Financial Education: How to educate children about money

Through education and encouragement, parents can help provide their children with the skills necessary to make a lifetime of good financial decisions.

In today's world, pursuing your life's goals is being challenged in new ways. Which makes now the perfect time to review your goals in terms of "Advice. Beyond investing." Because when we collaborate on what matters most to you, we can create a plan tailored for you.

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One of the most important life skills we can teach our children is how to handle money—how to save it, spend it, budget it, invest it and borrow it. However, while school classes typically include math, science and English, most formal educational programs leave financial skills out of the curriculum. According to the National Financial Educators Council, "the majority of children today never receive money management coursework during any level of schooling, including college. Most college graduates have spent 16 years of schooling that will help them earn more money, yet no time is spent teaching them fundamental personal finance lessons."[1]

Many of our clients tell us they would like to take a proactive approach to educating their children regarding spending and saving money wisely. In a survey conducted by Visa in 2012, however, 66.1% of parents in the U.S. talk to their children about money management issues at least once a month—and 18.5% of survey respondents said they feel that teenagers and young adults are prepared to manage their own money.[2] These figures indicate that parents are not effectively communicating financial management skills and that children may be ill-prepared to make sound financial decisions in the real world.

Many parents begin working with their children at an early age to develop the financial skills they will need as adults. Below, we discuss some of the strategies these parents use to help their children develop good money management skills.

Allowances

An allowance can be a way to introduce the concept of money management and budgeting to your children. The question of whether to link an allowance to chores varies from family to family. Here are some different options:

1. Establish a set allowance irrespective of whether children are expected to do chores.
2. Link an allowance to the performance of certain chores and pay children for each chore they do.
3. Establish a specific set of chores that the children are expected to do without getting paid and then make a list of extra chores for which they can get paid to complete. For instance, expect your children to make their beds, keep their rooms clean and dry the dishes. If they also cut the grass and fold their laundry, pay them for completing these extra chores.
4. Take a hybrid approach—for instance, set a base allowance to pay the children each week based on the performance of a core set of chores, with additional allowance earned for "extra" chores performed.

Once you've agreed upon an allowance amount, consider discussing with your children what you expect the allowance to cover. For instance, do you want your seven-year-old to use his allowance to buy some of the toys that you typically bought him in the past? Or do you want your 14-year-old to use her allowance to pay for movie night with her friends?

If you choose to give your children an allowance, you may wish to encourage them to divide the allowance into a number of different buckets:

1. Save some: For larger purchases down the road (e.g., iPads or clothes that you otherwise would not buy them as part of your normal expenditures). Discuss with them what they are saving for so they have a goal to work toward.
2. Spend some: For immediate spending.

3. Invest some: Money that you want them to invest for the long term (e.g., for a college fund, a car, etc.).
4. Give some to charity: Work with them to choose a cause that is important to them.

You may wish to provide your children with four different physical containers for each of these buckets (e.g., piggy banks or shoe boxes), so the division of the money is a concrete event. Having distinct purposes for an allowance may help your children understand that, as an adult, they will use their earnings to satisfy short-term spending needs as well as medium- and long-term needs and wants.

You can also use this "bucketing" approach for other types of earnings, such as income from mowing the lawn, operating a lemonade stand or working a part-time job. The concept is the same—not all money made is allocated to immediate spending.

Encourage savings

You may choose to match some or all of what the children save. For instance, you could match dollar for dollar, or $0.50 per dollar. This may help children understand how important you feel it is that they save, but may also encourage them to save more toward a fund to use for larger purchases in the future. You can accumulate the savings for them and then go to the bank with them each month to make the deposit, familiarizing them with how banking works. When the bank issues account statements each month, you can sit down with your children to review. Discussing the beginning and ending balances, along with the interest earned, will give you the opportunity to show them how compound interest works and track the progress they are making toward their savings goal. Once children get used to putting aside a certain amount or percentage of their allowance or earnings, they may be more likely as young adults to continue this practice, whether or not a match is made.

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Many of our clients tell us it is also important to help children understand the benefits of starting to save early. For instance, if a child saves $1,200 per year in a tax-deferred account for 40 years beginning at age 22 and earns 8% annually on her investments,* she will have accumulated just over $360,000 by age 62. If the child waits until age 30 to start, she will need to save $2,300 per year to accumulate the same amount by age 62. Thus, waiting just eight years almost doubles the amount of yearly savings a child would need to accumulate the same amount of funds at age 62! A child that understands this concept likely will be in the best position to take advantage of one of her biggest advantages—time.

Responsible spending

While saving and investing are important, so, too, is learning how to spend responsibly.

Discuss budgets

Consider talking to children about the various ways your household uses the money it earns—savings, charity, taxes, spending—to reinforce the concept that money earned is not entirely available for discretionary spending. You can help them understand how much of each dollar goes to different categories (e.g., $0.20 to taxes, $0.02 to vacation savings, $0.10 to long-term savings and investing, $0.10 to charity, leaving just $0.58 to spend).

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Then, discuss with your children what you expect to spend for certain categories. Break down what expenses you feel are non-discretionary, what you feel are discretionary, and even what you feel are luxury or special event type spending. You can use this budget during shopping trips, whether to the grocery store or mall, to help them understand why you say "yes" to some expenditures and "no" to others. This approach will also help them understand that there is a finite amount of money to satisfy many different spending desires and that sometimes hard decisions need to be made to balance what comes in with what goes out. Sooner or later, a child will earn her first paycheck. Prior to this, discuss with her that while she may make a certain dollar amount per hour worked, her take-home pay will be less. Discuss with her what taxes are used for, especially as they relate to things that are important to her (e.g., schools, police, fire department, etc.) and how marginal tax rates work. Once she gets her first W-2, together, review her gross pay versus net pay and the federal and state tax withholding that make up the difference. You could also print an IRS Form 1040 and review the main categories and what she will need to report each year.

