained

Once children step through the doors of middle school, it's important to start discussing budgets, savings goals and some of the more detailed aspects of the family finances. The Three Envelopes strategy can be an effective way to help young people think about expenses that have different time horizons attached to them. For many, compartmentalizing money can be the easiest way to organize their finances. Each envelope can be funded by the parent alone or in partnership with the child using money earned from an allowance or job. The purpose of this approach is simply to learn how to make good decisions and correctly allocate money based on the immediacy of the need:

- Envelope One: Immediate expenses, such as lunch money, gas money or entertainment
- Envelope Two: Short-term goals, such as buying a laptop or going on a senior trip. Charitable giving also belongs in this category
- Envelope Three: Longer-term goals, such as buying a car or saving for college

The Three Envelopes strategy can also open the door to larger discussions about the family's finances. Now that children are being asked to allocate money based on their own anticipated spending, a parent can begin showing how the family allocates money each month for utilities, groceries and other immediate expenses.

To further demonstrate these concepts, parents can give their child a grocery list and instructions to buy items on the list without spending more than the allotted amount — in other words, sticking to a budget. Exercises like this can help a child understand a parent's rationale for making certain household purchases. It also prepares children to manage similar tasks on their own.

Now the Real Fun Begins…Investing

Once a child has graduated from the school of savings, he or she is ready for the next stage: investing in stocks or mutual funds, which helps young people learn how investments perform and how businesses function. Investing in special types of accounts designed to fund retirement or college are good first choices.

Roth IRAs

One of the popular ways to get children started in investing is to open a Roth IRA account in their name. A Roth is a popular investment account for kids because of the advantage it provides in being able to grow assets in a tax-free account and because the account is funded with after tax dollars, withdrawals from the account are made tax-free, as well. Additionally, principal amounts may be withdrawn from the account before the account owner turns age 59½. After the account has been open for five years, the child would even be able to withdraw funds from principal contributions for non-retirement purposes such as educational funding or for a down payment on a first home.

When opening this type of account for a child, it's important to remember that a Roth IRA must be funded with earned income—a feature that may help reinforce a strong work ethic. For 2020, the maximum contribution amount to a Roth IRA by anyone under the age of 50 is $6,000 per year ($7,000 if you're age 50 or older). Money earned from summer or part-time jobs can be contributed up to that amount.

To understand the potential power of investing in a Roth IRA, consider the following hypothetical investment scenario in which a 15-year-old child makes $1,000 working a summer job. Assuming he or she contributes the full $1,000 into a Roth IRA, makes no further contributions, and invests in an equity mutual fund with an 8 percent average annual rate of return, that original investment would grow to $46,900 by the time the account owner turns 65. And, if that same child contributes $1,000 each summer until they turn 20 years old, assuming the same 8 percent average annual rate of return, he or she will have an account balance of nearly $250,000 when they turn 65. And because the Roth IRA has no required minimum distributions, the child can allow the account to grow past the age of 70. He or she will also have the option to pass these funds to children or grandchildren.

Finally, by giving children exposure to investing through retirement accounts, such as a Roth IRA, they become familiar with both concepts — investing and retirement planning — and may be more likely to adopt an employer-sponsored retirement plan once they start working.

529 Savings Plans

Another way to engage children in investing is to include them in the planning and funding of their own higher education. The 529 college savings plan has become popular because it's accessible, easy-to-understand, widely available and has attractive features.

Anyone can contribute to a 529 account, regardless of who owns it. That means that a friend, aunt or grandparent can add to a child's account at any time. Contributions for holidays and birthdays make great gifts. These investments can grow tax free, and money intended for educational purposes can be withdrawn tax free.

Beyond teaching the child how to make investments and plan for college costs, these accounts also give parents the opportunity to talk with kids about other types of college funding, including grants, loans and scholarships. These discussions help parents and children reach a clear understanding of how college will be financed.

On Their Own: The Importance of Budgeting

Once children are living on their own, a parent's best hope is that the money management lessons have taken hold. Reinforcing those lessons with continued emphasis on strategies such as the Three Envelopes makes good sense. Refining them with a detailed, real-life budget is even better. Although many people who struggle with finances cringe at the thought of setting a budget for themselves, it's necessary to get a clear picture of their personal spending versus income equation.

The sample budget below shows common expenditures based on a household income of $40,000. While it's important to create a monthly budget that reflects the specific needs of that household, this example provides guidelines of allocations for each item.

Budgeting 101

	Budget Expense Ranges	Sample on Income $40,000	Budget Per Month in Dollars
Housing	21% - 24%	$8,400 - $9,600	$700 - $800
Food	8% - 12%	$3,200 - $4,800	$267 - $400
Clothing	5%	$2,000	$167
Transportation	8% - 9%	$3,200 - $3,600	$267 - $300
Medical	2% - 3%	$800 - $1,200	$67 - $100
Insurance	3%	$1,200	$100
Recreation	5%	$2,000	$167
Gifts	1% - 2%	$400 - $800	$33 - $67
Debt Service	4%	$1,600	$133
Other	7% - 9%	$2,800 - $3,600	$233 - $300
Savings	15%	$6,000	$500

Sample family budget based on $40,000 annual income

Teach with Technology

Dr. Angela Lyons, economist at the University of Illinois, has spent years doing intensive research about financial literacy and the money management habits of young people. Among other things, she recommends that parents look to today's technology for help in teaching their kids about money and how to help them develop good financial practices that will serve them for a lifetime.

Consumer finance apps geared toward teaching children how to save money may be helpful, says Dr. Lyons. Given the popularity of gaming and mobile apps, these programs could be a great way for parents to engage with young people on a subject the child may otherwise show little interest in learning.

Countmybeanz.com offers children virtual savings and checking accounts that use a virtual currency called Beanz. Children collect Beanz by performing chores or other activities determined and assigned by their parents. Children can even donate to charity by opening a special donation account. Another online app, Threejars.com, teaches children about the fundamentals of budgeting. Using this app, children are given IOUs, which are deposited in a Save, Spend or Charity jar. Children can earn IOUs through chores, birthday gifts or any other activities assigned by the parent. Once they have accumulated enough IOUs in their Spend jar, children can submit purchase requests, which the parent can approve, deny or alter. The app also allows parents to deposit money into a donation jar, and children can request donations to any one of more than 200 global charity partners.

Conclusion

Dr. Lyons maintains that the United States is in the midst of a cultural shift regarding financial literacy.

"This generation of young people is more cautious and conservative because of what they saw their parents go through in 2008. If nothing else, they may need help in understanding the need to take more risk, as opposed to less," says Lyons.

As a result, an increasing number of schools at all levels have recognized the need for more personal finance coursework as part of their curriculum. And while additional resources from schools may help parents teach the lessons of financial responsibility, the best lessons begin at home. By communicating with children on a consistent basis about the importance of financial responsibility and leveraging a few strategies and tools along the way, parents can instill the types of habits that can stay with young people for the rest of their lives.

If you have any questions about teaching children how to responsibly manage money, or if you want further information about strategies that can be used as learning opportunities, please contact your wealth advisor.

Sources:
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