Prepaid credit card or debit card

You may decide to shift a portion of your children's expenses to them over time so they can learn to make financial decisions relating to how much they spend and on which items—and the consequences of those decisions. Consider giving your children a prepaid credit card or depositing money into a bank account on a regular basis that they can access via a debit card. They can then be responsible for using the funds over a specific period of time to purchase items that you have identified during your budget conversation as things that you are not going to cover. For instance, you may decide that you are going to pay for their clothes, but if they want an extra pair of shoes, they need to use the funds on their card to make this purchase. In addition to clothes, you may choose to do the same for items like school supplies and entertainment.

You may want to ease your children into these decisions by putting small amounts on a card or in the account and increase the amount over time. Check with them on a regular basis to discuss what they spent and how they feel about their purchases. This may involve an informal conversation or could be a more formal review of their account statements on a regular basis.

The important considerations are

– Let them make their own decisions
– Let them make their own mistakes
– When mistakes are made, don't bail them out! If they are saving for something but end up spending their money on something else, resist the urge to buy it for them

Credit cards

At some point, children are going to be introduced to the concept of credit—and for many, that introduction happens at a time and place over which you may have little influence (e.g., when they leave for college and they get their first credit card offer in the mail, or at the cash register of their favorite store in the mall). To prevent this, consider giving older children a credit card with a small maximum limit they are responsible for paying.

Discuss with them

1. How credit cards work—that each credit card purchase is a loan from the credit card company and the cost of this loan comes in the form of interest. Thus, it costs more over the long term to use credit to purchase something, unless the card is paid off each month
2. Work with them to find a card with a low interest rate and no annual fee
3. Emphasize that credit cards shouldn't be used to purchase things for which they couldn't otherwise pay cash, but are useful for purchasing things online and that the entire balance should be paid off each month

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Investing

Once you've covered spending and saving, help your children understand the basics of investing and how to invest for long-term goals such as the down payment on a house.

When teaching your children about investing, a good starting point is to introduce them to basic investment vehicles (e.g., stocks, bonds and mutual funds). This could entail opening a small account (either in your name or through a Uniform Transfer to Minors Account or a Uniform Gift to Minors Account, depending on state law) and purchasing stock in a few different companies. The companies could be ones to which your children can easily relate, such as toy, clothing, sports and entertainment companies. Review the account statement you receive each month with them to discuss how stock values rise and fall and the effect this may have on the amount they can eventually spend from the account. This may also entail discussing how dividends work, the potential for gain and loss, and the roles that risk tolerance and time horizon play when choosing appropriate investments.

Your UBS Financial Advisor can use his or her knowledge and expertise to help facilitate these conversations, as well as assist you with the logistics of setting up the appropriate accounts and choosing which securities to purchase. Involving your UBS Financial Advisor will have the added benefit of introducing your children to the financial services world and beginning to get them comfortable with the role advisors can play.

Giving back

Charitable giving is an important part of many families' decisions regarding how to allocate their financial resources. Instilling the value of giving back can start very early in a child's life. Earlier, we discussed how you can encourage children to allocate a portion of their allowance or earnings into a charitable bucket. Once children have the funds set aside, how can they use these funds to make the biggest impact? Rather than simply writing a check to your family's regular charity, consider taking the children to a store to buy clothing, toys or school supplies and have them donate these items to a local school or church.

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In combination with writing a check, volunteer time at the same organization. For instance, visit the local food bank with your child to help pack bags of food for distribution or participate in a fun walk or run event sponsored by a favorite charity.

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- Ask your children to identify the causes they feel are important and encourage them to fund organizations that support these causes (e.g., someone from the local zoo may have visited their school to talk about endangered species and your children may wish to donate to the zoo or an organization like the Nature Conservancy). Your children may need your help to identify specific organizations. You can ask them to do research and then to describe what the organizations do, including the types of things for which donations may be used

For many families, charitable giving is not only about material giving—it includes giving time through volunteering. Where appropriate, consider bringing your children along to charitable activities or, if not appropriate or practical, discuss with them what you are doing and how you think it will help the organization and the community in general. The goal is to help children understand why giving back is important to you, how you allocate the time and money you give, and to provide them with the framework within which to decide how to spend their own time and money.

For families who have a formal charitable giving vehicle, such as a family foundation or a donor advised fund, consider setting aside a small amount each year for your children to control. This can be formal or informal. You could ask your children to do research on worthy organizations, and then make a pitch to you on where they would like the donation to go. Our clients have shared with us that children are very engaged when they have autonomy over a gift in this way. They may walk away from the experience with a deeper sense of their own fortunes, and the needs of others.

Ultimately, most children will eventually become responsible for making their own financial decisions—whether they are ready or not. When education and encouragement are provided early and practiced often, parents can help their children to develop the skills necessary to make a lifetime of good financial decisions.

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See important notes and disclosures on the next page

[1] http://www.financialeducatorscouncil.org/financial-literacy-for-kids.html.
[2] Visa's International Financial Literacy, Barometer 2012.

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